

## Outlook

6.78 After last year's robust pace, global growth and world trade are projected to increase at slower but still impressive rates in 2005. Recent activity indicators show some uncertainty surrounding the strengthening of global economic recovery. Global imbalances and their potential disruptive impact on currency markets, hardening of interest rates, volatility in crude oil prices and uncertain prospects of soft landing of China's economy continue to be some of the major uncertainties and risks facing the global economy. Notwithstanding such international environment, India's external sector is expected to remain a source of strength, providing comfort to the conduct of its macroeconomic policies.

6.79 The record trade deficit in the first half of 2004-05, and the sustained surge in imports on account of a buoyant domestic economy, is likely to produce a current account deficit in 2004-05, after three consecutive years of surplus. Nevertheless, the outlook for balance of payments appears reasonably strong and resilient, even after taking into account any acceleration in imports resulting from positive macroeconomic outlook and volatility in crude oil prices. External sector is likely to benefit from the sustained momentum of manufacturing activity. Continued robust growth of exports of merchandise and services is likely to absorb additional imports. Merchandise exports are already showing signs of moving to a higher growth trajectory. The recent experience also suggests subtle shifts in international comparative advantage with software, business and other commercial services eclipsing the performance of merchandise exports. Overall capital flows are expected to remain buoyant given positive outlook on Indian economy. The large capital

flows have resulted in further accumulation of reserves, rendering reserve position comfortable as per various indicators of reserve adequacy. The growing strength of India's external sector provides the enabling conditions to accelerate the pace of external liberalization.

6.80 There is potential for technology-intensive services exports with India being seen as a global destination for R&D, engineering design, telecommunications, super-specialty healthcare and a manufacturing hub for high technology products. Textile exports are likely to get a boost with the expiry of the ATC. Dominance of competitive pricing pressures in the new regime, however, imply that the benefits to the industry will depend critically on expediting domestic policy reforms to enhance its competitiveness. The third amendment to the Patents Law has led to an unlocking of vast opportunities for India in both exports as well as its potential to become a global hub in the area of R&D-based clinical research outsourcing, particularly in the area of biotechnology. Given the global reach and marketing ability of FDI, export promotion policy further need to utilize the natural complementarity of FDI with export activity.

6.81 The current exchange rate policy of focusing on managing volatility with no fixed rate target, while allowing the underlying demand and supply conditions to determine the exchange rate movements in an orderly way, has stood the test of time. This broad approach of watchfulness, caution and flexibility for the foreign exchange market, therefore, needs to be continued. Further liberalization of the external sector is also likely to counter some of the upward pressure on the exchange rate of the rupee.