CHALLENGES AND OUTLOOK

6.130 Based on the trends in the first six months of the current financial year and other indicators, trade deficit would continue to widen in the current year, the exact quantum being predicated on the rise in acquisition cost of crude petroleum and prices of other commodities. As such, goods and services balance might also worsen to the extent that the rise in acquisition costs of petroleum are not matched by an increase in non-factor service exports, which had decelerated in the first half of the current financial year. The rise in the trade deficit may be moderate if the leads and lags in export receipts booked under 'other capital' is taken into account. However, current account deficit is likely to remain at moderate levels given the robust growth in invisible surplus partly compensating for the rising trade deficit. Capital inflows are expected to be robust in the current year keeping with the accommodative actions of the monetary authorities of the advanced economies to counter the impact of sub-prime mortgage crisis. Over the next few months this factor could be partly counter balanced by increasing risk aversion on the part of developed country investors. The outlook for capital inflows in the medium term therefore hinges upon the growth recovery in advanced economies, which in turn depends on how soon the financial market turbulence is overcome.

6.131 The IMF's update of WEO (January 2008) revised world growth prospects for 2008 to moderate to 4.1 per cent (lower by 0.3 per cent from its earlier October 2007 projections). Growth in the United States has been revised downwards to 1.5 per cent. With similar downward revisions to Euro area and Japan, advanced economies as a group has been placed at 1.8 per cent. With the exception of Africa, growth in other emerging market economies and developing countries is also estimated to slow down significantly (from 8.8 per cent as per October 2007 WEO to 6.9 per cent in the January update). While, emerging market economies will be affected by the slowdown in advanced economies, the observed underestimation of earlier growth projections for emerging Asia and the robust contribution from China and India to global growth indicate that the actual outcomes may be somewhat higher. The real impact of a slowdown will differ between economies like China in which net exports are a major driver of growth and those like India in which foreign net demand plays a minimal role

6.132 The outlook for exports in 2008-09 may not be as bright as in the past few years with lower projections in world GDP and world imports and exchange rate developments. Two developments which need to be monitored are the fall in export growth to the United States in general and fall in textiles exports in particular to the United States and even EU. The second being the fall in exports of business services, though import growth of these services have also fallen. This calls for some fundamental policy changes besides relief measures already given.

6.133 For the merchandise trade sector these include continuation of the reduction in customs duty resulting in low import duty, weeding out of unnecessary customs duty exemptions, abolishing export schemes that are redundant with fall in import duties and streamlining existing schemes, checking the proliferation of SEZs, evolving clear-cut policy for beneficial CECAs even with some developed countries instead of just FTAs/PTAs which should be well integrated with our economic and trade policy reforms and the blueprint for possible changes due to WTO negotiations.

6.134 For services trade the two major areas where reforms can help in sustaining export growth are related to domestic regulations and reforms and market access for services. Domestic regulations perform the role of tariffs in regulating services trade. Disciplining many of our domestic regulations can help in the growth and export of services. The basic elements include licensing requirements and procedures, qualification requirements and procedures, technical standards and regulatory transparency. There are also visible and invisible barriers to services trade. Policy reforms aimed at removing these barriers to increase our market access in major trading partners along with policies like marketing of services, including "services" in negotiations in different RTAs/FTAs and successful services negotiations in WTO, can help.

6.135 The slowdown in world growth and import demand will also affect the prices of oil and other commodities. Any resultant deceleration in their prices will benefit India, by moderating the growth of imports in value terms. Thus, the effect on the merchandise trade balance is likely to be less than on exports.

6.136 The world economy is faced with uncertain prospects posing challenges and requiring calibrated, concerted and coordinated policy stances from national authorities. Effective regulation of financial markets in developed and emerging markets is imperative in the wake of periodic bubbles in asset markets, which have a negative impact on the world economy at large. India's external sector reforms have transformed the Indian economy from a foreign exchange shortage to a foreign exchange surplus one. Flexible and prudent exchange rate policies, moderate and sustainable levels of current account deficits, change in the composition of capital flows with a significant reduction in the external debt to GDP ratio and reduction in the levels of short-term debt are ample proof of the success of reforms. The earlier foreign exchange conservation approach is being gradually changed to one of managing copious inflows. The mindsets also need to change in accordance with the new reality.

6.137 Despite short-term reversals, liberalization of the capital account must continue. Among other things, it would increase competition, improve the efficiency of financial intermediation and help discipline domestic policies to adjust to structural realities. Given that the process of adjustment involves gains and pains for different stakeholders and limits to absorptive capacity, further initiatives would continue to be gradual, calibrated and sequenced. While the set of policies that are in place have been influenced by the current context and may be appropriate in the short term, the stance for the medium-term and long-term need to address the root causes of the excess capital flows. As long as interest parity is violated, capital flows, particularly of the debt variety, would remain. Convergence of domestic and global interest rates is a *sine qua non* for fuller capital account convertibility, while similarity of tax rates and structures to international or regional levels will be very helpful.

6.138 Another important factor is the process of adjustment through the exchange rate. Exchange rate determination could be analyzed in terms of three time horizons — long-term, medium-term and short-term — with structural, cyclical and speculative factors affecting them, respectively. In the short run there could be some active management to contain volatility and shore up reserves to guard against speculative forces that might entail sudden stops or asset liability mismatches arising from abrupt reversals. In the long run, attempting to keep nominal exchange rates stationary would not be productive. If exchange rates were not allowed to adjust and to reflect fundamental changes, expectations of appreciation can build up pressures that can result in steep changes in macro parameters. This can be costly to the very stakeholders that were to be protected from pain. A balanced approched is therefore appropriate.