VI. THE EXTERNAL ECONOMY

India's balance of payments position remained comfortable during 2005-06, despite pressures from record high international crude oil prices. Merchandise exports continued to post a healthy growth rate. Growth in non-oil imports also remained strong on the back of buoyant investment activity. The surplus on the invisibles account expanded, led by exports of software and other business services, and private remittances, thereby financing almost four-fifth of the trade deficit. Nonetheless, the current account deficit during 2005-06 was almost double of that in the previous year, in line with the growth in investment demand in the economy. As a proportion of GDP, the current account deficit, however, remained modest. Net inflows under major components of capital flows – foreign direct investment, portfolio investment, NRI deposits and commercial borrowings – were higher than a year ago. With capital inflows substantially higher than the current account deficit, the overall balance of payments (BoP) recorded a surplus during 2005-06.

Developments during 2006-07 so far indicate some deceleration in growth of merchandise exports and non-oil imports. Oil imports remained large in view of further hardening of international crude oil prices. Capital flows, except FII flows, remained buoyant. During the year 2006-07 (up to July 14, 2006), foreign exchange reserves have increased by US $ 11.0 billion.

International Developments

The momentum and resilience of the global economy witnessed in 2005 continued in the first quarter of 2006. Emerging Asia forged ahead, with China registering double-digit expansion (10.9 per cent growth in the first half of 2006) and India growing rapidly as well in the first quarter of 2006. In the US, after transient impact of hurricanes on economic activity, growth bounced back in early 2006. There are, however, incipient signs of deceleration in spending in the US attributable to higher interest rates, gasoline prices and a cooling housing market. This may lead to a moderation of economic growth in the US in the remainder of 2006. In the euro area, economic growth is broadening and becoming more sustained with domestic demand making a significant contribution. Japanese economy continued to recover steadily on the back of rise in private consumption, business investment and exports (Table 42).

The outlook for the world economy remains fairly benign, buttressed by favourable financing conditions, healthy corporate profits, still accommodative macroeconomic policies in many countries and strong consumer confidence. The IMF projects the world economy to grow by 4.9 per cent in 2006, marginally

Table 42: Growth Rates – Global Scenario

(Per cent)

Country	2004	2005	2005-Q1	2005-Q2	2005-Q3	2005-Q4	2006-Q1
1	2	3	4	5	6	7	8
Advanced Economies							
Euro Area	2.1	1.3	1.5	1.5	1.6	1.7	1.9
Japan	2.3	2.7	1.1	2.7	2.7	4.0	3.8
Korea	4.6	4.0	2.7	3.3	4.5	5.3	6.1
UK	3.1	1.8	1.9	1.7	1.9	1.8	2.3
US	4.2	3.5	3.6	3.6	3.6	3.2	3.7
OECD Countries	3.3	2.7	2.6	2.7	2.9	2.9	3.1
Emerging Economies							
Argentina	9.0	9.2	8.0	10.1	9.2	9.1	8.6
Brazil	4.9	2.3	2.6	3.9	1.0	1.4	3.4
China	10.1	9.9	9.4	9.5	9.4	9.9	10.3
India	7.5 *	8.4 #	8.6	8.5	8.4	7.5	9.3
Indonesia	5.1	5.6	6.4	5.5	5.3	4.9	4.6
Malaysia	7.1	5.3	5.7	4.1	5.3	5.2	5.3
Thailand	6.2	4.4	3.3	4.4	5.3	4.7	6.0

* : FY 2004-05 # : FY 2005-06.

Source: International Monetary Fund; The Economist; and the OECD.

higher than that of 4.8 per cent in 2005. Renewed pressure on energy prices and the possibility of a disorderly unravelling of persisting global imbalances, however, continue to pose downside risks to global growth prospects.

Cross-border net private capital flows witnessed an increase from US $ 231 billion in 2004 to US $ 254 billion in 2005 mainly on account of higher direct investment flows attributable to privatisations and cross border mergers and acquisitions. The upward trend in private capital flows appears to have continued in early months of 2006. However, short to medium-term prospects critically hinge upon the course and dynamics of the necessary adjustments for unwinding of global imbalances.

World exports in US dollar terms grew by 11.9 per cent during January-February 2006 as compared with 13.8 per cent in the corresponding period of the previous year (Table 43). During the first quarter of 2006, exports of developing economies accelerated, while those of industrial countries recorded a deceleration. Amongst major countries, the US exports grew 14.2 per cent in the first quarter of 2006 (8.7 per cent growth a year ago) while China's exports growth remained firm at 26.6 per cent (34.8 per cent a year ago).

Balance of Payments: 2005-06

During 2005-06, India's exports remained buoyant recording an increase of 27.5 per cent, on balance of payments basis, led by manufactured goods and supported by exports of petroleum products. Imports also maintained a strong growth of 31.6 per cent on balance of payments basis, led by oil and non-oil imports.

Table 43: Growth in Exports – Global Scenario

(Per cent)

Region/Country	2005	2005-Q1	2006-Q1
1	2	3	4
World	**12.5**	**13.8 ***	**11.9 ***
Industrial Countries	**8.5**	**10.4 ***	**7.0 ***
USA	10.8	8.7	14.2
France	4.5	8.6	2.2
Germany	7.3	11.4 *	5.5 *
Japan	5.2	6.3	5.3
Developing Countries	**18.2**	**20.1**	**25.3**
Non-Oil Developing Countries	18.5	20.9	26.0
China	28.4	34.8	26.6
India	31.7	35.5 #	13.5 #
Indonesia	-33.1	32.2	14.9
Korea	12.0	12.7	10.7
Malaysia	12.0	16.5	14.0
Singapore	15.6	27.5	23.0
Thailand	14.4	12.7	18.6

***** : January-February. # : January-June.
Source : International Financial Statistics, International Monetary Fund, June 2006; DGCI&S for India.

According to the DGCI&S, imports of petroleum products, crude oil and lubricants (POL) in US dollar terms grew by 47.3 per cent during 2005-06 as compared with 45.1 per cent a year ago, reflecting the steep rise in international crude oil prices. In volume terms, oil imports recorded a modest growth of 4.2 per cent during 2005-06 (5.5 per cent in 2004-05). Non-oil imports (DGCI&S data) in US dollar terms also posted a strong growth of 20.5 per cent in 2005-06, *albeit* substantially lower than 41.8 per cent growth a year ago. While imports of capital goods remained buoyant, those of gold and silver showed a sharp deceleration while that of 'pearls, precious and semi-precious stones' recorded a decline.

Net surplus under the invisibles account expanded further during 2005-06 led by higher exports of services and private transfers (Table 44). Gross invisible receipts recorded a rise of 27.3 per cent during 2005-06 reflecting higher earnings from travel, business and professional services, software services and remittances from Indian workers abroad. Exports of services contributed almost two-third of gross invisible receipts while private transfers contributed another 27 per cent. Gross invisible payments during 2005-06 registered a rise of 24.4 per cent, mainly due to increase in payments relating to investment income, transportation services, and other business and technology related services. On the whole, the net invisible surplus during 2005-06 at US $ 40.9 billion was 31 per cent higher than that in 2004-05.

While the net invisible surplus expanded by US $ 9.7 billion to US $ 40.9 billion during 2005-06, the merchandise trade deficit, on balance of payments basis, expanded by US $ 14.9 billion to US $ 51.6 billion during the year. The current account deficit, therefore, almost doubled from US $ 5.4 billion during

Table 44: Invisibles Account (Net)

(US $ million)

Item	2004-05 PR	2005-06 P	2005-06			
	April-March		April-June PR	July-Sept. PR	Oct.-Dec. PR	Jan-March P
1	2	3	4	5	6	7
Services	14,199	22,265	5,372	6,139	4,432	6,322
Travel	985	1,368	178	250	432	508
Transportation	259	-1,117	-169	-96	-409	-443
Insurance	187	57	6	253	-127	-75
Government, not included elsewhere	67	-175	-17	-50	-18	-90
Software	16,526	22,262	4,853	4,989	5,755	6,665
Other Services	-3,825	-130	521	793	-1,201	-243
Transfers	20,844	24,276	5,503	4,990	6,436	7,347
Investment Income	-2,669	-5,027	-695	-1,409	-2,693	-230
Compensation of Employees	-1,145	-572	-132	-133	-164	-143
Total	**31,229**	**40,942**	**10,048**	**9,587**	**8,011**	**13,296**

PR : Partially Revised. P : Preliminary.

2004-05 to US $ 10.6 billion during 2005-06 (Table 45). After posting a deficit of US $ 4 billion per quarter, on an average, during the first three quarters of 2005-06,

Table 45: India's Balance of Payments

(US $ million)

Item	2004-05 PR	2005-06 P	2005-06			
	April-March		April-June PR	July-Sept. PR	Oct.-Dec. PR	Jan-March P
1	2	3	4	5	6	7
Exports	82,150	104,780	24,150	24,060	26,400	30,170
Imports	118,779	156,334	37,754	38,692	38,237	41,651
Trade Balance	-36,629	-51,554	-13,604	-14,632	-11,837	-11,481
	(-5.3)	(-6.5)				
Invisible Receipts	71,854	91,481	19,686	19,832	24,024	27,939
Invisible Payments	40,625	50,539	9,638	10,245	16,013	14,643
Invisibles, net	31,229	40,942	10,048	9,587	8,011	13,296
	(4.5)	(5.1)				
Current Account	-5,400	-10,612	-3,556	-5,045	-3,826	1,815
	(-0.8)	(-1.3)				
Capital Account (net)*	31,559	25,664	4,803	10,301	-846	11,406
		[31,164] @			[4,654] @	
of which:						
Foreign Direct Investment	3,240	5,733	1,198	1,086	1,412	2,037
Portfolio Investment	8,907	12,489	972	4,436	2,748	4,333
External Commercial Borrowings $	5,040	1,591	1,091	1,758	-4,281	3,023
		[7,091] @			[1,219] @	
Short-term Trade Credit	3,792	1,708	-151	1,123	759	-23
External Assistance	1,923	1,438	212	183	477	566
NRI Deposits	-964	2,789	-108	341	881	1,675
Change in Reserves #	-26,159	-15,052	-1,247	-5,256	4,672	-13,221

PR : Partially Revised. P : Preliminary.
* : Includes errors and omissions.
$: Medium and long term borrowings.
: On balance of payments basis (excluding valuation); (-) indicates increase.
@ : Excluding the IMD redemption.
Note : Figures in parentheses are per cent to GDP.

the current account recorded a surplus of US $ 1.8 billion during the fourth quarter (January-March 2006) reflecting a sharp rise in the net invisible surplus. As a proportion of GDP, the current account deficit remained modest, widening from 0.8 per cent in 2004-05 to 1.3 per cent in 2005-06.

Capital flows during 2005-06 [adjusted for the redemption of the India Millennium Deposits (IMDs)] were broadly of the same order as a year ago. Foreign investment flows, both direct and portfolio, picked up further reflecting sustained interest in India as an attractive investment destination due to strong economic activity and continued strength of the corporate sector. Demand for external commercial borrowings (adjusted for IMDs) remained large, in consonance with the step-up in investment activity in the country. Higher accretions to non-resident deposits could be attributed partly to increase in interest rates on these deposits during the year. The ceiling on NRE(R)A term deposits was revised upwards by 25 basis points to LIBOR/SWAP rates of US dollar *plus* 75 basis points on November 17, 2005.

With the surplus in the capital account more than offsetting the current account deficit, there was an accretion to the foreign exchange reserves of the order of US $ 15.1 billion on a balance of payments basis (*i.e.*, excluding valuation effects) during 2005-06.

External Debt

India's total external debt was placed at US $ 125.2 billion at end-March 2006, about US $ 2 billion above the end-March 2005 level. This increase was mainly on account of NRI deposits and trade credit (up to 1 year maturity) (Chart 55). The rise in NRI deposits, as noted earlier, could be attributed partly to the upward

Chart 55: Components of External Debt

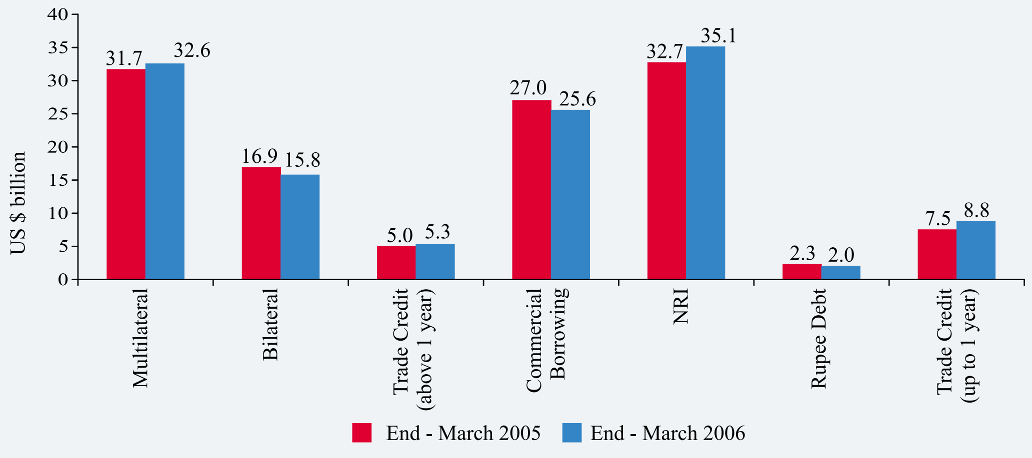


Table 46: Indicators of External Debt Sustainability

(Per cent)

Indicator	End-March 1995	End-March 2005	End-March 2006
1	2	3	4
Total debt /GDP	30.8	17.3	15.8
Short-term/Total debt	4.3	6.1	7.0
Short-term debt/Reserves	16.9	5.3	5.8
Concessional debt/Total debt	45.3	33.3	31.5
Reserves/ Total debt	25.4	114.9	121.1
Debt Service Ratio*	25.9	6.1	10.2

* : Relates to the fiscal year.

revision in interest rates on NRE(R)A term deposits. Recourse to higher short-term trade credit reflected rising import financing requirements. Though the corporate sector's demand for external commercial borrowings (including FCCBs) remained strong in consonance with the domestic industrial activity, the stock declined due to the one-off effect of the IMDs repayment of US $ 5.5 billion. The valuation effect, on account of appreciation of the US dollar against other major international currencies, had a moderating impact on the stock of external debt.

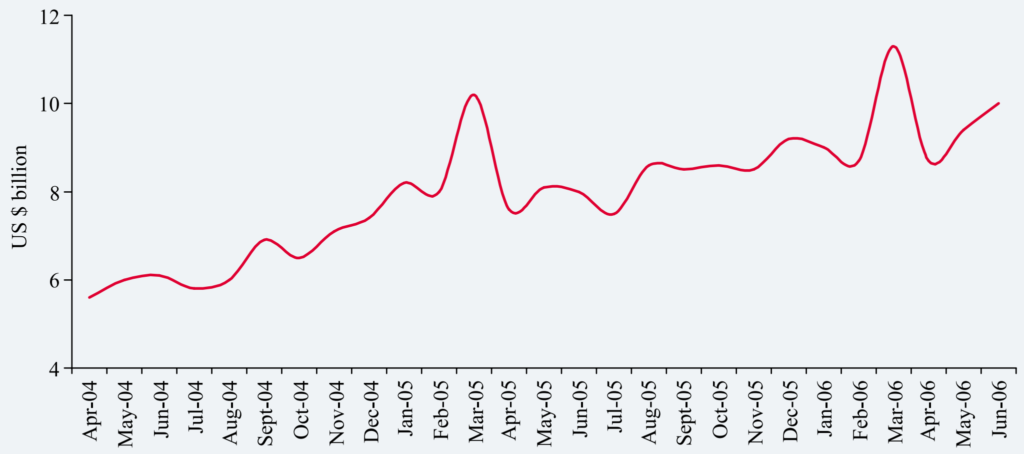
There has been a perceptible improvement in external debt indicators over the years indicating the growing sustainability of external debt of India. The ratio of external debt to GDP has almost halved over the past decade to 15.8 per cent at end-March 2006 from 30.8 per cent at end-March 1995. The debt service ratio remains low, although it increased from 6.1 per cent during 2004-05 to 10.2 per cent during 2005-06 due to the one-off effect of the IMDs repayment. Reflecting the rise in short-term debt during 2005-06, the ratios of short-term to total debt and short-term debt to reserves rose to 7.0 per cent and 5.8 per cent, respectively, but still remain fairly modest. India's foreign exchange reserves exceeded the external debt by US $ 26.4 billion providing a cover of 121.1 per cent to the external debt stock at end-March 2006 (Table 46).

Developments during 2006-07

During April-June 2006, growth in India's merchandise exports (in US dollar terms) decelerated to 16.9 per cent from 35.4 per cent a year ago (Chart 56).

Commodity-wise data (available up to April 2006) indicate that exports of both primary products and manufactured goods exhibited deceleration in growth. Exports of manufactured goods, led by engineering goods, remained the key driver of merchandise exports. Exports of petroleum products maintained high growth, reflecting the impact of elevated prices of petroleum products (Table 47). During April 2006, exports of the traditional items such as leather, iron ore, tea, rice, cashew and marine products declined, while ready-made garments and some agricultural products such as raw cotton, tobacco, spices, oil meal, sugar and molasses recorded an increase.

Chart 56: India's Merchandise Exports



Destination-wise, the US continued to be the major trade partner of India accounting for 15.9 per cent of India's total exports during April 2006, followed by the UAE (9.8 per cent), China (6.8 per cent), Singapore (6.0 per cent), UK (5.4 per cent), Germany (3.8 per cent) and Hong Kong (3.6 per cent) (Chart 57). Region-wise, North America was the fastest growing market for India's exports during April 2006 followed by Latin America, South Asia, East Asia and the European Union.

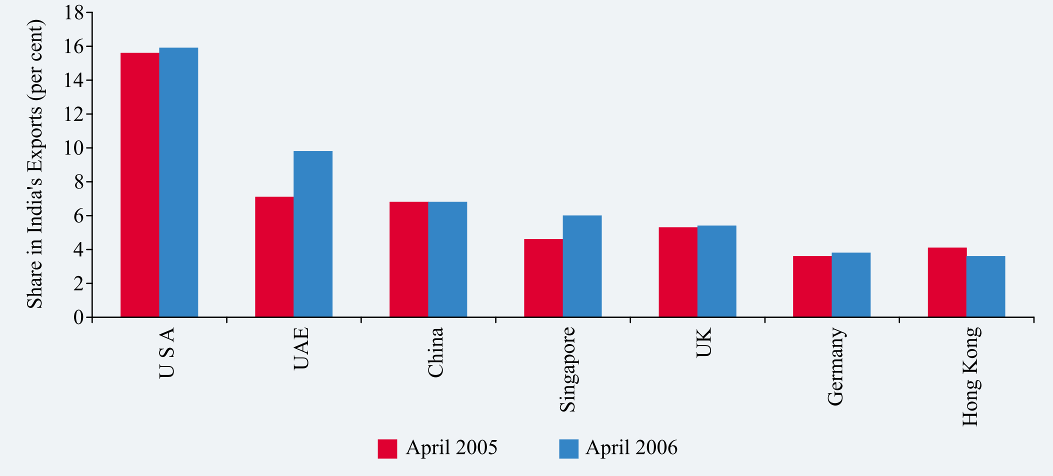
During April-June 2006, growth in imports moderated to 17.7 per cent from 45.4 per cent a year ago, attributable to deceleration in non-oil imports. POL imports continued to post large growth of 39.0 per cent during April-June

Table 47: Exports of Principal Commodities

Commodity Group	US $ billion			Variation (per cent)	
	2005-06	2005-06	2006-07	2005-06	2006-07
		April		April	
1	2	3	4	5	6
1. Primary Products	**16.4**	**1.3**	**1.4**	**32.3**	**9.0**
of which:					
a) Agriculture and Allied Products	10.2	0.8	0.9	19.0	15.7
b) Ores and Minerals	6.2	0.5	0.5	61.2	-1.8
2. Manufactured Goods	**71.8**	**5.4**	**6.2**	**37.4**	**16.6**
of which:					
a) Chemicals and Related Products	14.5	1.2	1.2	40.4	3.6
b) Engineering Goods	21.5	1.6	2.2	52.8	34.0
c) Textiles and Textile Products	16.0	1.3	1.4	44.2	11.5
d) Gems and Jewellery	15.5	1.0	1.2	12.8	16.4
3. Petroleum Products	**11.5**	**0.7**	**0.9**	**21.0**	**32.6**
4. Total Exports	**102.7**	**7.6**	**8.7**	**36.1**	**14.6**

Source : DGCI&S.

Chart 57: Destination of India's Exports



2006 (31.0 per cent a year ago). This increase was almost entirely on account of higher crude oil prices as, in volume terms, POL imports in April 2006 posted growth of only 3.9 per cent (11.2 per cent a year ago).

During April-June 2006, growth of non-oil imports decelerated to 9.6 per cent from a high of 51.7 per cent a year ago (Chart 58). Commodity-wise import data available for April 2006 show that the deceleration in growth of non-oil imports was partly on account of the decline in imports of 'pearls, precious and semi-precious stones' and gold and silver (Table 48). The decline in imports of gold and silver could be attributed to higher gold prices. Reflecting strong domestic investment activity, and in consonance with acceleration in domestic production

Chart 58: India's Non-Oil Imports

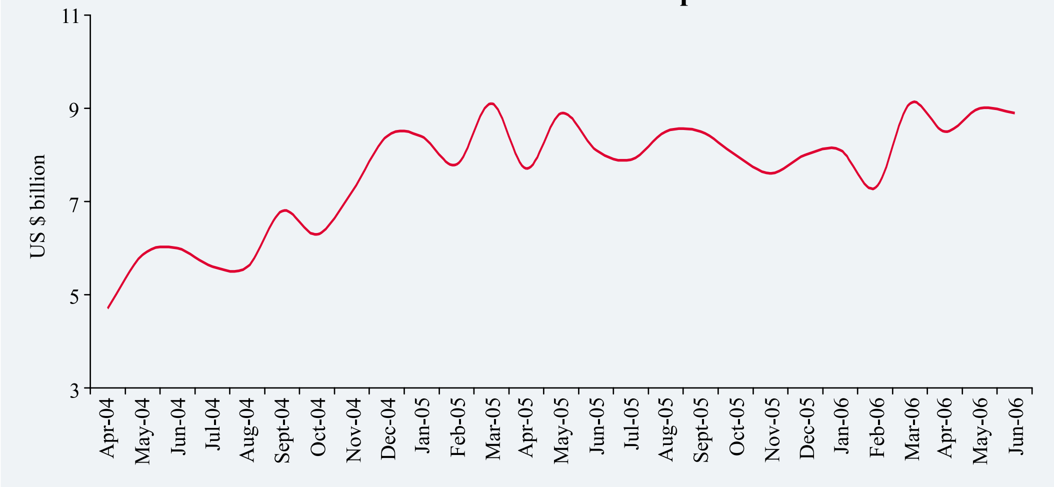


Table 48: Imports of Principal Commodities

Commodity Group	US $ billion			Variation (per cent)	
	2005-06	2005-06	2006-07	2005-06	2006-07
		April		April	
1	2	3	4	5	6
POL	44.0	3.1	4.2	32.3	35.6
Edible Oils	2.0	0.1	0.2	-23.9	60.0
Fertilisers	2.1	0.1	0.1	241.8	-44.1
Iron and Steel	4.4	0.3	0.3	126.6	-5.4
Capital Goods	31.7	2.2	2.9	79.1	29.4
Pearls, Precious and Semi-Precious Stones	9.1	0.8	0.6	116.4	-21.8
Chemicals Organic and Inorganic	6.9	0.5	0.5	74.0	-2.2
Gold and Silver	11.2	1.4	1.2	48.2	-14.9
Total Imports	**142.4**	**10.8**	**12.7**	**56.0**	**18.3**
Memo:					
Non-oil Imports	98.5	7.7	8.5	68.1	11.3
Non-oil Imports Excluding Gold and Silver	87.3	6.2	7.3	73.5	17.3
Mainly Industrial Imports*	81.0	5.8	6.9	75.2	18.0

* : Non oil imports net of gold and silver, bulk consumption goods, manufactured fertilisers and professional instruments.
Source : DGCI&S.

of capital goods, imports of capital goods continued to record strong growth, *albeit* lower than a year ago. Among bulk commodities, imports of metalliferrous ores and scraps, non-ferrous metals, and paper and paperboard including newsprint rose while imports of bulk consumption goods such as manufactured fertilisers and iron and steel witnessed a decline during April 2006.

China continued to be the largest source for India's imports during April 2006 with a share of 8.0 per cent in India's total imports, followed by Switzerland (6.6 per cent), the US (4.9 per cent), Australia (2.9 per cent), Belgium (2.5 per cent) and UAE (2.4 per cent). Developing economies (excluding OPEC) were the major source, accounting for 25.7 per cent of India's total imports. Within developing economies, East Asia was the main source, accounting for 19.5 per cent of India's total imports.

Notwithstanding some moderation in growth of imports, trade deficit expanded from US $ 10.5 billion during April-June 2005 to US $ 12.6 billion during April-June 2006 (Table 49).

Capital flows have remained large during 2006-07 so far. Foreign direct investment (FDI) inflows during April-May 2006 were higher than that during April-May 2005, reflecting strong fundamentals and growing investor interest. On the other hand, FIIs registered outflows during April-June 2006 mirroring the weakness in domestic equity markets in consonance with the trends in

Table 49: India's Merchandise Trade

				US $ billion
Item	2004-05	2005-06	2005-06	2006-07
			April-June	
1	2	3	4	5
Exports	83.5	102.7	23.7	27.7
Imports	111.5	142.4	34.2	40.3
Oil	29.8	44.0	9.4	13.1
Non-oil	81.7	98.5	24.8	27.2
Trade Balance	-27.9	-39.6	-10.5	-12.6
Non-oil Trade Balance	-5.1	-7.2	-0.7 *	-0.7 *
		Variation (Per cent)		
Exports	30.8	23.0	35.4	16.9
Imports	42.7	27.7	45.4	17.7
Oil	45.1	47.3	31.0	39.0
Non-oil	41.8	20.5	51.7	9.6

* : April.
Source: DGCI&S.

international markets. The number of FIIs registered with the SEBI increased from 882 at end-March 2006 to 928 by end-June 2006. Amounts raised through the issuances of American depository receipts (ADRs)/global depository receipts (GDRs) during April-May 2006 were substantially higher as stock markets offered corporates the opportunity to issue equities abroad (Table 50). Net inflows under various non-resident deposit schemes during April-May 2006 amounted to US $ 816 million as against outflows during April-May 2005, partly reflecting higher interest rates. The ceiling interest rate on FCNR(B) deposits was raised by 25 basis points to "LIBOR/SWAP rates for the respective currency/maturity" in March 2006 from "LIBOR/SWAP rates *minus* 25 basis points". The ceiling interest rate on NRE(R)A deposits, which was raised by 25 basis points in November 2005, was further increased by 25 basis points in April 2006 to LIBOR/SWAP rates of US dollar *plus* 100 basis points.

Table 50: Capital Flows

				(US $ million)
Components	2004-05	2005-06	2005-06	2006-07
	April-March		April-May	
1	2	3	4	5
Foreign Direct Investment into India	5,652	7,751	922	1,199
FIIs (net)	8,686	9,926	544 *	-1,787 *
ADRs/GDRs	613	2,552	360	1,007
External Assistance (net)	1,923	1,438	N.A.	N.A.
External Commercial Borrowings (net)	5,040	1,591	N.A.	N.A.
(Medium and long-term)		[7,091] @		
Short-term Trade Credits (net)	3,792	1,708	N.A.	N.A.
NRI Deposits (net)	-964	2,789	-118	816

@ : Excluding the IMD redemption.
* : April-June.
N.A.: Not Available.

Table 51: Foreign Exchange Reserves

(US $ million)

End-Month	Gold	SDR	Foreign Currency Assets	Reserve Position in the IMF	Total (2+3+4+5)
1	2	3	4	5	6
March 1995	4,370	7	20,809	331	25,517
March 2000	2,974	4	35,058	658	38,694
March 2005	4,500	5	1,35,571	1,438	1,41,514
March 2006	5,755	3	1,45,108	756	1,51,622
April 2006	6,301	6	1,53,598	772	1,60,677
May 2006	7,010	–	1,56,073	785	1,63,868
June 2006	6,180	–	1,55,968	764	1,62,912
July 2006 *	6,180	–	1,55,716	763	1,62,659

– : Negligible.
* : As on July 14, 2006.

India's foreign exchange reserves were US $ 162.7 billion as on July 14, 2006; at this level, they were US $ 11.0 billion higher over end-March 2006 level (Table 51). India holds the fifth largest stock of reserves among the emerging market economies and the sixth largest in the world. The overall approach to the management of India's foreign exchange reserves in recent years reflects the changing composition of the balance of payments and the 'liquidity risks' associated with different types of flows and other requirements. Taking these factors into account, India's foreign exchange reserves continued to be at a comfortable level and consistent with the rate of growth, the share of external sector in the economy and the size of risk-adjusted capital flows.