External Sector

7

The world economy entered 2005 with considerable growth momentum gained in 2004 — one of the best years in the last three decades, when the world economy grew by four per cent (5.1 per cent in purchasing power parity terms) and trade volume (goods and services) by 9.9 per cent (Table E.1). Even though the world economy is expected to post a deceleration in 2005 and 2006, both in overall growth as well as trade volume terms, short-term prospects remain generally positive. The United States and China continue to act as two major engines of continued growth of the world economy .

A special feature of the strong overall growth of the world economy in 2004 was that the improvement was almost universal. Every region and major country, except for India and Russia, grew more rapidly in 2004 than in 2003. Even in these two exceptional cases, though growth rates slipped from the high 2003 levels, they nevertheless remained above seven per cent.

The widespread nature of growth in developing countries in 2004 may be attributed to the fact that most countries benefited from one or more of three unusually coincidental developments: a rapid growth of trade in manufactured goods, increased prices for oil and most non-oil commodities, and calmer conditions in international financial markets.

Growth performance was more varied across the developed countries and regions. It was strong in the United States but moderate in Japan and the European Union. Germany and France registered significant acceleration over a relatively weak performance posted in 2003. The UK consolidated in 2004 its good growth performance in 2004.

The United States and China have been playing a mutually complementary role in generating global economic growth. Combined strong demand originating from these two countries has provided a wide-ranging boost to global growth. China has acted as a catalyst in several areas of economic activity in which the United States provided less impetus. For example, China's strong manufacturing sector accounted for a significant demand for raw materials, whereas growth in the United States triggered an accelerated demand for finished goods.

The United States and China have been playing a mutually complementary role in generating global economic growth

One of the major deficiencies of the international financial system continues to be the perceived need by developing countries to hold increasing amounts of foreign exchange as self-insurance. Such increases in foreign exchange reserves holdings were a partial reflection of the global external imbalances that not only persisted but also increased in 2004. Apart from depreciating the dollar, the global imbalances failed to have significant repercussions in 2004. However, as discussed in the preceding issue of this Review (April 2005), the possibility of an abrupt and globally damaging correction persists, since a depreciation of the dollar alone is unlikely to bring global imbalances to sustainable levels. Efforts to correct such imbalances should not focus only on reducing excessive demand in deficit countries or regions, since this may lead to a sudden contraction in global demand. However, some correction of the United States fiscal deficit, along with an improvement in its private savings rate might help. But the fear remains that expansionary measures elsewhere will counterbalance the contractionary effect of such measures.

India's Merchandise Trade

Exports

The 36-country real effective exchange rate (REER) for India has been appreciating since 2000-01, both in terms of export-based and trade-based weights. The appreciation has been relatively high at 3.9 per cent per annum on the average during the four-year period 2000-01 to 2003-04. The last fiscal 2004-05 has again seen an REER appreciation of four per cent (Table E.2). Notwithstanding this, India has seen remarkable success in merchandise exports during 2000-05, the only notable exception being 2001-02. Exports, measured in US dollars grew by more than 20 per cent in 2002-03 and 2003-04, and by 24.4 per cent 2004-05.

However, the remarkable success of India's merchandise exports during the last three years (2002-03 to 2004-05) loses some of its fizz if one takes into account the depreciation of the US dollar in the international market. The dollar has not only depreciated against the rupee but also against other major international currencies, including the euro. Consequently, the dollar has depreciated against the IMF's measure of the standard drawing rights (SDRs) by an average rate of 5.7 per cent per annum during the three-year period 2002-05. Export growth measured in SDR terms represents a measure closer to the growth in volume terms. Hence, the volume of India's exports, assuming the SDR to a proxy, increased by 15.4 per cent in 2002-03, 13.4 per cent in 2003-04 and by 20.2 per cent in 2004-05.

Exports appear to have been decelerating during recent months. Their growth rate during April-June 2005 is relatively low at 19.5 per cent compared to 35.6 per cent during the corresponding period in 2004. In terms of SDR, the growth rate of India's exports posted in April-June 2005 is even lower at 17.3 per cent.

Composition of India's Exports

The composition of India's merchandise exports is now available for 2004-05 (Table E.3). There has been remarkable growth in exports of ores and minerals from 20 per cent (in 2003-04) to 75.1 per cent (in 2004-05). Within manufactured goods, smart acceleration has been posted by categories of gems and jewellery, and consumer goods.

Despite a very good overall export performance, there should be serious concern over the slowdown in exports of textiles as well as readymade garments. Textile exports actually declined by 0.8 per cent in 2004-05 compared with a positive growth rate of 12 per cent in 2003-04. Exports of readymade garments declined even more sharply by 4.3 per cent in 2004-05, compared with a positive growth rate of 10.7 per cent posted in 2003-04. In SDR terms, exports of textiles declined by five per cent and those of readymade garments declined by 8.5 per cent in 2004-05.

Post-MFA Scenario

There has been some turbulence in international trade of textiles and readymade garments after the Multi-fibre Arrangement (MFA) was dismantled on January 1, 2005. May 2005 witnessed a peak in tensions between the United States and the European Union on the one hand, and China on the other.

China was permitted entry into the WTO in 2001 subject to certain conditions. The trade negotiators from the Western countries circumscribed detailed rules on possible quota re-introduction on the Chinese exports of textiles and garments, if required. These restraints could be used against China for three years following the demise of MFA (2005-2007).

While China is trying to grapple with international pressures, India has suffered a major setback in its exports of textiles and

The 36-country real effective exchange rate (REER) for India has been appreciating since 2000-01

Exports appear to have been decelerating during recent months readymade garments. Exports of textiles declined by 20.9 per cent during January-March, 2005 compared with a positive growth rate of 34.7 per cent posted in the corresponding period of 2004. Exports of readymade garments declined by 17.8 per cent during January-March, 2005 compared with a positive growth rate of 37.1 per cent posted in the corresponding period of 2004. These clearly are worrying signals for India (Table E.4).

One heartening fact is that India's exports of readymade garments to the United States increased by 13.9 per cent during January-March 2005 compared with a relatively low growth rate of two per cent posted in the corresponding period of 2004. The story has not been so good in the case of India's textile exports to the United States, which declined by 6.8 per cent in January-March 2005 compared with a positive growth rate of 16.6 per cent posted in the corresponding period of 2004 (DGCI&S).

The United States, although important, is not the only destination of India's exports. Based on the past three-year data (2001-02 to 2003-04), while about 29 per cent of Indian garment exports of are destined to reach the US, the corresponding share of India's textile exports to US is only 18 per cent.

Direction of India's Exports

India's exports to six of the top-15 export destination countries have grown in 2004-05 (Table E.5). There has been a sharp decline in India's exports to Hong Kong, Germany, Bangladesh and Sri Lanka. However, exports to the United States, Singapore, Belgium and Japan have seen major improvements.

Imports

Merchandise imports have also posted strong growth during the three-year period 2002-03 to 2004-05 (Table E.2). The oil import bill has risen mainly because of a significant increase in the international price of oil. However, it is important to observe that non-oil imports, contributing 72.6 per cent of total imports, posted rapid acceleration during this period, from a growth rate of 17 per cent in 2002-03, to 31.7 per cent in 2003-04, and further to 33.6 per cent in 2004-05. Measured in SDR terms, the corresponding growth rates were 12.1, 23.8 and 29.4 per cent, respectively. Such acceleration of the volume of non-oil imports is indicative of rapidly increasing domestic economic activity. Within import categories, export-related items and raw materials have posted impressive growth rates (Table E.6).

India's Balance of Payments

During the 51-year period 1950-51 to 2000-01, with the exception of eight surplus years, the Indian economy has always posted a deficit on the current account. Five of these eight "surplus years" occurred during the early 1950s, that is, prior to the commencement of the Second Five-Year Plan. The remaining three fell in the five years of the export boom of 1973-74 to 1977-78. More recently, India witnessed three years of current account surplus during the triennium ending (TE) 2003-04. However, the current account has again gone into deficit during 2004-05 (US $6,431 million).

The last time there was alarming increase in the level of current account deficit (CAD) was in 1991. The ratio of current account deficit to GDP reached above 3 per cent on the average during the TE 1990-91. The ten-year period of 1991-92 to 2000-01 saw a relatively comfortable CAD averaging 1.2 per cent of India's GDP. Throughout this period the balance of trade remained negative. So it was the increase in net invisible receipts including exports of non-factor (commercial) services, as well as private transfers (including remittances), that helped keep the CAD down.

The performances of invisible accounts continue to be healthy. Net exports of services increased from US$ 1,692 million in 2000-01 up to US$ 14,630 million in

India's exports of readymade garments to the United States increased by 13.9 per cent during January-March 2005, compared to a relatively low growth rate of two per cent in the corresponding period of 2004

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2004-05. Net private transfers increased from US$ 12,854 million in 2000-01 to US$ 22,833 million in 2003-04. However, the same have declined to US$ 20,459 million in 2004-05. (Table E.7).

While many of the export-oriented Asian economies including South Korea, Malaysia, the Philippines and Thailand improved upon their current account through posting strong growth in merchandise exports relative to their corresponding imports, India has done this through improved "invisible performance".

Net invisible receipts have grown by 21.8 per cent in 2004-05 over 2003-04. Net exports of services have posted 122 per cent growth with miscellaneous services registering an even higher growth of 188 per cent. In particular, net exports of software services have posted a growth rate of 41.5 per cent during 2004-05 (Table E.8).

The data thus point to a major revolution, rather than a steady change, in India's balance of payments. Invisibles have clearly become boldly visible.

Prognosis

The Indian economy has gained from the strong performance of the international economy. Despite the REER appreciation, its export performance has consistently been good during the last three years. Imports have also exhibited a healthy performance with continued acceleration of non-oil imports during the last three years.

India's overall export performance has posted signs of deceleration during the first five months of 2005, over the corresponding period in 2004. Decline in textile and readymade garment exports during January-March 2005 should be a major cause of worry. India needs to take quick measures to facilitate new investments in the manufacturing sector, particularly textiles and readymade garments.

India needs to take quick measures to facilitate new investments in the manufacturing sector, particularly textiles and readymade garments

The international financial environment appears to be somewhat fragile given the high levels of external and internal deficits of the US economy. Continued and deep dollar depreciation might cause various financial upheavals across the globe.

Table E.1: Growth of World Output, Trade and Consumer Prices (% Change, Y-o-Y)

Country/Region	**2003**	**2004**	**2005**	**2006**
A .World Output	4.0	5.1	4.3	4.4
World Output[a]	2.7	4.0	3.2	3.2
I. Advanced Economies	2.0	3.4	2.6	3.0
US	3.0	4.4	3.6	3.6
Japan	1.4	2.6	0.8	1.9
European Union, *of which*	1.2	2.5	2.1	2.5
France	0.5	2.3	2.0	2.2
Germany	-0.1	1.7	0.8	1.9
Italy	0.3	1.2	1.2	2.0
United Kingdom	2.2	3.1	2.6	2.6
NIEs of Asia	3.1	5.5	4.0	4.8
II. Other Emerging Market and Developing Countries	6.4	7.2	6.3	6.0
Developing Asia	8.1	8.2	7.4	7.1
China	9.3	9.5	8.5	8.0
Russia	7.3	7.1	6.0	5.5
India	7.5	7.3	6.7	6.4
B. World Trade				
I. Volume	4.9	9.9	7.4	7.6
II. Price Deflator in US $	10.7	9.4	5.2	0.2
in SDR	2.4	3.4	2.4	0.2
III. Imports				
i) Advanced Economies	3.6	8.5	6.5	6.3
ii) Other Emerging Market and Developing Countries	8.9	15.5	12.0	11.0
IV. Exports				
i) Advanced Economies	2.8	8.1	5.9	6.8
ii) Other Emerging Market and Developing Countries	10.7	13.8	9.9	9.7
C. Consumrer Prices				
i) Advanced Economies	1.8	2.0	2.0	1.9
ii) Other Emerging Market and Developing Countries	6.0	5.7	5.5	4.6

[a] GDP in constant dollars at 1995 prices and market exchange rates (Global Economic Prospects, 2005)

Note: World trade comprises of trade in goods and services
Values for 2005 and 2006 are IMF projections unless otherwise specified

Source: IMF, *World Economic Outlook*, April 2005
World Bank, *Global Economic Prospects*, 2005

Table E.2: India's Foreign Trade (US$ Million) and Currency Movement (% change, Y-o-Y)

Year	US Dollar vis-à-vis SDR* (%)	REER # (%)	Exports	Growth rate (%)	Oil imports	Growth rate (%)	Non-oil imports	Growth rate (%)	Total imports	Growth rate (%)	Trade balance
2000-01	-4.1	4.6	44560.3	21.0	15650.1	24.2	34886.4	-5.9	50536.5	1.7	-5976.2
2001-02	-3.2	3.0	43826.7	-1.6	14000.3	-10.5	37413.0	7.2	51413.3	1.7	-7586.6
2002-03	4.9	5.5	52719.4	20.3	17639.5	26.0	43772.6	17.0	61412.1	19.4	-8692.7
2003-04	7.9	2.6	63978.8	21.4	20599.2	16.8	57651.7	31.7	78250.9	27.4	-14272.1
2004-05	4.2	4.0	79593.6	24.4	29084.9	41.2	77036.3	33.6	106121.2	35.6	-26527.6
					April-June						
2004-05	4.4	4.4	17483.3	35.6	7207.9	57.5	16237.8	29.0	23445.7	36.6	-5962.4
2005-06	3.2	NA	20900.3	19.5	9598.4	33.2	22761.8	40.2	32360.1	38.0	-11459.8

* A negative/positive sign indicates appreciation/depreciation of the US Dollar vis-à-vis SDR
# A positive/negative sign indicates appreciation/depreciation of the Indian Rupee
Note: REER is the index of real effective exchange rate of Indian Rupee vis-à-vis USD based on 36 country bilateral export weights
Source: DGCI&S, in RBI, *Handbook of Statistics on Indian Economy,* 2003-04
GOI, Ministry of Commerce and Industry, Press Release, July 18, 2005

Table E.3: Growth of India's Major Export Commodities

Commodity/ Commodity Groups	Share in Total Exports %		Growth Rate %	
	2003-04	2004-05	2003-04	2004-05
I. Agricultural & Allied Products	11.9	10.1	13.5	5.1
II. Ores & Minerals	3.7	5.3	20.0	75.1
III. Manufactured Goods *of which*	76.6	73.1	21.8	18.7
1. Leather & Leather Manufactures	3.4	2.9	18.3	4.7
2. Chemicals & Related Products	10.2	9.5	23.9	15.2
3. Engineering Goods	19.5	20.6	38.7	31.6
4.Textiles (excl RMG)	9.4	7.5	12.0	-0.8
5. Readymade Garments (RMG)	9.8	7.6	10.7	-4.3
6. Gems and Jewellary	16.7	17.2	18.4	28.2
7. Handicrafts	0.8	0.4	-35.7	-32.0
8. Carpets	0.9	0.7	11.2	0.7
9. Other Manufactured Products	5.7	6.6	36.9	44.4
IV.Petroleum & Crude Products	5.6	8.5	40.0	88.3
V. Other Commodities	3.0	2.9	59.4	21.7
All Commodities	100.0	100.0	21.4	24.4

Source: DGCI&S

Table E.4: Growth in India's Exports of Textiles and Readymade Garments During January-March

	Exports to world		Exports to USA	
Commodities	**2004**	**2005**	**2004**	**2005**
Textiles (excl RMG) *of which*	34.7	-20.9	16.6	-6.8
1) Cotton Yarn Fabric Madeups	31.2	-30.7	0.7	-13.0
2) Natural Yarn Fabrics and Madeups	53.4	-10.8	44.8	26.2
3) Manmade Yarn Fabric Madeups	36.6	-13.8	120.0	-31.4
4) Coir & Coir Manufact. & Other Manufactures	44.4	0.7	41.0	14.4
Readymade Garments (RMG)	37.1	-17.8	2.0	13.9
USD per SDR*	8.6	2.4		

* A negative/positive sign indicates appreciation/depreciation of the US Dollar vis-à-vis SDR
Source: DGCI&S

Table E.5: Share and Growth of India's Exports to Major Destinations

	Share in Total Exports %		Growth Rate %	
Country	**2003-04**	**2004-05**	**2003-04**	**2004-05**
U S A	18.2	16.7	6.6	14.2
U Arab Emirates	8.1	8.9	55.7	37.0
China Peoples Republic	4.7	5.8	51.2	53.5
Singapore	3.4	4.8	51.1	76.7
Hong Kong	5.2	4.6	26.2	10.7
U K	4.8	4.5	22.4	16.0
Germany	4.0	3.3	22.1	2.8
Belgium	2.9	3.1	9.9	33.8
Italy	2.7	2.7	28.9	23.6
Japan	2.7	2.5	-7.3	14.4
France	2.0	2.0	20.6	24.3
Bangladesh PR	2.8	2.0	49.7	-9.9
Netherland	2.0	1.9	24.4	16.5
Saudi Arab	1.8	1.7	20.7	20.6
Sri Lanka DSR	2.1	1.7	44.8	1.5
ROW	33.7	33.8	20.8	24.7
Total	100.0	100.0	21.4	24.4

Source: DGCI&S

Table E.6: India's Imports of Major Non-oil Commodities

	Share in Total Imports %		Growth Rate %	
Commodities	**2003-04**	**2004-05**	**2003-04**	**2004-05**
I. Food & related items	6.0	4.4	27.8	-0.9
II. Export related items	20.8	20.4	24.1	30.6
III. Capital goods	34.2	31.2	34.8	22.0
IV. Raw materials & intermediaries	25.5	28.6	39.2	49.4
V. Manufactured goods	9.9	10.0	47.4	35.7
VI. Other commodities	4.6	4.2	12.9	24.5
Total Non-Oil Imports	100.0	100.0	31.7	33.6

Source: DGCI&S

Table E.7: Overall Balance of Payment in India, Net Credit (US$ Million)

	2000-01	2001-02	2002-03	2003-04	2004-05
A. Current account					
1. Merchandise Trade Balance	-12460	-11574	-10690	-15454	-38130
2. Net Invisible Receipts *of which*	9794	14974	17035	26015	31699
a) Services	1692	3324	3643	6591	14630
b) Private Transfers	12854	15398	16387	22833	20459
Current Account Balance	-2666	3400	6345	10561	-6431
B. Capital account					
1. Foreign investment *of which*	5862	6686	4161	14776	11944
a) FDI in India	4031	6125	5036	4674	5526
b) FII in India	2760	2021	979	11378	8907
2. External assistance	410	1117	-3128	-2742	1922
3. Commercial borrowings (including short term credit)	4854	-2378	-722	-106	9739
4. Banking capital	-1961	2864	10425	6231	4002
5. Rupee debt service	-617	-519	-474	-376	-417
6. Other capital	292	781	578	2759	4985
Capital Account Balance	8840	8551	10840	20542	32175
C. Error & ommissions	-306	-194	-200	318	415
D. Overall balance	5868	11757	16985	31421	26159
E. Monetary movements	-5868	-11757	-16985	-31421	-26159
1. I.M.F	-26	0	0	0	0
2. Foreign exchange reserves (increase -/ decrease +)	-5842	-11757	-16985	-31421	-26159

Sources: RBI Monthly Bulletin, various issues, Press Release June 30, 2005

Table E.8: India's Invisibles on Current Account, Net Credit (US$ Million)

	2000-01	2001-02	2002-03	2003-04	2004-05
Invisibles	9794	14974	17035	26015	31699
Services	1692	3324	3643	6591	14630
Travel	693	123	-29	611	-497
Transportation	-1512	-1306	-736	929	509
Insurance	47	8	19	57	294
G.n.i.e	332	235	65	70	142
Miscellaneous *of which*	2132	4264	4324	4924	14182
Software services	5750	6884	8863	11750	16626
Transfers	13106	15856	16838	23396	21048
Official	252	458	451	563	589
Private	12854	15398	16387	22833	20459
Income	-5004	-4206	-3446	-3972	-3979

Sources: RBI Monthly Bulletin, various issues, Press Release June 30, 2005