III. The External Economy

With recovery in export growth in the second half and revival in capital inflows, the external sector of the economy improved during 2009-10. The current account deficit, however, widened to 2.9 per cent of GDP, primarily due to lower surplus in the invisibles account. Through better absorption of foreign capital, the higher current account deficit contributed to the recovery in growth. Gross external debt and net international liabilities of the country increased during the year. The debt sustainability indicators, however, continued to remain comfortable. As on July 16, 2010, the foreign exchange reserves stood at US$ 281.9 billion.

International Developments

III.1 The global economy witnessed a robust recovery in the first quarter of 2010 before encountering heightened downside risks stemming from concerns relating to sovereign debt sustainability in several European countries. The uncertainty about the fiscal stress spreading from the "periphery" countries to the "core" in the euro area and even to other advanced economies led to significant erosion in risk appetite which was reflected in flight to safety, greater volatility in markets, and tighter financing conditions.

III.2 Taking into account the strong 5.1 per cent growth in global output in the first quarter of 2010, in July 2010, the IMF revised its growth projections upwards for 2010 to 4.6 per cent from 4.2 per cent earlier (Chart III.1a). The pace and the drivers of growth are expected to remain divergent across countries. The emerging and developing economies are projected to grow by 6.8 per cent, led by China and India, as against 2.6 per cent growth projected for advanced economies. In the euro area, the impact of tighter financing conditions on growth is expected to be significantly offset by the positive effects of euro depreciation.

III.3 The advanced economies, which exhibited both year-on-year and sequential quarter-on-quarter recovery in the first quarter of 2010, face the major downside risk in the form of pressures from the markets to reverse fiscal expansion (Chart III.1b and c). Recovery in industrial production, however, continues (Chart III.1d). The global composite Purchasing Managers' Index (PMI) moderated somewhat in May and June 2010 as compared to its 34-month high level in April 2010, though it remained higher than its average level in 2009.

III.4 The improving demand conditions have helped in the recovery of world trade, which grew by about 25 per cent in value terms, on a year-on-year basis, during the first quarter of 2010. According to the IMF, exports of emerging and developing economies have witnessed higher growth than those of advanced economies in recent months. Despite the high growth, the global export performance is yet to reach its pre-crisis level. In fact, world exports declined by 3.0 per cent, on a quarter-on-quarter basis (Chart III.1e). For the year as a whole, the IMF projects world trade (in goods and services) to grow by 9 per cent as against 11.3 per cent decline in 2009.

III.5 In a recent joint report on G-20 trade and investment measures, the WTO, OECD and UNCTAD noted the importance of trade and investment to firmly anchor the economic recovery. Several countries continue to impose new trade restrictions, though there has been a decline in the number of new measures. According to the WTO, the new import restricting measures introduced during November 2009-May 2010 (along with new initiations of investigations into the imposition of trade remedy measures) cover close to 0.4 per cent of annual world imports as compared with 1.0 per cent during October 2008-October 2009. There has also been an increase in export restrictions worldwide in the form of introduction of new export duties, prohibitions, and export quotas. Economic conditions around the world, in particular persistent high levels of unemployment and mounting pressure on government finances, may continue to feed protectionist pressures. Unemployment rates in advanced economies remain high though there is evidence of stabilisation/ some decline in recent months (Chart III.1f). High fiscal stress levels of advanced economies is a potential risk to the global economy. If fiscal austerity is implemented to restore market normalcy, it could impede recovery. On the other hand, if the fiscal stress is allowed to continue to avoid weakening of recovery, adverse market response could add further volatility (Chart III.1g and h).

III.6 According to the IMF, capital flows to EMEs could initially decline because of waning risk appetite of global investors. The World Bank's recent assessment also suggests that capital inflows to developing countries could moderate on the back of increased competition for global savings from a five-fold increase in public sector financial requirements in high income countries. Because of higher growth prospects, lower public debt and monetary exit ahead of advanced economies, EMEs will, however, attract larger capital inflow in the later part of the year, which in turn could exert pressures on exchange rate and asset prices.

III.7 The external environment, thus, suggests that India's import growth could exceed its export growth because of the

Chart III.1: Key Global Indicators

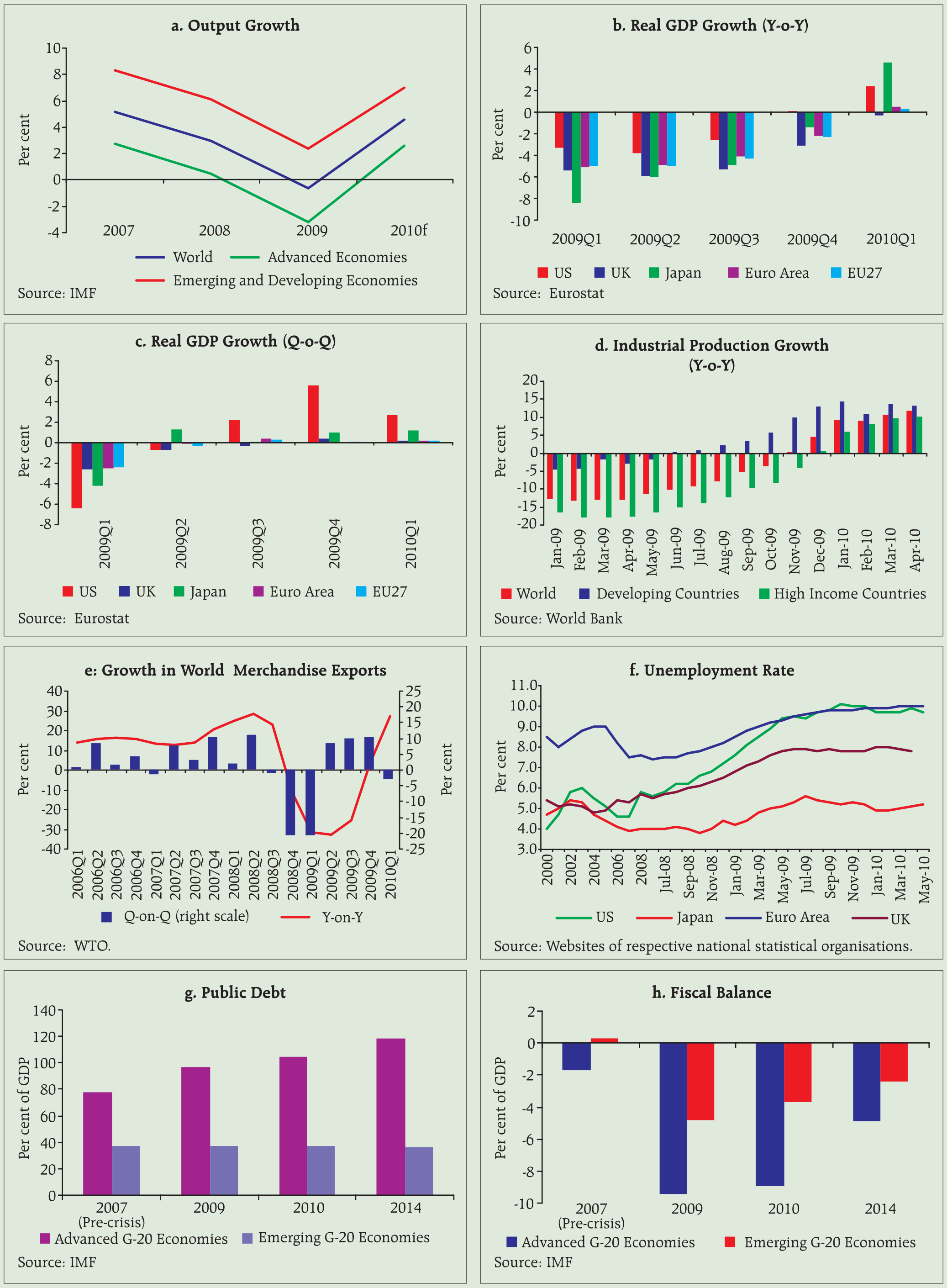
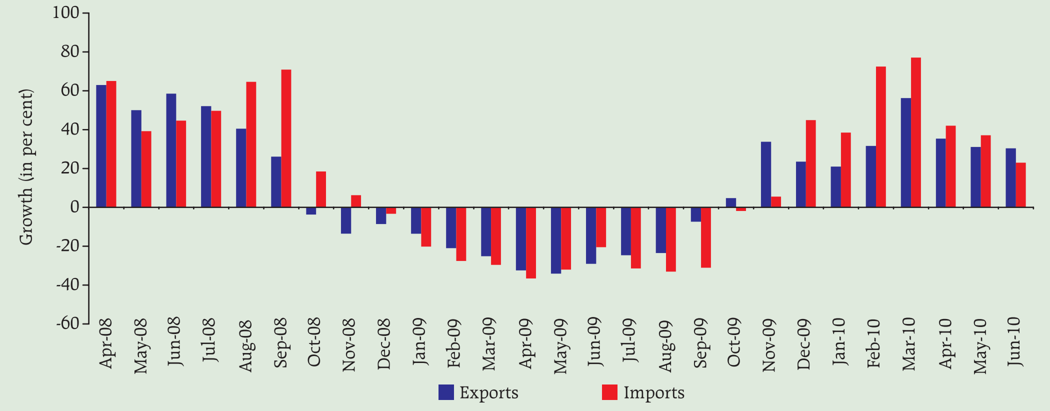


Chart III.2: India's Merchandise Trade



asymmetry in the speed of GDP growth between India and the global economy. As a result, possible widening of current account deficit may also require higher net inflows of foreign capital, which could remain volatile in a global market where risk appetite of investors may take some time to recover.

Merchandise Trade

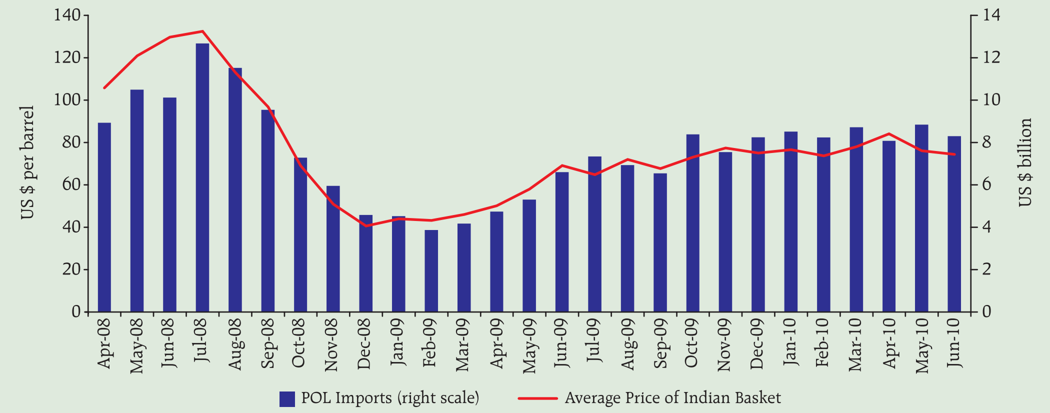
Exports

III.8 India's exports, which contracted sharply in the wake of the crisis, have exhibited positive growth since October 2009 (Chart III.2).

Imports

III.9 Imports too, which were hit by the crisis, have recovered sharply with high positive growth since November 2009. For the full year 2009-10, however, there was a net decline in imports. Oil and non-oil imports registered a decline of 7.0 per cent and 4.9 per cent, respectively, during 2009-10 (Chart III.3 and Table III.1).

Chart III.3: India's POL Imports and International Crude Oil Prices



III.10 The overall merchandise trade deficit during 2009-10 was at US$ 108 billion, down from US$ 118 billion in 2008-09, due to relatively larger decline in imports than exports during the year (Table III.1). In the first quarter of 2010-11, import growth, however, has exceeded export growth.

Balance of Payments (BoP)

Current Account

III.11 The deficit in the current account expanded to 2.9 per cent of GDP in 2009-10 from 2.4 per cent of GDP in 2008-09. In absolute terms, current account deficit rose in both quarters of the second half of 2009-10 over the quarters in the first half of the year, which coincided with stronger domestic recovery in growth, ahead of the global recovery (Table III.2). The merchandise trade deficit in 2009-10 at US$ 117.3 billion was similar to US$ 118.7 billion in 2008-09. As percentage of GDP, however, the trade deficit was lower at 8.9 per cent in 2009-10 as compared with 9.8 per cent in 2008-09. The wider deficit in the current account, thus, resulted from lower surplus in the invisibles account.

Invisibles

III.12 Invisibles surplus was lower at US$ 79 billion in 2009-10 (6.0 per cent of GDP) from US$ 90 billion in 2008-09, mainly due to decline in receipts under transportation, business, financial and communication services coupled with significant increase in payments of miscellaneous services such as business and financial services (Table III.3). During 2009-10, invisibles surplus financed 67.3 per cent of the trade deficit as against 75.8 per cent during 2008-09.

Capital Account

III.13 The surplus in the capital account increased during the fourth quarter of 2009-10 mainly due to large inflows under portfolio investments and short-term trade credits. However, net external commercial borrowings (ECBs) remained low, mainly due to increased repayments of commercial loans. Inflows under foreign direct investment witnessed some moderation. Banking capital registered net outflows on account of build-up of assets abroad by banks coupled with net outflows under NRI deposits. For the year as a whole, net capital

Table III.1: India's Merchandise Trade

Item	April-March		April-May			
	2009-10 P		2009-10 R		2010-11 P	
	Absolute (US$ billion)	Growth (%)	Absolute (US$ billion)	Growth (%)	Absolute (US$ billion)	Growth (%)
1	2	3	4	5	6	7
Exports	178.7	-3.6	24.8	-33.3	33.0	33.2
Oil	28.1	2.1	3.0	-45.9	..	..
Non-oil	150.5	-4.6	21.8	-31.0	..	..
Imports	286.8	-5.6	39.2	-34.3	54.7	39.5
Oil	87.1	-7.0	10.0	-48.3	16.9	68.5
Non-oil	199.7	-4.9	29.2	-27.6	37.8	29.6
Trade Balance	**-108.2**	**-8.6**	**-14.4**	**-36.1**	**-21.7**	**50.3**
Non-Oil Trade Balance	**-49.2**	**-5.9**	**-7.4**	**-15.3**	**..**	**..**

R: Revised. P: Provisional. .. Not Available.

Source: DGCI&S.

Table III.2: India's Balance of Payments

(US$ billion)

	2008-09 Apr-Mar PR	2009-10 Apr-Mar P	2008-09 Jan-Mar PR	2009-10 Apr-Jun PR	2009-10 Jul-Sep PR	2009-10 Oct-Dec PR	2009-10 Jan-Mar P
1	2	3	4	5	6	7	8
1. Exports	189.0	182.2	38.5	39.2	43.5	47.1	52.4
2. Imports	307.7	299.5	58.7	64.8	72.6	78.1	83.9
3. Trade Balance (1-2)	-118.7	-117.3	-20.2	-25.6	-29.1	-31.1	-31.5
4. Net Invisibles	89.9	78.9	19.0	21.2	20.4	18.9	18.5
5. Current Account Balance (3+4)	-28.7	-38.4	-1.2	-4.5	-8.8	-12.2	-13.0
6. Gross Capital Inflows	312.4	344.0	59.4	77.1	95.4	81.3	90.2
7. Gross Capital Outflows	305.2	290.4	58.0	73.1	76.6	66.6	74.1
8. Net Capital Account (6-7)	7.2	53.6	1.4	4.0	18.8	14.7	16.1
9. Overall Balance (5+8)#	-20.1	13.4	0.3	0.1	9.4	1.8	2.1
Memo:							
i. Export growth (%)	13.7	-3.6	-20.0	-31.8	-18.9	19.3	36.2
ii. Import growth (%)	19.4	-2.7	-20.8	-21.7	-21.7	6.3	43.0
iii. Trade balance (as a % of GDP)	-9.8	-8.9					
iv. Net invisibles growth (%)	18.7	-12.2	-15.8	-3.7	-23.3	-15.6	-2.6
v. CAD as a % of GDP	2.4	2.9					
vi. Foreign Exchange Reserves (as at end of the period)	252.0	279.1	252.0	265.1	281.3	283.5	279.1

P: Preliminary. PR: Partially Revised. #: Includes errors and omissions. CAD: Current Account Deficit.

flows were significantly higher (4.1 per cent of GDP) as compared with the previous year (0.6 per cent of GDP), mainly due to large inflows under FDI, portfolio investments and short-term trade credits (Table III.4 and Chart III.4).

Table III.3: Invisibles Gross Receipts and Payments

(US$ billion)

Item	Invisibles Receipts				Invisibles Payments			
	April-March		Jan-March		April-March		Jan-March	
	2008-09 PR	2009-10 P	2008-09 PR	2009-10 P	2008-09 PR	2009-10 P	2008-09 PR	2009-10 P
1	2	3	4	5	6	7	8	9
1. Travel	10.9	11.9	2.7	3.4	9.4	9.3	2.6	2.6
2. Transportation	11.3	11.1	2.9	3.1	12.8	11.9	2.5	3.6
3. Insurance	1.4	1.6	0.3	0.4	1.1	1.3	0.3	0.3
4. Govt. not included elsewhere	0.4	0.4	0.1	0.1	0.8	0.5	0.4	0.2
5. Miscellaneous	77.7	68.7	17.7	19.9	27.9	36.5	7.3	12.2
Of which:								
Software	46.3	49.7	10.8	14.3	2.8	1.5	0.5	0.3
Non-Software	31.4	19.0	6.9	5.6	25.1	35.0	6.8	11.9
6. Transfers	47.5	54.4	10.0	13.2	2.7	2.3	0.4	0.6
Of which								
Private Transfers	46.9	53.9	9.8	13.1	2.3	1.8	0.3	0.5
7. Income	14.3	13.0	3.4	2.7	18.8	20.4	4.6	4.8
Investment Income	13.5	12.1	3.2	2.5	17.5	18.7	4.3	4.3
Compensation of Employees	0.8	0.9	0.2	0.2	1.3	1.7	0.3	0.5
Total (1 to 7)	**163.5**	**161.2**	**37.1**	**42.8**	**73.6**	**82.3**	**18.1**	**24.4**

P: Preliminary. PR: Partially Revised.

Table III.4: Net Capital Flows

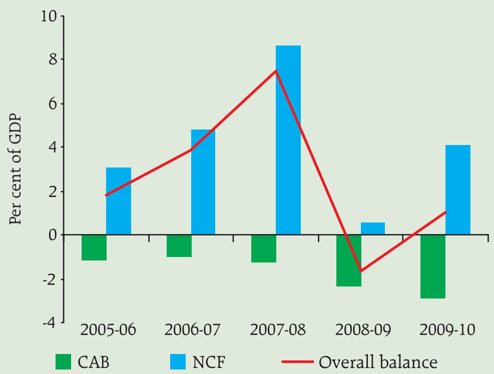
(US$ billion)

	2008-09 Apr-Mar PR	2009-10 Apr-Mar P	2009-10 Apr-Jun PR	Jul-Sep PR	Oct-Dec PR	Jan-Mar P
1	2	3	4	5	6	7
1. Foreign Direct Investment (FDI)	17.5	19.7	6.1	6.5	3.9	3.2
Inward	35.0	31.7	8.7	10.7	7.1	5.1
Outward	17.5	12.0	2.6	4.2	3.2	1.9
2. Portfolio Investment	-14.0	32.4	8.3	9.7	5.7	8.8
Of which:						
FIIs	-15.0	29.0	8.2	7.0	5.3	8.5
ADR/GDRs	1.2	3.3	0.0	2.7	0.5	0.1
3. External Assistance	2.6	2.0	0.1	0.5	0.6	0.8
4. External Commercial Borrowings	7.9	2.5	-0.5	1.2	1.7	0.1
5. NRI Deposits	4.3	2.9	1.8	1.0	0.6	-0.6
6. Banking Capital excluding NRI Deposits	-7.5	-0.8	-5.2	3.3	1.3	-0.4
7. Short-term Trade Credits	-1.9	7.7	-1.5	0.8	3.3	5.0
8. Rupee Debt Service	-0.1	-0.1	–	–	–	-0.1
9. Other Capital	-1.5	-12.7	-5.2	-4.3	-2.4	-0.9
Total (1 to 9)	**7.2**	**53.6**	**4.0**	**18.8**	**14.7**	**16.1**

P: Preliminary. PR: Partially Revised. – : Negligible.

III.14 Available information during 2010-11 so far shows some moderation in capital inflows (Table III.5). There has been a perceptible slowdown in net FII inflows and inflows under NRI deposits, but FDI to India remains stable reflecting the confidence of global investors in India's growth prospects.

Chart III.4: India's Balance of Payments



CAB: Current Account Balance. NCF: Net Capital Flows.

III.15 Notwithstanding some depreciation of the rupee against the US dollar in the first

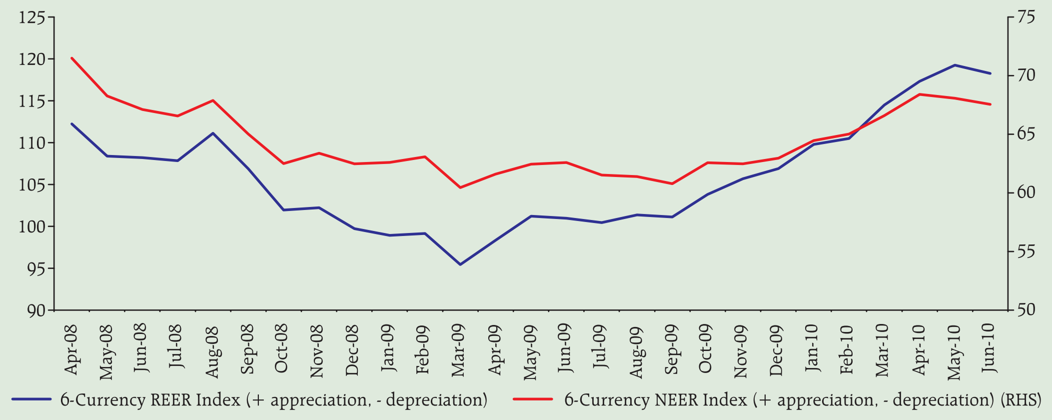
Table III.5: Recent Trends in Capital Flows

(US$ billion)

Component	Period	2009-10	2010-11
1	2	3	4
FDI to India	April-May	4.4	4.4
FIIs (net)	April-July 16	8.7	6.2
ADRs/GDRs	April-June	0.04	1.0
ECB Approvals	April-June	2.7	5.3
NRI Deposits (net)	April-June	1.8	1.3

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

Chart III.5: 6-Currency REER and NEER



quarter of 2010-11 due to volatile portfolio flows, the appreciation of the real effective exchange rate continued, reflecting high inflation differentials between India and its trading partners (Chart III.5 and Table III.6).

Foreign Exchange Reserves

III.16 During the year 2009-10, India's foreign exchange reserves, on a BoP basis (*i.e.*, excluding valuation effects), increased by US$ 13.4 billion as against a decline of US$ 20.1 billion during the previous year. The valuation gain, which reflects the depreciation of the US dollar against major international currencies, was about US$ 13.6 billion during 2009-10 as compared to a valuation loss of US$ 37.7 billion recorded during the previous year. Accordingly, the valuation gains alone accounted for about 50.4 per cent of the increase in the reserves during 2009-10. Including the valuation effects, India's foreign exchange reserves increased by US$ 27.1 billion during 2009-10 to reach the level of US$ 279.1 billion as at end-March 2010 (Table III.7 and Chart III.6). India's foreign exchange reserves stood at US$ 281.9 billion as on July 16, 2010.

Table III.6: Nominal and Real Effective Exchange Rates of the Indian Rupee (Trade Based Weights, Base : 1993-94 = 100)

		(Per cent, appreciation +/depreciation -)			
	Index June 2010 P	2008-09	2009-10 P	2009-10 (Apr-Jun) P	2010-11 (Apr-Jun) P
1	2 3	4	5	6	
36-REER	101.2 ^	-13.6	13.3	1.7 #	1.4 #
36-NEER	89.6 ^	-10.3	9.3	4.6 #	1.5 #
6-REER	118.3	-14.0	20.0	5.8	3.3
6-NEER	67.6	-14.8	10.2	3.5	1.4
Rs/USD	47.1 @	-21.5	12.9	5.2 *	-4.2 *

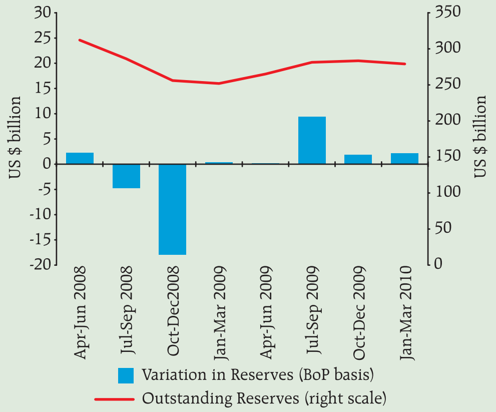
NEER : Nominal Effective Exchange Rate.
REER : Real Effective Exchange Rate. P: Provisional.
#: April-May. ^: May 2010. *: Up to July 20.
@: Rupee-US dollar exchange rate as on July 20, 2010
Note: Rise in indices indicates appreciation of the rupee and *vice versa.*

Table III.7: Foreign Exchange Reserves

(US$ million)

Month (End Period)	Gold	SDR	Foreign Currency Assets	Reserve Position in the IMF	Total (2+3+4+5)
1	2	3	4	5	6
March 2009	9,577	1	241,426	981	251,985
March 2010	17,986	5,006	254,685	1,380	279,057
July 16, 2010	19,894	4,987	255,677	1,343	281,901

Chart III.6: India's Foreign Exchange Reserves



External Debt

III.17 As at end March 2010, India's external debt stock stood at US$ 261.4 billion, an increase of US$ 36.9 billion over its level at end-March 2009. The increase was mainly on account of increase in long-term debt, such as external commercial borrowings, NRI deposits and SDR related liabilities (Table III.8). Of the total increase in India's external debt, the valuation effect on account of depreciation of the US dollar against major international currencies accounted for 17.8 per cent. Further, short-term debt was US$ 52.5 billion on original maturity basis and was US$ 107.6 billion on residual maturity basis. In terms of currency composition, the US dollar denominated debt accounted for 58.2 per cent of India's total external debt at end-March 2010. Key debt sustainability indicators suggest that India's external debt remain at comfortable level.

Table III.8: India's External Debt

(US$ billion)

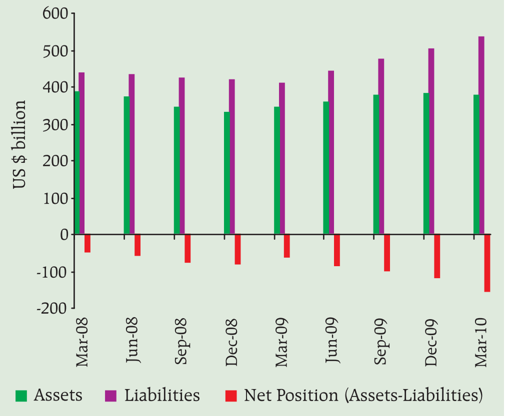
Item	End-March 2008	End-March 2009 PR	End-March 2010 P	Variation (March 2010 over March 2009)	
				Amount	Per cent
1	2	3	4	5	6
1. Multilateral	39.5	39.5	42.7	3.2	8.1
2. Bilateral	19.7	20.6	22.6	2.0	9.6
3. International Monetary Fund	1.1	1.0	6.0	5.0	493.4
4. Trade Credit (above 1 year)	10.3	14.5	16.9	2.4	16.5
5. External Commercial Borrowings	62.3	62.4	71.0	8.6	13.7
6. NRI Deposit	43.7	41.6	48.1	6.5	15.7
7. Rupee Debt	2.0	1.5	1.6	0.1	8.5
8. Long-term (1 to 7)	178.7	181.2	209.0	27.8	15.4
9. Short-term	45.7	43.4	52.5	9.1	21.0
Total (8+9)	**224.4**	**224.5**	**261.4**	**36.9**	**16.5**
					(per cent)
Total Debt /GDP	18.1	20.5	18.9		
Short-term Debt/Total Debt	20.4	19.3	20.1		
Short-term Debt/Reserves	14.8	17.2	18.8		
Concessional Debt/Total Debt	19.7	18.7	16.8		
Reserves/Total Debt	138.0	112.2	106.7		
Debt Service Ratio	4.8	4.6	5.5		

P: Provisional. PR: Partially Revised.

International Investment Position

III.18 India's net international liabilities increased by US$ 34.5 billion during the fourth quarter of 2009-10 mainly due to increase in net inflows under portfolio and foreign direct investment to India. Total external financial assets decreased marginally by US$ 1.8 billion to US$ 378.8 billion as at end-March 2010 over the previous quarter due to decline in reserve assets. The reserve assets declined by US$ 4.4 billion due to the valuation loss of US$ 6.6 billion, owing to the appreciation of the US dollar against major international currencies during the quarter. Total international financial liabilities increased by US$ 32.8 billion over the previous quarter to US$ 536.5 billion as at end-March 2010 mainly on account of increase in inflows under both portfolio investment and foreign direct investment (Chart III.7).

Chart III.7: International Investment Position of India



III.19 Overall, the external sector developments during 2009-10 suggest higher absorption of foreign capital through a higher current account deficit, a factor that contributed to the recovery. Trends in capital inflows during 2010-11 so far suggest some moderation, while import growth has remained ahead of export growth, reflecting stronger growth in India relative to the global recovery. The near-term external sector outlook could be conditioned by the impact of expected higher import growth relative to exports on the current account deficit and its financing through the capital account in an environment of expected moderation in the capital flows to EMEs.