III. THE EXTERNAL SECTOR

Current account deficit (CAD) moderated in Q3 of 2010-11, reflecting significant acceleration in exports. While concerns on CAD in 2010-11 have receded, the spike in oil prices poses the risk of CAD widening in 2011-12. Capital flows are expected to improve financing the CAD comfortably. However, the dominance of portfolio equity flows and the decline in FDI raise concern over the stability of capital flows. While the earthquake in Japan is unlikely to significantly affect India, risk of further worsening of the geo-political situation in MENA and a possible turnaround in global interest rate cycle would have to be factored into macro-policies.

Concerns on CAD have receded, but have not dissipated

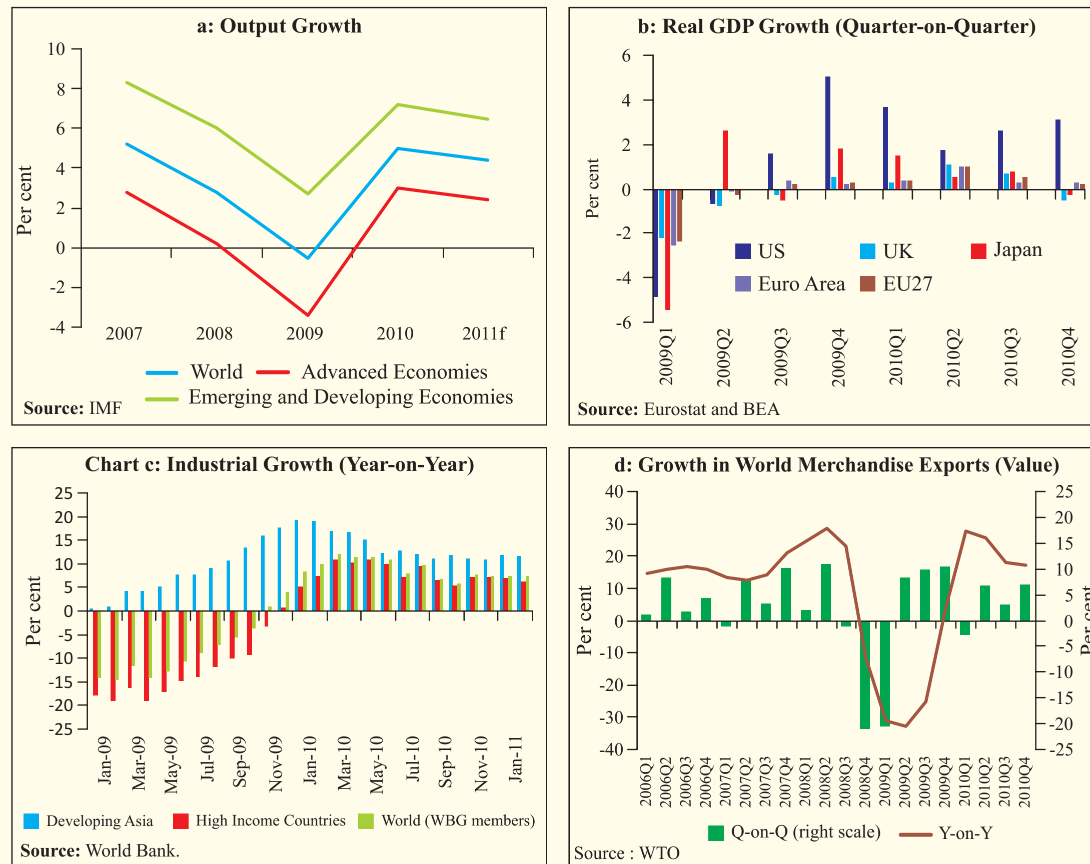
III.1 Current account deficit (CAD) that amounted to 3.7 per cent of GDP in H1 of 2010-11 moderated to 2.1 per cent of GDP in Q3 primarily reflecting pick up in exports. With this trend gaining further pace in Q4, the CAD for the full year may settle at around 2.5 per cent of GDP. However, the downward drift could reverse if the current spurt in global crude oil prices persists. With a larger CAD, any abrupt tightening of external financing could put pressure on the exchange rate, raise cost of capital and feed through into inflation. Developments in global economic and financial market conditions could impact the capital account, especially if the central banks in advanced economies (AEs) start withdrawing monetary accommodation. Such a withdrawal, however, is likely to raise global interest rates, reduce leveraged positions in global commodity markets and so help deflate global commodity prices.

Global recovery advances but sovereign balance sheets pose risk

III.2 The global economic recovery is broadly on track. However, uncertainty remains with significant sovereign and banking sector default risks prevailing in parts of Europe. Furthermore, the recovery continues to move at multi-speed characterised by large output gaps in AEs and closing or closed gaps in emerging market and developing economies (EMDEs). More significantly, unemployment rates have begun to fall in US and Germany. The risk of double dip recession has receded. Nevertheless, still-stagnant real estate markets, stubbornly high unemployment and possibility of contagion from weak sovereign balance sheets of peripheral European countries continue to present major concerns in the AEs. IMF, in April 2011, has projected the world real GDP growth to slow down modestly to 4.4 per cent in 2011 from 5 per cent in 2010 (Chart III.1a). The key downside risk to global growth relates to the potential for oil prices to surprise further on the upside because of supply disruptions. Among the AEs, there was a diverging trend in growth during the fourth quarter *vis-à-vis* the previous quarter (Chart III.1b).

Outlook for capital flows to EMEs suggests risks from sudden reversals

III.3 While the capital flows to EMEs are likely to remain strong, they do run the risks of turning volatile, with possible episodes of sudden reversals. As strong capital flows in the first place were caused by the multi-speed recovery around the world and the consequent differential exit from accommodative monetary

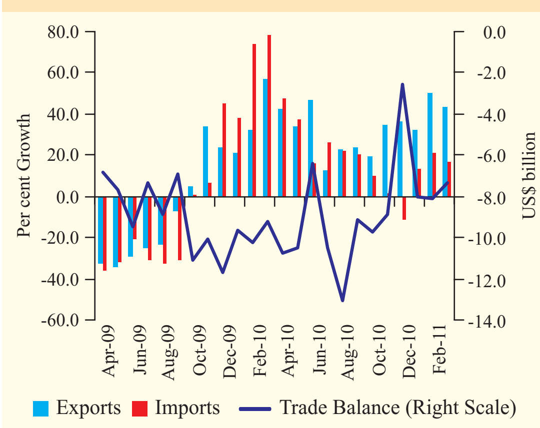


policy, the start of the exit in AEs can result in increased "home-bias" in investments and changes in portfolio allocations. US recovery and the need for massive reconstruction in Japan can bolster this trend. Net private capital flows to EMEs, according to the IIF, are estimated to increase by 6 per cent in 2011 to US $ 960 billion on top of an increase of 50 per cent during 2010 (IIF, January 2011). Net private financial flows to EMDEs, according to IMF's World Economic Outlook (April 2011), are projected at US $ 388 billion in 2011 as against US $ 470 billion in 2010.

World trade recovery continues, while industrial production regains speed after stagnation

III.4 World trade and industrial production slowed during the latter half of 2010, reflecting a global inventory cycle. Recent data show a mixed picture. Industrial production had begun to regain speed at the start of the calendar year (Chart III.1c). However, both the manufacturing and the services Purchasing Managers' Index had dipped in March 2011 in the aftermath of earthquake in Japan, though the index values suggest continued expansion. Global trade is recovering with the value of world merchandise trade, led by Asia, accelerating perceptibly in the fourth quarter of 2010 compared to the same period of 2009 (Chart III.1d). In volume terms, world trade expanded by 12 per cent in 2010. World imports of EMDEs are back to pre-crisis trends, but those of advanced economies continue to lag. Japan's disaster is likely to have some impact on East Asian economies, which have strong trade and financial links with Japan, before a reconstruction-led recovery starts.

Chart III.2: India's Merchandise Trade



Diversification in India's exports augurs well for trade balance

III.5 The robust growth in India's exports reflects diversification of products from labour intensive manufactures to higher value-added products in engineering and petroleum sectors and to destinations across emerging markets and developing economies which led to moderation in trade deficit during 2010-11(Charts III.2 and 3).

Impact of MENA unrest significant, that of Japan will be marginal

III.6 The ongoing political unrest in some of the Middle East and North African (MENA) countries and the natural disaster in Japan are not expected to directly affect India's trade position as these economies do not have a high share in India's international trade; there could, however, be significant indirect effects arising from the possible rise in oil prices and other commodity prices. Oil alone constitutes about one-third of India's total imports (Chart III.4 and Table III.1). Further, some transitory impact

Chart III.3a: Composition of India's Exports

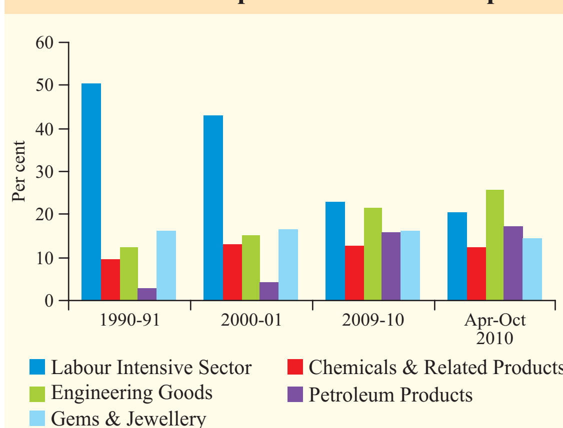


Chart III.3b: Destination of India's Exports

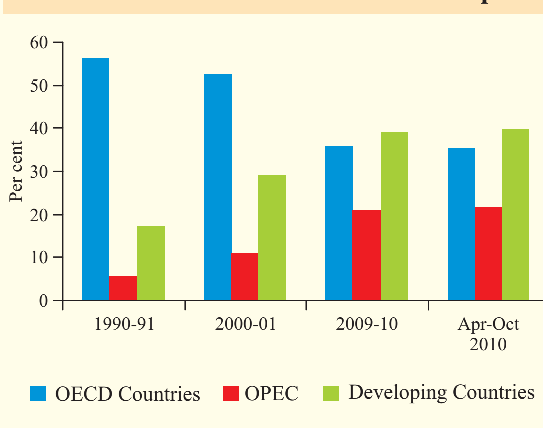


Chart III.4: India's POL Imports and International Crude Oil Prices

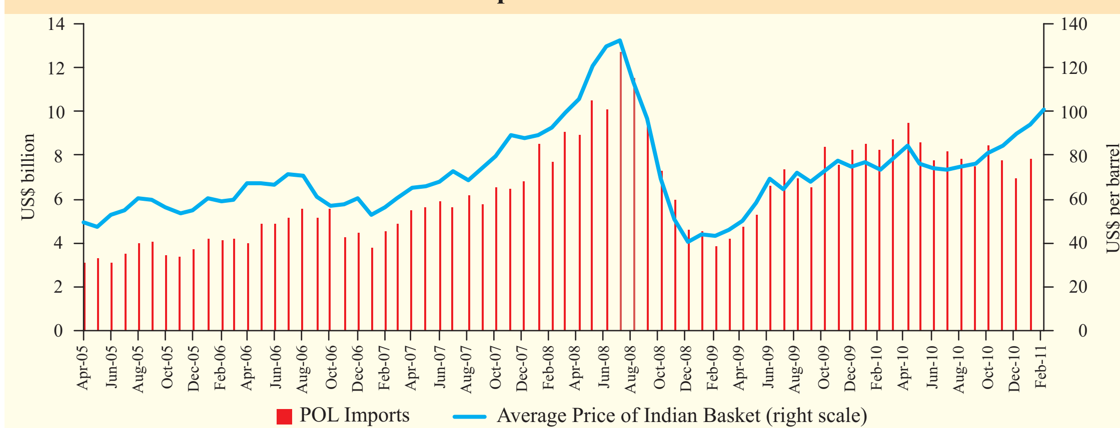


Table III.1: India's Merchandise Trade

(US$ billion)

Item	2009-10 (R)		2010-11 (P)*	
	Absolute	Growth (%)	Absolute	Growth (%)
1	2	3	4	5
Exports	178.2	-2.5	245.9	37.6
Oil	28.1	2.1	42.5	51.2
Non-oil	150.1	-3.2	203.5	35.5
Imports	287.4	-3.8	350.3	21.9
Oil	86.8	-7.4	88.2	12.4
Non-oil	200.6	-2.2	217.1	20.4
Trade Balance	**-109.2**	**-5.7**	**-104.4**	**-4.4**
Non-Oil Trade Balance	**-50.5**	**1.2**	**-41.8**	**-6.9**

* : For oil and non-oil imports and non-oil trade balance data pertain to April-February.

R : Revised. P : Provisional.

Source: DGCI&S.

on investment flows and aid commitments from Japan may occur.

CAD moderation aided by net invisibles receipts too

III.7 Both the trade and invisible accounts contributed to the improvement in current account during Q3 of 2010-11. The higher invisibles surplus was mainly on account of an improvement in net services exports and private transfers (Table III.2). As a result, the CAD moderated from 3.7 per cent of GDP in H1 of 2010-11 to 3.1 per cent of GDP during April-December 2010 which was, however, higher than 2.6 per cent of GDP during April-December 2009.

III.8 Services exports recorded a strong growth during October-December 2010 over the corresponding quarter of the previous year led by travel, transportation, business, financial and software services. While net business services receipts gradually improved over the quarters, software exports rebounded strongly in Q3 of 2010-11. The robust growth in software exports could be attributed to the transformation in Indian information technology (IT) service offerings from application development and maintenance to provision of full services

Table III.2: India's Balance of Payments

(US $ billion)

Item	2009-10	2009-10 (PR)				2010-11		
		Q1	Q2	Q3	Q4	Q1 (PR)	Q2 (PR)	Q3 (P)
1	2	3	4	5	6	7	8	9
1. Exports	182.2	39.2	43.4	47.2	52.5	55.3	51.8	66.0
2. Imports	300.6	65.4	73.0	78.1	84.1	88.0	89.6	97.5
3. Trade Balance (1-2)	-118.4	-26.3	-29.6	-30.9	-31.6	-32.8	-37.8	-31.6
4. Net Invisibles	80.0	22.1	20.4	18.7	18.8	20.3	21.0	21.9
5. Current Account Balance (3+4)	-38.4	-4.2	-9.2	-12.2	-12.8	-12.5	-16.8	-9.7
6. Gross Capital Inflows	345.7	77.8	96.0	81.6	90.3	95.3	112.6	174.2
7. Gross Capital Outflows	292.3	74.2	76.7	66.9	74.5	78.8	91.3	159.3
8. Net Capital Account (6-7)	53.4	3.7	19.3	14.6	15.8	16.6	21.3	14.9
9. Overall Balance (5+8)#	13.4	0.1	9.4	1.8	2.1	3.7	3.3	4.0

: Overall balance also includes errors and omissions apart from items 5 and 8.

PR : Partially Revised. P : Provisional.

Table III.3: Net Invisibles

(US $ billion)

Item	October-December		April-December	
	2009-10 (PR)	2010-11 (P)	2009-10 (PR)	2010-11 (P)
1	2	3	4	5
1. Services	8.2	12.2	27.3	34.2
Of which:				
Travel	1.1	1.5	1.8	2.8
Transportation	-0.4	-0.3	-0.3	-0.5
Software Services	12.9	14.7	34.2	39.9
Business Services	-2.1	-0.9	-4.9	-3.1
Financial Services	-0.4	-0.1	-0.5	-0.4
2. Transfers (Private)	12.8	13.4	39.5	39.5
3. Income	-2.5	-3.9	-5.8	-10.6
Investment Income	-2.2	-3.6	-5.2	-9.9
Compensation of Employees	-0.3	-0.3	-0.5	-0.8
Total (1+2+3)	**18.5**	**21.7**	**61.0**	**63.1**

PR: Partially Revised. P: Preliminary.

comprising testing, infrastructure, consulting and system integration as well as the benefits of geographical diversification. Investment income receipts declined significantly over the corresponding period of the previous year, mainly due to the persistence of lower interest rates abroad. Private transfer receipts continued to be robust during the year so far. On the other hand, invisibles payments in Q3 were also higher due to larger payments under almost all components of invisibles, particularly investment income and business services. Net invisibles balance improved significantly in Q3 of 2010-11 over the corresponding quarter of the preceding year (Table III.3).

Composition and volatility in capital flows remain a concern

III.9 Although the net capital flows in Q3 of 2010-11 remained broadly the same as in the corresponding quarter of the preceding year, the composition and volatility of capital flows raised some concerns (Table III.4). For example, the FDI flows moderated. This was mainly on account of lower FDI inflows under services and 'construction, real estate and mining'. Though net FII flows were higher, they were volatile with several bouts of net outflows during the quarter.

III.10 Certain lead indicators of capital flows suggest that FDI inflows continued to be moderate during Q4 of 2010-11. FII flows also remained moderate being negative initially, but turned positive thereafter. ECB approvals increased on the back of strong domestic

Table III.4: Net Capital Flows

(US $ billion)

Item	October-December		April-December	
	2009-10 (PR)	2010-11 (P)	2009-10 (PR)	2010-11 (P)
1	2	3	4	5
Net Capital flows	14.6	14.9	37.6	52.7
Of which:				
1. Foreign Direct Investment (FDI)	3.0	2.1	15.4	7.6
Inward FDI	7.2	5.3	27.0	18.0
Outward FDI	-4.2	-3.2	-11.6	-10.4
2. Portfolio Investment	5.7	6.3	23.6	30.1
Of which:				
FIIs	5.3	7.2	20.5	29.5
ADR/GDRs	0.5	0.2	3.2	1.8
3. External Assistance	0.8	1.2	1.9	4.2
4. External Commercial Borrowings	1.7	3.6	2.4	9.3
5. NRI Deposits	0.6	0.2	3.5	2.3
6. Short-term Trade Credit	3.2	1.5	3.1	8.5

PR: Partially Revised. P: Preliminary.

Table III.5: Capital Flows in 2010-11 so far

(US $ billion)

Component	Period	2009-10	2010-11
1	2	3	4
FDI to India	April-February	33.8	25.9
FIIs (net)	April-March	29.0	29.4
ADRs/GDRs	April-March	3.3	2.0
ECB Approvals	April-March	20.7	25.6
NRI Deposits (net)	April-March	2.9	3.2

FDI : Foreign Direct Investment.
FII : Foreign Institutional Investors.
ECB : External Commercial Borrowings.
ADR : American Depository Receipts.
GDR : Global Depository Receipts.
NRI : Non Resident Indians.

demand and interest rate differentials (Table III.5). Notwithstanding some easing of pressures with respect to financing of CAD, the moderation in equity inflows coupled with rising debt flows during 2010-11 so far poses risks to sustainability. Any unforeseen global developments may affect CAD and its financing and, therefore, warrant close monitoring of the evolving situation.

Higher absorption of capital inflows leaves modest reserve accretion

III.11 As net capital inflows were in excess of CAD, India's foreign exchange reserves increased modestly during Q3 of 2010-11. India's foreign exchange reserves stood at US$ 309.7 billion as on April 22, 2011. Net capital inflows, though relatively higher, were largely absorbed by higher CAD during April-December 2010 and did not complicate the monetary management.

Indicators of Real Effective Exchange Rate (REER) exhibit appreciation

III.12 The real effective exchange rate (REER) indices for 6-currency, 30-currency and 36-currency baskets exhibited appreciation of the Indian rupee during 2010-11. The 6-currency index showed maximum appreciation compared to other indices reflecting higher inflation differential with these countries

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

(Per cent, appreciation+/depreciation-)

	Index	Year-on-Year Variation (Average)		
	April 15 2011 P	2008-09	2009-10 P	2010-11 P
1	2	3	4	5
36-REER	102.3	-9.9	-3.1	7.7
36-NEER	92.8	-10.9	-2.6	2.9
30-REER	93.7	-10.2	-4.6	4.5
30-NEER	94.7	-8.3	-2.2	1.0
6-REER	115.8*	-9.3	-0.01	12.7
6-NEER	90.8*	-13.6	-3.4	5.7
Rs/USD	44.5	-12.5	-3.1	4.1
Rs/USD (end-March)	44.7	-21.5	12.9	1.1

NEER : Nominal Effective Exchange Rate.
REER : Real Effective Exchange Rate.
P : Provisional.
* : Data pertain to March 2011.
Note : Rise in indices indicates appreciation of the rupee and vice versa.

(Table III.6). The REER appreciation may not have implications for external sector competitiveness as there are a host of other factors such as global recovery leading to a pick-up in demand as well as diversification of the export basket and across destinations and various Government initiatives that have a bearing on the export performance.

External debt rises

III.13 External debt stock as at end-December 2010 showed an increase of around 14 per cent over the level of end-March 2010 reflecting increases in ECBs and short-term credit as well as valuation effects due to depreciation of the US dollar against other major currencies (Table III.7).

III.14 The debt sustainability indicators witnessed a modest deterioration at end-December 2010 on account of the continued dominance of debt creating flows (Table III.8).

Net international liabilities increase

III.15 Large increase in India's net international liabilities during the quarter,

Table III.7: India's External Debt

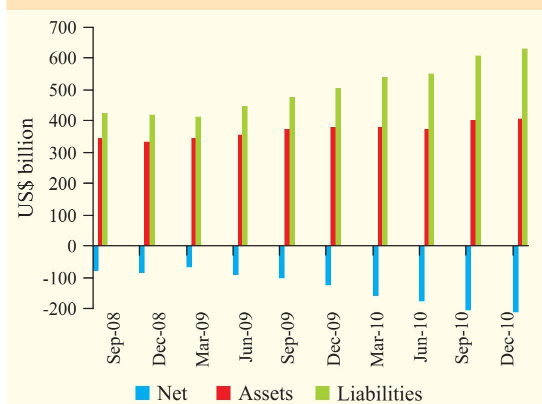
(US$ billion)

Item	External debt outstanding			Variation	
	End-March 2009	End-March 2010 (PR)	End-December 2010 (P)	December 2010 over March 2010 Amount	Per cent
1	2	3	4	5	6
1. Multilateral	39.5	42.9	47.6	4.7	11.0
2. Bilateral	20.6	22.6	25.2	2.6	11.5
3. IMF	1.0	6.0	6.1	0.1	1.7
4. Trade Credit	14.5	16.9	19.0	2.1	12.4
5. Commercial Borrowings	62.4	70.9	84.7	13.8	19.5
6. NRI Deposits	41.6	47.9	50.7	2.8	5.8
7. Rupee Debt	1.5	1.7	1.6	-0.1	-5.9
8. Long-Term Debt (1 to 7)	**181.2**	**208.8**	**234.9**	**26.1**	**12.5**
9. Short-Term Debt	**43.4**	**52.3**	**62.6**	**10.3**	**19.7**
Total Debt (8+9)	**224.6**	**261.2**	**297.5**	**36.3**	**13.9**

PR : Partially Revised. P : Provisional.
Source: Ministry of Finance, Government of India and Reserve Bank of India.

despite moderation in CAD, mainly reflected the valuation effects due to exchange rate movements (Chart III.5).

Chart III.5: International Investment Position



Oil prices and capital flow volatility to shape external balance

III.16 Hardening of international crude oil prices on the back of geo-political concerns pose risks to current account balance during 2011-12. Higher growth in software exports and robust transfer receipts may provide some cushion. Financing of the current account, however, may not be a problem as capital flows are likely to improve considering India's long-run growth prospects and policies supporting FDI, as also larger FII investments in debt markets. Nonetheless, the composition and volatility of capital flows could have implications for external sector vulnerability, warranting close monitoring.

Table III.8: External Sector Vulnerability Indicators

(Per cent)

Indicator	End-December 2009	End-March 2010	End-September 2010	End-December 2010
1	2	3	4	5
1. Total Debt/GDP	-	18.0	-	-
2. Ratio of Short-term to Total Debt (Original Maturity)	18.0	20.0	20.9	21.0
3. Ratio of Short-term to Total Debt (Residual Maturity)	-	41.2	42.9	-
4. Ratio of Concessional Debt to Total Debt	17.7	16.8	16.0	15.6
5. Ratio of Reserves to Total Debt	112.8	106.8	101.4	99.9
6. Ratio of Short-term Debt to Reserves	15.7	18.8	20.6	21.1
7. Reserves Cover of Imports (in months)	12.4	11.1	10.3	9.9
8. Reserves Cover of Imports and Debt Service Payments (in months)	11.6	10.5	9.8	9.4
9. Debt Service Ratio (Debt Service Payments to Current Receipts)	5.1	5.5	3.8	3.9