6

External Sector

The world economy witnessed a sharp upturn in 2004, on account of robust growth in both advanced and emerging market economies. Global output is projected to grow by 5 per cent in 2004, the highest in nearly three decades. Economic activity rebounded strongly in advanced economies with the growth impetus emanating from upbeat performances by the United States (US) and Japan. Among emerging market economies, the Commonwealth of Independent States (CIS) and developing Asia continued to add stability to the overall process of global expansion and consolidation (Table 6.1).

6.2 The US economy was once again the prime determinant of global growth among the G-3 (US, Japan and the Euro area), despite indications of a slight slowdown during the later part of 2004. A similar trend was witnessed in Japan, which is projected to improve output growth by nearly 2 percentage points over 2003. Indications of a broad-based recovery were evident in the Euro area as well, on account of strong growth in the United

Table 6.1 : External environment
(Annual per cent change unless otherwise noted)

			Projections	
	2002	**2003**	**2004**	**2005**
A. World output	**3.0**	**3.9**	**5.0**	**4.3**
Advanced economies	**1.6**	**2.1**	**3.6**	**2.9**
United States	1.9	3.0	4.3	3.5
European Union	0.8	0.5	2.2	2.2
Japan	-0.3	2.5	4.4	2.3
Other advanced economies	3.6	2.4	4.3	3.5
Newly industrialized Asian economies	5.0	3.0	5.5	4.0
Other emerging market and developing economies	**4.8**	**6.1**	**6.6**	**5.9**
Developing Asia	6.6	7.7	7.6	6.9
China	8.3	9.1	9.0	7.5
India	5.0	7.2	6.4	6.7
ASEAN-4*	4.3	5.1	5.5	5.4
Commonwealth of Independent States (CIS)	**5.4**	**7.8**	**8.0**	**6.6**
Russia	4.7	7.3	7.3	6.6
B. World trade volume (goods & services)	**3.3**	**5.1**	**8.8**	**7.2**
C. World trade prices (in US$ terms)				
Manufactures	2.4	13.2	7.5	1.5
Oil	2.5	15.8	28.9	–
Non-fuel primary commodities	0.6	7.1	16.8	-3.9
D. Emerging market and developing countries; Private capital flows (net) (in US $ billion)	61.2	120.4	81.6	47.5

*** Includes Indonesia, Malaysia, Philippines and Thailand.**

Source: World Economic Outlook; September 2004; The International Monetary Fund.

Kingdom (UK) and recoveries by Germany and France. While a moderation of growth stimulus in the US and Japan is expected to be temporary, sustaining the upturn in the Euro area is contingent upon the region's ability to successfully encounter the challenge of integrating the ten new 'accession' economies of the Eastern Europe into the common market of the European Union.

6.3 Like in recent years, growth in developing Asia was spearheaded by the Chinese economy, which continued to expand robustly, on account of a sharp rise in investment and credit. India, another major economy of developing Asia, also contributed significantly to the maintenance of the growth momentum of the region. Augmentation of private capital flows to the region was testimony to the overall strength of its economic fundamentals. The broad-based global recovery, which manifested in a sharp increase in demand for merchandise exports from the export-oriented economies of developing Asia, accompanied by robust inflows of workers' remittances in China and India, resulted in surplus current account balances for most economies of the region, followed by a concomitant rise in the volume of reserves.

6.4 In spite of the encouraging advance in global recovery, significant concerns continue to persist regarding the sustenance of the process. Much of these concerns emanate from the already high global energy prices. Despite some softening in the interim, the

Box 6.1 : Impact of a declining US dollar and its consequences

Since 2002, the US US dollar has been depreciating against the Euro and the Pound Sterling. From 2003, the US dollar started weakening against the Japanese Yen also.

US dollars per national currency unit: 2000-2004

	2000	2001	2002	2003	2004#
Euro	0.924	0.896	0.944	1.131	1.217
Pound Sterling	1.516	1.440	1.501	1.634	1.822
Japanese Yen*	107.8	121.5	125.4	115.9	109.7

*: Expressed as Yen per US Dollar; #: Projections
Source : World Economic Outlook: September 2004 (IMF)

The gradual weakening of the US dollar can be traced to the deepening structural imbalances in the US economy, manifested in its widening fiscal and current account deficits. The US fiscal balance, as a proportion of its GDP, has deteriorated from a surplus of 1.3 per cent in 2000 to a deficit of 4.9 per cent in 2004. Over the same period, the US current account deficit, again as a proportion of GDP, has worsened from 4.2 per cent to 5.4 per cent. In 2004, although there were fiscal deficits in the Euro area and Japan as well, their current account balances were in surplus to the tune of 0.8 per cent, and 3.4 per cent, respectively.

For decades, willingness of foreign investors, including central banks, to hold US dollar assets has sustained the US current account deficit. Any apprehensions regarding a rapid and sudden loss of the value of US US dollar vis-à-vis other currencies can erode the confidence in the US dollar and lead the US to raise interest rates on its debt to neutralize such a development. Higher US interest rates are likely to have a depressing effect on the currently buoyant US economy which, in turn, can have repercussions on overall global economic activity.

Even the steady depreciation of the US dollar vis-à-vis the Euro has created problems for the Euro Zone. Erosion of competitiveness has led to difficulties in consolidating its recovery . There are no signs as yet of China, with a large trade surplus vis-a-vis the US, revaluing its currency. If and when the Renminbi gets revalued, it may set in motion a series of unanticipated and jerky realignments in the currency markets of emerging market economies. Unless policy-induced corrections in the value of the Dollar, whenever they occur, are engineered carefully and calibrated appropriately, the consequent adjustments can create undesirable ripple effects in various parts of the world economy.

prospects remain uncertain, given the low levels of inventories held by most nations, and the lurking threat of supply disruptions. The large expansion in economic activity across the world has also generated somewhat unanticipated inflationary pressures, especially in primary products and steel. These pressures run the risk of tighter monetary policies and higher interest rates in advanced economies, inducing reallocation of international portfolios and attendant volatility in the pattern of capital flows to emerging markets. Regional prospects for developing Asia continue to be dominated heavily by the fear – albeit, somewhat reduced — of a 'hard landing' in China. Finally, the current account and fiscal deficits in the US continue to expand, intensifying macroeconomic imbalances, and perpetuating concerns over misalignments in global foreign exchange markets and over sudden adjustments (Box 6.1).