6

External Sector

The robust expansion in global economic activity observed in 2004, moderated somewhat in 2005, *inter alia*, on account of supply concerns arising from stiffening global energy prices. However, such concerns are yet to manifest in drastic revision of inflationary expectations and tightening of global financial markets. With the latter remaining reasonably benign, flow of funds to emerging markets has remained stable, though the latest World Economic Outlook (WEO, September 2005) of the International Monetary Fund (IMF) expects shorter term portfolio flows to emerging markets to reduce in the near term.

6.2 The momentum of the global economic expansion was provided mainly by the US and developing Asia (Table 6.1). This is in marked contrast to the leading roles played by the G-3 group of nations (i.e. the Euro Area, Japan and the US) in the earlier episodes of cyclical upswings in global output growth. Barring the US, where growth impulses were buoyed by steady

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

			Projections	
	2003	**2004**	**2005**	**2006**
World output	4.0	5.1	*4.3*	*4.3*
Advanced economies	1.9	3.3	*2.5*	*2.7*
United States	2.7	4.2	*3.5*	*3.3*
Euro area	0.7	2.0	*1.2*	*1.8*
Japan	1.4	2.7	*2.0*	*2.0*
Other advanced economies	2.5	4.4	*3.2*	*3.9*
Newly industrialised Asian economies	3.1	5.6	*4.0*	*4.7*
Other emerging market and developing countries	6.5	7.3	*6.4*	*6.1*
Developing Asia	8.1	8.2	*7.8*	*7.2*
China	9.5	9.5	*9.0*	*8.2*
India	7.4	7.3	*7.1*	*6.3*
ASEAN-4*	5.4	5.8	*4.9*	*5.4*
Commonwealth of Independent States (CIS)	7.9	8.4	*6.0*	*5.7*
Russia	7.3	7.2	*5.5*	*5.3*
World trade volume (goods & services)	5.4	10.3	*7.0*	*7.4*
World trade prices (in US $ terms)				
Manufactures	14.4	9.7	*6.0*	*0.5*
Oil	15.8	30.7	*43.6*	*13.9*
Non-fuel primary commodities	6.9	18.5	*8.6*	*-2.1*
Emerging market and developing countries :				
Private capital flows (net) (in US $ billion)	158.2	232.0	*132.9*	*53.8*

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

Source : World Economic Outlook; September 2005; The International Monetary Fund.

improvements in financial and labour market conditions, the significance of the G-3 in charting global growth appears to be diluting. The Euro area, in particular, is showing increasing evidence of slipping into a contractionary mode. Despite encouraging signals of consolidation emanating from Japan, principally on account of robust growth in domestic consumption, the onus of carrying forward the process of global expansion seems to have fallen on developing Asia, and within the region, China and India in particular.

6.3 Notwithstanding concerns regarding 'overheating', the Chinese economy continues to maintain its remarkable progress mainly on account of heavy investment. However, the impact of its recent exchange rate reforms - in the form of a conscious and measured move towards a managed float regime – on domestic demand will only unfold gradually over time (Box 6.1). India, on the other hand, has emerged as the third fastest growing major emerging market economy, after China and Argentina, and is expected to retain a robust growth outlook in the near term.

6.4 Some concerns, particularly the high crude prices, continue to shroud the global economic outlook in the medium term. Not only was there a sharp increase in consumption of crude in 2004, but on the expectations of likely shortfalls in supply relative to continued high crude demand, forward markets for crude have become increasingly tight. If crude oil prices continue to remain high, then adverse effects on global activity are likely to follow from higher production costs and lower investor and consumer confidence. Energy price induced inflationary expectations can also raise global interest rates, and affect global capital flows, particularly to emerging markets.

6.5 Limiting the impact of such potential supply-side shocks calls for dedicated efforts towards expanding the global trade and commerce agenda. Though developing economies like India have been able to wrest some concessions from the recently concluded Hong Kong Ministerial of the World Trade Organisation (WTO), in the form of greater market access for industrial products and the facility to devise tariff lines for protecting livelihood securities of farmers, lack of sustained progress on the Doha Development Agenda (DDA) continues to impede rapid expansion of global trade.

Box 6.1 : Exchange rate reform in China

On July 21, 2005, China delinked the Renminbi (RMB) from the US Dollar, and announced that henceforth market forces would play a greater role in determining the value of the RMB against different global currencies. While the move put an end to the speculation over when China will introduce flexible exchange rate, the eventual flexibility granted was somewhat limited. The daily trading price of the RMB against the US Dollar has been allowed to float within a narrow band of +/- 0.3 per cent around the central parity decided by the People's Bank of China (PBOC). Similarly, trading prices of the RMB against other non-Dollar currencies have been allowed to float within a certain band fixed by the PBOC.

Since allowing the RMB to float, the Chinese currency has mildly strengthened against the US Dollar: from a monthly average of 8.23 against the US Dollar in July 2005 (and 8.11 Yuan per US Dollar on July 21, 2005) to a monthly average of 8.08 against the US Dollar in December 2005.

The international demand for allowing greater flexibility in determining the Chinese exchange rate has primarily been on account of the widening trade imbalances between the US and developing Asia. While the US current account deficit has been estimated to cross 6 per cent of its GDP in 2005 (WEO; September 2005; IMF), the growth of the deficit has been matched by similar growth in current account surpluses for leading Asian economies like China and Japan. A pegged Chinese currency acted as a benchmark for other export-oriented Asian economies in assessing competitiveness of their currencies vis-à-vis the US Dollar. A continued strengthening of the Yuan against the Dollar may set in motion a series of currency adjustments within developing Asia, leading to an overall appreciation of regional currencies vis-à-vis the Dollar, and a concomitant reduction in the current account imbalances between various economies of the region and the US.