6

External Sector

India's external economic environment continued to be supportive of growth in output and trade in 2005-06 and 2006-07 so far. The continued expansion in world output growth for a record fourth year in a row in 2007 (Table 6.1), amidst rising concerns about continuing global macroeconomic imbalances, protracted Doha negotiations, volatile international crude oil prices, and inflation, testifies to the emergence of a new phase of the external economic scenario. This new phase has been marked by robust and broad-based growth in emerging market economies, particularly with China and India together accounting for about 40 per cent of global growth measured in purchasing power parity terms. Increasingly, India is being recognized as an important player in the global economic scenario.

6.2 The robust phase of global output expansion in the recent past has been accompanied by stable growth in world trade volume; reasonable stability in world trade prices; and supportive growth in capital flows (net) to emerging market economies and developing countries. Despite persistence of

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

			Projections	
	2004	**2005**	**2006**	**2007**
World output	**5.3**	**4.9**	**5.1**	**4.9**
Advanced economies	**3.2**	**2.6**	**3.1**	**2.7**
United States	3.9	3.2	3.4	2.9
Euro area	2.1	1.3	2.4	2.0
Japan	2.3	2.6	2.7	2.1
Other advanced economies	4.6	3.7	4.1	3.7
Newly industrialised Asian economies	5.9	4.5	4.9	4.4
Other emerging market and developing countries	**7.7**	**7.4**	**7.3**	**7.2**
Developing Asia	8.8	9.0	8.7	8.6
China	10.1	10.2	10.0	10.0
India	8.0	8.5	8.3	7.3
ASEAN-4*	5.8	5.1	5.0	5.6
Commonwealth of Independent States (CIS)	8.4	6.5	6.8	6.5
Russia	7.2	6.4	6.5	6.5
World consumer prices				
Advanced economies	2.0	2.3	2.6	2.3
Other emerging market and developing countries	5.6	5.3	5.2	5.0
World trade volume (goods & services)	**10.6**	**7.4**	**8.9**	**7.6**
World trade prices (in US dollar terms)				
Manufactures	9.4	3.6	2.2	2.3
Oil	30.7	41.3	29.7	9.1
Non-fuel primary commodities	18.5	10.3	22.1	-4.8
Capital flows				
Other emerging market and developing countries				
Private capital flows (net) in US$ billion	213.4	261.7	205.6	188.3

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

Source : World Economic Outlook, September 2006, IMF.

high oil prices and the higher aggregate demand, inflation, both as measured by GDP deflator and consumer prices (2.3 per cent in 2005 and 2.6 per cent in 2006) for advanced economies and consumer prices (5.3 per cent in 2005 and 5.2 per cent in 2006) for emerging market economies and developing countries, has been low. While the key world economic indicators point to a virtuous phase of global economic activity that provides a conducive environment for deepening the process of development, some downside risks remain.

6.3 With a share of 20.1 per cent in global output in 2005, US continues to impact the world economy significantly. The current account deficit of the US after persisting around 5 per cent or more of GDP for five years is expected to be close to US$1 trillion in 2007. Such a large current account deficit has been matched by similarly large surpluses in other countries and led to apprehensions about an abrupt unwinding of the global macroeconomic imbalances and disruptive sudden changes in cross-currency rates with associated adverse implications for the world economy (Box 6.1).

6.4 The extended timeline of December 2006 of the Doha Round of negotiations under the World Trade Organisation (WTO) has been missed. Agricultural subsidies and non-agricultural market access are proving to be stumbling blocks. International crude oil prices, per barrel, which rose rapidly for Brent from an average of US$42.1 in 2004-05 to US$57.9 in 2005-06, reached an all-time high of US$78.7 on August 8, 2006. While a warm winter, among other reasons, led to a decline in such prices to a low of US$50.7 on January 17, 2007, considerable uncertainty remains about volatile oil prices. Some concerns have also been expressed about the sustainability of this phase of high growth momentum, particularly in China and India, without overheating and build up of inflationary pressures.

6.5 There appears to be some diminution of the downside risks over time. Initially, the IMF in its bi-annual publication *World Economic Outlook* (WEO) April 2006 issue, had projected global output to grow by 4.9 per cent in 2006. With a pick up in growth in US, Euro Area and Japan and the continued momentum in the emerging market economies and developing countries in the first half, in the WEO September 2006, the IMF upped the growth forecast to 5.1 per cent.

Box 6.1 : Global imbalances

Global imbalances in the form of two or more countries having large non-zero current account balances are not a new phenomenon. Even in the era of gold standard, with fixed exchange rates, there were current account deficits financed by large capital flows to fund investment overseas and/or finance expenditure in the settlements or colonies. But such imbalances used to adjust through gold movement across countries.

In the post-gold standard era, conventional economic theory envisions equilibrium in international transactions across nations to be established mainly through market determined exchange rates in the medium to long run. Global imbalances, in the current conjecture, refer to the persistence of large current account deficit in US which is financed mainly through corresponding surpluses in some other countries. US has been experiencing growing deficits in its external current account, particularly trade, while simultaneously, international financial system has been contracting dollar-denominated liabilities to offset such deficits. The US current account deficit grew from 4.8 per cent of GDP and 5.7 per cent of GDP in 2003 and 2004, respectively to US$791.5 billion, equivalent of 6.4 per cent of GDP, in 2005. This, however, did not result in any appreciable decline in the external value of the US dollar primarily because East Asian and other economies were running huge current account surpluses and investing such surpluses in US financial assets, particularly bonds. This led some analysts to postulate that US dollar was the *de facto* international reserve currency, and the existing system of payment settlement could be sustained indefinitely. Such a view has been described as Bretton Woods 2 System.

The IMF, in its *World Economic Outlook* 2005 had cautioned that an abrupt decline in capital inflows to the US: "could engender a rapid dollar depreciation and a sharp increase in US interest rates, with potentially serious adverse consequences for global growth and international financial markets". In the event, the US dollar depreciated in nominal effective terms by 2.1 per cent in 2006 up to November.

Furthermore, the capital flows to finance the US current account deficit, it has been pointed out by many analysts, have been appropriated not for investment, but for consumption expenditure, particularly the US fiscal deficit. A cooling of asset prices in US (particularly housing) and rising bond yields together with tightening of monetary policy, it has been widely feared, may impact the global economy significantly. A sudden and sharp revision in the asset prices or US bond yields could affect global financial stability and through abrupt contraction in consumption, cause recessionary trends. It is in this context that the need to unwind the global imbalances in an orderly fashion assumes importance. The IMF has initiated a dialogue for this purpose with key stakeholders.