

External Sector

World Economy

The world economy decelerated in 2005 with the estimated growth rate slipping to 4.8 per cent compared with 5.3 per cent in 2004 (Table E.1). The growth expectations for 2006 and 2007 remain close to 2005 performance. While the IMF reports growth figures on the basis of purchasing power parity, the UN estimate of the world economic growth, which is calculated at market prices, is 3.1 per cent for 2005¹.

Most of the developed economies, except Japan, experienced slower growth during 2005. While Japan and the United States are expected to sustain their 2005 growth rates in 2006, brisk growth recovery this year is expected in the EU, supported by higher growth in France, Germany, Italy and the United Kingdom, as well as in the NIEs of Asia.

The United States remains the main engine of global economic growth supported by the dynamic growth of China, India and few other large developing economies, especially East Asian ones.

The international trade has been providing momentum to the growth of the world economy. The volume of the world trade is expected to grow in 2006 at a rate higher than in 2005. The trade flows in 2005 grew by more than 50 per cent of the pace of world output and a similar pattern

is expected in 2006. China and India have witnessed sustained and intensive export dynamism. Consequent to increases in oil and non-agricultural commodity prices, many of the developing countries have gained from substantial improvement in their terms of trade over the past few years. The prices of primary commodities are expected to rise further in 2006 and start declining only in 2007. (Table E.2).

There are various downside risks that could seriously affect world economic growth in the near future. These include possibilities of oil prices rising further, a disorderly unwinding of the macroeconomic imbalance of major economies and failure to ink a successful multilateral trade pact².

The high oil prices are taking greater toll in growing number of oil-importing developing countries. As a follow-up on the initial rise in oil prices, many countries avoid passing on such inflation to their consumers by providing subsidies. Such measures would become less viable in the medium to long run, if oil prices continue to remain high or increase further. On the other hand, while the oil exporting countries have been getting some windfall gains, the increased inflows of money are creating inflationary pressures and appreciation of the real exchange rate.

Global growth expectations for 2006 and 2007 remain close to the 2005 performance

Possibilities of oil prices rising further and a disorderly unwinding of the macroeconomic imbalances of the major economies are downside risks to global growth

1 "World Economic Situation and Prospects 2006", the United Nations. The section on World Economy draws upon this reference.

2 For details, refer the External Sector in the Quarterly Review of January 2006.

The global imbalances widened further during 2005. The current account deficit of the United States crossed \$800 billion. There was corresponding increase in current account surplus in Europe, East Asia and oil-exporting countries. However, the continued rise in the United States' net foreign liability position could dissuade foreign investors to buy dollar-denominated assets. This might lead to a sudden decline in the value of the US dollar and abrupt and disorderly adjustment of the global financial imbalances.

Another worrying feature is that in several parts of the world, growing savings surpluses appear to be essentially caused by stagnating or reduced investment rates. The global investment rate has been declining and had reached historic low in 2002. There has been slight recovery thereafter and the rate remains below 22 per cent of the world output. Some economists have termed this as "global savings glut". The investment demand has been "anaemic" in many of the countries running current account surpluses with the exception of China.

Finally, the international trade flows in the coming years would be guided by the degree of success of the multilateral trade discipline that is likely to come through successful conclusion of the Doha Development Agenda (DDA). A weak-looking WTO has already been leading to uncertainty, resulting in mushrooming of bilateral and regional preferential integration agreements (PIAs). The drive for autonomous liberalisation has decelerated. Hopefully, such PIAs would become building blocs of freer global trade. However, given the amount of complexity that such PIAs have introduced, these may well turn out to be thwarting and stumbling blocs for successful culmination of the DDA hopes.

India's Trade Policy

The Annual Supplement of India's

Foreign Trade Policy (FTP) 2004-2009 was announced on 7 April 2006 by the Minister of Commerce and Industry. It has patting itself by quoting the high export growth figures of 2004-05 and 2005-06.

Some changes have been introduced in the existing foreign trade policy through 'Focus Product' and 'Focus Market' schemes. Export incentives would be provided on export of certain products that are expected to have relatively high employment potential. Such incentives would also be extended to certain export destinations particularly in Latin America and Africa. Incentives would also be provided to export of products originating from village industries. Various new features have been added to promote export of services under the 'Served from India Scheme'.

The Supplement has introduced a number of measures for facilitating export of value added products catering to the changing needs of the market and facilitating easier product movement across borders and allowing import of precious metal scrap for refining. Import of new vehicles has been permitted without homologation by the auto-component manufacturers for R&D purposes. Supplies of food, beverages and refuelling of international long haul flights would now be treated as exports and thus qualify for benefits under various Export Promotion Schemes. Import of inputs for the processing of certain marine products has been further facilitated.

The failure of the 'Advance Licensing Scheme' to permit import of the required inputs before exports, particularly by small exporters, has led to a new 'Duty Free Import Authorisation Scheme'.

The incidence of un-rebated service tax and fringe benefit tax on exports will now onwards be factored in the various duty neutralisation and remission schemes. The Export Promotion Capital Goods (EPCG) Scheme has been made more flexible

The global investment rate has been declining and gone below 22 per cent

Supplies of food, beverages and refuelling of international long haul flights would now be treated as exports

through extending the export obligation period by two years. Export-oriented Units (EoUs) would be nurtured simultaneously even as the Special Economic Zones (SEZs) progress.

India's Merchandise Trade

For the first time, India's exports have reached \$101 billion, registering growth rate of 24.7 per cent. The imports, at \$140 billion, have grown by 31.5 per cent. These include \$43 billion oil imports.

During the three-year period from 2002-03 to 2004-05, the US dollar depreciated against IMF's measure of Standard Drawing Rights (SDRs). After three years, the US dollar has appreciated vis-à-vis SDR by 1.7 per cent during the period April-February 2005-06 (Table E.3).

The 36-country export-weighted Real Effective Exchange Rate (REER) has been depreciating since 2001-02, except for the year 2003-04 when it appreciated by 3.2 per cent. The REER appreciated again during April-December 2005 by 3.2 per cent.

Composition of India's Exports

Details of the composition of merchandise exports are available for April-December 2005-06 (Table E.4). During this period, the overall exports posted a growth of 28 per cent as compared to 25.3 per cent during April-December 2004-05.

The exports of agriculture and allied products, and manufactured goods have accelerated during April-December 2005-06. Within manufactured goods, exports of readymade garments and handicrafts have exhibited smart acceleration. However, exports of ores and minerals, and petroleum and crude products have decelerated during the first three-quarters of 2005-06. Measured in US dollars, exports of petroleum and crude products have posted high growth rate of 63.5 per cent during April-December 2005-06. However, this is

less than the growth rate of 92.4 per cent posted during the corresponding period of the previous year.

Direction of India's Exports

Table E.5 presents India's total merchandise exports to the top 15 destinations for the period April-December 2005-06. The exports to seven of the top 15 destinations have accelerated during this period. The growth in exports to the Netherlands has been most impressive at 71 per cent as compared to only 16.6 per cent during April-December 2004-05. Other destinations that have witnessed acceleration in exports are the USA, the UK, Hong Kong, Germany, Japan and Sri Lanka. The exports to eight of the top 15 destinations, including China and Singapore have slowed down.

The USA continues to be the most attractive destination for India's exports. Exports to the USA account for 17.2 per cent of total exports during April-December 2005-06. Notwithstanding deceleration in exports, China's share in overall exports has increased during this period. Shares of exports to Singapore, the UK and the Netherlands have increased noticeably. Despite acceleration in exports to Japan, its share in overall exports has fallen.

Composition of Imports

The non-oil imports, measured in US dollars, have grown at 33 per cent during April-December 2005-06 as compared to nearly same growth of 32.5 per cent during April-December 2004-05 (Table E.6). The structure of non-oil imports shows that imports of manufactured goods and capital goods have accelerated while imports of export-related items, raw materials and intermediaries, and other commodities have decelerated during April-December 2005-06.

The capital goods imports consti-

India's exports in 2005-06 have reached \$101 billion, registering growth rate of 24.7 per cent

Exports of readymade garments and handicrafts have exhibited smart acceleration during April-December 2005

tute 33.2 per cent of total non-oil imports during April-December 2005-06. The imports of raw materials and intermediaries which include items such as coal, coke and briquettes, gold and silver and ores and metal scrap, constitute the second strongest importing category with a share of 26.6 per cent in total non-oil imports. The share of export-related items has declined between April-December 2005-06 and April-December 2004-05. The sharp acceleration in imports of manufactured goods has resulted in increasing their share from 10.2 per cent in April-December 2004-05 to 12.4 per cent during April-December 2005-06. The share of food and related items has declined to 3.4 per cent in total non-oil imports during April-December 2005-06.

Balance of Payments (BOP)

The merchandise trade deficit is likely to touch a record high in 2005-06. The surplus on invisible receipts would, however, lead to a lower absolute value of the current account deficit (CAD), which would be matched by surplus on capital account.

India's trade deficit touched \$41.5 billion during April-December 2005, i.e. about 57 per cent higher than its corresponding value for 2004 (Table E.7)³. With net invisible receipts having increased by 36 per cent to \$28 billion, the CAD has increased to \$13.5 billion, which is 127 per cent above its corresponding value of April-December 2004.

The two most important categories contributing to net increase of \$28 billion on "invisibles account" include

trade in services (mainly software) and private transfers (Table E.8).

Overall export of services touched \$41.2 billion during April-December 2005, which is 33 per cent higher than the corresponding value achieved in 2004 (Table E.9). The exports of software services touched \$16.1 billion and posted a growth of 32 per cent. The export of software services constituted about two-fifths of total export of services during this period.

The surplus of capital account during April-December 2005 is estimated at \$14.7 billion. Once it is adjusted for "errors and omissions" of \$538 million and increase in foreign exchange reserves of \$1,776 million, it matches the CAD of \$13.5 billion. The major items in the capital account that have helped meet exceptionally high CAD include inflow of foreign institutional investments (FIIs) worth \$8.2 billion and foreign direct investments worth \$5.3 billion.

India's foreign exchange reserves stood above \$151.6 billion at the end of the fiscal 2005-06, which is \$10 billion higher than the corresponding value of \$141.2 billion as on April 1, 2005⁴. The reserves on 31 March 2006 included \$145.1 billion worth of foreign currency assets and \$5,755 million worth of gold.

Prognosis

India has posted extremely good merchandise export performance of above 25 per cent growth during 2005-06. The exports have grown and accelerated at rates above 20 per cent during the preceding three years. The export of services has also been growing at remarkably high

The capital goods imports constitute 33.2 per cent of total non-oil imports during April-December 2005

Export of services touched \$41.2 billion during April-December 2005, which is 33 per cent higher than the corresponding value achieved in 2004

3 It may be noted that this RBI-BOP based trade deficit is much higher than the DGCI&S reported trade deficit of about \$30 billion during the same period. This discrepancy arises on account of difference in coverage, valuation and timing. Much of this has to do with defence imports reported in RBI-BOP data but not included in the DGCI&S data.

4 Refer to Reserve Bank of India Bulletin, Weekly Statistical Supplement, April 7, 2006.

rates. The growth rate was above 70 per cent in 2004-05 and above 33 per cent during April-December 2005-06.

The continued high oil price has not let India move into a comfortable CAD zone despite impressive exports. The value of oil imports increased by 45 per cent in 2004-05 and by 47 per cent in 2005-06.

India seems to have made a good advantage of exploiting its export opportunities during the first half of the first decade of the new millennium. Such opportunities came through as a result of its autonomous economic reform process as also increased import demand in many of its traditional export destinations as well as enhanced export to many of the East Asian countries, especially China.

While the foregoing discussion in this section paints a happy and hopeful picture of India's growing export prowess during the next two to three years, much more has to be done with regard to the policy that would sustain such might for a longer term. Conducive environment should be provided to bring in new investments both in high-tech as well as labour-intensive sectors of production. The efficient re-allocation of existing non-performing locked-in capital assets into productive use would add overall productivity to the economy. While trade in services has stood India in good stead on its BOP during the last decade, merchandise exports have started facing infrastructural bottlenecks as well as policy impediments arising from continued shirk on reforming labour and exit laws.

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

Country/Region	2004	2005	2006	2007
A. World Output	5.3	4.8	4.9	4.7
I. Advanced Economies	3.3	2.7	3.0	2.8
US	4.2	3.5	3.4	3.3
Japan	2.3	2.7	2.8	2.1
European Union, <i>of which</i>	2.5	1.8	2.4	2.3
France	2.1	1.4	2.0	2.1
Germany	1.6	0.9	1.3	1.0
Italy	0.9	0.1	1.2	1.4
United Kingdom	3.1	1.8	2.5	2.7
NIEs of Asia	5.8	4.6	5.2	4.5
II. Other Emerging Market and Developing Countries	7.6	7.2	6.9	6.6
Developing Asia	8.8	8.6	8.2	8.0
China	10.1	9.9	9.5	9.0
Russia	7.2	6.4	6.0	5.8
India	8.1	8.3	7.3	7.0
III. World Growth Based on Market Exchange Rates	4.0	3.4	3.6	3.4
B. World Trade (Goods & Services)				
I. Volume	10.4	7.3	8.0	7.5
II. Price Deflator in US \$	9.7	5.2	0.7	0.4
in SDR	3.8	5.5	3.5	0.2
III. Imports				
i) Advanced Economies	8.9	5.8	6.2	5.6
ii) Other Emerging Market and Developing Countries	15.8	12.4	12.9	11.9
IV. Exports				
i) Advanced Economies	8.5	5.3	6.6	6.1
ii) Other Emerging Market and Developing Countries	14.6	11.5	10.9	10.3
C. Consumer Prices				
i) Advanced Economies	2.0	2.3	2.3	2.1
ii) Other Emerging Market and Developing Countries	5.7	5.4	5.4	4.8

Note: Values for 2006, 2007 are IMF projections unless otherwise specified

Source: IMF, *World Economic Outlook*, April 2006

Table E.2: Growth in World Trade Prices

World Prices	annual percentage change			
	2004	2005	2006	2007
1. World Trade Prices in US \$				
Manufactures	9.6	4.5	-1.4	1.2
Oil	30.7	41.3	14.8	2.9
Non-fuel Primary Commodity	18.5	10.3	10.2	-5.5
2. World Trade Prices in SDR				
Manufactures	3.7	4.7	1.4	0.9
Oil	23.6	41.6	18.0	2.6
Non-fuel Primary Commodity	12.1	10.5	13.2	-5.7
3. World Trade Prices in EURO				
Manufactures	-0.3	4.3	2.8	1.2
Oil	18.9	41.0	19.7	2.8
Non-fuel Primary Commodity	7.8	10.0	14.9	-5.5

* current projections

Source: IMF, *World Economic Outlook*, April 2006**Table E.3: 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	3.6	44560.3	21.0	15650.1	24.2	34886.4	-5.9	50536.5	1.7	-5976.2
2001-02	-3.2	-0.1	43826.7	-1.6	14000.3	-10.5	37413.0	7.2	51413.3	1.7	-7586.6
2002-03	4.9	-2.6	52719.4	20.3	17639.5	26.0	43772.6	17.0	61412.1	19.4	-8692.7
2003-04	7.9	3.2	63842.6	21.1	20569.5	16.6	57579.6	31.5	78149.1	27.3	-14306.5
2004-05	4.2	-0.8	80672.4	26.4	29858.3	45.2	76772.2	33.3	106630.5	36.4	-25958.1
2005-06	-1.7	3.2	100606.9	24.7	43844.3	46.8	96393.4	25.6	140237.7	31.5	-39630.7

* 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:

1. REER is the index of real effective exchange rate of Indian Rupee vis-à-vis USD based on 36 country bilateral export weights

2. REER for 2005-06 corresponds to the period April-December 2005-06

Source:

DGCIS, in RBI, *Handbook of Statistics on Indian Economy*, 2004-05

GOI, Ministry of Commerce and Industry, Press Release, April 5, 2006

Reserve Bank of India, Monthly Bulletin, March 2006

www.ExchangeRate.com

**Table E.4: Share and Growth of India's Major Export Commodities
(April-December, % \$ Value)**

Commodity/ Commodity Groups	Share in Total Exports		Growth Rate	
	2004-05	2005-06	2004-05	2005-06
I. Agricultural & Allied Products	10.2	9.8	12.2	22.7
II. Ores & Minerals	5.0	5.5	92.1	41.9
III. Manufactured Goods of which	73.3	70.0	19.5	22.2
1. Leather & Leather Manufactures	3.0	2.7	11.6	12.6
2. Chemicals & Related Products	9.6	9.6	17.4	27.2
3. Engineering Goods	20.4	20.5	33.4	28.7
4. Textiles (excl RMG)	8.0	6.8	6.5	9.0
5. Readymade Garments (RMG)	7.8	8.1	2.3	34.1
6. Gems and Jewellery	16.7	15.4	17.5	18.1
7. Handicrafts	0.5	0.4	-25.2	10.3
8. Carpets	0.8	0.8	6.0	31.5
9. Other Manufactured Products	6.4	5.5	47.7	9.9
IV. Petroleum & Crude Products	8.8	11.2	92.4	63.5
V. Other Commodities	2.7	3.5	23.1	64.6
All Commodities	100.0	100.0	25.3	28.0
USD per SDR*			4.8	-1.1
REER (Appreciation/ Depreciation) [#]			-1.1	3.2

* 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

Source: DGCI&S

**Table E.5: Share and Growth of India's Exports to Major Destinations
(April-December, % \$ Value)**

Country	Share in Total Exports		Growth Rate	
	2004-05	2005-06	2004-05	2005-06
U S A	17.5	17.2	17.5	25.9
U Arab Emirates	8.7	8.2	45.0	20.5
China Peoples Republic	5.3	6.0	59.4	46.0
Singapore	4.7	5.7	91.3	55.6
U K	4.4	5.2	16.4	49.7
Hong Kong	4.4	4.4	1.9	28.2
Germany	3.3	3.4	6.2	29.8
Belgium	3.0	2.7	29.5	14.6
Netherland	1.9	2.6	16.6	71.0
Italy	2.6	2.3	24.5	13.7
Japan	2.5	2.3	9.3	20.1
Sri Lanka DSR	1.8	2.1	7.0	49.7
France	2.0	2.0	30.0	26.0
Saudi Arab	1.8	1.8	30.8	27.7
South Africa	1.3	1.6	95.4	63.4
ROW	34.8	32.5	22.8	19.7
ASEAN	4.5	3.9	11.3	12.5
NIEs	11.2	12.3	32.8	41.5
EU	20.9	21.7	20.4	33.1
Total	100.0	100.0	25.3	28.0
USD per SDR*			4.8	-1.1
REER (Appreciation/ Depreciation) [#]			-1.1	3.2

* 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:

Values are sorted on exports for April-December 2005-06

ASEAN includes Indonesia, Malaysia, Phillipines, Thailand

NIEs includes Hong Kong, Korea, Taiwan, Singapore

EU includes Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, UK

Source: DGCI&S

**Table E.6: Share and Growth of India's Imports of Major Non-oil Commodities
(April-December, % \$ Value)**

Commodities	Share in Total Imports		Growth Rate	
	2004-05	2005-06	2004-05	2005-06
I. Food & related items	4.7	3.4	-2.1	-2.0
II. Export related items	19.7	18.5	26.3	24.6
III. Capital goods	31.3	33.2	29.2	41.0
IV. Raw materials & intermediaries	28.6	26.6	44.0	23.5
V. Manufactured goods	10.2	12.4	36.0	61.2
VI. Other commodities	5.5	5.9	58.9	43.4
Total Non-Oil Imports	100.0	100.0	32.5	33.0
USD per SDR*			4.8	-1.1
REER (Appreciation/ Depreciation) [#]			-1.1	3.2

* 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

Source: DGCI&S

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

	2003-04	2004-05	April-December	
			2004-05	2005-06
A. Current account				
1. Merchandise Trade Balance	-13718	-36629	-26500	-41531
2. Net Invisible Receipts <i>of which</i>	27801	31229	20573	28056
a) Services	10144	14199	8967	15854
b) Private Transfers	21608	20253	14057	17091
Current Account Balance	14083	-5400	-5927	-13475
B. Capital account				
1. Foreign investment <i>of which</i>	13744	12147	7837	12886
a) FDI in India	4322	5589	4300	5309
b) FII in India	11356	8907	5100	8155
2. External assistance	-2858	1923	673	914
3. Commercial borrowings (including short term credit)	-1506	8832	5820	142
4. Banking capital	6033	3874	1611	1357
5. Rupee debt service	-376	-417	-297	-142
6. Other capital	1699	4668	3595	-444
Capital Account Balance	16736	31027	19239	14713
C. Error & omissions	602	532	218	538
D. Overall balance	31421	26159	13530	1776
E. Monetary movements	-31421	-26159	-13530	-1776
1. I.M.F	0	0	0	0
2. Foreign exchange reserves (increase -/ decrease +)	-31421	-26159	-13530	-1776
USD per SDR (% change)	7.9	4.2	4.8	-1.1
REER (Appreciation/ Depreciation) (% change) [#]	3.2	-0.8	-1.1	3.2

* 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

Source: Reserve Bank of India, Monthly Bulletin, various issues, Release on 31 March 2006

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

	2003-04	2004-05	April-December	
			2004-05	2005-06
Invisibles	27801	31229	20573	28056
Services	10144	14199	8967	15854
Travel	1435	985	415	951
Transportation	879	259	277	-291
Insurance	56	187	95	215
G.n.i.e	28	67	85	-34
Miscellaneous of which	7746	12701	8095	15013
Software services	12324	16526	11726	15078
Transfers	22162	20844	14424	17153
Official	554	591	367	62
Private	21608	20253	14057	17091
Income	-4505	-3814	-2818	-4951
USD per SDR (% change)*	7.9	4.2	4.8	-1.1
REER (Appreciation/ Depreciation) (% change) [#]	3.2	-0.8	-1.1	3.2

* 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

Source: Reserve Bank of India, Monthly Bulletin, various issues, Release on 31 March 2006

**Table E.9: India's Invisibles on Current Account, Credit
(US\$ Million)**

	2003-04	2004-05	April-December	
			2004-05	2005-06
Invisibles	53508	71854	49057	62844
Services	26868	46031	30894	41182
Travel	5037	6495	4468	5329
Transportation	3207	4798	3496	4500
Insurance	419	909	727	773
G.n.i.e	240	328	282	221
Miscellaneous of which	17965	33501	21921	30359
Software services	12800	17200	12209	16056
Transfers	22736	21276	14734	17778
Official	554	623	390	374
Private	22182	20653	14344	17404
Income	3904	4547	3429	3884
USD per SDR (% change)*	7.9	4.2	4.8	-1.1
REER (Appreciation/ Depreciation) (% change) [#]	3.2	-0.8	-1.1	3.2

* 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

Source: Reserve Bank of India, Monthly Bulletin, various issues, Release on 31 March 2006