VI EXTERNAL SECTOR

6.1 The most significant feature of macroeconomic performance in 2003-04 was the developments in the external sector. Aided by a favourable external environment, India's balance of payments was characterised by robust exports of both merchandise and invisibles, a current account surplus of the order of 1.4 per cent of GDP, massive capital inflows brought in by sustained investor optimism about the resurgence of growth in India and an unprecedented accretion to the foreign exchange reserves which surpassed the level of external debt by the end of the year. This was also reflected in a marked improvement in India's international investment position. Under the circumstances, managing the surges in capital flows turned out to be an important objective of macroeconomic management during 2003-04. Strategic shifts in the policy stance were reflected in aggressive prepayment of external debt by official and private sectors to benefit from softer international interest rates, significant liberalisation of the exchange and payments system extended to freeing outward capital flows, fine tuning of interest rates on non-resident deposits to align them more closely with international interest rates and a tighter linkage between funds raised abroad and end-use domestically.

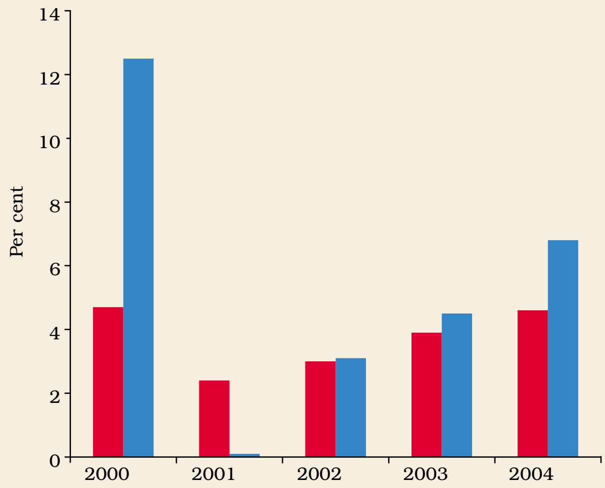
6.2 This Section reviews developments in India's external accounts in 2003-04. Beginning with a survey of international economic developments, the Section delineates the strong improvement in merchandise trade in terms of compositional and geographical shifts in exports and imports. The Section also highlights the crucial role played by invisibles in sustaining current account surpluses. The analysis underscores the growing significance of exports of software and IT enabled services and workers' remittances. A review of developments in the capital account reflects the return of non-debt creating flows to the top of the hierarchy of capital flows into India. The impact of these developments on the foreign exchange reserves and the international investment position are also set out in this Section.

INTERNATIONAL DEVELOPMENTS

6.3 World real GDP is estimated to have risen by 3.9 per cent in 2003 from 3.0 per cent in 2002 as the global recovery took root and extended its reach to all regions of the world, *albeit* with variations in the pace and spread (Appendix Table VI.1). The strength of the upturn was strongest in emerging Asia - led by China and India - and the US. Global growth surged to six per cent in the second half of 2003 on an annualised basis, regaining the momentum achieved before the onset of the synchronised downturn in 2000. More recent data indicate that the strong growth of 2003 has continued into early 2004. According to the IMF, the 'solid' improvement in global activity was associated with an acceleration in world trade, a sharp pick-up in industrial production and a resumption of business and consumer confidence. World trade shed the sluggishness characterising the first half of 2003 and expanded by 4.5 per cent during 2003, although it remained well below the average of 6.4 per cent recorded in the 1990s. Nominal trade flows were much more buoyant than real trade volumes with world exports in US dollar terms rising by 16.5 per cent due to weakening of the US dollar. China turned out to be the key driver of world trade, with imports rising by 41 per cent in US dollar terms. Accordingly, Asia recorded the strongest expansion in trade, followed by North America and Africa. Higher commodity prices, partly reflecting the depreciation of the US dollar, translated into gains in terms of trade for fuel and non-fuel exporters (Chart VI.1).

6.4 Exceptionally strong growth in the US in the second half of 2003 was led by private consumption buoyed up by the monetary-fiscal stimulus as well as an

Chart VI.1 : Growth in World Output and Trade



Note : Data for 2004 are IMF Projections.
Source : *World Economic Outlook*, IMF, April 2004

upturn in business investment on account of continuing productivity gains and improvement in corporate profitability on the back of balance sheet restructuring. Employment, however, remained weak by historical standards and, along with the massive trade and fiscal deficits, carried the most serious risks to recovery. Growth in the UK also remained strong and was supported by the cyclical upturn and expansionary fiscal policy. Housing price concerns prompted a counter-cyclical monetary policy response in the second half of 2003. In the Euro area, growth remained subdued due to weak domestic demand towards the close of 2003, although incipient recovery appears to have set in. In Japan, an exceptionally strong recovery was reflected in buoyant exports and a rebound in private investment. Deflationary pressures eased considerably with a modest improvement in the health of the financial system. Growth in emerging Asia shrugged off the SARS - related slowdown and bounded to seven per cent in 2003 led by strong domestic consumption and exports, despite appreciation of local currencies against the US dollar. A noteworthy development in 2003 was the emergence of China as a major export destination and the main driver of intra-regional trade. The economies in East Asia and the South-East Asia gained considerably from exports to China. Fears of overheating in China cast a shadow on macroeconomic performance in the region towards the close of 2003. Growth in the Latin America region strengthened with rising exports, supported modestly by domestic demand. In Africa, improvement in growth was mainly confined to oil exporting countries.

6.5 Despite large fiscal deficits, policy interest rates remained at historically low levels in most industrial countries - zero in Japan and Switzerland, one per cent in the US, two per cent in the Euro area, and at or near historic lows in the UK and Canada. Domestic bond markets rallied in most countries with some consolidation towards the end of the year tempering the heightened appetite for risk. Financial markets witnessed a broad based rally with rise in equity prices and decline in bond spreads, particularly emerging market bonds. Reflecting improved investment opportunities and receding systemic risks, capital flows to emerging market economies (EMEs) increased to US $ 131.2 billion in 2003 from US $ 47.0 billion in 2002 (Table 6.1).

6.6 Inflation remained generally subdued in 2003. Commodity prices surged in response to changing demand-supply balances, especially of intermediate commodities. Fuel prices soared, driven up by increased demand, production cuts by the OPEC and continuing geo-political uncertainties. Inflationary expectations in industrial countries remained low on account of continued excess capacity and weak labour markets. Owing to competitive pressures, corporates preferred to absorb rising input costs into their profits which also kept consumer prices low.

Table 6.1: Net Capital Flows to Emerging Markets and Developing Countries

(US $ billion)

Item	2003	2002	2001
1	2	3	4
Private capital flows	**131.2**	**47.0**	**20.6**
Private direct investment	119.3	139.3	189.1
Private portfolio investment	-87.5	-98.6	-95.7
Other private capital flows	99.3	6.3	-72.8
Official flows	**-7.2**	**3.3**	**25.8**

Source : *World Economic Outlook*, IMF, April 2004.

6.7 Although overall global growth prospects have improved markedly, some risks and uncertainties still remain. The major downside risks facing the global economy continue to emanate from global imbalances and the associated possibility of disruptive currency adjustments and lingering structural problems in the Euro area and Japan. Many developing countries are experiencing current account surpluses *vis-á-vis* the US. The fiscal deficit in the US, which was earlier being financed by domestic private sector, is now being financed by central banks of Asia. According to the IMF, net financial obligations of the US to the rest of the world could reach 40 per cent of its total economy within a few years which would be unprecedented. The twin deficits in the US economy is a challenge confronting the international community. Some of the other downside risks facing the global economy appear to be arising from (i) the rising global commodity prices, particularly oil prices, (ii) increasing probability of a global hardening of interest rates and the subsequent adjustments, and (iii) the timing and sequencing of the policy induced slowdown of the 'overheated' Chinese economy aimed at ensuring a 'soft landing'.

6.8 Inflation is slowly returning worldwide with the narrowing of output gaps, thus, restricting ability of producers to absorb input costs into profit margins. Higher fuel prices, largely reflecting the spurt in demand from the US and China, pose serious inflation and growth risks. The International Energy Agency (IEA), in a report released in 2004, has warned that a US $ 10 price increase per barrel of oil sustained over one year could trim about 0.8 per cent of Asia's overall economic growth. Some non-fuel commodity prices have flattened after reaching peaks in the first quarter with supply responding to increasing demand. Accordingly, central banks have been sensitising markets to exit strategies from the accommodative monetary policy stance that prevailed over the past two years. Leading central banks such as the US Federal

Reserve System and the Bank of England raised their key policy rates by 25 basis points each in June 2004 and again by 25 basis points each in August 2004.

BALANCE OF PAYMENTS

6.9 The evolution of India's balance of payments (BoP) during 2003-04 reflected robust improvements on several fronts. Merchandise exports surged ahead of the growth of world trade, drawing strength from a distinct firming up of activity in the domestic economy and sustained external demand. Software exports remained resilient and vigorous in the face of the IT slowdown worldwide and a protectionist reaction against outsourcing in some industrial countries. Remittances from expatriate Indians rose strongly, making India one of the largest recipients of such flows. Accordingly, even as burgeoning import demand expanded the merchandise trade deficit to about 2.8 per cent of GDP, the current account recorded a surplus for the third year in succession on a steadily expanding scale. A noteworthy aspect of the strength of the current account is that the rising degree of openness - merchandise and invisibles transactions taken together - estimated at close to 37 per cent of GDP in 2003-04 was driven by a robust export performance. This augurs well for the rising international competitiveness of the Indian economy and the sustainability of the external sector (Table 6.2 and Appendix Table VI.2).

6.10 Significant two-way movements in capital flows dominated the BoP outcome in 2003-04. The strong improvement in India's macroeconomic performance created a preferred habitat for private capital flows, led by unprecedented flows of portfolio investment. This was also reflected in an upgradation of the sovereign rating to investment grade during 2003-04 for the first time since 1997-98. Notwithstanding large outflows in the form of policy-induced prepayments of multilateral and bilateral loans as well as the one-shot redemption of Resurgent India Bonds (RIBs), the capital account recorded sustained inflows. Consequently, net capital inflows in 2003-04 were the highest ever. By March 2004, India had accumulated the sixth largest stock of international reserves in the world, sufficient to finance

Table 6.2: Balance of Payments – Key Indicators

(US $ million)

Item/Indicator	2003-04(P)	2002-03	2001-02	2000-01	1999-2000	1990-91
1	2	3	4	5	6	7
i) Trade Balance	-16,706	-12,910	-12,703	-14,370	-17,841	-9,437
ii) Invisibles, net	25,425	17,047	13,485	10,780	13,143	-243
iii) Current Account Balance	8,719	4,137	782	-3,590	-4,698	-9,680
iv) Capital Account, net	22,122	12,113	10,573	10,018	10,444	7,056
v) Overall Balance #	31,421	16,980	11,757	5,856	6,402	-2,492
vi) Foreign Exchange Reserves* [Increase(-), Decrease (+)]	-31,421	-16,980	-11,757	-5,830	-6,142	1,278
Indicators (per cent)						
1. Trade						
i) Exports/GDP	10.4	10.3	9.4	9.8	8.4	5.8
ii) Imports/GDP	13.2	12.8	12.0	13.0	12.4	8.8
iii) Export Volume Growth	n.a.	21.8	3.9	23.9	15.5	11.0
2. Invisibles						
i) Invisible Receipts/GDP	8.6	8.5	7.7	7.6	6.8	2.4
ii) Invisible Payments/GDP	4.4	5.2	4.9	5.3	3.8	2.4
iii) Invisibles (Net)/GDP	4.2	3.3	2.8	2.3	2.9	-0.1
3. Current Account						
i) Current Receipts@/GDP	19.0	18.7	17.0	17.4	15.1	8.0
ii) Current Receipts Growth@	19.8	17.6	2.4	17.6	12.9	6.6
iii) Current Receipts@/ Current Payments	107.7	104.1	100.5	95.3	93.0	71.5
iv) Current Account Balance/ GDP	1.4	0.8	0.2	-0.8	-1.0	-3.1
4. Capital Account						
i) Foreign Investment/GDP	3.0	1.1	1.7	1.5	1.2	0.0
ii) Foreign Investment/Exports	25.5	10.7	18.1	15.1	13.8	0.6
5. Others						
i) Debt - GDP Ratio	17.6	20.2	21.0	22.6	22.1	28.7
ii) Debt - Service Ratio	18.3	15.1	13.9	17.2	16.2	35.3
iii) Liability - Service Ratio	19.1	16.1	14.9	18.4	17.0	35.6
iv) Import Cover of Reserves (in months)	17.0	13.8	11.3	8.6	8.2	2.5

P : Preliminary. n.a. : Not available.
: Includes errors and omissions. * : Excluding valuation changes. @ : Excluding official transfers.

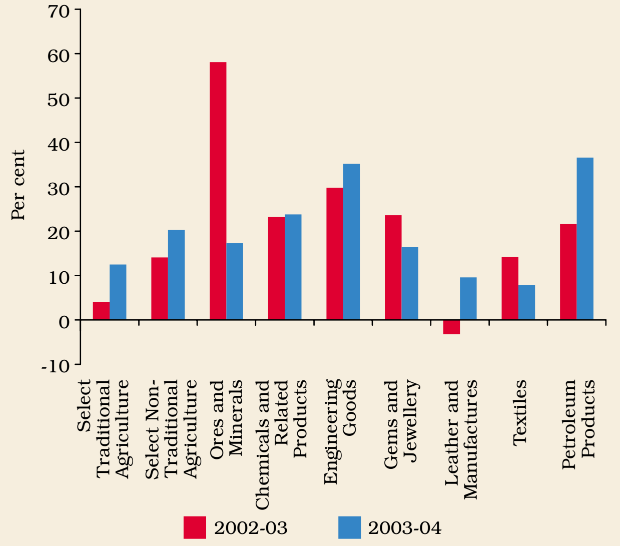
17 months of imports and over five years of debt servicing. The level of reserves exceeded the level of external debt for the first time in India's history. In 2003-04, India also turned creditor to the IMF.

Merchandise Trade

6.11 According to the Directorate General of Commercial Intelligence and Statistics (DGCI&S), merchandise exports grew by 20.4 per cent in US dollar terms during 2003-04 on top of 20.3 per cent recorded in the preceding year (Appendix Table VI.3). Export performance surpassed, by a significant measure, the target set for the year (*i.e.,* 12 per cent) and reflected the growing competitiveness of the Indian manufacturing sector. Certain traditional items in the primary products category did suffer erosion in competitiveness.

6.12 Commodity-wise data for 2003-04 indicate that manufactured products - mainly engineering goods, chemicals and gems and jewellery - were the main drivers of export growth (Appendix Table VI. 4). The rapid expansion in exports of engineering goods, propelled by technology-intensive items such as automobiles and iron and steel, is an indication of the increasing technological sophistication and the growing competitiveness of Indian manufacturing. Exports of gems and jewellery recorded a sharp increase, benefiting from the promotional measures announced in the EXIM Policy. Exports of petroleum products also rose sharply, reflecting the maturing of domestic refining capacity. In the textiles segment, while exports of items using domestic raw materials (*i.e.,* cotton yarn and fabrics) declined, those using synthetic/imported raw materials (man made yarn, fabrics and made-ups) registered a sharp increase. Exports of primary products declined mainly in respect of the traditional items such as cashew, rice and marine products. On the other hand, exports of non-traditional items such as wheat, other cereals, poultry products, fruits and vegetables, meat and meat preparations maintained the rising profile acquired in recent years (Chart VI.2). Over the years, the composition of primary products has shifted significantly in favour of non-traditional items.

Chart VI.2 : Exports of Major Commodities (Growth Rates)



6.13 The destination pattern of India's exports shows that exports to Asian countries increased sharply, indicative of the role of improvement in the macroeconomic performance in generating demand (Table 6.3). The pace of expansion in exports to the OECD countries moderated. Among the advanced economies, however, exports to France, Germany, Italy, the Netherlands and the UK increased sharply. Exports to the US also increased, *albeit* at a slower pace, while exports to Japan declined.

Table 6.3: Export Destinations

(Per cent)

Country	India's Export Growth		Partner Country's Real GDP Growth		Country	India's Export Growth		Partner Country's Real GDP Growth	
	2003-04	2002-03	2003	2002		2003-04	2002-03	2003	2002
1	2	3	4	5	1	2	3	4	5
1. UAE	52.7	33.5	7.0	1.9	12. France	20.1	13.7	0.2	1.2
2. People's Republic of China	49.8	107.5	9.1	8.0	13. Germany	19.7	17.8	-0.1	0.2
3. Singapore	48.9	46.2	1.1	2.2	14. Saudi Arabia	19.1	13.8	6.4	1.0
4. Sri Lanka	43.4	46.0	5.5	3.9	15. Malaysia	18.6	-3.1	5.2	4.1
5. Iran	40.1	158.8	5.9	7.2	16. South Korea	18.2	36.8	3.1	7.0
6. Bangladesh	40.0	17.3	5.4	4.9	17. Thailand	16.3	12.3	6.7	5.4
7. Indonesia	36.0	54.8	4.1	3.7	18. Canada	8.8	19.4	1.7	3.3
8. Italy	25.5	12.5	0.3	0.4	19. Belgium	8.7	19.5	1.1	0.7
9. Hong Kong	24.4	10.4	3.3	2.3	20. US	5.2	28.0	3.1	2.2
10. Netherlands	21.9	21.3	-0.8	0.2	21. Russia	0.7	-11.8	7.3	4.7
11. UK	21.5	15.5	2.3	1.7	22. Japan	-8.0	23.4	2.7	-0.3

Sources : DGCI&S and IMF, *World Economic Outlook*, April 2004.

6.14 India's exports to the SAARC countries and China grew sharply by 47.8 per cent and 49.8 per cent, respectively. China emerged as a major trading partner for India. Exports to other major Asian countries such as Hong Kong, Indonesia, Singapore and the UAE also increased sharply. India's participation in regional/bilateral trading arrangements with Asian countries is being increasingly reflected in the changing destination profile of exports in the favour of these countries (Box VI.1).

Box VI.1

Regional Trading Agreements in Asia

Preferential trade among and within a defined geographical trade region is perceived as a second best option in the context of current progress in trade negotiations under the aegis of the World Trade Organization (WTO). According to the WTO, 43 per cent of global merchandise trade is channelised through preferential trading arrangements and this is expected to cross 50 per cent by 2005.

The South Asian Preferential Trade Agreement (SAPTA) among the SAARC countries (Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka), which was signed in April 1993, became operational in December 1995. The Governments of South Asian countries decided in May 1997 to move from preferential trading to free trade by 2001, thereby transforming SAPTA into the South Asian Free Trade Agreement (SAFTA) as a part of the larger cooperation plan of the SAARC. In January 2004, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka signed a free trade zone agreement under SAFTA whereby reduction in trade barriers among member countries would begin in 2006.

India has also been actively participating in the regional grouping of Bangladesh, India, Myanmar, Sri Lanka, Thailand Economic Cooperation (BIMST-EC) to promote regional cooperation in trade and investment among member countries. In the Joint Declaration issued after the BIMST-EC Summit held at Bangkok in July 2004, it was agreed that the grouping would henceforth be known as Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC). Member countries, *inter alia*, agreed to focus on specific areas of cooperation, including but not limited to trade and investment, transport and communication, tourism, energy, human resource development, agriculture, fisheries, science and technology and people-to-people contact. Furthermore, the countries agreed to explore the expansion of BIMSTEC cooperation into areas of culture, education, public health, protection of bio-diversity and traditional knowledge, rural community development, small and medium scale enterprise, construction, environment, information and communication technology, biotechnology, weather and climatic research, natural disaster mitigation and management. Members also agreed to take all possible steps including timely completion of the Free Trade Area negotiations for realisation of the full potential of BIMSTEC trade and investment. India made a number of proposals, which, *inter alia*, included hosting a BIMSTEC Ministerial meeting on Energy Cooperation in 2005, setting up a BIMSTEC Centre on Weather and Climate Research and Information in New Delhi and sharing remote sensing data on agriculture.

Efforts have also been made to promote mutually beneficial bilateral trade. The Indo-Sri Lanka Free Trade Agreement signed in December 1998 became operational in March 2000. Under the agreement, tariff on a large number of items would be phased out within an agreed timeframe. While India would reduce the tariff to zero in three years, Sri Lanka would do so in eight years. Both sides would maintain negative lists of items where protection to local industry is considered necessary. For furthering bilateral economic co-operation, a Joint Study Group set up in 2003, recommended a Comprehensive Economic Partnership Agreement (CEPA) between India and Sri Lanka covering broader areas of services and investment in addition to trade in goods. India and Bangladesh have agreed to streamline customs and allied administrative procedures to facilitate unhindered flow of trade between the two countries. India agreed to provide duty free access to 40 tariff lines at a 6-digit level corresponding to 16 categories of Bangladesh products. India and Nepal have extended the validity of the bilateral trade treaty between the two countries for a further period of five years with modification to take care of some of the areas of mutual concern. The treaty would expire on March 5, 2007.

There are two major regional trading groups in Asia. A Preferential Trading Agreement (PTA) among the ASEAN members (Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam) signed in 1979, provides for preferential tariffs and non-tariff treatment. Realising the negligible impact of this effort on trade among members due to limited product coverage, the ASEAN countries agreed in January 1991 to establish an ASEAN Free Trade Area (AFTA) by the year 2008. A Framework Agreement setting out the transition towards the AFTA and a Common External Preferential Tariff (CEPT), which came into force in 1994, was accepted as the main formal tariff-cutting mechanism for achieving the free trade area.

India has a sizeable trade with the ASEAN. This group accounted for 9.1 per cent of India's total exports and 9.5 per cent of its imports in 2003-04. Efforts have been made during the last few years to strengthen India's ties with the ASEAN countries. A Framework Agreement on Comprehensive Economic Cooperation was signed between India and the ASEAN in October 2003 with the objective, *inter alia*, of strengthening and enhancing economic, trade and investment co-operation. The contemplated measures for economic co-operation include negotiations for establishing an India-ASEAN Regional Trade and Investment Area (RTIA).

Furthermore, for improving bilateral economic cooperation between India and Singapore, a Joint Study Group on India-Singapore Comprehensive Economic Cooperation Agreement (CECA) was constituted, which submitted its Report in April 2003.

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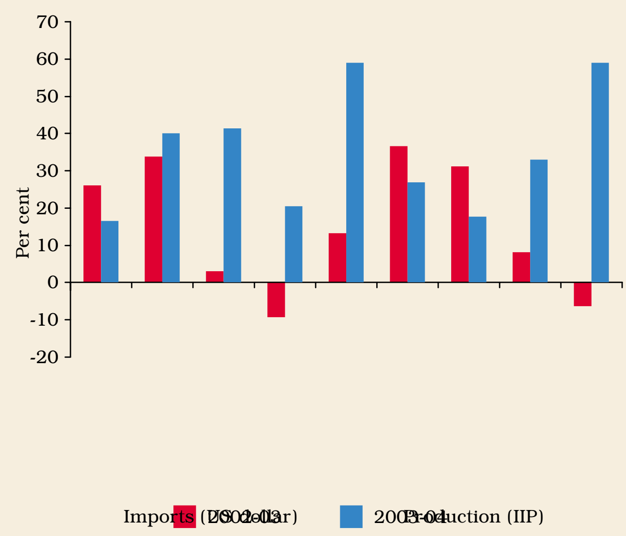
6.15 India's imports increased by 25.4 per cent during 2003-04 reflecting a pick-up in domestic industrial activity (Appendix Table VI.3). Oil imports recorded a moderate growth of 16.6 per cent mainly on account of increased volumes driven by the growing demand (consumption *plus* exports) and the stagnant domestic production of crude oil (*viz.,* 33 million tonnes in 2002-03) (Chart VI.3).

6.16 Non-oil imports recorded an increase of nearly 29.0 per cent, led by a sharp increase of 26.9 per cent in the imports of capital goods during 2003-04 on top of the large increase in the preceding year. Non-oil imports excluding gold and silver increased by 25.7 per cent. The co-incident expansion of imports of capital goods and domestic production during 2003-04 is strengthening the environment for a revival of investment demand (Chart VI.4).

6.17 The pick-up in domestic industrial activity fuelled a surge in imports of several intermediate manufactures and raw materials such as iron and steel, non-ferrous metals, paper, paper board and manufactures (including newsprint), artificial resins and plastic materials, chemical materials and products and metalliferous ores and metal scraps. Imports of gold and silver, which had declined in 2002-03, increased by as much as 59.0 per cent during 2003-04, mainly due to revival in rural demand on the back of the rebound in agricultural output. Imports of edible oil increased mainly on account of refined palm oil and palmolein (Chart VI.5, Appendix Table VI.5).

Chart VI.4 : Capital Goods – Imports and Production (Growth Rates)



6.18 Country-wise data indicate an increase in imports from all the major regions. As in the case of exports, the sourcing pattern of imports also shows a distinct tilt in favour of Asian countries. Imports from the East Asian countries, *viz.,* China, Japan, Hong Kong, Malaysia, Singapore, South Korea and Thailand increased sharply during 2003-04. Among other major countries, imports from Australia, Germany, Indonesia, Switzerland, UAE and the US also increased significantly.

Chart VI.3 : Crude Oil – Imports, Production and International Prices

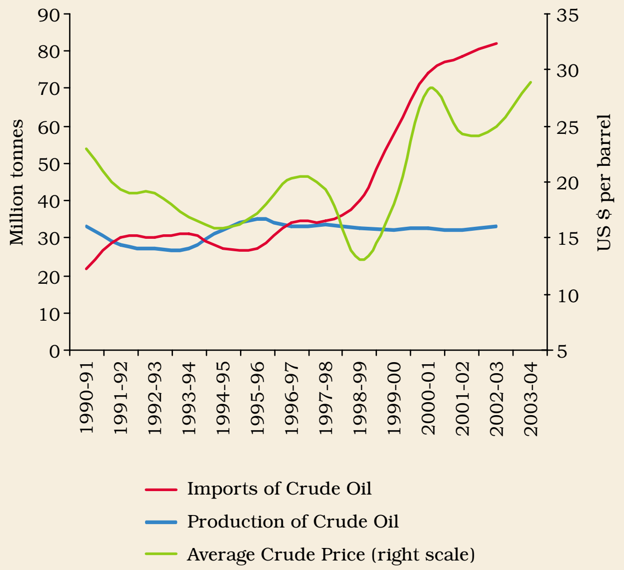
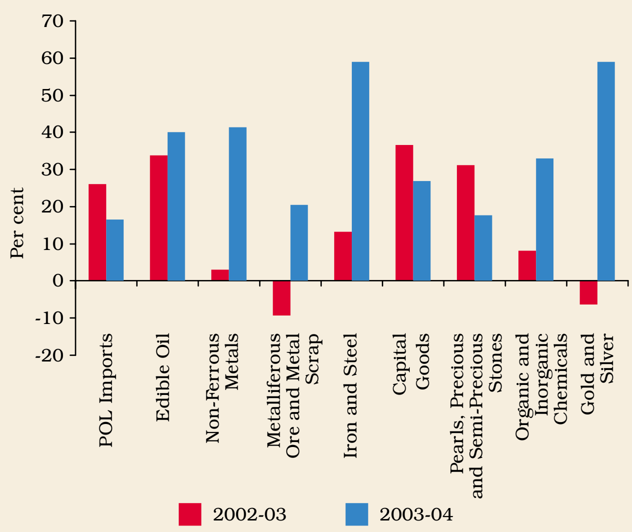


Chart VI.5 : Imports of Major Commodities (Growth Rates)



6.19 During the first quarter of 2004-05 (April-June), exports recorded a robust growth of 28.1 per cent as compared with 8.4 per cent in the corresponding period of the previous year. Imports during the same period posted an increase of 30.8 per cent as compared with 25.3 per cent during April-June 2003. The surge in imports was largely on account of non-oil imports, which increased by 25.8 per cent during April-June 2004 on top of an increase of 31.0 per cent in the corresponding period of the preceding year. The increase in non-oil imports was consistent with the sharp pick-up in domestic industrial production, especially in the capital goods and the intermediate goods sectors. Rising international oil prices contributed to the surge in POL imports.

Invisibles

6.20 The surplus in the invisibles account rose steadily throughout the year, peaking in the fourth quarter. It reached an all-time high at US $ 25.4 billion in 2003-04 (Appendix Table VI.6). Net invisible surpluses have traditionally been a source of support to India's BoP, offsetting merchandise trade deficits and economising on the reliance on external financing. Moreover, a distinct stability has characterised these flows which have shown a remarkable resilience in the face of financial crises and the synchronised global slowdown. The ratio of net invisibles to the trade balance, a measure of BoP support from invisibles, maintained a rising trend through the 1990s, reaching as high as 152.2 per cent in 2003-04 (Chart VI.6).

6.21 Spearheading the progressive improvement in the invisibles balance have been the heterogeneous category of professional and business services including software (which is recorded under 'services') and remittances from nationals employed overseas (recorded under 'transfers'). In recent years, and particularly in 2003-04, these receipts also displayed a growing co-movement. Both entail movement of natural persons. Moreover, with rising skill intensity in the temporary migration from India, the distinction between the two categories is getting increasingly blurred.

6.22 The income account under invisibles has traditionally been in deficit in India's BoP on account of interest payments on external debt, profit/ dividend and other payments related to foreign investment in India. During 2003-04, the deficit on the income account worsened on account of a one-time outgo of accumulated interest payments on RIBs (Chart VI.7).

Services

6.23 Exports of services rose by 10.6 per cent in 2003-04. India ranked 20th in the world with a share of 1.4 per cent in global exports of services in 2003. An upward shift in the trend growth of services exports from 7.9 per cent in the first half of the 1990s to 15.3 per cent in the period from 2000-01 to 2003-04 reflected a distinct strengthening along with greater stability. The coefficient of variation of services exports, which increased from 12.0 per cent in the

Chart VI.6 : Invisibles and Trade Deficit

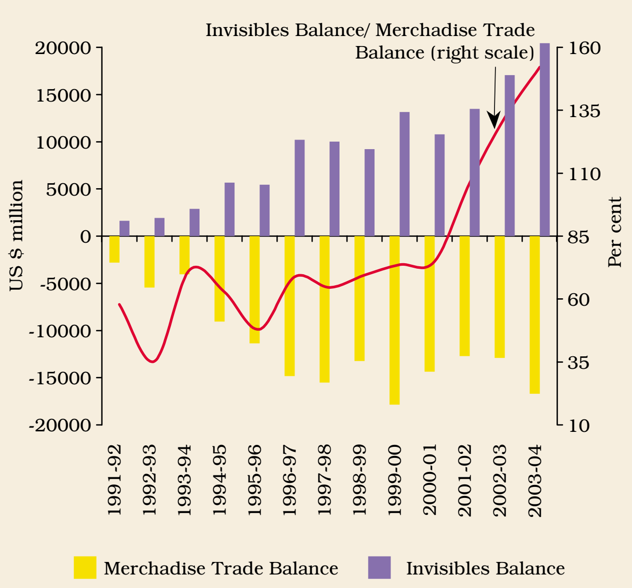
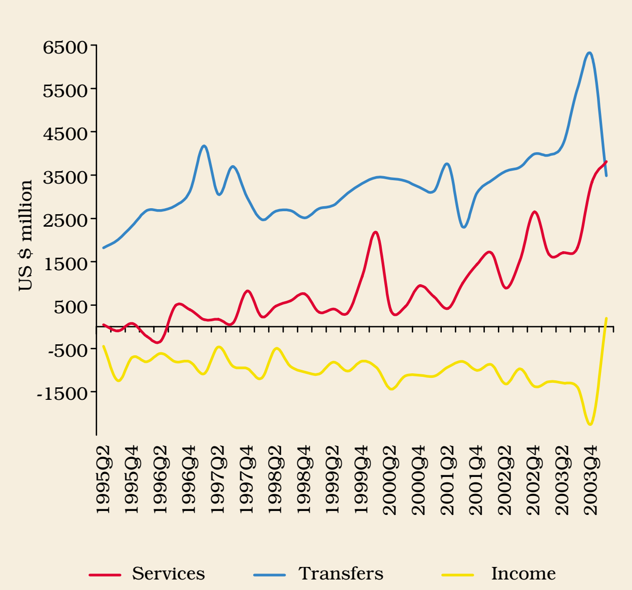


Chart VI.7 : Movement of Net Invisible Receipts



first half of the 1990s to 34.7 per cent in the second half, declined to 17.3 per cent during the period from 2000-01 to 2003-04.

6.24 Travel receipts, a traditional service export from India which had stagnated on account of global recessionary conditions and geo-political instability, also recovered. A strong revival of international tourist interest in India in 2003-04 was reflected in tourist arrivals increasing by 19.6 per cent in contrast to a marginal rise of 0.8 per cent in 2002-03. The US, the UK, Canada and the SAARC countries were the principal sources of tourist traffic into India in 2003-04. Typical of the usual seasonal pattern, earnings from travel peaked in the second half of 2003-04, coinciding with the tourist season in India.

6.25 Earnings on account of transportation and insurance moved in close alignment with merchandise exports. According to the Association of Shipping Corporation of India, about six per cent of India's exports and 23.0 per cent of imports (including 31 per cent of POL imports) were transported by the Indian shipping industry. With transportation and insurance earnings rising by an unprecedented 25.1 per cent, net receipts from transportation turned positive in 2003-04 after a prolonged gap of about 20 years.

6.26 In recent years, sectoral shifts within the spectrum of service exports have also imparted a measure of stability. The buoyant growth of professional, technical and business services has provided a cushion against the slowdown in traditional services such as travel and transportation (Table 6.4). These 'new economy' services witnessed an average annual growth of about 37 per cent during the period 1995-96 to 2003-04, contributing to over 70 per cent of total service exports in 2003-04. Studies have shown that India has a comparative advantage in exports of communication, software and other business services.

Table 6.4: Profile of India's Services Exports

(Per cent of total services exports)

Year	Travel	Transportation	Insurance	G.N.I.E.	Software	Miscellaneous*
1	2	3	4	5	6	7
1990-91	32.0	21.6	2.4	0.3	0.0	43.7
1995-96	36.9	27.4	2.4	0.2	10.2	22.9
2000-01	16.8	10.1	1.4	3.5	33.6	34.6
2001-02	14.1	9.5	1.3	2.3	36.6	36.3
2002-03	12.1	10.1	1.5	1.2	38.5	36.6
2003-04	14.3	11.6	1.5	0.9	44.2	27.5

* : Miscellaneous services excluding software.
Note : G.N.I.E: Government Not Included Elsewhere.

6.27 Export of software and IT-enabled services rose by about 28 per cent in 2003-04 (Table 6.5). These exports have expanded at a steady rate of over 25 per cent, even though a global IT slowdown arrested the high growth run in the second half of the 1990s. Within this sector, IT enabled services (ITES) and the Business Process Outsourcing (BPO) segments emerged as the anchors of growth. India has remained a dominant exporter globally due to low cost, high quality of product and services and adequate supply of skilled labour. This has enabled it to expand its market share in global IT spending from around 1.5 per cent in 2000-01 to an estimated 3.4 per cent in 2003-04, despite a global slowdown in IT trade. Within ITES service lines, payment services, administration and finance were the fastest growing segments with impressive growth rates of 105 per cent, 74 per cent and 61 per cent, respectively, during 2003-04.

6.28 In terms of outsourcing of IT services, proficiency in the English language provides a comparative advantage to India's exports *vis-á-vis* those of competitors such as China and Mexico. Ireland, which was the biggest hub of ITES, was surpassed by India mainly on account of a relatively larger supply of IT professionals. In order to build upon the current dominant position in the global market, there is an increasing emphasis on diversifying overseas markets, improving cost competitiveness, moving up the IT value chain and focusing on new verticals such as healthcare, utilities and retailing to offset global reduction in IT spending in traditional verticals such as telecom and manufacturing. In the recent period, some downside risks have emerged due to restrictions on outsourcing of software services in certain parts of the world. It is estimated, however, that outsourcing has been resulting in cost saving in the range of 40-60 per cent for the trans-national corporations (see Box II.6, Section II). Exports of other

Table 6.5: Indian Services and Software Exports

(US $ million)

Year	IT Services Exports	ITES-BPO Exports	Total Software and Services Exports
1	2	3	4 (2+3)
1995-96	754	–	754
1996-97	1,100	–	1,100
1997-98	1,759	–	1,759
1998-99	2,600	–	2,600
1999-00	3,397	565	3,962
2000-01	5,287	930	6,217
2001-02	6,152	1,495	7,647
2002-03	7,045	2,500	9,545
2003-04 (Estimates)	8,600	3,600	12,200

ITES : IT enabled services. BPO : Business Process Outsourcing.
Source : NASSCOM.

Box VI.2

New Initiatives for Monitoring Trade in Services

Recent developments in negotiations under the General Agreement on Trade in Services (GATS), the ongoing liberalisation of current and capital account transactions and rationalisation of the reporting requirements have placed an increasing demand on comprehensive information relating to international trade in services. Timely and more disaggregated information on international transactions in services assumes vital importance for effective monitoring, especially because the cross border transactions in services are both on-site and off-site.

Under the common international initiative for strengthening information system on international trade in services, a comprehensive 'Manual on Statistics of International Trade in Services' has been designed by the United Nations to provide a coherent conceptual framework within which countries can structure the statistics collected and disseminated by them.

A Technical Group on Statistics of International Trade in Services appointed in the Reserve Bank submitted its report in March 2002. In pursuance of the recommendations of this Group, the purpose codes for capturing data on international trade in services were revised. This revision in purpose codes is designed to broadly comply with the requirements under the WTO in respect of the General Agreement on Trade in Services (GATS). Under the newly designed software for reporting, transaction-wise details of currency, amount, purpose and country are required to be entered. The package Foreign Exchange Transactions - Electronic Reporting System (FET-ERS) Version 6.2(R) effective April 1, 2004 provides for on-line validation to avoid data entry errors. With the new reporting system in place, the coverage and quality of data on India's international trade in services is likely to be strengthened which would, in turn, contribute to effective monitoring of cross-border transactions.

References

1. Reserve Bank of India (2002), *Statistics of International Trade in Services: Report of the Technical Group*, March.
2. United Nations (2002), *Manual on Statistics of International Trade in Services*.

professional and business services also rose during 2003-04, mainly under communication, financial, management, advertising and office maintenance.

6.29 The impact of the liberalisation of exchange restrictions on current payments was reflected in higher imports of transportation services, financial services, management related services and other business services. Travel payments rose under the segment 'business related travel' and basic travel quota, attributable to outward movement of workers and professionals and spurt in outbound tourist traffic from India. Higher interest payments occurred on account of bullet payment of interest on maturing RIBs. The spurt in investment income payments from 2000-01 onwards was due to the inclusion of reinvested earnings as payments following adoption of the revised definition of foreign direct investment (FDI). The Reserve Bank took initiatives to gather comprehensive information on India's trade in services in the context of the ongoing negotiation on international trade in services under the GATS framework (Box VI.2).

Workers' Remittances

6.30 Inward remittances from Indians working abroad continued to surge, reaching US $ 19.2 billion in 2003-04 and maintaining India's position as the leading recipient of remittances in the world. The sustained expansion in remittances since the 1990s was underpinned by structural reforms, including a market-based exchange rate, current account convertibility as well as a shift in the labour outflow pattern from semi-skilled to increasingly high skilled categories. A gradual shift has occurred in the sources of remittances from oil producing countries of Asia to Europe and America. During 2003-04, workers' remittances remained the mainstay of the current account (Table 6.6).

Table 6.6: Inward Workers' Remittances to India

Year	Flows (US $ million)	Share in Current Receipts (Per cent)	Flows (Per cent of GDP)
1	2	3	4
1990-91	2,083	8.0	0.7
1995-96	8,539	17.1	2.4
1999-00	12,290	18.1	2.8
2000-01	12,873	16.2	2.8
2001-02	12,192	14.9	2.5
2002-03	15,174	15.8	3.0
2003-04	19,235	16.7	3.2

Current Account

6.31 India's current account surplus rose to 1.4 per cent of GDP in 2003-04, extending a phase of surpluses which began in 2001-02. Current account surpluses were also being run across EMEs, the lone exception being Mexico. The counterpart has been the massive current account deficit of the US, indicative of the critical role of the US economy in global recovery (Table 6.7).

Table 6.7: Current Account Balances of Select Countries

(Per cent of GDP)

Country	2003	2002	2001	2000	1996
1	2	3	4	5	6
Argentina	5.7	10.5	-1.6	-3.1	-2.5
Brazil	0.8	-1.7	-4.6	-4.0	-3.0
China	2.1	2.8	1.5	1.9	0.9
Germany	2.4	2.8	0.2	-1.4	-0.6
India*	1.4	0.8	0.2	-0.8	-1.6
Indonesia	3.9	4.5	4.8	5.3	-3.2
Japan	3.2	2.8	2.1	2.5	1.4
Korea	2.0	1.0	1.7	2.4	-4.1
Malaysia	11.1	7.6	8.3	9.4	-4.4
Mexico	-1.5	-2.2	-2.9	-3.1	-0.8
Philippines	2.1	5.5	1.9	8.4	-4.6
Thailand	5.6	5.5	5.4	7.6	-7.9
US	-4.9	-4.6	-3.9	-4.2	-1.5

* : Data for India pertain to financial year (April-March).
Note : (-) indicates deficit.
Source : *World Economic Outlook*, IMF, April 2004.

6.32 India's current account surplus is structurally different from that of EMEs. For most EMEs, it is the merchandise trade account which is in surplus, reflecting high merchandise export growth. In contrast, India's current account surplus, in 2003-04 was on account of services, while the trade account recorded a deficit of the order of 2.8 per cent of GDP (Table 6.8).

6.33 India's current receipts grew at an average rate of 19 per cent during 2002-03 and 2003-04. Consequently, the ratio of current receipts to current payments rose to 107.7 per cent in 2003-04. The steady growth of current receipts has stabilised the 'interest payments to current receipts' ratio at a level of 5.6 per cent and the debt-service ratio at 18.3 per cent (see Table 6.2), which was one of the lowest among the EMEs. The robust pace of growth of current receipts underpinned the current account surplus in 2003-04.

Table 6.8: Current Account Balances of Developing Countries

(US $ billion)

Year	India*		Developing Asia		Western Hemisphere	
	Trade Balance	Services Balance	Trade Balance	Services Balance	Trade Balance	Services Balance
1	2	3	4	5	6	7
1996	-14.8	0.7	-29.4	-6.8	-1.3	-11.4
2000	-14.4	2.5	62.6	-10.2	-4.4	-11.8
2001	-12.7	4.6	56.1	-10.2	-12.0	-13.5
2002	-12.9	6.8	67.3	-5.1	16.3	-8.6
2003	-16.7	10.7	59.3	-12.3	34.3	-7.2

* : Data for India pertain to financial year (April-March).
Note : (-) indicates deficit.
Source : *World Economic Outlook*, IMF, April 2004.

Capital Account

6.34 Large shifts characterised the capital account which dominated the BoP in 2003-04. Massive movements of financial flows occurred in both directions. Debt creating flows ebbed in response to policy changes such as prepayment of high cost official debt and rationalisation of interest rates on NRI deposits. The bullet redemption of RIBs also dampened the net debt flows. Non-debt creating flows, particularly portfolio investments, surged ahead of the resumption of private financial flows to the EMEs. India attracted the highest portfolio investment inflows to Asia in 2003, second only to Korea. With this resurgence, total foreign investment inflows accounted for 65.5 per cent of net capital inflows in 2003-04 (Appendix Table VI.7).

Foreign Investment

6.35 A striking feature of the developments in the capital account in recent times has been the growing significance of non-debt creating flows in line with the policy preference for such flows. Foreign investment - both direct and portfolio - rose to an all-time high in 2003-04, amounting to 3.0 per cent of GDP and 25.5 per cent of merchandise exports (see Table 6.2). Net investment by foreign institutional investors (FIIs) rebounded from depressed levels in the preceding year to record an unprecedented surge during 2003-04. Portfolio flows were recycled to India following readjustments of global portfolios of institutional investors, triggered by the robust improvement in macroeconomic fundamentals, financial performance of the corporate sector and the buoyant and attractive valuations in the Indian equity markets relative to other EMEs in Asia (Table 6.9).

6.36 FDI flows remained subdued during 2003-04 in line with the slowing down of FDI flows to the developing countries in general (Chart VI.8).

6.37 Although Mauritius continues to be the single largest source of FDI into India, its relative significance has been declining. FDI from Mauritius declined sharply during the last two years, constituting 26.1 per cent of total FDI flow to India in 2003-04 as against 32.2 per cent in 2002-03 and as much as 62.3 per cent in 2001-02. The bulk of FDI was channelised into services, computers (hardware and software) and engineering industries (Table 6.10).

Table 6.9: Foreign Investment Flows to India

(US $ million)

	2003-04(P)	2002-03 (R)	2001-02(R)
1	2	3	4
A. Direct Investment (I+II+III)	**4,675**	**4,660**	**6,131**
I. Equity (a+b+c+d+e)	**2,387**	**2,700**	**4,095**
a) Government (SIA/ FIPB)	928	919	2,221
b) RBI	534	739	767
c) NRI	–	–	35
d) Acquisition of shares*	735	916	881
e) Equity capital of unincorporated bodies	190	126	191
II. Re-invested earnings	**1,800**	**1,498**	**1,646**
III. Other capital #	**488**	**462**	**390**
B. Portfolio Investment (a+b+c)	**11,377**	**979**	**2,021**
a) GDRs / ADRs	459	600	477
b) FIIs@	10,918	377	1,505
c) Off-shore funds and others	–	2	39
C. Total (A+B)	**16,052**	**5,639**	**8,152**

P : Provisional. R : Revised. – : Nil/Negligible.

* : Relates to acquisition of shares of Indian companies by non-residents under Section 5 of the FEMA, 1999.

: Data pertain to inter-company debt transactions of FDI entities.

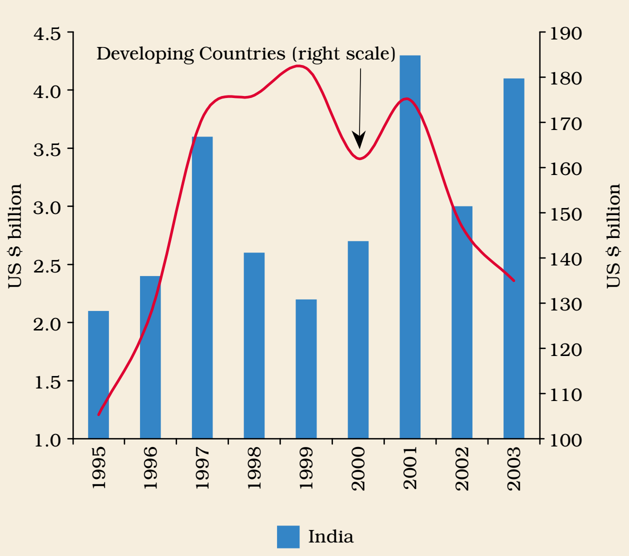
@ : Data represent net inflow of funds by FIIs.

Note : 1. Data on reinvested earnings for 2002-03 and 2003-04 are estimates.

2. Data on foreign investment presented in this table represent inflows into the country and may not tally with the data presented in other tables. They may also differ from data relating to net investment in stock exchanges by FIIs in Section V of this Report.

6.38 The sectoral pattern of FDI inflows to India shows that despite a slowdown in the overall level of FDI, flows into the engineering sector have remained stable, largely in consonance with buoyancy in export growth in that sector. Empirical studies in the Indian context suggest a lagged feedback effect from export growth to FDI. On the other hand, FDI inflows into the software sector continued to exhibit a downward trend despite the robust export performance of the software sector. This suggests that FDI is complementary rather than substitutive in sectors where domestic entrepreneurship and production have acquired an international competitiveness. FDI inflows into the services sector declined to US $ 431 million from a peak of US $ 1,128 million in 2001-02, in spite of high growth in services domestically and sustained exports of professional and commercial services (Table 6.10).

Chart VI.8 : FDI Flows in India *vis-á-vis* Developing Countries



6.39 There has been a growing international interest in the monitoring of portfolio investment flows, particularly in evolving international benchmarks for recording and evaluating information on these flows. The Coordinated Portfolio Investment Survey (CPIS), conducted under the auspices of the IMF, is guided by the objective of removing imbalances and gaps in statistics on global portfolio capital flows (Box VI.3).

Table 6.10: Foreign Direct Investment : Country-wise and Industry-wise Inflows*

(US $ million)

Country/Industry	2003-04(P)	2002-03	2001-02
1	2	3	4
Total FDI	**1,462**	**1,658**	**2,988**
Country-wise Inflows			
Mauritius	381	534	1,863
US	297	268	364
UK	157	224	45
Germany	69	103	74
Netherlands	197	94	68
Japan	67	66	143
France	34	53	88
Singapore	15	39	54
Switzerland	5	35	6
South Korea	22	15	3
Others	218	227	280
Industry-wise Inflows			
Chemical and allied products	46	53	67
Computers	151	297	368
Engineering	274	262	231
Electronics and electrical equipments	103	95	659
Finance	4	54	22
Food and dairy products	63	35	49
Pharmaceuticals	79	44	69
Services	431	509	1,128
Others	311	309	395

* : Data in this table exclude FDI inflows under the NRI direct investment route through the Reserve Bank and inflows due to acquisition of shares under Section 5 of the FEMA, 1999.

P : Provisional.

Box VI.3
Coordinated Portfolio Investment Survey

The Coordinated Portfolio Investment Survey (CPIS), which is conducted simultaneously by all the participating economies, uses standard definitions and encourages best practices in data collection. CPIS is a unique tool for capturing the world totals as well as geographical distribution of the holdings of portfolio investment assets in the form of both equity and debt, thereby leading to a better understanding of these flows. Specifically, the objectives of the Survey are to collect and bilaterally exchange among the participating as well as other countries comprehensive information on portfolio flows, including on the country of residence of the issuer of the stock of cross border instruments.

The progressive liberalisation of international flows has brought into focus measurement difficulties. These difficulties have been reflected in the imbalances at the global level between recorded financial assets and liabilities, with higher flows usually being recorded for liabilities than for assets. Concerned with these global imbalances and the associated discrepancies in income flows at the global level, the IMF Committee on Balance of Payments Statistics decided in 1993 to promote the idea of an internationally coordinated benchmark survey of long-term portfolio investment holdings to facilitate cross country comparisons, permit data exchanges and encourage standardisation and best practice. By undertaking a benchmark survey of holdings, countries would be in a position to obtain a reasonable estimate of the outstanding balances (at market price) of the level of portfolio investment held by their residents. By exchanging comparable data (subject to confidentiality constraints), participating countries can improve the statistics of non-resident holdings of their portfolio investment liabilities as well as associated financial flows and investment income data. Each participating country conducts its own national survey at a particular reference date. After the completion of the Survey, the national compilers supply them to the IMF, which facilitates exchange of data among countries. Along with the CPIS, the IMF also assesses the geographical breakdown of holdings of securities held as a part of reserve assets through its survey of Securities held as Foreign Exchange Reserves (SEFER). The Survey of Geographical Distribution of Securities held by International Organisations (SSIO) is also conducted by the IMF along with the SEFER.

Reference

1. International Monetary Fund (2002), *Coordinated Portfolio Investment Survey Guide*, Second Edition.

Debt flows

6.40 External assistance recorded a net outflow during 2003-04. Negative net resource transfers under external aid (disbursements net of principal repayments and interest payments) have occurred since 1995-96 (Appendix Table VI.8). During 2003-04, the Government prepaid high cost bilateral and multilateral loans of US $ 3.8 billion on the top of the prepayment of US $ 3.1 billion in 2002-03 (Table 6.11). About 68 per cent of the total prepayment in 2003-04 was to multilateral institutions, *i.e.,* the World Bank and the Asian Development Bank (ADB). Among bilateral donors, prepayments to Canada and the Netherlands were sizeable.

6.41 Amortisation of external commercial borrowings (ECBs) rose during 2003-04 in comparison with that during 2002-03. The higher outflow in 2003-04 was on account of redemption of RIBs amounting to US $ 5.2 billion (including accrued interest) in October 2003. ECBs by corporates picked up during January-March 2004 in response to an improvement in the domestic investment climate and the relatively favourable interest rates available in the international financial markets.

6.42 Net inflows into deposit schemes for non-resident Indians (NRIs) were strong in the first half of 2003-04. These flows shared the overall investor optimism generated by the improvement in India's macroeconomic performance and responded to positive interest rate differentials in India *vis-à-vis* international interest rates, rendered attractive by a stable exchange rate. As a consequence of rationalisation of interest rates (see Section VIII in Part II), the inflows moderated in the second half of 2003-04, particularly in respect of the non-resident external rupee accounts [NR(E)RA] scheme. Average monthly inflows slowed down from US $ 365 million during April-September 2003 to US $ 59 million during the second half of 2003-04 except for a sharp increase in October 2003, following one-off effects created by redeployment of a sizeable portion of redemption

Table 6.11: Prepayment of External Assistance

(US $ million)

Year	Donor	Amount Prepaid	Premium Amount
1	2	3	4
2002-03	Multilateral	3,048	62
	IBRD	1,651	27
	ADB	1,397	35
	Bilateral	115	4
	Total	**3,163**	**66**
2003-04	Multilateral	2,584	24
	IBRD	1,398	14
	ADB	1,186	10
	Bilateral	1,230	1
	Total	**3,814**	**25**

Table 6.12: Balances under NRI Deposit Schemes

(US $ million)

Scheme	Outstanding (At end-March)		Net Inflows@	
	2004	2003	2003-04	2002-03
1	2	3	4	5
1. FCNR(B)	10,961	10,199	762	526
2. NR(E)RA	20,559	14,923	4,695	6,195
3. NR(NR)RD	1,746	3,407	-1,816	-3,745
Total	**33,266**	**28,529**	**3,641**	**2,976**

@ : All figures are inclusive of accrued interest and valuation changes arising on account of fluctuations in non-dollar currencies against the US dollar.

Note : Net inflows in respect of NR(E)RA and NR(NR)RD deposits in columns 4 and 5 may not match with the differences between the outstanding stocks on account of exchange rate fluctuations during the year.

proceeds of RIBs. In spite of policy-driven deterrents, net inflows into total NRI deposits were higher in 2003-04 than in the previous year after accounting for shifts from non-resident non-repatriable rupee deposits [NR(NR)RD] to NR(E)RA (Table 6.12).

6.43 Net inflows under banking capital were lower during 2003-04 than in the previous year. Banking capital inflows took the form of drawdown from *nostro* balances and overseas borrowings in the first quarter of 2003-04 as banks compensated for outflows under the foreign currency non-resident (banks) [FCNR(B)] Scheme. Overseas borrowings continued to rise strongly through the rest of the year. On the other hand, *nostro* balances were built up in September 2003 in anticipation of the RIB redemption but were unwound in the subsequent period.

EXTERNAL DEBT

6.44 India's external debt stock amounted to US $ 112.6 billion at end-March 2004 (Table 6.13 and Appendix Table VI.10). During the year, all components of external debt recorded a decline except NRI deposits, bilateral debt and short-term debt. The increase in debt stock between end-March 2002 and end-March 2004 was contributed mostly by NRI deposits with their share increasing to 28.0 per cent of the debt stock from 18.3 per cent. This was due to the effect of increased inflows into the repatriable schemes reflecting discontinuation of the NR(NR)RD scheme (which was not part of external debt) with effect from April 1, 2002. The stock of external debt was also augmented by the redeployment of redemption proceeds of RIBs in NRI deposits.

6.45 Critical indicators of debt sustainability exhibited significant improvement during the year. The ratio of

Table 6.13: India's External Debt

(US $ million)

Item	End-March	End-March	Variation during the Year	
	2004	2003	Absolute	Per cent
1	2	3	4	5
Multilateral	29,614	29,994	-380	-1.3
Bilateral	17,489	16,814	675	4.0
Trade Credit	4,588	4,974	-386	-7.8
ECB	22,286	22,540	-254	-1.1
NRI Deposit	31,171	23,160	8,011	34.6
Rupee Debt	2,709	2,818	-109	-3.9
Short Term	4,736	4,569	167	3.7
Total	**1,12,593**	**1,04,869**	**7,724**	**7.4**

external debt to GDP showed a steady improvement, dropping to 17.6 per cent as at end-March 2004 from 30.8 per cent as at end-March 1995. The debt-service ratio increased during the year mainly on account of redemption of RIBs and prepayments (Table 6.14). Excluding these special transactions, the debt-service ratio would decline to 10.4 per cent. India improved its rank among the top 15 debtor countries from third in 1991 to eighth in 2002. Importantly, among the top 15 debtor countries, India's short-term debt to total debt ratio and short-term debt to foreign exchange reserve ratio are the lowest. India's foreign exchange

Table 6.14: External Debt Service Payments

(US $ million)

Item	2003-04	2002-03
1	2	3
1. External Assistance@	7,302	6,308
2. External Commercial Borrowings*	10,446	6,357
3. IMF #	0	0
4. NRI Deposits (Interest Payments)	2,825	1,268
5. Rupee Debt Service	376	474
6. Total Debt Servicing	20,949	14,407
7. Total Current Receipts **	1,14,332	95,475
8. External Debt to GDP Ratio	17.6	20.2
9. Short Term Debt to Total Debt Ratio (%)	4.2	4.4
10. Short Term Debt to Foreign Exchange Reserves Ratio (%)	4.2	6.0
11. Foreign Exchange Reserves to External Debt Ratio (%)	100.3	72.6
12. Debt-Service Ratio (%) ##	18.3	15.1
13. Interest Payments to Current Receipts Ratio (%)	5.6	3.7
14. Debt to Current Receipts Ratio (%)	98.5	109.7
15. Liability-Service Ratio (%)	19.1	16.1

@ : Inclusive of non-Government loans.
* : Inclusive of interest on medium and long term credits.
# : Excluding charges on net cumulative allocation of SDRs.
** : Excluding official transfers.
: Ratio of total debt servicing (Item 6) to total current receipts (Item 7).

Note : 1. Debt service payments in this table follow the accrual method of accounting consistent with BoP compilation and may, therefore, vary from those recorded on a cash basis.
2. Liability-service ratio represents debt service payments and remittances of profits and dividends taken together as a ratio of total current receipts.

reserves provided a cover of a little over 100 per cent of total external debt outstanding as on March 31, 2004.

FOREIGN EXCHANGE RESERVES

6.46 India's foreign exchange reserves increased by US $ 36.9 billion (including valuation gains) during the year, the largest increase ever recorded in a single year. The large accumulation occurred despite the depletion of reserves on account of redemption of RIBs and prepayment of official debt.

6.47 At around US $ 113.0 billion on March 31, 2004 (Table 6.15 and Appendix Table VI.9), India held the fifth largest stock of international reserve assets among EMEs and ranked sixth in the world. As on August 13, 2004, the foreign exchange reserves amounted to US $ 119.3 billion.

6.48 In February 2003, the International Monetary Fund (IMF) designated India as a creditor country under its Financial Transaction Plan (FTP). India, therefore, participated in the IMF's financial support to Burundi in March-May 2003, to Brazil in June-September 2003 and to Indonesia in December 2003. The total lending under FTP to the IMF amounted to US $ 561.3 million during 2003-04.

Reserve Management and Operations

6.49 The significant accretions to the foreign exchange reserves in recent years, especially in 2003-04, have underscored the importance of appropriate reserve management strategies. Foreign currency assets (FCA) and gold holdings together account for about 90 per cent of the combined balance sheets of the Issue and the Banking Departments of the Reserve Bank. The structural shift in the composition of the Reserve Bank's balance sheet in favour of foreign assets has several implications, the most important of which is a change in its risk/return profile.

6.50 The broad objectives of management of foreign exchange reserves in India are similar to those of any other EME. The design of investment portfolios, however, varies widely across countries, reflecting essentially the exposure to liquidity, currency, interest rate and counterparty credit risks and the scope of active management thereof. Portfolio design takes into account a host of factors such as the exchange rate regime, the extent of openness of the economy, the size of the external sector relative to GDP, the state of development and integration of financial markets. In India, the primary objective of reserve management has been to preserve the long-term value of the reserves, in terms of purchasing power, by eschewing risks that may cause sharp volatility in returns. Considerations of safety, liquidity and return provide a hierarchy of preferences that permeates all strategic as well as tactical decisions on deployment of reserves.

6.51 The Reserve Bank of India (RBI) Act, 1934 provides the overarching legal framework for deployment of FCA and gold, defining the broad parameters in respect of currency, instruments, issuers and counterparties. The relevant provisions are contained in Section 17 of the Act. While major convertible currencies constitute the choice set for currency composition of FCA, the investment universe for FCA comprises deposits with other central banks, the Bank for International Settlements (BIS), top-rated foreign commercial banks, debt securities issued by sovereigns and supranational institutions with residual maturity not exceeding 10 years and any other instruments or

Table 6.15: Foreign Exchange Reserves

(US $ million)

As at end of March	Gold	SDR	Foreign Currency Assets	Reserve Position in the IMF	Total (2+3+4+5)	Use of IMF Credit
1	2	3	4	5	6	7
1993	3,380	18	6,434	296	10,128	4,799
1994	4,078	108	15,068	299	19,553	5,040
1995	4,370	7	20,809	331	25,517	4,300
1996	4,561	82	17,044	310	21,997	2,374
1997	4,054	2	22,367	291	26,714	1,313
1998	3,391	1	25,975	283	29,650	664
1999	2,960	8	29,522	663	33,153	287
2000	2,974	4	35,058	658	38,694	26
2001	2,725	2	39,554	616	42,897	0
2002	3,047	10	51,049	610	54,716	0
2003	3,534	4	71,890	672	76,100	0
2004	4,198	2	107,448	1,311	112,959	0

institutions as approved by the Central Board of the Reserve Bank.

Risk Management

6.52 Guidelines in pursuance of the provisions of the RBI Act, 1934 are in place for facilitating investment of FCA. Appropriate benchmarks have been established for the purpose of configuring currency allocation of FCA and maturity pattern (duration) of the investment portfolios in each currency segment. Benchmarks are constructed to reflect the strategic investment objectives after taking into account, *inter alia*, the longer-term prospects of the markets in which FCA are deployed. They also embody the risk tolerance and the expected return in respect of FCA. Tactical deviations from benchmarks are permitted to a limited extent for augmenting returns without, however, altering the risk profile in a significant manner. The benchmarks are reviewed periodically. One of the abiding features of investment benchmarks has been diversification with regard to currency, markets and instruments.

6.53 Accordingly, FCA are invested in multi-currency and multi-market portfolios. During the year 2003-04, there was a moderate shift in the deployment pattern of FCA, whereby, the share of deposits increased and that of securities fell correspondingly, reflecting interest rate uncertainties in major international markets (Table 6.16).

6.54 Movements in the FCA occur mainly out of purchases and sales of foreign exchange by the Reserve Bank in the foreign exchange market in India, including a small volume of transactions in the forward segment. In addition, income arising out of the deployment of foreign exchange reserves is held in the portfolio of the Reserve Bank. External aid receipts of the Central Government also flow into the reserves. In line with the international practices, the Reserve Bank expresses the foreign exchange reserves in US dollar terms for public dissemination, which implies that the movement of the US dollar against other currencies in which FCA are held would also influence its share in the FCA.

Table 6.16: Deployment Pattern of Foreign Exchange Reserves

(US $ million)

	As on March 31, 2004	As on March 31, 2003
1	2	3
1. Foreign Currency Assets	107,448	71,890
(a) Securities	35,024	26,929
(b) Deposits with other central banks and BIS	45,877	33,463
(c) Deposits with foreign commercial banks	26,547	11,498
2. Special Drawing Rights	2	4
3. Gold (including gold deposits)	4,198	3,534
4. Reserve Position in the IMF	1,311	672
5. Total Foreign Exchange Reserves (1+2+3+4)	**112,959**	**76,100**

6.55 Decisions involving the pattern of investments are driven by the broad parameters of portfolio management with a strong bias for capital preservation and liquidity. The entire stock of FCA is invested in assets of the highest quality with a significant proportion convertible into cash at short notice. The counterparties with whom deals are conducted are subject to a rigorous selection process, based on their international reputation and track record, apart from factors such as size, capital, rating, financial position and efficiency of operations. Counterparties could be banks, subsidiaries of banks or security houses.

6.56 The broad strategy for reserve management, including currency composition and investment policy, is decided in consultation with the Central Government. This decision-making procedure is supported by reviews of the strategy on a regular periodic basis within the Reserve Bank. In view of the significant accretion to reserves in 2003-04, this internal review mechanism was further strengthened by the inclusion of two in-house senior experts who are otherwise not involved in the foreign exchange management operations. There has been a renewed emphasis on managing and controlling the exposure to financial and operational risks attendant on deployment of reserves. The risk management functions are also being revamped to ensure development of sound governance structures in line with international best practices, improved accountability, a culture of risk awareness across all operations and efficient allocation of resources for development of in-house skills and expertise.

Audit and Monitoring

6.57 Considerable attention has been devoted to strengthening operational risk control arrangements. Concurrent audit, which is carried out on a real time basis in respect of transactions undertaken by the front office, has been one of the effective tools in this regard. The scope of concurrent audit has recently been expanded to include certain critical areas of the back office operations. A comprehensive external review of the scope of concurrent audit is on the cards. The incidence of exceptions, transgression of exposure limits and errors, being in the nature of operational risk events as revealed in concurrent audit and annual special audit of the front office transactions, have been minimal.

Infrastructure and Related Aspects

6.58 A new IT application for reserve management became operational in September 2003. This is an ORACLE 8i-based Relational Database Management System (RDBMS) application running on HP-UX 11i operating systems. The application is an advanced integrated system linking the front office, back office, middle office and accounting functions, facilitating, Straight Through Processing (STP) of transactions undertaken at the front office.

6.59 The Reserve Bank uses SWIFT as the messaging platform to settle its trades and to send financial messages to its counter parties, banks with whom *nostro* accounts are maintained, custodians of securities and other business partners. Major upgrades to SWIFT facilities, which took place in recent years globally, were successfully carried out by the Reserve Bank. SWIFT is moving towards a significantly improved communication protocol to replace the existing one by the end of 2004. The Reserve Bank achieved SwiftNet migration by end-June 2004, well ahead of the deadline set for the purpose.

External Asset Managers

6.60 A small portion of the reserves is assigned to external asset managers with the objectives of gaining access to and deriving benefit from their market research. This also makes it possible to take advantage of the technology available with asset managers and to provide training to the Reserve Bank's personnel. The asset managers are carefully selected from among internationally reputed asset management entities. They are given clear investment guidelines and benchmarks and their performance is evaluated at periodic intervals. External asset managers' views and outlook on international bond and currency markets are examined and taken as inputs for investment decisions.

Accounting Approach

6.61 Foreign currency assets are held as assets in the Issue Department (foreign securities) as well as in the Banking Department (balances held abroad and investment). Gold is also held in the Issue Department (under gold coin and bullion) and in the Banking Department. Although SDRs form part of India's official reserves, they are held by the Central Government and are not reflected in the Reserve Bank's balance sheet.

6.62 Key accounting practices in the management of reserves are: (i) all realised as well as accrued but unrealised interest/discount incomes are taken to the revenue account with the exception of penal interest and dividend which are accounted for on a receipt basis; (ii) all realised gains/losses on foreign exchange and securities transactions are also taken to the revenue account; (iii) unrealised gains/losses on currency and gold revaluation are taken to the Currency and Gold Revaluation Account (CGRA); (iv) unrealised losses on bonds revaluation are taken to the revenue account as direct deduction from interest income; and (v) outstanding forward exchange contracts are revalued and net losses, if any, are charged to the profit and loss account.

6.63 In the case of bonds/securities held as a part of the FCA, revaluation is undertaken every month on the basis of the month-end market prices. The principle of 'lower of market or book value' is followed, *i.e.*, if the market value is lower than the book value, the holdings are written down to the market value and valuation is not altered subsequently even if the market value increases. The income from the foreign exchange reserves is combined with other income of the Reserve Bank.

Disclosure and Transparency Issues

6.64 The Reserve Bank has been making available in the public domain data relating to foreign exchange reserves and its operations in the foreign exchange market. The movements in foreign exchange reserves of the Reserve Bank are published on a weekly basis in the Weekly Statistical Supplement (WSS) to the Reserve Bank's monthly Bulletin. As a part of the Special Data Dissemination Standards (SDDS), the IMF prescribed a data template for disclosure of the international reserves and foreign currency liquidity in respect of countries, subscribing to it. The Reserve Bank has already achieved full disclosure of information pertaining to international reserves and foreign currency liquidity position under the SDDS. The Reserve Bank's Annual Report, 2002-03 and the Report on Currency and Finance, 2002-03 extensively covered the subject of reserve management.

6.65 With the concurrence of the Central Government, the Reserve Bank decided to compile and make public half-yearly reports on management of foreign exchange reserves for enhancing transparency and also for expanding the level of disclosure in this regard. The first report with reference to September 30, 2003 was placed in the public domain through the websites of both the Central Government and the Reserve Bank in February 2004. The second report on foreign exchange reserves with reference to March 31, 2004 is available at the

Reserve Bank's website. This transparency in foreign exchange operations has been appreciated by market participants and also by the IMF.

Adequacy of Reserves

6.66 The Reserve Bank has been pursuing a policy of maintaining an adequate level of foreign exchange reserves to meet import requirements, unforeseen contingencies and liquidity risks associated with different types of capital flows. Adequacy of reserves has emerged as an important parameter in gauging its ability to cushion external shocks. This is viewed not only in relation to trade needs, but also in terms of the preparedness to meet short-term liabilities and to fulfill the need for maintaining orderly conditions in the foreign exchange market in the event of occasional mismatch between supply and demand. A long-term perspective on liquidity is also taken with a view to ensuring that reserves are also adequate in terms of short-term debt obligations and portfolio investments. At end-March 2004, the import cover of reserves was about 17 months. The ratio of short-term debt to foreign exchange reserves declined from 146.5 per cent at end-March 1991 to 4.2 per cent at end-March 2004. The ratio of volatile capital flows (defined to include cumulative portfolio inflows and short-term debt) to reserves declined from 146.6 per cent at end-March 1991 to 36.0 per cent at end-March 2004. In terms of overall external debt and total external liabilities, India's reserves were broadly adequate. Furthermore, India's net debt, *i.e.,* gross external debt minus foreign exchange reserves, was extinguished by end-March 2004. As regards the money-based indicators, there has been a marked improvement, indicative of reduced vulnerability of economic activity to any possibility of massive capital outflows. In terms of macro indicators, the ratio of India's reserves to GDP improved from 2.0 per cent at end-March 1991 to 17.7 per cent at end-March 2004.

6.67 In the recent period, assessment of reserve adequacy has also been influenced by the introduction of new measures that are particularly relevant for EMEs such as India. One such measure requires that the usable foreign exchange reserves should exceed scheduled amortisation of foreign currency debts (assuming no rollover) during the following year. Another adequacy measure is based on a 'Liquidity at Risk' rule that defines the 'worst-case' liquidity needs that a country could face. Under this approach, a country's foreign exchange liquidity need is estimated under different simulated scenarios, using a range of variables, including exchange rates, commodity prices and credit spreads.

INTERNATIONAL INVESTMENT POSITION

6.68 India's net international investment position (IIP) recorded a marked improvement during 2002-03 with net foreign liabilities declining by 12.7 per cent (Table 6.17).

6.69 India's international assets grew by 28.6 per cent, largely on account of reserve assets. Consequently, the share of reserve assets in total foreign assets improved significantly in March 2003. The share of 'other investments' comprising mainly deposits, currency holding and other international assets declined sharply (Table 6.18). This was attributable to the appreciation of the rupee *vis-à-vis* the US dollar as also a sharp decline in returns on investments in the form of bank deposits and fixed income securities in international markets. Indian banks liquidated a sizeable portion of their short-term investments in foreign assets and converted them into

Table 6.17: International Investment Position of India

(US $ million)

Item	End-March 2003P	End-March 2002PR	End-March 1997PR
1	2	3	4
A. Assets			
1. Direct investment abroad	5,054	4,006	617
2. Portfolio investment	721	670	282
2.1 Equity securities	386	356	172
2.2 Debt securities	335	314	110
3. Other investments	12,812	14,256	10,097
3.1 Trade credits	1,097	753	973
3.2 Loans	1,416	2,204	548
3.3 Currency and deposits	7,499	8,765	5,287
3.4 Other assets	2,800	2,534	3,288
4. Reserve assets	76,100	54,715	26,714
Total Foreign Assets	94,687	73,647	37,710
of which: Banks	9,138	11,093	7,271
B. Liabilities			
1. Direct investment in India	30,827	25,408	10,630
2. Portfolio investment	32,138	31,540	18,744
2.1 Equity securities	20,089	18,613	13,631
2.2 Debt securities	12,049	12,927	5,113
3. Other investments	91,788	85,521	89,388
3.1 Trade credits	4,745	3,819	5,698
3.2 Loans	60,993	62,724	67,743
3.3 Currency and deposits	25,569	18,509	15,300
3.4 Other liabilities	482	470	646
Total Foreign Liabilities	1,54,753	1,42,469	1,18,762
of which: Banks	37,169	30,154	18,383
Net Foreign Liabilities (B-A)	60,066	68,822	81,052
of which: Banks	28,031	19,061	11,112
Net Foreign Liabilities as per cent of GDP	11.8	14.4	21.0

P : Provisional. PR : Partially Revised.

Note : Data are partially revised based on extended coverage of FDI data and revised external debt information for 2002 and 2003.

Table 6.18: Distribution of International Assets and Liabilities of India

(Per cent)

Year (end-March)	Distribution of Assets			
	Direct Investment	Portfolio Investment	Other Investment	Reserve Assets
1	2	3	4	5
1997	1.6	0.7	26.8	70.8
1998	1.7	0.7	26.3	71.4
1999	3.6	0.3	25.3	70.8
2000	3.4	0.2	25.7	70.7
2001	4.2	0.8	26.3	68.7
2002	5.4	0.9	19.4	74.3
2003	5.3	0.8	13.5	80.4

	Distribution of Liabilities		
	Direct Investment	Portfolio Investment	Other Investment
	6	7	8
1997	9.0	15.8	75.3
1998	11.5	16.7	71.8
1999	12.3	18.4	69.4
2000	13.3	19.0	67.7
2001	14.7	22.6	62.8
2002	17.8	22.1	60.0
2003	19.9	20.8	59.3

rupee assets. Reflecting the impact of the liberalisation of norms relating to Indian joint ventures/ wholly owned subsidiaries abroad and the growing international competitiveness of Indian corporates, direct investment abroad by the Indian entities turned out to be another high growth component of international assets during 2002-03.

6.70 India's total foreign liabilities increased by 8.6 per cent during 2002-03 due mainly to direct investment and 'other investments' comprising external borrowings, non-resident deposits and trade credits. Of the total foreign liabilities outstanding at end-March 2003, loans constituted the largest component (39.4 per cent), followed closely by portfolio investment (20.8 per cent), direct investment in India (19.9 per cent) and currency and deposits (16.5 per cent).

Table 6.19: Composition of India's International Liabilities

(Per cent)

Year (end-March)	Debt Liabilities	Non-debt Liabilities
1	2	3
1997	79.0	21.0
1998	76.7	23.3
1999	77.1	23.0
2000	74.5	25.6
2001	72.5	27.5
2002	68.8	31.2
2003	66.8	33.2

6.71 The share of non-debt liabilities in total foreign liabilities increased, *albeit* moderately. Debt liabilities accounted for around two-thirds of total foreign liabilities at end-March 2003 (Table 6.19). The share of debt in India's total foreign liabilities was significantly higher than that of Hong Kong, Korea, Malaysia, Singapore and Thailand.

6.72 The net foreign liabilities of the Indian banking sector increased by 19.8 per cent, despite a rise in its foreign assets by 21.2 per cent between March 2003 and March 2004. Foreign currency denominated assets of local residents increased sharply *vis-à-vis* foreign currency liabilities to local residents (Table 6.20).

Table 6.20: International Liabilities and Assets of Banks in India

(US $ million)

Category/Item	Amount outstanding at end of				
	March 2004	December 2003	September 2003	June 2003	March 2003
1	2	3	4	5	6
Total International Liabilities	**50,871**	**46,105**	**47,023**	**44,285**	**42,209**
of which:					
FCNR(B) Deposits	10,460	9,690	9,478	9,331	9,261
NRE Rupee Deposits	17,501	15,496	14,370	13,017	11,184
Foreign Currency Borrowings	7,743	6,003	5,002	3,994	3,876
Bonds (including RIBs and IMDs)	6,389	6,128	9,557	9,464	9,281
NR(NR) Rupee Deposits	1,690	2,121	2,399	2,796	3,201
ADRs and GDRs	1,474	1,554	1,146	909	807
EEFC Accounts	1,045	1,015	965	975	1,028
Total International Assets	**26,680**	**23,704**	**23,513**	**22,993**	**22,015**
of which:					
Foreign Currency Loans to Residents	10,159	9,147	8,563	8,215	7,760
Outstanding Export Bills	4,750	4,376	4,317	4,226	4,051
NOSTRO Balances	9,053	7,587	8,079	8,147	7,728

RIBs : Resurgent India Bonds. IMDs : India Millennium Deposits. ADRs : American Depository Receipts.
GDRs : Global Depository Receipts. EEFC : Exchange Earners' Foreign Currency.
Note : All figures are inclusive of accrued interest. In view of the incompleteness of data coverage from all bank branches, data reported here are not strictly comparable with those from all branches.

Box VI.4
International Comparison of International Investment Position

In the aftermath of the financial crises during the 1990s, there has been a general consensus that, apart from the cross border financial flows, stocks of international assets and liabilities of the country as captured by the international investment position (IIP) are an essential component of the analysis of external sector vulnerability. While large build-up of foreign exchange reserves in many Asian EMEs including India, abundance of liquidity in the international financial system and narrowing of the yield spread for fixed-income securities issued by EMEs are often taken as indicators of strength and resilience of the external sector of these economies, it is important to take a closer look at the composition of international assets and liabilities.

Despite considerable consolidation in recent years, India's net international liabilities at US $ 60 billion at end-March 2003 remain significant. In absolute terms, India's net international liabilities were higher than those of other EMEs such as Malaysia, the Philippines and Thailand but lower than those of Korea and Indonesia. As a ratio of GDP, however, India's international assets as well as liabilities were the lowest among the select countries (Table).

Recent trends show that the share of reserve assets in the total international assets is generally much higher for East Asian EMEs as compared with the industrialised countries. Except for Hong Kong and Singapore, reserve assets accounted for close to or higher than 50 per cent of the total international assets for the East Asian EMEs. In the case of India, however, the ratio was the highest at 80 per cent. In terms of composition of international liabilities, FDI was an important source of external finance for countries such as Hong Kong, Malaysia, Singapore and Thailand, while for other EMEs including India, the stock of portfolio investment was higher than the stock of FDI. The net international liabilities to foreign exchange reserves ratio could be taken as an indicator of resilience of the economy in the event of external payments crisis. In terms of this indicator, India's resilience to withstand external sector crisis was higher than most of the Asian EMEs, but lower than that of Malaysia, Hong Kong and Singapore.

Table : Cross-Country IIP: Select Indicators (end-December 2002)

(Per cent)

Country	As a Ratio of GDP		Reserve Assets as a Ratio of Total International Assets	As a Ratio of Total International Liabilities		
	Foreign Assets	Foreign Liability		Direct Investment	Portfolio Investment	Other Investment
1	2	3	4	5	6	7
India	18.6	30.5	80.4	19.9	20.8	59.3
Hong Kong	606.9	404.6	10.9	49.0	13.6	37.4
Indonesia	31.7	100.0	66.2	7.6	9.4	83.0
Japan	73.1	38.1	15.3	4.9	38.4	56.7
Korea	43.6	58.8	58.5	22.4	41.6	36.0
Malaysia	76.3	85.8	47.8	29.3	13.9	56.9
Philippines	40.0	88.6	51.9	16.2	26.5	57.5
Singapore	428.4	378.2	21.4	44.3	13.4	42.4
Thailand	46.0	82.2	66.9	36.5	17.1	46.3
US	592.5	821.1	2.6	17.5	39.2	43.2

Note : Data for India relate to end-March 2003.

6.73 In the post East Asian crisis, central banks in the EMEs of Asia have exhibited strong preference for reserves as an insurance against external shocks. A comparison of the international investment position of India *vis-à-vis* other EMEs of Asia reveals that although other Asian countries, such as Indonesia, Korea, Malaysia, the Philippines and Thailand also maintain high levels of reserve assets, the ratio of reserves to total foreign assets in these countries stands lower than that of India (Box VI.4).

Outlook

6.74 Favourable global growth prospects are being signalled by the IMF, which revised its 2004 growth forecast upwards to 4.6 per cent in its *World Economic Outlook,* April 2004. Recent data show considerable uncertainty surrounding the strengthening of global economic recovery on account of the outlook on international crude oil prices. Global imbalances and possibility of disruptive currency movements, firming up of commodity prices, transition to high interest rates and the uncertain prospects of soft landing of the China's economy continue to be some of the major uncertainties and risks facing the global economy.

6.75 India's external sector would benefit from the prospects of strengthening of world output and trade in 2004. Merchandise exports have started the year on a high note, rising by 28 per cent during April-June 2004. The optimistic industrial outlook augurs well for consolidating and building upon the gains in international competitiveness. The key engines - software and remittances - are likely to be sustained, given the intensity of skill and specialised competency in labour outflows. By current reckoning, India has entered a phase of durable current account surpluses in the BoP, even after accounting for any acceleration in imports resulting from the positive macroeconomic outlook. The level of reserves is comfortable at present. Globalisation and the interface with new types of external transactions, particularly those impacting the overall international investment position, however, warrant a careful and continuous re-assessment of the adequacy of reserves.