

III. THE EXTERNAL SECTOR

The weakness in the external sector observed in 2011-12 continued during the first quarter of 2012-13, mainly reflecting uncertainty in global economic and financial conditions coupled with weak domestic macroeconomic conditions. The rupee witnessed renewed pressures and depreciated against the US dollar in Q1 of 2012-13, in line with the trend registered by major EDE currencies. Capital flows have remained subdued and volatile. Notwithstanding various policy measures initiated by the Reserve Bank, significant depreciation of the rupee, softening commodity prices and moderation in gold imports, improvement in the trade deficit will continue to hinge upon global macroeconomic conditions and therefore, upside risks remain. With services exports likely to decelerate during 2012-13, the risks of CAD going above its sustainable rate, and difficulties in financing it, persist.

Global factors continue to weigh on India's exports

III.1 India's merchandise exports, which had decelerated in 2011-12, contracted in Q1 of 2012-13 mainly reflecting subdued demand conditions in key global markets, particularly the EU and the US (Table III.1). In particular, exports of engineering goods, petroleum products, gems and jewellery and readymade garments have been affected. Evidently the significant depreciation in the rupee since H2 of 2011-12 could not sufficiently offset the impact of the slowdown in global demand. In

recent years, due to export diversification efforts, the share of developing economies in India's total exports witnessed a gradual increase. However, as the sluggish economic conditions in advanced economies (AEs) slowly spilled over to other emerging and developing economies (EDEs), diversification did not yield results similar to those seen in previous years. Going forward, economic conditions especially in EU are likely to remain muted for some time. As a result, growth in global trade volume, including exports from EDEs, is likely to be lower in 2012. Indian exports are likely to reflect this general trend.

Table III.1: India's Merchandise Trade

Item	(US\$ billion)							
	April-March				April-June			
	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	76.5	36.4	75.2	-1.7
<i>Of which:</i> Oil	41.5	47.1	55.6	34.0	15.3	76.2	12.9	-15.6
Non-oil	209.7	39.3	249.0	18.8	61.2	29.1	62.3	1.8
Imports	369.8	28.2	489.4	32.4	122.7	36.3	115.3	-6.1
<i>Of which :</i> Oil	106.0	21.6	154.9	46.2	39.4	52.5	41.5	5.3
Non-oil	263.8	31.1	334.5	26.8	83.3	29.7	73.8	-11.5
Gold	40.5	41.6	56.2	38.8	16.1	109.1	8.5	-47.5
Non-Oil Non-Gold	223.3	29.3	278.3	24.6	67.2	18.9	65.3	-2.9
Trade Deficit	-118.6		-184.8		-46.2		-40.1	
<i>Of which:</i> Oil	-64.5		-99.3		-24.1		-28.6	
Non-oil	-54.1		-85.5		-22.1		-11.5	

R: Revised. P: Provisional.

Source: DGCI&S.

Softening of international commodity prices narrowed the trade deficit

III.2 The weakness in India's external position in 2011-12 stemmed partly from the import-induced surge in the current account deficit (CAD). Given the inelastic nature of India's imports of petroleum, oil and lubricants (POL) and gold, the rise in international prices of these commodities led to overall high imports. This trend, however, reversed in Q1 of 2012-13. The decline in imports in the quarter was sharper than that in exports (Chart III.1a). Import moderation was mainly on account of a modest contraction in POL imports and a significant contraction in gold and silver imports. The lower growth in POL reflects the softening of international crude oil prices, while the decline in gold and silver imports appears to reflect the impact of policy measures taken in January and March 2012 (Chart III.1b). Growth moderation in non-oil imports in recent months appears to be on account of confluence of various factors, *viz.*, domestic slowdown, global uncertainty, moderation in global commodity prices and the possible impact of rupee depreciation in some sectors. As a result, the trade deficit narrowed somewhat in Q1 of 2012-13 compared with the corresponding period of the previous year.

Upside risks to trade deficit persist

III.3 Recent trend of faster deceleration in imports than exports has given rise to the

possibility that CAD could improve in 2012-13. However, current assessment suggests that such improvement could be insufficient to ensure CAD sustainability. The upside risk to CAD remain significant. The response of exports to depreciation of rupee has so far remained muted due to subdued global demand. Downside risks to export growth are large in view of worsening global conditions. Exchange rate sensitivity of India's import is also limited.

Slowdown in global IT spending may dampen growth in software exports

III.4 Despite the challenges in global market conditions, services exports, in general and software exports in particular sustained the growth momentum in 2011-12 (Table III.2). However, net services exports earnings at US\$14 billion in Q1 of 2012-13, have declined by about 12 per cent y-o-y, suggesting loss of momentum. Services exports in gross terms expanded by 3 per cent, while imports increased by 19 per cent in this quarter. Going forward, NASSCOM projection of 11-14 per cent growth in software exports in 2012-13, suggests deceleration. Current indications, borne out by dollar revenue guidance of IT majors, suggest that software export earnings may even be lower than projected by NASSCOM. The risk of lower software exports may arise from reduced spending on technology by US corporations, continued uncertainty in the euro area countries and likely euro depreciation. As

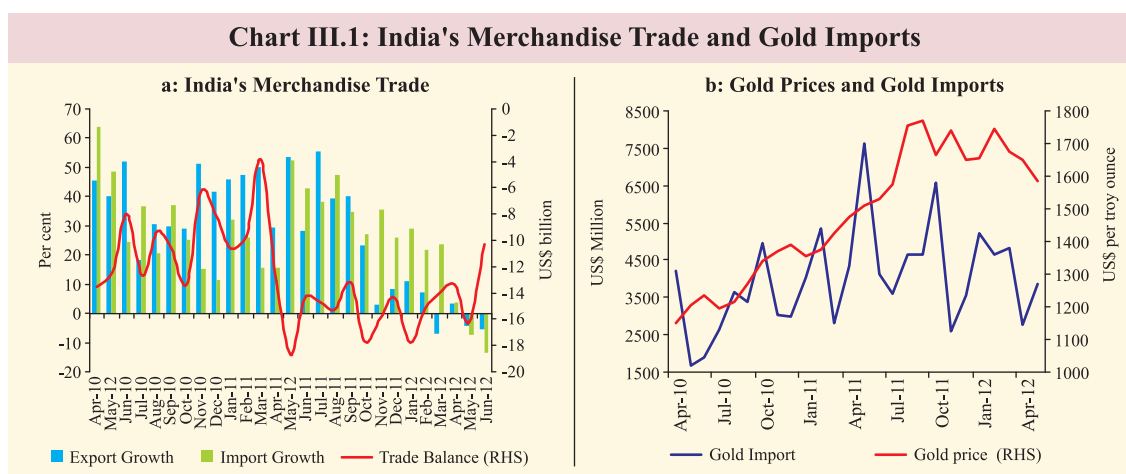


Table III.2: Major Items of India's Balance of Payments

(US\$ billion)							
	2010-11 (PR)	2011-12 (P)	2011-12				2010-11
			Q1 (PR)	Q2 (PR)	Q3 (PR)	Q4 (P)	Q4 (PR)
1	2	3	4	5	6	7	8
1. Goods Exports	250.6	309.8	78.8	79.6	71.5	80.0	77.4
2. Goods Imports	381.1	499.5	123.7	124.1	120.1	131.7	107.4
3. Trade Balance (1-2)	-130.5	-189.7	-44.9	-44.5	-48.6	-51.7	-30.0
4. Services Exports	131.7	140.9	33.7	32.3	37.3	37.7	35.3
5. Services Imports	83.0	76.9	17.4	18.3	21.1	20.0	20.7
6. Net Services (4-5)	48.7	64.0	16.3	14.0	16.2	17.7	14.6
7. Goods & Services Balances (3+6)	-81.8	-125.7	-28.6	-30.5	-32.4	-34.0	-15.4
8. Primary Income (Net)	-17.3	-16.0	-3.6	-4.0	-3.8	-4.6	-4.5
9. Secondary Income (Net)	53.1	63.5	14.8	15.6	16.2	16.9	13.6
10. Net Income (8+9)	35.8	47.5	11.2	11.6	12.4	12.3	9.1
11. Current Account Balance (7+10)	-46.0	-78.2	-17.4	-18.9	-20.2	-21.7	-6.3
12. Capital Account Balance	0.04	-0.1	-0.3	0.2	0.1	-0.2	-0.02
13. Financial Account Balance	48.9	80.7	18.7	19.0	20.6	22.4	7.1
<i>of which: Change in Reserves (increase-/decrease+)</i>	-13.1	12.8	-5.4	-0.3	12.8	5.7	-2.0
14. Errors & Omissions (-) (11+12+13)	-3.0	-2.4	-0.9	-0.4	-0.5	-0.6	-0.8
<i>Memo: As ratio to GDP</i>							
15. Trade Balance	-7.7	-10.3	-9.8	-9.9	-10.7	-10.6	-6.2
16. Net Services	2.9	3.5	3.6	3.1	3.5	3.6	3.0
17. Net Income	2.1	2.6	2.4	2.6	2.7	2.5	1.9
18. Current Account Balance	-2.7	-4.2	-3.8	-4.2	-4.4	-4.5	-1.3
19. Capital and Financial Account, Net (Excl. changes in reserves)	3.7	3.7	5.2	4.4	1.7	3.4	1.9

P: Preliminary; PR: Partially Revised

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

software exports account for nearly 63 per cent of net receipts of invisibles, any deceleration in these exports may aggravate the already high CAD recorded in recent quarters.

Capital flows may remain volatile due to global uncertainties

III.5 The exacerbation in CAD during 2011-12 led to depletion of reserves notwithstanding improved capital flows (Table III.3). Since Q1 of 2012-13, concerns about the growth and financial health of euro area countries have further intensified. In addition, signs of weakness in the US and China have also made investors more cautious and driven up global financial market volatility. These factors, combined with weakening domestic macroeconomic conditions, led to a net FII outflow of US\$ 1.7 billion in Q1 of 2012-13.

Concerns about the domestic business environment appear to be weighing on FDI inflows as well. NRI deposits, however, have picked up in recent months (Table III.4). Since concerns about the growth outlook for AEs seem to have prompted investors to reconsider the resilience of emerging market growth as well, the outlook for capital flows to EDEs including India remains subdued.

Rupee gains in Q4 of 2011-12 dissipated in Q1 of 2012-13

III.6 The rupee gained by 4.1 per cent in Q4 of 2011-12, partly reflecting the favourable impact of policy measures by the Reserve Bank to improve capital flows and curb speculative pressure in foreign exchange market. The intervention in the foreign exchange market also helped in containing the depreciation. However,

Table III.3: Disaggregated Items of Financial Account

(US\$ billion)							
	2010-11	2011-12	2011-12				2010-11
	(PR)	(P)	Q1	Q2	Q3	Q4	Q4
1	2	3	(PR)	(PR)	(PR)	(P)	(PR)
1. Direct Investment (net)	9.4	22.1	9.3	6.5	5.0	1.4	1.1
1.a Direct Investment to India	25.9	33.0	12.4	9.5	6.9	4.2	5.5
1.b Direct Investment by India	-16.5	-10.9	-3.1	-3.0	-1.9	-2.9	-4.4
2. Portfolio Investment	28.2	16.6	2.3	-1.4	1.8	13.9	-0.01
2.a Portfolio Investment in India	29.4	16.8	2.5	-1.6	1.9	14.1	-0.03
2.b Portfolio Investment by India	-1.2	-0.2	-0.2	0.2	-0.04	-0.2	0.02
3. Other investment	24.4	29.2	12.6	14.2	1.0	1.4	8.1
3.a Other equity (ADRs/GDRs)	2.0	0.6	0.3	0.2	0.1	0.03	0.2
3.b Currency and deposits	3.8	12.1	1.2	3.1	3.2	4.6	2.0
Deposit-taking corporations, except the central bank: (NRI Deposits)	3.2	11.9	1.2	2.8	3.3	4.7	0.9
3.c Loans*	18.6	16.8	14.9	9.5	-7.7	-0.03	1.0
3.c.i Loans to India	18.3	15.7	14.9	8.9	-8.1	-0.02	0.7
Deposit-taking corporations, except the central bank	1.2	4.1	11.5	3.9	-8.7	-2.6	-2.7
General government (External Assistance)	5.0	2.5	0.4	0.3	1.4	0.3	0.8
Other sectors (ECBs)	12.2	9.1	3.0	4.7	-0.8	2.3	2.7
3.c.ii Loans by India	0.3	1.0	-0.02	0.6	0.5	-0.01	0.3
General government (External Assistance)	-0.03	-0.2	-0.04	-0.04	-0.04	-0.04	-0.01
Other sectors (ECBs)	0.3	1.2	0.02	0.6	0.5	0.03	0.3
3.d Trade credit and advances	11.0	6.7	3.1	2.9	0.6	0.2	2.7
3.e Other accounts receivable/payable - other	-11.1	-6.9	-6.8	-1.5	4.9	-3.3	2.2
4. Reserve assets (increase-/decrease+)	-13.1	12.8	-5.4	-0.3	12.8	5.7	-2.0
Financial Account (1+2+3+4)	48.9	80.7	18.7	19.0	20.6	22.4	7.1

P: Preliminary; PR: Partially Revised

*: Includes External Assistance, ECBs, non-NRI Banking Capital and short term trade credit.

Note: Total of subcomponents may not tally with aggregate due to rounding off.**Table III.4: Capital Flows in 2011-12 and 2012-13 So Far**

(US\$ billion)					
Component	2011-12				2012-13
	Apr.- Jun.	Jul.- Sep.	Oct.- Dec.	Jan.- Mar.	Apr.- Jun.
	Average of the monthly flows				
1	2	3	4	5	6
FDI in India	4.1	3.1	2.3	1.5	2.2*
FDI by India	1.0	1.0	0.6	1.0	0.5
FIIIs (Net)	0.8	-0.5	0.6	4.7	-0.6
ADRs/GDRs	0.1	0.1	0.03	0.01	0.01
ECB Inflows	1.0	1.6	0.9	0.8	-0.4
NRI Deposits (Net)	0.4	0.9	1.1	1.6	2.4*

*April-May.

the rupee started weakening from the first week of April 2012 as portfolio capital inflows dried up. The large trade deficit, domestic policy uncertainty and growing apprehensions about the euro area affected the overall investment sentiment. As a result, the rupee reached a low of 57.2 on June 27, 2012 and the real effective exchange rate (*i.e.*, the REER based on 6, 30 and 36 currency baskets) recorded a depreciation (Table III.5).

Increasing external debt is a concern

III.7 Since equity flows dwindled, various measures were taken to encourage other capital flows into the country. These include an increase

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

(Per cent, appreciation+/depreciation-)						
1	Index July 20, 2012 P	Year-on-Year Variation (Average)			2011-12 (March 2012 over January 2012)	2012-13 (July 20, 2012 over March 2012)
		2009-10 P	2010-11P	2011-12		
2	3	4	5	6	7	
36-REER	91.4	-3.2	8.0	-3.2	2.3	-7.2
36-NEER	78.6	-2.6	3.1	-6.4	1.2	-9.7
30-REER	83.5	-4.6	4.8	-2.9	2.3	-7.2
30-NEER	80.3	-2.2	1.1	-5.4	1.0	-9.6
6-REER	104.6	-0.3	13.0	-6.8	2.5	-7.1
6-NEER	76.4	-3.7	5.7	-7.9	1.4	-9.9
₹/US\$ (Average)	54.5#	-3.2	4.0	-4.9	2.0	-7.7#
₹/US\$ (end-March)	55.9*	12.9	1.1	-12.7	-2.9	-8.6*

P: Provisional. NEER: Nominal Effective Exchange Rate. REER: Real Effective Exchange Rate.

*: As on July 26, 2012. #: April-July 26, 2012 over March 2012.

Note: Rise in indices indicates appreciation of the rupee and *vice versa*.

in FII investment in debt securities (both government and corporate debt), enhancing all-in-cost ceiling for ECBs and trade credit and the deregulation of interest rates on rupee-denominated NRI deposits, *i.e.*, NRE and NRO accounts. On account of the greater recourse to such debt creating flows in financing CAD, India's external debt increased significantly during Q4 of 2011-12 (Table III.6). Further, the repayment of commercial borrowings of about US\$ 15 billion (including FCCBs of about US\$ 4.7 billion) is due during 2012-13. Thus, there

is a pressing need to improve the equity flows to finance CAD and maintain the external debt at a manageable level.

Sustainability of CAD and its financing remain concerns

III.8 External sector vulnerability indicators showed mixed trend in Q4 of 2011-12 (Table III.7). There has been a marginal improvement in the ratio of short-term debt to total debt. While debt GDP ratio and debt service ratio remained same, other indicators such as ratio

Table III.6: India's External Debt

(US \$ billion)							
Item	End-Mar 2011 PR	End-Jun 2011 PR	End-Sep 2011 PR	End-Dec 2011 PR	End-Mar 2012 QE	Variation (End-Mar 2012 over End-Dec 2011)	
						Amount	Per cent
1	3	4	5	6	7	8	9
1. Multilateral	48.5	49.4	49.1	49.9	50.5	0.5	1.1
2. Bilateral	25.7	26.2	27.1	27.1	26.8	-0.3	-1.1
3. International Monetary Fund	6.3	6.4	6.2	6.1	6.1	0.1	0.9
4. Trade Credit (above 1 year)	18.6	18.7	19.5	19.8	19.9	0.1	0.6
5. External Commercial Borrowings	88.6	92.9	96.3	98.7	104.4	5.7	5.8
6. NRI Deposits	51.7	52.9	52.3	52.5	58.6	6.1	11.6
7. Rupee Debt	1.6	1.6	1.4	1.3	1.3	0.0	0.0
8. Long-term (1 to 7)	240.9	247.9	252.0	255.4	267.6	12.3	4.8
9. Short-term	65.0	68.5	71.5	76.0	78.2	2.2	2.9
Total (8+9)	305.9	316.4	323.5	331.4	345.8	14.5	4.4

PR: Partially Revised. QE: Quick Estimates.

Table III.7: External Sector Vulnerability Indicators

(Per cent)							
Indicator	End-Mar 2010	End-Jun 2010	End-Mar 2011	End-Jun 2011	End-Sep 2011	End-Dec 2011	End-Mar 2012
1	2	3	4	5	6	7	8
1. Ratio of Total Debt to GDP	18.0	-	17.8	15.9	17.8	20.0	20.0
2. Ratio of Short-term to Total Debt (Original Maturity)	20.0	20.9	21.2	21.6	22.1	22.9	22.6
3. Ratio of Short-term to Total Debt (Residual Maturity)	41.2	42.5	42.2	43.3	43.4#	43.5#	42.6
4. Ratio of Concessional Debt to Total Debt	16.8	15.9	15.5	15.1	14.8	14.4	13.9
5. Ratio of Reserves to Total Debt	106.9	98.0	99.6	99.8	96.3	89.5	85.1
6. Ratio of Short-term Debt to Reserves	18.8	21.0	21.3	21.7	23.0	25.6	26.6
7. Reserves Cover of Imports (in months)	11.1	10.7	9.6	9.2	8.5	7.7	7.1
8. Reserves Cover of Imports and Debt Service Payments (in months)	10.5	10.1	9.1	8.8	8.0	7.3	6.8
9. Debt Service Ratio (Debt Service Payments to Current Receipts)	5.8	4.1	4.3	4.8	4.7	5.6	5.6
10. External Debt (US\$ billion)	260.9	270.3	305.9	316.4	323.5	331.4	345.8

-: Not available. #: RBI Estimate.

of foreign exchange reserves to total debt and the short-term debt to foreign exchange reserves, deteriorated as at end-March 2012 compared with end-December 2011. India's Net International Investment Position (NIIP) also weakened (Table III.8).

Rising vulnerability to external shocks

III.9 The CAD-GDP ratio was high at 4.5 per cent in Q4 of 2011-12, taking the full year

Table III.8: Overall International Investment Position of India

(US\$ billion)					
Period	Mar-11 (PR)	Jun-11 (PR)	Sep-11 (PR)	Dec-11 (P)	Mar-12 (P)
1	2	3	4	5	6
NIIP	-203.6	-216.5	-196.6	-204.8	-244.8
Assets	439.8	450.0	453.9	431.6	437.1
Liabilities	643.4	666.5	650.5	636.5	682.0
NIIP-GDP Ratio*	-12.1	-11.9	-11.0	-11.3	-13.2

PR: Partially Revised P: Preliminary.

* Based on annualised GDP.

ratio to an all time high of 4.2 per cent. Such high level of CAD, especially against the backdrop of volatile global macroeconomic conditions and volatile capital flows, raise grave concerns about its sustainability. A recent analysis shows that with GDP growth of 7 per cent, CAD-GDP ratio of around 2.5 per cent is sustainable. The estimate is based on analysis of threshold level of India's net external liability to GDP ratio to work out sustainable CAD-GDP ratio in various growth scenarios. With an increase in deficit beyond this level, financing could be a constraint and the external sector vulnerability may rise further. High external debt, along with a deterioration in the net international investment position and a moderate decline in forex reserves also weakened the resilience of India's external sector in Q4 of 2011-12. Going forward, the trend in CAD will largely depend on the global macroeconomic and trade environment. The trend in capital flows will depend on global liquidity conditions, as well as the domestic investment and policy environment.