III. THE EXTERNAL SECTOR

India's external sector imbalances have persisted and brought the rupee under pressure. Despite the moderation in the current account deficit (CAD) in Q4 of 2012-13, it remained above the sustainable level. The trade gap widened during Q1 of 2013-14 compared with Q1 of 2012-13. Exports contracted in Q1, while gold imports increased significantly. With uptrend in US yields, portfolio outflows since mid-May 2013 have caused the rupee to depreciate sharply against the US dollar. This was, however, broadly in line with other EMDE currencies, which also weakened as financial markets across the globe re-priced risks. Going forward, the CAD is expected to moderate in 2013-14. However, volatile markets and the potential tapering of quantitative easing in the US pose a risk to CAD financing. External sector policies would need to be carefully calibrated over the short to medium term with a view to containing the CAD within manageable levels and financing it through more stable flows.

Global trade remains subdued

III.1 With global growth remaining weak, world trade has remained subdued. The exports of many EMDEs, *viz.*, Brazil, Russia, Malaysia and Indonesia, have contracted in recent months (Table III.1). The subdued trend in Chinese export growth in May and June 2013, coupled with signs of its economic activity slowing, has further dimmed the prospects of global trade expansion.

III.2 India followed the trend of major EMDEs with a decline in its exports during Q1 of 2013. Improving export growth during 2013-14 will remain a challenge given the subdued prospects of global trade expansion. The IMF, in its July 2013 update of the WEO, has lowered the growth projection of world trade volume for 2013 by 0.5 percentage points to 3.1 per cent.

Trade deficit continues to be a concern in Q1 of 2013-14

III.3 Trends in exports and imports in Q1 of 2013-14 suggest a widening of the merchandise trade deficit. The trade deficit widened from US$ 42.2 billion in Q1 of 2012-13 to US$ 50.2 billion in Q1 of 2013-14, mainly on account of a sharp increase in gold imports. Reflecting global demand conditions, exports contracted in May and June 2013 after recording growth for five consecutive months (since December 2012). The engineering goods, gems & jewellery, electronics and iron ore sectors were the main contributors to the decline in exports in Q1 of 2013-14 (Chart III.1).

III.4 In contrast, imports grew by 6.0 per cent in Q1 of 2013-14 as against a decline of 5.7 per cent in Q1 of 2012-13. Gold imports have almost doubled from US$9.2 billion in Q1 of 2012-13 to US$ 17.9 billion in Q1 of 2013-14. Notwithstanding a fall of 5.7 per cent in international crude oil prices (Indian basket) in Q1 of 2013-14 (y-o-y), POL imports grew by 6.4 per cent. Non-oil non-gold imports continued

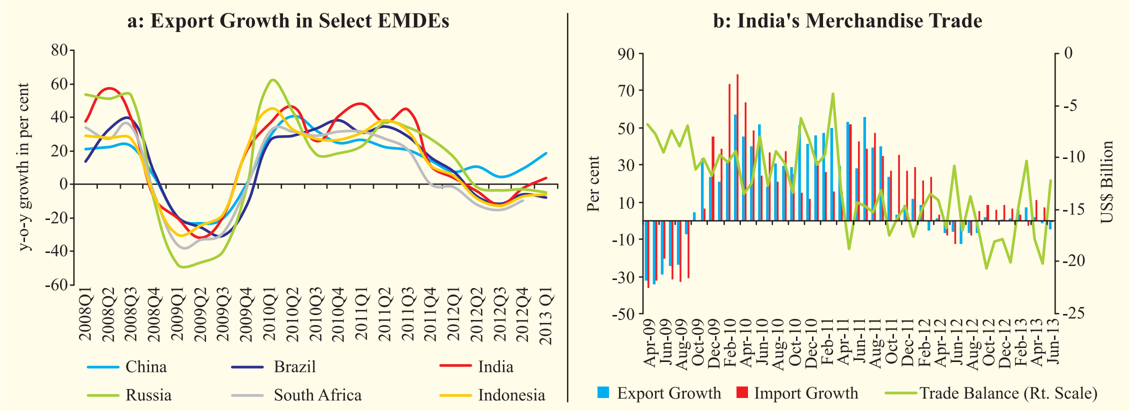
Table III.1: Country-wise Merchandise Export Growth

(Per cent)

	2012				2013		
	Q1	Q2	Q3	Q4	Q1	Apr	May
1	2	3	4	5	6	7	8
Brazil	7.5	-7.4	-11.6	-6.1	-7.7	5.4	-6.0
Hong Kong	-1.1	2.1	4.3	7.4	4.0	9.0	..
China	7.6	10.5	4.5	9.4	18.4	14.7	1.0
Euro area	-3.0	-12.5	-12.1	-3.4	-3.2	2.5	..
India	4.0	-4.0	-8.5	0.7	4.7	1.7	-1.1
Indonesia	5.3	-8.1	-12.9	-7.2	-6.1	-5.2	..
Malaysia	3.5	-0.4	-4.7	0.7	-3.2	-3.3	-5.8
Russia	16.3	-1.5	-3.6	-3.2	-4.9	-2.3	..
Singapore	6.0	-0.6	-5.9	-0.1	-6.8	2.7	1.6
Thailand	-2.9	0.7	-6.4	16.1	4.4	4.2	..
UK	2.5	-3.6	0.3	-2.9	-3.9	1.2	..
US	8.7	5.7	1.1	2.7	0.5	1.8	..

Source: International Financial Statistics, IMF and respective statistical agencies.

Chart III.1: Merchandise Trade Growth



to show contraction, reflecting subdued domestic growth conditions. Apart from gold and POL, the rise in imports of pearls, precious & semi-precious stones, non-ferrous metals and electronic goods also contributed to higher imports in Q1 of 2013-14 (Table III.2).

CAD narrowed significantly in Q4 of 2012-13

III.5 The current account deficit (CAD) moderated sharply to 3.6 per cent of GDP in Q4 of 2012-13 from 6.5 per cent in Q3 (4.4 per cent of GDP in Q4 of 2011-12). This was owing to the narrowing of the merchandise trade deficit underpinned by a pick-up in exports and a decline in imports (BoP basis) in Q4. However, net service exports remained subdued in Q4. The moderation in net secondary income compared with Q4 of 2011-12 mainly reflected a fall in net private remittances from abroad. Further, there was a significant outflow on account of income payments, reflecting growing liability-servicing obligations (Table III.3).

III.6 Despite the moderation in the CAD in Q4, the overall CAD during 2012-13 at 4.8 per

Table III.2: India's Merchandise Trade

(US$ billion)

Item	April–March				April–June			
	2011-12		2012-13 P		2012-13		2013-14	
	Value	Growth	Value	Growth	Value	Growth	Value	Growth
1	2	3	4	5	6	7	8	9
Exports	306.0	21.8	300.6	-1.8	73.5	-4.0	72.5	-1.4
Of which: Oil	56.0	35.1	60.0	7.1	13.0	-15.2	13.2	1.6
Non-oil	249.9	19.2	240.6	-3.7	60.4	-1.2	59.2	-2.0
Gold	6.7	10.9	6.5	-3.3	1.6	-3.1	1.4	-13.6
Non-oil Non-gold	243.2	19.5	234.1	-3.8	58.8	-1.1	57.8	-1.7
Imports	489.3	32.3	491.5	0.4	115.7	-5.7	122.6	6.0
Of which: Oil	155.0	46.2	169.4	9.3	39.4	-0.2	41.9	6.4
Non-oil	334.4	26.7	322.1	-3.7	76.4	-8.3	80.8	5.8
Gold	56.5	39.3	53.8	-4.7	9.2	-42.6	17.9	93.5
Non-oil Non-gold	277.9	24.5	268.3	-3.4	67.1	-0.1	62.9	-6.3
Trade Deficit	-183.4		-190.9		-42.2		-50.2	
Of which: Oil	-98.9		-109.4		-26.3		-28.6	
Non-oil	-84.4		-81.5		-15.9		-21.5	
Non-oil Non-gold	-34.7		-34.2		-8.3		-5.1	

Source: DGCI&S.

cent of GDP was far above the sustainable level (Table III.3). Trends in trade data suggest that the CAD may remain high in Q1 of 2013-14. However, in subsequent quarters, the CAD is expected to improve, since the import demand for gold may moderate. The global price of gold has declined sharply, partly due to US dollar appreciation and signs of recovery in the US economy. With the end of the gold super-cycle, the speculative demand for gold is likely to decline. Besides, various measures have been undertaken domestically to curb import demand for gold, that *inter alia* include (i) a hike in customs duty to 8 per cent and (ii) measures towards rationalisation of gold imports by both nominated agencies and banks.

III.7 In particular, on July 22, 2013, all nominated banks / agencies were instructed to ensure that at least one fifth of every lot of import of gold (in any form/purity) is retained in customs bonded warehouses for the purpose of export and fresh imports of gold is permitted only after 75 per cent of the retained gold is actually exported. This new measure replaced the earlier restrictions on import of gold on consignment basis and opening letters of credit subject to 100 per cent cash margin. To some extent, the recently launched inflation-linked bonds may also wean away investors who use gold as a hedge against inflation. If the current recovery in the US and Japan continues, it may help improve India's exports to these destinations. The combined influence of these factors may augur well for India's CAD during 2013-14.

Capital flows became volatile

III.8 Although net capital flows moderated in Q4 of 2012-13, they were adequate to finance the CAD, and indeed there was net accretion of US$ 2.7 billion in India's foreign exchange reserves during this period. The lower net capital flows in Q4 of 2012-13 were mainly due

Table III.3: Major Items of India's Balance of Payments

(US $ billion)

	2011-12 (PR)	2012-13 (P)	2012-13 Q1 (PR)	2012-13 Q2 (PR)	2012-13 Q3 (PR)	2012-13 Q4 (P)
1	2	3	4	5	6	7
1. Goods Exports	309.8	306.6	75.0	72.6	74.2	84.8
2. Goods Imports	499.5	502.2	118.9	120.4	132.6	130.4
3. Trade Balance (1-2)	-189.7	-195.7	-43.8	-47.8	-58.4	-45.6
4. Services Exports	140.9	145.7	35.8	35.0	37.1	37.8
5. Services Imports	76.9	80.8	20.8	18.7	20.4	20.9
6. Net Services (4-5)	64.0	64.9	15.0	16.3	16.6	17.0
7. Goods & Services Balances (3+6)	-125.7	-130.7	-28.8	-31.5	-41.7	-28.7
8. Primary Income (Net)	-16.0	-21.5	-4.9	-5.6	-5.8	-5.2
9. Secondary Income (Net)	63.5	64.4	16.8	16.1	15.7	15.8
10. Net Income (8+9)	47.5	42.9	11.9	10.5	9.9	10.6
11. Current Account Balance (7+10)	-78.2	-87.8	-16.9	-21.0	-31.9	-18.1
12. Capital Account Balance	-0.1	-0.3	-0.2	-0.2	0.02	0.2
13. Financial Account Balance	80.7	85.4	16.1	21.0	30.8	17.6
of which: Change in Reserves	12.8	-3.8	-0.5	0.2	-0.8	-2.7
14. Errors & Omissions -(11+12+13)	-2.4	2.7	1.1	0.2	1.1	0.3
Memo: As a ratio to GDP						
15. Trade Balance	-10.1	-10.6	-10.2	-11.4	-12.0	-9.0
16. Net Services	3.3	3.5	3.5	3.9	3.4	3.3
17. Net Income	2.5	2.3	2.8	2.5	2.0	2.1
18. Current Account Balance	-4.2	-4.8	-4.0	-5.0	-6.5	-3.6
19. Capital and Financial Account, Net (Excl. changes in reserves)	3.6	4.8	3.8	4.9	6.5	4.0

Note: Total of sub-components may not tally with aggregate due to rounding off.
P: Preliminary; PR: Partially Revised.

Table III.4: Disaggregated Items of Financial Account

(US$ billion)

	2011-12 (P)	2012-13 (P)	2012-13			
			Q1 (PR)	Q2 (PR)	Q3 (PR)	Q4 (P)
1	2	2	3	4	5	6
1. Direct Investment (net)	**22.1**	**19.8**	**3.8**	**8.2**	**2.1**	**5.7**
1.a Direct Investment to India	33.0	26.9	5.9	9.5	4.3	7.2
1.b Direct Investment by India	-10.9	-7.1	-2.1	-1.4	-2.2	-1.4
2. Portfolio Investment	**16.6**	**26.7**	**-2.0**	**7.6**	**9.7**	**11.3**
2.a Portfolio Investment in India	16.8	27.6	-1.7	7.9	9.8	11.5
2.b Portfolio Investment by India	-0.2	-0.9	-0.3	-0.3	-0.1	-0.2
3. Financial Derivatives & Employee Stock Options	**-**	**-2.3**	**-0.6**	**-0.5**	**-0.4**	**-0.9**
4. Other Investment	**29.2**	**45.2**	**15.4**	**5.6**	**20.0**	**4.2**
4.a Other equity (ADRs/GDRs)	0.6	0.2	0.1	0.1	0.0	0.0
4.b Currency and deposits	12.1	15.3	6.4	3.5	2.6	2.8
Deposit-taking corporations, except the central bank: (NRI Deposits)	11.9	14.8	6.6	2.8	2.7	2.8
4.c Loans*	16.8	10.7	3.5	3.0	5.7	-1.6
4.c.i Loans to India	15.7	11.1	3.5	3.3	5.9	-1.6
Deposit-taking corporations, except the central bank	4.1	1.3	3.0	2.0	2.7	-6.3
General government (External Assistance)	2.5	1.3	0.1	0.1	0.4	0.6
Other sectors (ECBs)	9.1	8.6	0.4	1.2	2.9	4.1
4.c.ii Loans by India	1.0	-0.4	0.1	-0.3	-0.2	0.0
General government (External Assistance)	-0.2	-0.3	-0.1	-0.1	-0.1	-0.1
Other sectors (ECBs)	1.2	-0.1	0.1	-0.3	-0.1	0.1
4.d Trade credit and advances	6.7	21.7	5.4	4.1	7.7	4.5
4.e Other accounts receivable/payable	-6.9	-2.7	-0.1	-5.1	4.0	-1.5
5. Reserve assets	**12.8**	**-3.8**	**-0.5**	**0.2**	**-0.8**	**-2.7**
Financial Account (1+2+3+4)	**80.7**	**85.4**	**16.1**	**21.0**	**30.8**	**17.6**

Note: Total of sub-components may not tally with aggregate due to rounding off.
P: Preliminary; PR: Partially Revised.
*: Includes External Assistance, ECBs, non-NRI Banking Capital and short term trade credit.

to higher repayments of short-term trade credit and overseas borrowings by banks compared with Q3. Net FDI flows were, however, significantly higher in Q4 of 2012-13 than in the preceding quarter (Table III.4).

III.9 Trends to date in 2013-14 suggest an uptrend in capital flows in the form of FDI and NRI deposits, while ECBs showed a decline as compared with previous quarter (Table III.5). Net FII flows were substantial until the third week of May 2013, followed by a significant outflow in the subsequent period. Since the last week of May 2013, there was a net outflow of US$ 12.1 billion on account of FIIs (till July 18). The reversal of FII flows from the domestic market was mainly evident in the debt segment. The outflows of FIIs from the domestic debt market was led by the global bond sell-offs on Fed signals that raised the prospects of global interest rates hardening, shifts in yield spreads and the elevated cost of hedging a volatile rupee (Chart III.2).

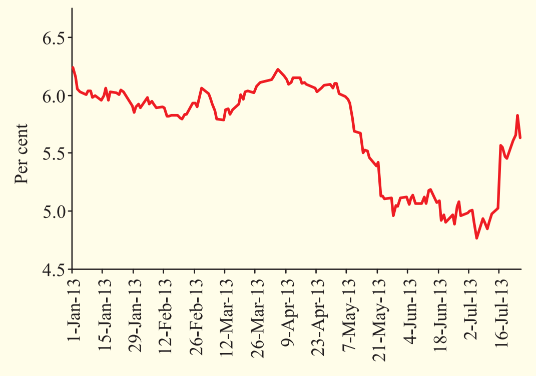
Table III.5: Trend in Capital Flows

(US$ billion)

	2012-13 (Monthly Average)				2013-14 Apr-May
	Q1	Q2	Q3	Q4	
1	2	3	4	5	6
FDI in India	2.0	3.2	1.4	2.4	2.7
FDI by India	0.7	0.5	0.7	0.5	0.3
FIIs	-0.6	2.6	3.3	3.8	-0.2#
ADRs/GDRs	0.03	0.03	0.0	0.0	0.0
ECBs	0.1	0.4	1.0	1.4	0.8
NRI Deposits	2.2	0.9	0.9	0.9	1.5

#: Apr-Jun 2013

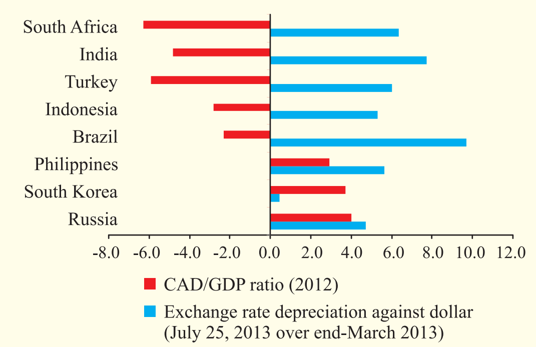
Chart III.2: Spread between 10-year Sovereign Yield of India and USA



Rupee depreciated significantly in Q1 of 2013-14

III.10 In line with most EMDEs, the Indian rupee depreciated by around 9 per cent during Q1 of 2013-14 (Chart III.3). The Rupee appreciated in April 2013, but the trend reversed from the start of May, with dollar gaining strength on better growth prospects. Wider trade deficit and rising gold imports also put pressure on the rupee. Since the Fed Chairman's May 22, 2013, testimony the rupee depreciated significantly (by 7.5 per cent) till July 15 as global investors began unwinding their risky positions in emerging markets, anticipating that the US Fed could begin tapering its asset purchases. The dollar strengthening against major currencies, coupled with widening trade deficit drove the rupee to a new low of ₹61.05 against the dollar on July 8, 2013.

Chart III.3: CAD and Exchange Rate Movement (in per cent)



Note: CAD/GDP ratio for India pertains to FY 2012-13.

III.11 The Reserve Bank's measures on July 15, 2013 to address exchange rate volatility helped stabilise the rupee subsequently. The government's announcement on July 16, 2013 proposing to liberalise FDI in single brand retail, petroleum and natural gas, defence production and some other sectors also improved sentiments and work towards bring some stability to the rupee.

III.12 In terms of the real exchange rate, as at the end of Q1 of 2013-14, the 6-currency and 36-currency REER showed depreciation of 9.0 per cent and 7.9 per cent, respectively, over March 2013, reflecting weakening of the rupee in nominal terms (Table III.6).

External debt rose further in Q4 of 2012-13

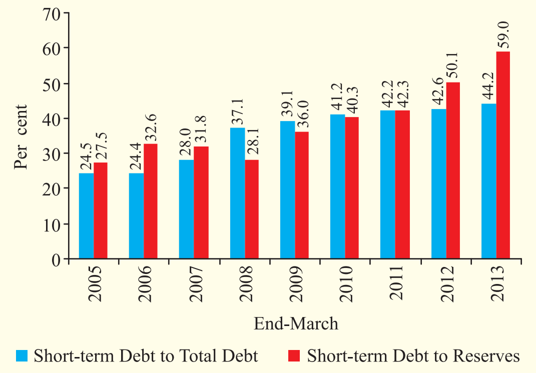
III.13 The widening CAD, financed through higher debt flows, resulted in a significant rise in India's external debt during 2012-13 (Chart III.4). India's external debt stood at US$ 390 billion at end-March 2013. There has been a sizeable rise in external commercial borrowings (ECBs) and rupee-denominated non-resident Indian deposits. Short-term debts, on residual maturity basis have surged by about US$ 25

Table III.6: Nominal and Real Effective Exchange Rates: Trade-Based (Base: 2004-05=100)

	Index July 19, 2013 (P)	y-o-y Variation (Average) 2012-13	FY Variation (July 19, 2013) over March 2013
1	2	3	4
36- REER	87.72	-6.7	-7.7
36-NEER	72.39	-10.4	-8.0
6-REER	96.85	-5.8	-9.3
6-NEER	69.14	-10.3	-9.5
₹/US$ (over end-March)	59.80	-11.9	-9.0

NEER: Nominal Effective Exchange Rate.
REER: Real Effective Exchange Rate. P: Provisional.
Note: Rise in indices indicates appreciation of the rupee and vice versa.

Chart III.4: Short Term Debt Indicators (based on residual maturity)



billion in 2012-13 (Table III.7). In view of the rise in external debt and shortening maturities, there is a need to keep a close vigil on external debt levels and its components, especially private corporate debt. In this milieu, the Reserve Bank has proposed to levy capital and provisioning requirements for corporates that have unhedged foreign currency exposure and issued draft guidelines for the same.

Table III.7: India's External Debt

(US$ billion)

Item	End-March 2011 (PR)	End-March 2012 (PR)	End-Dec 2012 (PR)	End-Mar 2013 (P)	Variation (end-Mar 2013 over end-Dec 2012) Per cent
1	2	3	4	5	6
1. Multilateral	48.5	50.5	51.6	51.6	0.0
2. Bilateral	25.7	26.9	26.4	25.1	-4.9
3. IMF	6.3	6.2	6.1	5.96	-2.5
4. Trade Credit (above 1 year)	18.6	19.1	18.6	17.7	-4.7
5. ECBs	88.5	104.8	112.7	120.9	7.2
6. NRI Deposits	51.7	58.6	67.6	70.8	4.8
7. Rupee Debt	1.6	1.4	1.3	1.3	0.3
8. Long-term (1 to 7)	240.9	267.3	284.3	293.3	3.2
9. Short-term (Original Maturity)	65.0	78.2	93.3	96.7	3.6
10. Short-term (Residual Maturity) #	129.1	147.4	166.1	172.3	3.7
Total (8+9)	**305.9**	**345.5**	**377.6**	**390.0**	**3.3**

PR: Partially Revised, P: Provisional, #: RBI Estimate.
Note: Growth rates are based on data up to 3 decimal points.

Vulnerability indicators show further worsening

III.14 With rising debt and deceleration in GDP growth, external sector vulnerability increased in 2012-13 compared with the previous year. India's external debt to GDP ratio increased to 21.2 per cent at end-March 2013 from 19.7 per cent at end-March 2012. Moreover, the ratio of short-term debt (both original and residual maturity) to total external debt increased further at end-March 2013. The ratio of reserves to total debt deteriorated through 2012-13 and stood at 74.9 per cent by the end of March 2013. Reflecting widening CAD, the net international investment position (IIP) as a ratio to GDP worsened from (–)14 per cent at end-March 2012 to (–)16.7 per cent at end-March 2013 (Table III.8).

Table III.8: External Sector Vulnerability Indicators

(per cent)

Indicator	End-Mar 2011	End-Mar 2012	End-Mar 2013
1	2	3	4
1. Ratio of Total Debt to GDP	17.5	19.7	21.2
2. Ratio of Short-term to Total Debt (Original Maturity)	21.2	22.6	24.8
3. Ratio of Short-term to Total Debt (Residual Maturity)#	42.2	42.6	44.2
4. Ratio of Concessional Debt to Total Debt	15.5	13.9	11.7
5. Ratio of Reserves to Total Debt	99.7	85.2	74.9
6. Ratio of Short-term Debt to Reserves	21.3	26.6	33.1
7. Ratio of Short-term Debt (Residual Maturity) to Reserves#	42.3	50.1	59.0
8. Reserves Cover of Imports (in months)	9.5	7.1	7.0
9. Debt-Service Ratio (Debt Service Payments to Current Receipts)	4.4	6.0	5.9
10. External Debt (US$ billion)	305.9	345.5	390.0
11. International Investment Position (IIP) (US$ billion)	-207.0	-249.5	-307.3
12. IIP/GDP ratio	-11.9	-14.0	-16.7

RBI Estimate

CAD may moderate in 2013-14, but risks to its financing remain

III.15 The CAD narrowed somewhat in Q4, but it remained above the sustainable level. It is likely that the widening trade deficit in Q1 of 2013-14 compared with the corresponding period of the previous year may manifest in a wider CAD in the quarter. However, the CAD could moderate over subsequent quarters if gold imports show significant contraction, global crude oil prices stay low and exports get some support from global recovery. Nevertheless, the CAD is likely to stay significantly higher than the sustainable level of 2.5 per cent. As such, a strategy aiming at its reduction and at the same time ensuring its financing with stable and non-debt resources, such as FDI will be necessary. It is also important to remove structural impediments constraining India's export competitiveness and to sustain non-debt-creating flows over the medium term.

III.16 There are certain global risks that call for appropriate policy attention. International crude oil prices, though showing a downtrend since February 2013, would largely be impacted by the outlook on global growth, geo-political uncertainties and supply-side factors. High remittances underpinned by significant depreciation of the rupee in recent months and anticipated recovery in source countries may attenuate concerns relating to financing the CAD. However, the most important risk is that at some stage, exit from accommodative monetary policy in the US may tighten global liquidity, with implications for capital flows to EMDEs, including India. The resulting volatile capital flows could impede smooth financing of the CAD in 2013-14. In this context, continued policy reforms assume utmost importance to ensure a conducive economic and business environment to attract more stable capital flows to the Indian economy.