External Sector

The growing influence of global developments on the Indian economy was manifest in the surge in capital inflows in 2007-08, a phenomenon observed earlier in other emerging market economies. This is a natural concomitant of the robust macroeconomic fundamentals like high growth, relative stability in prices, healthy financial sector and high returns on investment. Sometimes, it also reflects the rigidities in the economy, particularly the interest differentials. Even as the external environment remained conducive to the nation's growth, the problems of managing a more open capital account came to the fore in terms of the economy approaching the limits of its absorptive capacity with the pace of adjustment becoming somewhat difficult in the short run. On the other side, the nation's rapid growth, in conjunction with other major emerging market economies, helped keep the global growth momentum strong.

6.2 Growth in world trade volume of goods and services decelerated from 9.2 per cent in 2006 to 6.6 per cent in 2007 and is projected to remain around the same levels in 2008 (Table 6.1). World trade prices, in contrast were projected to rise sharply for manufactures, but likely to moderate for oil and other commodities. However, with sharp rise in oil prices of late, the growth in value terms may remain high. With broad-based growth and relative stability, the pace of net private capital flows to emerging market economies and developing countries accelerated with a growth of 124 per cent in 2007, which posed adjustment problems in these economies.

Balance of payments

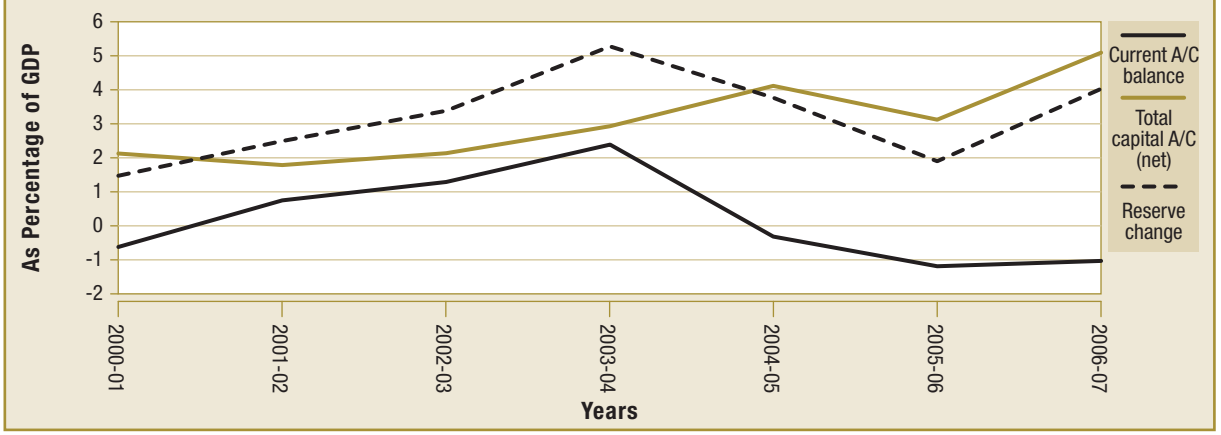
6.3 The strength, resilience and stability of the country's external sector is reflected by various indicators. These include a steady accretion to reserves, moderate levels of current account deficit, changing composition of capital inflows, flexibility in exchange rates, sustainable external debt levels with elongated maturity profile and an increase in capital inflows. The current account has followed an inverted "U" shaped pattern during the period from 2001-02 to 2006-07, rising to a surplus of over 2 per cent of GDP in 2003-04. Thereafter it has returned close to its post-1990s reform average, with a current account deficit of 1.2 per cent in 2005-06 and 1.1 per cent of GDP in 2006-07.

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

Items			Projections	
	2005	2006	2007	2008
World trade volume (goods & services)	**7.5**	**9.2**	**6.6**	**6.7**
World trade prices (in US$ terms)				
Manufactures	3.7	3.8	7.9	2.8
Oil	41.3	20.5	6.6	9.5
Non-fuel primary commodities	10.3	28.4	12.2	-6.7
Capital flows				
Emerging market and developing countries				
Private capital flows (net) in US$ billion	271.1	220.9	495.4	291.3

Source: World Economic Outlook - October 2007, IMF.

Figure 6.1 Current a/c balance, total capital a/c and reserve change



Capital inflows, as a proportion of GDP, have been on a clear uptrend during the six years (2001-02 to 2006-07) of this decade. They reached a high of 5.1 per cent of GDP in 2006-07 after a somewhat modest growth rate of 3.1 per cent in 2005-06. The net result of these two trends has been a gradual rise in reserve increase to reach 4 per cent of GDP in 2006-07 (Figure 6.1). With capital inflows exceeding financing requirements, foreign exchange reserve increase was of the order of US$ 15.1 billion in 2005-06 and US$ 36.6 billion in 2006-07 (Table 6.2). As a proportion of GDP, external debt was 17.2 per cent and 17.9 per cent in 2005-06 and 2006-07 respectively.

6.4 The current account, after being in surplus during 2001-02 to 2003-04, reverted to a deficit in 2004-05. This was despite a robust growth in net invisibles account fuelled by software exports and private transfers. The current account deficit (CAD) is attributable to the widening trade deficit, driven primarily by the rise in international prices of petroleum products and gold. Thus large merchandise trade deficit coexists with a lower

Table 6.2 Balance of Payments: Summary

(In US$ million)

	1990-91	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06R	2006-07PR	2006-07PR (April-September)	2007-08P (April-September)
1. Exports	18477	45452	44703	53774	66285	85206	105152	128083	61450	73665
2. Imports	27915	57912	56277	64464	80003	118908	157056	191254	95224	116066
3. Trade balance	-9438	-12460	-11574	-10690	-13718	-33702	-51904	-63171	-33774	-42401
4. Invisibles (net)	-242	9794	14974	17035	27801	31232	42002	53405	23434	31688
Non-factor services	980	1692	3324	3643	10144	15426	23170	31180	14497	14689
Income	-3752	-5004	-4206	-3446	-4505	-4979	-5855	-6573	-3321	-1444
Pvt. Transfers	2069	12854	15398	16387	21608	20525	24493	27941	12265	18420
5. Goods & services balance	-8458	-10768	-8250	-7047	-3574	-18276	-28734	-31361	-19277	-27712
6. Current account balance	-9680	-2666	3400	6345	14083	-2470	-9902	-9766	-10340	-10713
7. External assistance (net)	2204	410	1117	-3128	-2858	1923	1702	1767	386	729
8. Commercial borrowing (net)[a]	2254	4303	-1585	-1692	-2925	5194	2508	16155	5735	10557
9. NR deposits (net)	1537	2316	2754	2978	3642	-964	2789	4321	2210	-78
10. Foreign investment (net)	103	5862	6686	4161	13744	13000	15528	15541	6135	22214
of which :										
(i) FDI (net)	97	3272	4734	3217	2388	3713	3034	8479	4491	3880
(ii) Portfolio	6	2590	1952	944	11356	9287	12494	7062	1644	18334
11. Other flows (net)[b]	1090	-4356	-615	8321	5735	9476	-180	8967	4523	17727
12. Capital account total (net)	7188	8535	8357	10640	17338	28629	24954	46372	18989	51149
13. Reserve use (- increase)	1278	-5842	-11757	-16985	-31421	-26159	-15052	-36606	-8649	-40436

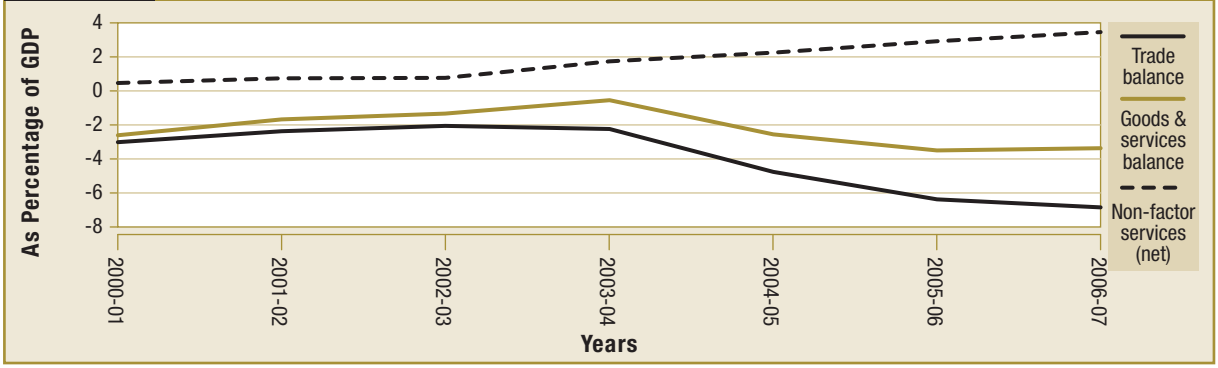
Source: Reserve Bank of India.

PR: Partially Revised, P: Preliminary, R: Revised.

[a] **Figures include receipts on account of India Millennium Deposits in 2000-01 and related repayments, if any, in the subsequent years.**

[b] **Include, among others, delayed export receipts and errors & omissions.**

Figure 6.2 Trade balance, goods & services balance and non-factor services (net)



deficit on the goods and services account because of the surplus on non-factor services. Even in the years when there were some surpluses on the current account, India had deficit on goods and services account and a relatively larger trade deficit (Figure 6.2).

6.5 The rising trend in capital inflows has been accompanied by a change in its composition. The most welcome feature was the rise in gross foreign direct investment inflows of US$ 23.0 billion in 2006-07. With FDI outflows also increasing steadily over the last five years, overall net flows moderated. Portfolio investment in the first half of 2006-07 was lower in comparison because of the initial slump in equity markets. Debt flows, primarily external commercial borrowings, shot up from a level of 0.7 per cent of GDP in 1990-91 to 1.8 per cent in 2006-07. Thus, the rupee faced upward pressure in the second half of 2006-07; but on an overall yearly average basis, it depreciated by 2.2 per cent.

Current account

6.6 Current account deficit (CAD) mirrors the saving-investment gap in the national income accounts and thus constitutes foreign savings. The challenge before the emerging market economies is to leverage foreign savings to promote domestic growth without having the long-term consequences of external payment imbalances. However, current account deficits, per se, need not necessarilly enhance the productive capacity and thus overall GDP growth. This would depend on underlying component factors leading to the current account deficit. The distinction between gross capital inflow and net inflow is useful. As the latter must equal the CAD, there is no way in which net use of foreign savings can increase without an increase in the CAD. The gross inflow can, however, increase to the extent that it is offset by gross outflow in the form of build-up of foreign exchange reserves, reduction in government external debt or outward investment by entrepreneurs. Higher gross inflows have value even if net flows do not increase to the same extent, as they can improve competition in the financial sector, improve the quality of intermediation and the average productivity of investment, and thus raise the growth rate of the economy. The challenge before the Government is to maximize these benefits while minimizing the costs of exchange rate management.

6.7 Figure 6.3 shows that the rise and fall of the current account balance during the period 2000-01 to 2006-07 has been driven largely by the goods and services (G&S) balance, with the two having virtually the same pattern as a proportion of GDP. The surplus from factor income including remittances which fluctuated between 2 per cent and 3 per cent of GDP has helped moderate the substantial deficit on the trade account. Both the trade (goods & services) balance and the factor surplus improved between 2000-01 and 2003-04 leading to an improvement of the current account and both reversed direction thereafter resulting in a declining trend in the current account. In the past two years the current account deficit, trade (G&S) deficit and factor surplus have averaged 1.2, 3.5 and 2.0 per cent of GDP, respectively (Table 6.3).

6.8 The trends in the goods and services trade deficit have, in turn, been largely driven by the merchandise trade deficit since 2004-05. During 2000-01 to 2003-04, the merchandise trade deficit was around 2 per cent of GDP and the rising non-

Figure 6.3 Current a/c balance, goods & services balance and factor balance

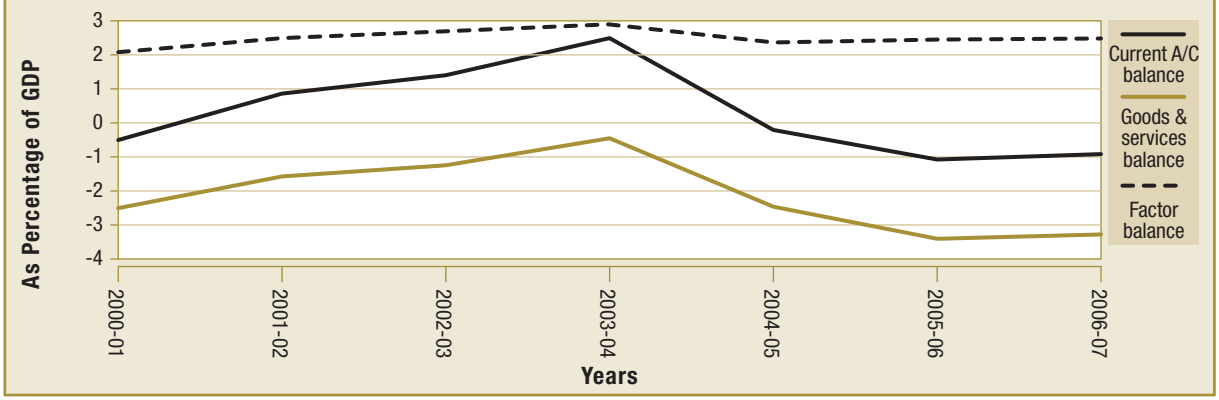


Table 6.3 Selected indicators of external sector

Items/Years	1990-91	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	(Apr.-Sept) 2006-07	(Apr.-Sept) 2007-08
1. Growth of exports - BoP (%)	9.0	21.1	-1.6	20.3	23.3	28.5	23.4	21.8	24.8	19.9
2. Growth of imports - BoP (%)	14.4	4.6	-2.8	14.5	24.1	48.6	32.1	21.8	24.7	21.9
3. Growth of non-factor services (credit)	7.2	3.6	5.4	21.1	29.4	61.0	33.3	32.1	36.9	8.6
4. Growth of non-factor services (debit)	1.4	25.2	-5.2	23.9	-2.3	66.4	24.0	28.7	26.4	14.3
5. Exports/imports - BoP (%)	66.2	78.5	79.4	83.4	82.9	71.7	67.0	67.0	64.5	63.5
6. Exports/imports goods & services (%)	73.1	85.1	88.2	91.4	96.3	87.5	85.0	86.7	83.1	79.8
7. Import cover of FER (No. of months)	2.5	8.8	11.5	14.2	16.9	14.3	11.6	12.5	10.4	12.8
8. External assistance (net)/TC (%)	26.2	4.8	13.4	-29.4	-16.5	6.7	6.8	3.8	2.0	1.4
9. ECB (net)/TC (%)	26.8	50.6	-19.0	-15.9	-16.9	18.1	10.1	34.8	30.2	20.6
10. NR deposits/TC (%)	18.3	27.2	33.0	28.0	21.0	-3.4	11.2	9.3	11.6	-0.2
(As per cent of GDPmp)										
11. Exports	5.8	9.9	9.4	10.6	11.1	12.2	13.0	14.0		
12. Imports	8.8	12.6	11.8	12.7	13.3	17.1	19.4	20.9		
13. Trade balance	-3.0	-2.7	-2.4	-2.1	-2.3	-4.8	-6.4	-6.9		
14. Invisibles balance	-0.1	2.1	3.1	3.4	4.6	4.5	5.2	5.8		
15. Goods & services balance	-2.7	-2.7	-1.7	-1.4	-0.6	-2.6	-3.6	-3.4		
16. Current account balance	-3.1	-0.6	0.7	1.3	2.3	-0.4	-1.2	-1.1		
17. ECB	0.7	1.1	-0.3	-0.3	-0.5	0.7	0.3	1.8		
18. Foreign direct investment (net)	0.0	0.8	1.0	0.6	0.4	0.5	0.4	0.9		
19. Portfolio investment	0.0	0.6	0.4	0.2	1.9	1.3	1.5	0.8		
20. Total capital account (net)	2.7	2.1	1.7	2.1	2.9	4.1	3.1	5.1		
21. External Debt	28.7	23.3	21.2	20.3	17.8	18.5	17.2	17.9		

Source: RBI.

Notes:
(i) TC: Total capital flows (net).
(ii) ECB: External commercial borrowing.
(iii) FER: Foreign exchange reserves, including gold, SDRs and IMF reserve tranche.
(iv) GDPmp: Gross domestic product at current market prices.
(v) As total capital flows are netted after taking into account some capital outflows, the ratios against item No. 5, 6 and 7 may, in some years, add up to more than hundred per cent.
(vi) Rupee equivalents of BOP components are used to arrive at GDP ratios. All other percentages shown in the upper panel of the table are based on US dollar values.

factor services surplus resulted in an improving trend in the overall trade balance (Figure 6.3). From 2004-05 the merchandise trade balance has been deteriorating and despite the continual rise in the non-factor services surplus, the overall G&S balance has followed the deteriorating trend of the former (Figure 6.3).

6.9 A widening of merchandise trade was one way in which foreign savings could be absorbed and growth in exports and imports was a key

component of the growth process. As a proportion of GDP, on balance of payments (BoP) basis, exports rose from a level of 5.8 per cent in 1990-91 to reach a level of 14.0 per cent of GDP in 2006-07 (Table 6.3). The average annual growth rate in the last five years has been placed at a high of 23.5 per cent. However, imports have grown even faster in the last five years at an annual average of 28.2 per cent. As a proportion of GDP, on BoP basis, imports in 2006-07 were placed at 20.9 per cent of GDP. Thus, trade deficit widened to 6.9 per cent of GDP in 2006-07.

6.10 The higher trade deficit could be attributed to a rise in petroleum, oil and lubricants (POL) as well as non-POL components in imports. Continued uptrend in prices in the international markets and rise in the price of gold were the major contributors to this process.

6.11 Of the seven major components of non-factor services in the invisibles account of the BoP, six components — travel, transportation, insurance, financial services, communication services and business services — contributed on a net basis only 9 per cent of the surplus on account of services trade in 2006-07. Thus, the seventh component viz., software services, comprising information technology (IT) and IT-enabled services (ITES), was the main driver of the surpluses generated from non-factor services.

6.12 The net surplus from travel grew modestly in 2006-07. Travel receipts grew by 22.1 per cent on an annual average basis for the last three years reflecting in part the attractiveness of India as a tourist destination; travel payments were also catching up with corresponding average annual growth at 24.3 per cent. Transportation payments exceeded receipts, resulting in a modest deficit. The classification in BoP accounting system of software, business, financial and communication under the head “miscellaneous” allude to the recent nature of their importance. Growth in software services receipts (both IT and ITES) was phenomenal at an annual average of 32.9 per cent in the last five years. As per revised data of the RBI, growth in business services on a net basis as made available by RBI was higher at 39.4 per cent in 2006-07; the other services, albeit posting lower growth rates, have nevertheless helped catalyze the growth process through appropriate technology transfer from the rest of the world. Thus, higher levels of surplus arising from services helped moderate the overall goods and services balance. As a proportion of GDP, goods and services deficit was placed at 3.4 per cent of GDP in 2006-07, which was lower than the level of 3.6 per cent of GDP in 2005-06.

6.13 Private transfers continued its traditional role of being a major source for the invisibles account surplus with annual average growth at 13.5 per cent in the five-year period 2002-03 to 2006-07. According to a report published by the World Bank containing estimates of cross-country data on migration and remittances, India topped the list of countries that received remittances. Investment income (net) which reflects the servicing costs on the payment side and return on Foreign Currency Assets (FCA) on the receipts side, has remained negative over the years indicating higher interest outgo. Investment income (net) was placed at US$ (-) 3.5 billion in 2002-03. With the rapid build up of foreign currency assets the credit side of investment income also grew as rapidly as the debit side. Given the latter's higher base, net investment income deteriorated to US$ (-) 6 billion in 2006-07.

6.14 Current receipts in 2006-07 amounted to US$ 243.2 billion and current payments were placed at US$ 252.9 billion. Current receipts covered 96.1 per cent of the current payments in 2006-07. Consequently, current account deficit was placed at US$ 9.8 billion in 2006-07 (US$ 9.9 billion in 2005-06).

6.15 The nature of the current account deficit is indicated by the contribution of the oil trade deficit and non-oil trade deficit in conjunction with the surpluses on factor and non-factor services (Table 6.4).

6.16 Based on sharp upward movements in exchange rates and foreign exchange reserves, there is a general apprehension about the developments on the BoP front and its consequences in terms of competitive losses and thereby on the growth prospects of exports. BoP data for the first half of the current financial year shows some deceleration in growth in exports from a level of 24.8 per cent in 2006-07 (April-September) to 19.9 per cent in 2007-08 (April-September). Simultaneously, growth in imports in the first half of 2007-08 fell to 21.9 per cent from 24.7 per cent in 2006-07 (April-September). On

Table 6.4 Decomposition of current account deficit

Items\Years	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
	(As per cent of GDPmp)						
1. Oil balance in trade account	-3.0	-2.5	-3.0	-2.8	-3.3	-4.0	-4.2
2. Non-oil balance in trade account	1.8	0.9	1.2	0.4	-0.7	-1.7	-2.3
3. Trade balance (1+2)[1]	-2.7	-2.4	-2.1	-2.3	-4.9	-6.4	-6.9
4. Non-factor services balance	0.4	0.7	0.7	1.7	2.2	2.9	3.4
5. Goods & services balance	-2.3	-1.7	-1.4	-0.6	-2.6	-3.6	-3.4
6. Factor balance	1.7	2.3	2.5	2.8	2.2	2.3	2.3
7. Invisibles balance	2.1	3.1	3.4	4.6	4.5	5.2	5.8
8. Current account balance (3+7)	-0.6	0.7	1.2	2.3	-0.4	-1.2	-1.1

Compiled from RBI (BoP data) and the Directorate General of Commercial Intelligence and Statistics (DGCI&S) (trade data)

Note: [1]Due to trade data divergence between BoP basis and DGCI&S, the totals may not add up.

BoP basis, merchandise trade deficit rose to US$ 42.4 billion in 2007-08 (April-September), equivalent of 8.1 per cent of GDP from a level of US$ 33.8 billion in 2006-07 (April-September), equivalent of 8.3 per cent of GDP. In the same reference period, a deceleration in software services exports to 15.2 per cent from 37.2 per cent led to a lower growth in net invisibles surplus (17.5 per cent from 35.2 per cent). Receipts from business services actually declined from US$ 8 billion in 2006-07 (April-September) to US$ 6.4 billion in 2007-08 (April-September) and, with payments rising marginally, there was a decline of 91 per cent in 2007-08 in net receipts. Thus, as a proportion of GDP, goods and services deficit rose to 5.3 per cent in 2007-08 (April-September) from a level of 4.7 per cent in 2006-07 (April-September).

6.17 Private transfers receipts (mainly remittances) shot up, year-on-year, by 49.2 per cent as against 19.2 per cent in the corresponding period of the previous year. Investment income (net) grew by 60.0 per cent in 2007-08 (April-September) reflecting the burgeoning foreign exchange reserves. Net invisible surplus grew by 35.2 per cent to reach US$ 31.7 billion in 2007-08 (April-September), equivalent of 6.1 per cent of GDP. Thus, higher invisible surplus was able to moderate somewhat the rising deficits on trade account and current account deficit was placed at US$ 10.7 billion in 2007-08 (April-September), equivalent of 2.0 per cent of GDP.

Merchandise trade

Global demand

6.18 According to the World Trade Organization (WTO) statistics, world merchandise trade growth at 8 per cent in real (i.e. constant price) terms in 2006 was higher than the 6.5 per cent growth in 2005. The growth of merchandise trade in 2006 was the second highest since 2000 and well above the average annual growth of the last decade (1996-2006). Growth of world demand for exports accelerated to 8 per cent in 2006 from 6.5 per cent in 2005, pulled up by a sharp acceleration of European imports to 7 per cent (from 4 per cent). However, import growth in United States, which is one of the most important markets for Indian exports, decelerated from 6 per cent in 2005 to 5.5 per cent in 2006 (Table 6.5).

India's merchandise trade

6.19 The Foreign Trade Policy (2004-09), announced by the Government in August 2004, had visualized a doubling of India's merchandise trade in five years. With an enabling policy framework and concerted efforts by the Government for facilitating a favourable environment for international trade, exports have nearly tripled between 2001-02 and 2006-07. India's merchandise exports (in US dollar terms and on customs basis), which have grown continuously at more than 20 per cent since 2002-03, posted 22.6 per cent growth in 2006-07. The value of merchandise exports reached US$ 111 billion in April-December 2007

Table 6.5 Merchandise trade by regions/ countries (annual growth at constant prices – per cent)

	Exports			Imports		
	2004	2005	2006	2004	2005	2006
World	10.0	6.5	8.0	—	—	—
United States	8.5	8.0	10.5	11.0	6.0	5.5
Europe	7.0	4.0	7.5	7.0	4.0	7.0
Asia	15.5	11.5	13.5	14.5	8.0	8.5
Japan [b]	13.5	5.0	10.0	6.5	2.0	2.0
China	24.0	25.0	22.0	21.5	11.5	16.5
India	15.5	20.5	11.5	16.0	20.5	12.0
South and Central America[a]	13.0	8.0	2.0	18.5	14.0	10.5
Commonwealth of Independent States (CIS)	12.0	3.5	3.0	16.0	18.0	20.0
Africa and Middle East	8.0	5.0	1.0	14.0	13.0	8.5

Source: WTO.
[a] Includes the Caribbean.
[b] Trade volume data are derived from customs values deflated by standard unit values and an adjusted price index for electronic goods.

with a growth of 21.6 per cent. For the year 2007-08, an export target of US$ 160 billion was set and during the first nine months of the current year, 69.4 per cent of the export target has been achieved despite the appreciating rupee.

6.20 Export performance was dominated by volume growth till 2002-03. There was a reversal of this trend in 2003-04, with increasing contribution of higher unit value in export performance. Subsequent years witnessed a surge in exports both in terms of volume and unit value with a relatively higher growth of volume (Table 6.6). During 2006-07, export volume increased by 15.8 per cent mainly due to items like crude materials, machinery and transport equipment, and mineral fuels and lubricants. The unit value of such exports increased by 8.1 per cent mainly due to the three categories : manufactured goods classified chiefly by materials; food and food articles; and mineral fuels and lubricants.

6.21 Growth of the unit value index of exports, decelerated in the late 1990s and early 2000s to reach a negative value of -1 per cent in 2001-02. Since then it has accelerated smartly to average a growth of 8.6 per cent per annum during 2003-04 to 2006-07. In contrast, the growth rate of the unit value index of imports has fluctuated wildly since 2000-01 partly due to fluctuations in the

Table 6.6 Performance of the foreign trade sector (annual per cent change)

Year	Export growth			Import growth			Terms of trade	
	Value (in US$)	Volume	Unit Value	Value (in US$)	Volume	Unit Value	Net	Income
1990-00	7.7	10.6	8.4	8.3	12.4	7.2	1.5	11.7
1990-95	8.1	10.9	12.6	4.6	12.9	7.6	5.0	16.5
1995-00	7.3	10.2	4.3	12.0	11.9	6.9	-2.0	7.0
2000-01	21.0	23.9	3.3	1.7	-1.0	8.2	-4.5	18.3
2001-02	-1.6	3.7	-1.0	1.7	5.0	1.1	-2.1	1.5
2002-03	20.3	21.7	0.3	19.4	9.5	10.7	-9.4	10.3
2003-04	21.1	6.0	8.5	27.3	20.9	-0.1	8.6	15.1
2004-05	30.8	17.6	8.9	42.7	14.7	21.6	-10.9	5.0
2005-06	23.4	11.8	9.0	33.8	48.2	-10.7	22.7	36.9
2006-07	22.6	15.8	8.1	24.5	24.1	2.7	5.2	21.8
2007-08[a]	**21.6**			**25.9**				

Source: DGCI&S, Kolkata.
[a]April-December 2007.

global prices of oil and other commodities and partly due to unit value changes in machinery and transport equipment and chemicals and related products. Though the quantum/volume of imports has shown a rising trend since 2000-01, the 48.2 per cent growth in 2005-06 was way above this trend. This was due to a rise in imports of machinery and transport equipment needed for industrial activity and infrastructure development and imports of food items, particularly cereals, to meet domestic supply shortages.

6.22 The net terms of trade, which measures the unit value index of exports as a proportion of unit value index of imports, fell sharply in 2004-05 and rose in 2005-06 due to the sharp rise/fall in unit value index of imports. It moderated in 2006-07 registering a growth of 5.2 per cent with unit value index of imports growing by a nominal 2.7 per cent while unit value index of exports at 8.1 per cent growth continued its steady growth of 8-9 per cent registered since 2003-04. Income terms of trade, reflecting capacity to import, continued its sharp growth in 2006-07 on top of a high growth in 2005-06. This was due to high growth of 15.8 per cent in volume of exports in 2006-07. Even gross terms of trade, which measures the volume index of imports as a ratio of volume index of exports, grew by 7.3 per cent in 2006-07 on top of a 32.3 per cent growth in 2005-06.

6.23 India's share in world merchandise exports, after remaining unchanged at 0.8 per cent between 2003 and 2004, reached 1 per cent in 2005, and remained there in 2006 and also in the first six months of 2007 (Table 6.7). The increase in China's share of world exports between 2001 and 2007 at 4.1 percentage points is one-half of the total increase in the share of developing countries over this period. While China's exports continued to grow at more than 27 per cent both in 2006 and the first six months of 2007, India's export growth was lower. Thailand and Brazil, with higher value of exports than India in absolute terms, also registered good export growth rate for the above period.

6.24 The simple average growth of India's exports from 2000 to 2006 was 19.3 per cent per annum. The growth of 29.8 per cent in 2005 was above the trend, due to a rise in the export of refined petroleum products and textiles and clothing in the year of dismantling of the quotas. Though the 14.5 per cent growth in January-June 2007 is below the trend, the Directorate General of Commercial Intelligence and Statistics (DGCI&S) data indicates a 20.3 per cent growth for January-December 2007.

India's merchandise imports

6.25 Merchandise imports grew by 24.5 per cent to US$ 185.7 billion in 2006-07 due to the high growth of 30 per cent of POL and 22.2 per

Table 6.7 Export growth and share in world exports of select countries

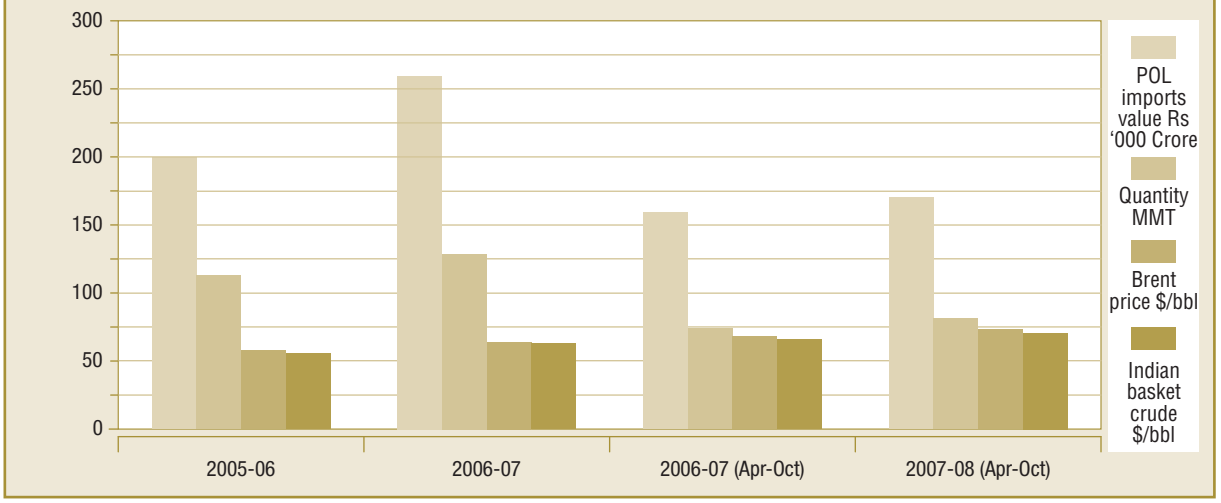
	Country	Value (US$ billion)	Growth rate (%)				Share in world exports (%)				Change in shares
			CAGR	Annual							
		2006	2000-04	2005	2006	2007[a]	2001	2005	2006	2007[a]	2007/2001
1	China	969	24.2	28.5	27.2	27.6	4.3	7.3	8.0	8.4	4.1
2	Hong Kong	317	6.4	11.6	9.7	10.0	3.1	2.8	2.6	2.4	-0.7
3	Malaysia	161	6.4	12.1	14.0	7.7	1.4	1.4	1.3	1.3	-0.1
4	Indonesia	104	2.0	22.9	19.0	13.6	0.9	0.8	0.9	0.8	-0.1
5	Thailand	131	8.6	14.6	19.1	13.7	1.1	1.1	1.1	1.1	0.0
6	Singapore	325	10.2	11.8	14.4	36.2	2.4	2.7	2.7	2.7	0.3
7	India	120	15.9	29.8	21.0	14.5 20.3[b]	0.7	1.0	1.0	1.0	0.3
8	Brazil	138	15.2	22.7	16.0	19.6	0.9	1.1	1.1	1.1	0.2
9	Mexico	250	3.2	13.2	16.8	4.3	2.6	2.1	2.1	2.0	-0.6
10	Russia	305	14.7	33.3	25.0	8.4	1.7	2.3	2.5	2.4	0.7
11	Korea	272	9.6	15.6	18.4	-8.7	2.0	2.2	2.3	2.2	0.2
12	Developing countries	5458	12.1	22.0	19.7	15.5	36.8	43.8	45.3	45.0	8.2
13	World	12040	9.4	14.1	15.7	13.8	100	100	100	100	0.0

Source: IFS statistics, October, 2007 IMF.

[a] **January-June 2007**

[b] **January-December 2007, DGCI&S data.**

Figure 6.4 POL imports



cent of non-POL. POL import growth was due to both volume growth by 13.8 per cent and increase in import price of the Indian crude oil import basket by 12.1 per cent. While the price of Indian crude basket continued to be lower than the Brent price, the rise in Brent price at 10.8 per cent was lower than the rise in price of the Indian crude import basket (Figure 6.4). Non-POL import growth was due to increase in gold and silver imports at 29.4 per cent compared to 1.5 per cent in the previous year. Non-POL non-bullion imports grew by 21.4 per cent reflecting the growing needs of imports for industrial activity and as inputs for exports.

6.26 In the current year (April-December 2007) import growth at 25.9 per cent by value was primarily due to the growth in non-POL imports at 31.9 per cent. Gold and silver imports grew by 29.3 per cent and non-POL non-bullion imports by 33 per cent. The former was due to higher domestic demand both to meet festive demand and pick up in gems and jewellery exports and the latter due to the growing demand by the industrial sector. POL import volume growth was subdued at 9.3 per cent in April-October 2007.

6.27 Trade deficit increased to US$ 59.4 billion (as per customs data) in 2006-07 and US$ 57.8 billion in the first nine months of the current year. However, net POL import growth peaked at 41.4 per cent in 2005-06 and decelerated sharply to 19 per cent in 2006-07, despite the 30 per cent growth in POL imports, as a substantial part was input for export production. In the first half of 2007-08, there was a further moderation in the growth of net POL imports (Table 6.8). Imports of gold and silver are highly variable and have increased sharply in April-September 2007 after a decline in April-September 2006.

Trade Composition

6.28 The composition of exports shows a perceptible shift in this decade from light manufactures to heavy manufactures and petroleum

Table 6.8 Growth in POL trade and non-POL imports[a]

	Total import	POL import	POL export	Net POL import	Non-POL import	Gold & silver	Non-POL, non-gold & silver
2001-02	1.7	-10.5	13.0	-13.9	7.2	-3.1	8.9
2002-03	19.4	26.0	24.0	26.4	17.0	-6.9	20.4
2003-04	27.3	16.6	37.9	12.7	31.5	59.9	28.5
2004-05	42.7	45.1	91.2	34.9	41.8	62.6	39.0
2005-06	33.8	47.3	66.2	41.4	28.8	1.5	33.1
2006-07	24.5	30.0	59.3	19.1	22.2	29.4	21.4
2006 (April-Sept)	23.5	41.2	101.2	22.3	16.1	-3.1	19.2
2007 (April-Sept)	27.7	16.9	27.6	11.4	33.2	71.0	28.2

Source: DGCI&S and own calculations.

[a] Growth rate in US dollar terms.

crude and products (Table 6.9). The share of textiles and ready-made garments (RMG) has fallen dramatically by 11.1 percentage points in 2006-07 over 2000-01 followed by gems and jewellery, leather and leather manufactures and handicrafts. Share of engineering goods and petro products has increased by 7.6 percentage points and 10.7 percentage points, respectively. The share of primary products has declined somewhat with the decline in share of exports from agricultural and allied sector being partly offset by a rise in the share of ores and minerals by 2.8 percentage points. The share of chemicals, including petrochemicals, has increased marginally. The share of petroleum crude and products has risen further to 18 per cent in the first half of 2007-08 from 15 per cent in 2006-07. Engineering goods' share also maintained a rising trend in 2007-08.

6.29 Export growth in 2006-07 was driven mainly by petroleum products with 59.3 per cent growth and engineering goods with 38.1 per cent growth. The perceptible increase in the share of petroleum products in total exports reflected not only the rise in POL prices but also India's enhanced refining capacity. The rising share of engineering goods reflected India's revival of heavy manufactures. Induced by strong international demand and higher prices, exports of ores and minerals, after growing at a compound annual growth rate (CAGR) of 50 per cent in the first half of this decade, moderated to 12.6 per cent in 2006-07.

6.30 The composition of imports showed much less change than that of exports (Table 6.10). POL continues to be the single major item of import with its share stabilizing at the 30-31 per cent level. The share of capital goods imports shows the sharpest rise of about 4.9 percentage points in 2006-07 over 2000-01 due to a 3.7 percentage point rise in the share of transport equipment and 1.6 percentage point rise in the share of non-electrical machinery (excluding machine tools). It has, however, plateaued at 13 per cent in the first half of 2007-08. The greatest decline is in the import share of pearls and precious and semi-precious stones, reflecting the fall in export share of gems and jewellery. Imports of gold and silver have been at around 8 per cent though it has increased to 10 per cent in the first half of 2007-08. Share of electronic goods imports has increased to 9 per cent, while food and allied imports show a marginal fall in share due to the fall in the share of edible oils, though import of cereals has shot up in 2006-07 from a negligible level. With the rise in crude oil prices, growth in POL imports continued to be high in 2006-07 though it moderated in the first half of this fiscal. The high growth in capital goods imports was contributed by both electrical and non-electrical machinery, reflecting higher domestic investment, resurgence of manufacturing, and rising needs of the export sector. There was also substantial growth

Table 6.9 Commodity composition of exports

Commodity group	Share (per cent)					CAGR	Growth rate (per cent)[a]			
				April-Sep.		2000-01 to			April-Sep.	
	2000-01	2005-06	2006-07	2006-07	2007-08	2004-05	2005-06	2006-07	2006-07	2007-08
I. Primary products	16.0	15.4	15.1	13.5	13.4	16.9	18.9	19.8	18.5	16.7
Agriculture & allied	14.0	10.2	10.3	9.5	9.3	9.0	19.8	23.5	24.7	15.1
Ores & minerals	2.0	5.2	4.8	4.0	4.1	49.9	17.4	12.6	6.0	20.6
II. Manufactured goods	78.8	72.0	68.6	68.4	67.4	15.3	19.6	16.9	18.1	15.9
Textile incl. RMG	23.6	14.5	12.5	12.9	11.1	4.3	20.4	5.7	33.5	1.2
Gems & jewellery	16.6	15.1	12.6	12.7	13.0	16.8	12.8	2.9	-0.6	20.4
Engineering goods	15.7	20.7	23.3	22.8	23.5	25.4	23.4	38.1	48.1	21.2
Chemical & related products	10.4	11.6	11.2	11.1	10.4	21.7	17.3	19.1	28.4	10.2
Leather & leather manufactures	4.4	2.6	2.4	2.4	2.3	5.5	11.1	12.1	7.7	12.7
Handicrafts (Incl. carpet handmade)	2.8	1.2	1.1	1.1	0.8	-5.3	30.3	4.1	5.2	-14.5
III. Petroleum, crude & products (including coal)	4.3	11.5	15.0	16.5	17.9	38.7	66.2	59.3	106.2	27.6
Total exports	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**17.0**	**23.4**	**22.6**	**27.3**	**17.6**

Source: DGCI&S and own calculations.

[a] Growth rate in US dollar terms.

Table 6.10 Commodity composition of imports

Commodity Group	Share (per cent)					CAGR 2000-01 to 2004-05	Growth rate (per cent)[a]			
				April-September					April-September	
	2000-01	2005-06	2006-07	2006-07	2007-08		2005-06	2006-07	2006-07	2007-08
Food & allied products	3.3	2.5	2.9	2.3	2.2	24.3	-4.7	42.4	-5.8	26.6
1. Cereals	0.0	0.0	0.7	0.1	0.1	16.1	36.8	3589.6	803.8	-55.5
2. Pulses	0.2	0.4	0.5	0.3	0.5	38.0	41.3	53.8	9.6	92.8
3. Edible oils	2.6	1.4	1.1	1.2	1.2	17.2	-17.9	4.2	-11.8	32.9
Fuel (of which)	33.5	32.1	33.2	36.3	33.6	18.5	44.8	29.0	39.8	18.0
4. POL	31.3	29.5	30.8	33.8	31.0	17.5	47.3	30.0	41.2	16.9
Fertilizers	1.3	1.3	1.6	1.7	1.9	17.2	59.4	52.4	54.4	48.2
Capital goods (of which)	10.5	15.8	15.4	13.1	13.2	28.9	62.5	21.8	44.3	28.3
5. Machinery except electrical & machine tool	5.9	7.4	7.5	8.1	8.2	26.2	49.0	24.9	39.5	28.3
6. Electrical machinery	1.0	1.0	1.1	1.1	1.1	25.6	25.9	30.3	37.9	28.6
7. Transport equipment	1.4	5.9	5.1	2.1	2.5	57.7	104.2	6.8	55.7	51.2
Others (of which)	46.3	43.7	43.8	37.8	40.4	23.5	21.1	24.6	-2.8	36.4
8. Chemicals	5.9	5.7	5.2	5.6	5.2	23.6	23.2	14.1	13.2	19.8
9. Pearls, precious & semi precious stones	9.6	6.1	4.0	4.1	4.2	18.3	-3.1	-18.0	-32.8	30.6
10. Gold & silver	9.3	7.6	7.9	7.7	10.3	24.5	1.5	29.4	-3.1	71.0
11. Electronic goods	7.0	8.9	8.6	9.0	8.9	29.9	32.5	20.6	34.0	26.2
Grand total	100.0	100.0	100.0	100.0	100.0	22.2	33.8	24.5	23.5	27.7

Source: Calculated on the basis of data from DGCI&S, Kolkata.
[a] Growth rate in US dollar.

in import of industrial inputs like iron and steel and transport equipment (in the first half of 2007-08) to support the high growth in the manufacturing sector. With a surge in domestic demand both for exports and consumption, import growth of gold and silver was buoyant in both 2006-07 and the first half of 2007-08.

Services trade

6.31 Services, particularly finance (insurance) and transportation of goods, are traditional complements to goods trade. With the spread of telecommunications and computer technologies, virtually all commercial services have become tradable across borders. The trend of globalization, reinforced by liberalization policies and the removal of regulatory obstacles, has fuelled steady growth of international investment and trade in services.

World trade in services

6.32 In the US$ 2.75 trillion world export of commercial services, the major exporters of services are the developed countries. India and China were among the top 10 exporters of commercial services in the world in 2006, the rest being the developed countries. India had the highest growth rate of 36 per cent in 2006, followed by China with 24 per cent. In commercial services imports, India moved from 15th position in 2004 to 13th position in 2005 and remind in 13th position in 2006, with 2.4 per cent share. The growth rate of India's imports of services at 29 per cent in 2006 was the highest among the top 40 importers with Saudi Arabia at second place with 27 per cent. The United States, the European Union-15 and Japan constitute a major portion of the world market for services imports.

6.33 Among the three broad categories of commercial services, the growth in other commercial services was the most buoyant in both 2005 and 2006 compared to transport and travel (Table 6.11).

India's services exports

6.34 With a sustained high growth of export of services, including a growth of 32.1 per cent in

Table 6.11 World exports of commercial services trade by major category, 2006

	Value (US$ billion)	Annual percentage change			
	2006	2000-06	2004	2005	2006
Commercial services	2755	11	20	11	12
Transport	630	10	25	13	10
Travel	745	8	18	8	9
Other commercial services	1380	13	19	12	15

Source: WTO.

2006-07, export value reached US$ 76.2 billion last year. Growth has been particularly rapid in the miscellaneous services category consisting of software services, business services, financial services and communication services. Growth of these services was 70.5 per cent in 2004-05, 37.5 per cent in 2005-06 and 36.7 per cent in 2006-07. Travel services exports grew by 16.2 per cent and transportation by 27.3 per cent in 2006-07 (Table 6.12).

6.35 Miscellaneous service exports constitute 75.6 per cent of India's services exports in 2006-07 (Table 6.12). While software services was the major item under miscellaneous services, since 2003-04 non-software miscellaneous services exports have grown rapidly, and now almost equal the value of software exports. The major contributors among non-software miscellaneous services are business services with 25.3 per cent share and 107 per cent growth, financial services with 11.1 per cent share and 140.9 per cent growth in 2006-07 and communications services with 8 per cent share and 33.3 per cent growth in 2006-07. The "others" category has registered a large negative growth probably reflecting the improved data classification by RBI following the recommendations of the committees to systematize the data on services.

6.36 During April-September 2007-08, the growth rate of services exports was only 8.6 per cent over the corresponding period of the previous year due to the negative growth in non-software services, particularly business and communication services. This is mainly due to the fall in exports of business and management consultancy and architectural, engineering and other technical services. India's share in world commercial services' exports increased from 2.3 per cent in 2005 to 2.7 per cent in 2006 with its ranking improving from 11 to 10. This compares with a merchandise export share of 1 per cent and a ranking improvement from 29 in 2005 to 28 in 2006. By 2006-07 commercial services exports were around 60 per cent of merchandise exports.

Table 6.12 Exports of services

Commodity Group	Share (per cent)					CAGR	Growth rate (per cent)*			
				April-September		2000-01 to			April-September	
	2000-01	2005-06	2006-07	2006-07	2007-08	2004-05	2005-06	2006-07	2006-07	2007-08
Travel	21.5	13.6	12.0	10.6	12.1	19.0	17.8	16.2	15.7	23.7
Transporation	12.6	11.0	10.6	11.3	11.9	23.1	35.1	27.3	27.1	14.9
Insurance	1.7	1.8	1.6	1.7	2.2	34.6	21.1	13.2	-4.5	42.5
GNIE	4.0	0.5	0.3	0.3	0.5	-0.6	-21.7	-20.4	-18.5	65.3
Miscellaneous, of which	60.3	73.0	75.6	76.1	73.3	27.0	37.5	36.7	44.0	4.6
Software services	39.0	40.9	41.1	42.9	45.5	35.6	33.3	32.6	37.2	15.2
Non-software services of which	21.3	32.1	34.5	33.2	27.8	30.3	43.1	41.9	54.0	-9.1
Business services	2.1	16.1	25.3	24.1	17.8	84.4	80.1	107.0	138.1	-19.8
Financial services	2.1	2.1	3.8	2.8	4.2	25.4	136.1	140.9	56.1	61.5
Communication services	7.0	2.7	2.8	3.2	2.5	8.5	13.8	33.3	90.3	-15.2
Total service exports	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**24.1**	**33.3**	**32.1**	**36.9**	**8.6**

Source: Calculations based on RBI data.

6.37 India's country-wise exports of services based on other country data shows that the United States and the United Kingdom are important destinations for service exports with the rest of EU and South East Asia being relatively less important. In the EU, India has a presence in the travel services imports of France and Italy, while in South East Asia it has a presence in transportation services imports of Hong Kong.

India's services imports

6.38 Imports of commercial services have become important in recent years reaching US$ 44.4 billion in 2006-07 with a growth of 28.7 per cent (Table 6.13).

6.39 Business services is the most important category of service in imports, followed by transportation and travel. Business services grew by 120.6 per cent in 2006-07. However, in the first half of 2007-08, there is a sharp fall in the growth rate of business services imports (as in the case of business services exports) mainly due to the fall in imports of architectural, engineering and other technical services and relatively low growth in imports of business and management consultancy services. With high growth in imports of financial services and software services both in 2006-07 and the first half of 2007-08, their shares have also increased substantially. Travel and transportation imports have also registered good growth for the above period.

Capital account

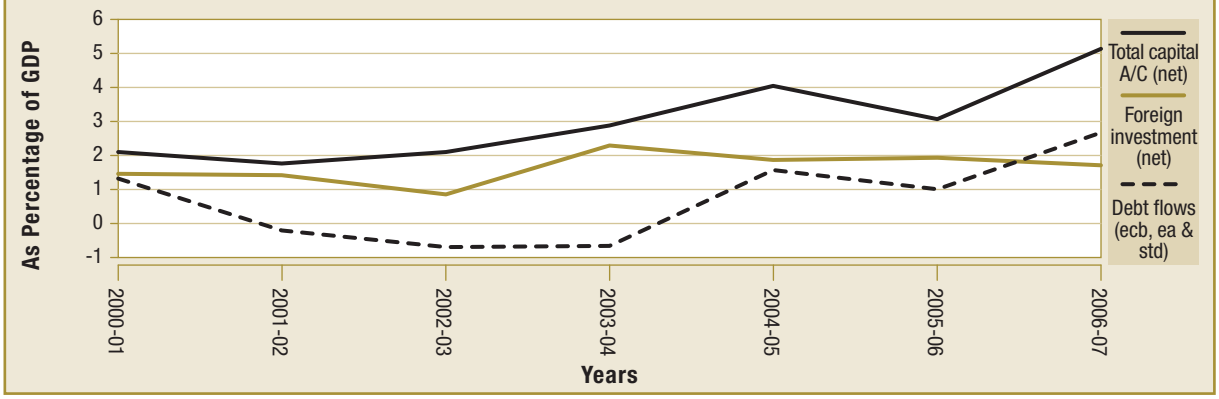
6.40 Capital inflows can be classified by instrument (debt or equity), duration (short-term

Table 6.13 Imports of services

Commodity Group	Share (per cent)					CAGR	Growth rate (per cent)			
				April-September		2000-01 to			April-September	
	2000-01	2005-06	2006-07	2006-07	2007-08	2004-05	2005-06	2006-07	2006-07	2007-08
Travel	19.2	19.2	15.1	17.8	18.7	20.6	26.5	0.7	12.6	20.0
Transporation	24.4	24.2	18.2	21.5	26.4	21.1	83.7	-3.2	0.0	40.7
Insurance	1.5	3.2	1.4	1.5	2.2	47.2	54.6	-42.5	-25.3	67.8
GNIE	2.2	1.5	0.9	1.1	1.2	14.9	28.7	-23.8	-13.0	21.9
Miscellaneous, of which	52.6	51.8	64.4	58.1	51.5	23.5	5.7	59.9	50.7	1.3
Software services	4.1	3.9	5.1	4.4	5.8	76.9	67.3	69.4	71.2	48.8
Non-software services of which	48.6	47.9	59.3	53.7	45.7	23.2	2.7	59.1	49.3	-2.6
Business services	7.0	22.5	38.5	31.9	29.3	56.8	5.9	120.6	115.8	5.0
Financial services	13.5	2.8	4.7	3.4	7.0	-7.2	16.0	116.3	25.1	135.8
Communication services	0.9	0.8	1.5	1.5	1.3	58.9	-60.8	128.0	142.3	4.5
Total Service imports	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**21.6**	**24.0**	**28.7**	**26.4**	**14.3**

Source : Calculations based on RBI data.

Figure 6.5 Total capital a/c (net), foreign investment (net) and debt flows



ecb: External commercial borrowing. ea: External assistance. std: Short-term debt.

or long-term) and nature (stable or volatile) of flows. Such taxonomy helps calibrate the policy of liberalization of the capital account. Figure 6.5 shows that foreign investment (net) has been a relatively stable component of total capital flows, fluctuating broadly between 1 per cent and 2 per cent of GDP during this decade. However, it seems to have shifted to a higher plane from 2003-04 with average for 2003-04 to 2006-07 roughly double that during 2000-01 to 2002-03. In contrast, the debt flows have fluctuated much more, with a down trend till 2003, which resulted in net outflows in the three years to 2003-04, and a rising trend from 2004-05. The trend in net capital flows since 2003-04 therefore seems to be broadly driven by the rising ratio of debt flows (Figure 6.5). Variations in debt flows have been primarily due to lumpy repayments on government guaranteed or related External Commercial Borrowing (ECB).

6.41 Net capital flows rose from a level of US$ 25.0 billion in 2005-06 to reach US$ 46.4 billion in 2006-07, which implies a growth of 85.8 per cent. The major developments in 2006-07 include: (i) a quantum jump in external commercial borrowings (net); (ii) significant rise in foreign direct investment inflows with a simultaneous rise in outward investment; (iii) large inflows in the form of non-resident Indian (NRI) deposits; and, (iv) an initial fall in portfolio investment, which was somewhat compensated by a recovery in the latter half of the year. The World Economic Outlook (WEO) reported that many emerging markets and developing countries similarly experienced historically high levels of net foreign exchange inflows. The acceleration in gross flows was sharper than net flows. Net private capital flows to emerging market economies and developing countries, after falling by 18.5 per cent in 2006, have risen by 124.3 per cent to reach US$ 495.4 billion in 2007. Thus, net capital flows into India have been substantial in the current financial year.

Non-debt Flows

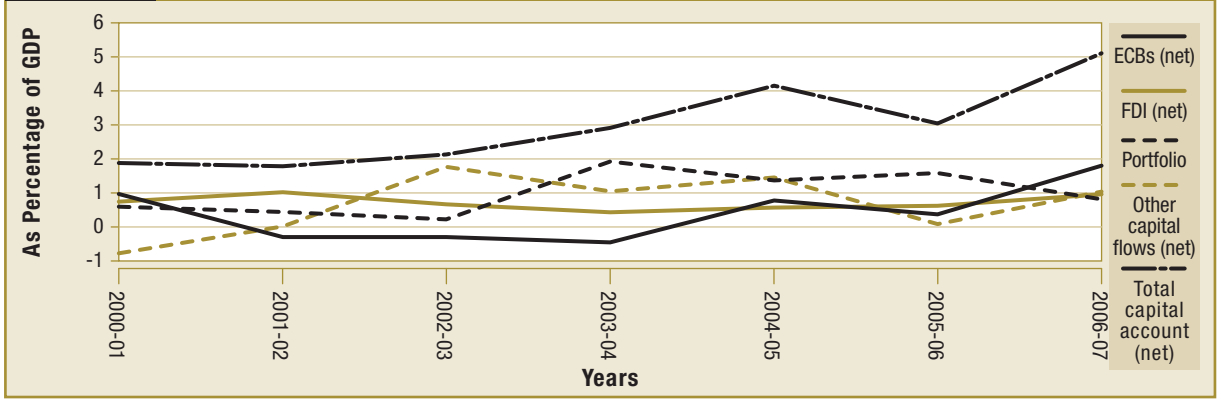
Foreign investment

6.42 As a proportion of total capital flows and on a net basis, foreign investment has had a mixed trend in the post-reform period. In 2006-07, the proportion stood at 33.5 per cent, down from 62.2 per cent in 2005-06 with negligible growth in foreign investment, year-on-year. The proportion rose to 43.4 per cent in the first half of 2007-08. Of the two major components of foreign investment, namely, FDI and portfolio investment comprising foreign institutional investment (FII), Euro equities and others, the latter had been a major but not-so-stable source of foreign investment flows in the period 1993-94 to 2005-06 (Figure 6.6)

Foreign direct investment

6.43 In the schema of classification of capital flows based on duration, FDI has been the most attractive type of capital flows for emerging market economies because of its lasting nature and also because it is considered a vehicle for transformation of the domestic production process through bridging the technological gap. Concerted efforts towards attracting FDI through an emphasis on policies of promoting non-debt creating capital inflows during the reform period did not yield results on the expected lines initially.

Figure 6.6 ECB, FDI, portfolio, other capital flows and total capital account



6.44 With reform in policies, better infrastructure and a more vibrant financial sector, FDI inflows into India accelerated in 2006-07. On a gross basis, FDI inflows into India, after rising to a level of US$ 6.2 billion in 2001-02, fell to US$ 4.5 billion in 2003-04. After a recovery, the proportion has risen to reach US$ 23.0 billion in 2006-07. The trend continued in the current financial year with gross FDI flows at US$ 11.2 billion in the first six months. FDI inflows continued to be preponderantly of the equity variety, broad-based and spread across a range of economic activities like financial services, manufacturing, banking services, information technology services and construction.

6.45 FDI grew appreciably on both gross and net basis. While on a gross basis, the growth in 2006-07 was 150.2 per cent, on a net basis it was 179.5 per cent. Even as FDI into India (credit side) grew substantially, a simultaneous pick up in outward investment moderated the overall net inflows. Outward investment by India shot up from levels less than US$ 2.4 billion in the period 2003-04 to 2004-05 to reach US$ 14.4 billion in 2006-07. Thus, overall net FDI in 2006-07 was at US$ 8.5 billion. The trend continued in the current year also with FDI inflows in the period April-September 2007 being moderated by outward investment of US$ 7.3 billion to yield net flows of US$ 3.9 billion. The proportion of payments to receipts under FDI into India was 0.7 per cent and 0.4 per cent in 2005-06 and 2006-07, respectively. This indicates the lasting and stable nature of FDI flows in India.

Portfolio investment

6.46 With greater openness in the emerging market economies and developing countries, portfolio investment flows became net outflows in four out of the last six years ending 2006. According to the WEO, private net portfolio flows to these economies, after being overall outflows in the period 2001-03, recorded modest levels of positive inflows of US$ 21.1 billion and US$ 23.3 billion in 2004 and 2005, respectively. The year 2006 witnessed a great reversal with a massive net outflow of US$ 111.9 billion. The reversal in emerging Asia was the highest with an outflow of US$ 120.8 billion in 2006. There was no such outflow from India in 2006, though the level of portfolio inflows was lower than in 2005.

6.47 With heightened volatility in Asian and global financial markets in 2006-07, net portfolio inflows into India amounted to US$ 7.1 billion for 2006-07. Portfolio net flows after being negative in the initial months (May-July 2006) picked up momentum in August-November 2006 only to slow down again in March 2007. Euro equities, which were relatively a very small component of portfolio flows (less than US$ 1 billion in the period 1997-98 to 2004-05), have risen in 2005-06 and 2006-07 to reach US$ 2.6 billion and US$ 3.8 billion, respectively. In 2006-07, Euro equities constituted 54.3 per cent of the total portfolio net flows. However, this composition was more due to lower net inflows under FII. Portfolio investment inflows in the first six months was US$ 83.4 billion and outflows was US$ 65 billion leaving a net inflow of US$ 18.3 billion, which implies a growth of 1,015.2 per cent, year-on-year.

6.48 In the schema of classification based on duration, portfolio investment flows fall under short-term variety. The proportion of net portfolio outflows to total portfolio flows under this head indicates the nature of such flows. In the seven-year period from 2000-01, the proportion of net flows to total gross flows (inflows plus outflows) were below 13 per cent, with the exception of 2003-04 when it was higher at 25.2 per cent. In 2006-07, the proportion was abysmally low at 3.3 per cent (Table 6.14).

6.49 An analysis of the monthly data on net FII inflows released by the Securities and Exchange Board of India (SEBI) also indicates similar volatility. For instance, the standard deviation (a statistical measure of dispersion indicating how widely the values of the data set are spread; a larger standard deviation means greater dispersion) of the net inflows under FII was very high (US$ 2,423.4 million) in the 12 months ending December 2007. The same measure for 24 months ending December 2007 yielded a somewhat lower (US$ 1,882.8 million) dispersion. In terms of another statistical measure, namely coefficient of variation (indicates the variation in a set of values around its average; a coefficient above 1 indicates higher variation), the SEBI data yields results of 1.69 and 1.79 for the 12 and 24 months period ending December 2007. Notwithstanding the fact that portfolio investment flows have been volatile, there has not been any significant net outflow for the year as a

Table 6.14 Portfolio net flows as a proportion of total portfolio flows

Year	In US$ million				In per cent
	Credit	Debit	Net	Total (2+3)	proportion (4/5)
1	2	3	4	5	6
2000-01	13619	11029	2590	24648	10.5
2001-02	9259	7307	1952	16566	11.8
2002-03	8833	7889	944	16722	5.7
2003-04	28218	16862	11356	45080	25.2
2004-05	40847	31560	9287	72407	12.8
2005-06	68120	55626	12494	123746	10.1
2006-07	109622	102560	7062	212182	3.3

Source: RBI.

whole in the post-reform period, except in 1998-99.

Other non-debt flows

6.50 In the BoP system of accounts of the RBI, the head "Other Capital" covers mainly the leads and lags in export receipts (the difference between the custom data and the banking channel data), funds held abroad, and the residual item of other capital transactions not included elsewhere such as flows arising from cross-border financial derivative and commodity hedging transactions, migrant transfers, and sale of intangible assets such as patents, copyrights, trademarks, etc. In 2006-07, Other Capital (net) including banking capital amounted to US$ 8.8 billion. Payments transaction like short-term credits, which earlier were not captured explicitly elsewhere, were accounted under this residual head implicitly. In its Press Release dated December 29, 2007, reporting BoP developments for the second quarter, the RBI had, among other things, indicated some accounting changes in this head (Box 6.1).

Box 6.1 Changes in the BoP system of recording

The RBI, in conformity with the best international practices and as per the provisions of Balance of Payments Manual 5 (BPM5) of the IMF, made certain changes in the system of recording BoP flows. In the earlier system of recording of international transactions between residents and non-residents, trade credits or credits for financing imports by Indian residents extended by foreign suppliers up to 180 days were not covered explicitly and were subsumed under the head 'Other Capital' or errors and omissions. However, such credit beyond 180 days was recorded and reported. Usually very short-term credit less than 180 days get rolled over within a year and as such they are recorded on a net basis only. However, using the internationally accepted methodology as recommended in BPM5, the RBI started recording these transactions for both BoP and external debt purposes. While in the case of BoP there was no change in the overall balance as other capital and errors and omissions were lower to the extent that short-term credits were higher, total stock of outstanding external debt went up (details in the subsequent section on external debt).

Transactions by non-resident Indians (NRIs) in the Non-Resident Ordinary (NRO) account were earlier included under 'Other Capital' in the capital account. The RBI has put in place a reporting system and record these data separately. As such, transactions under the NRO account have now been included under NRI deposits. Besides, the RBI, taking cognizance of the importance of the services in invisibles account and the possibility of some overlap between business services and software services of the ITES variety, had reviewed the data reported by authorized dealers and revised the business services data and started providing greater details of the non-software services. The methodology of the revision was detailed in its Press Release dated December 31, 2007.

6.51 As per the RBI's revised data on Other Capital, leads and lags in export payments, which was negative in 2005-06 and less than a billion US dollars in 2006-07, shot up in April-September 2007 and reached US$ 3.7 billion. In 2007-08, advance received for effecting FDI (pending with authorized dealers) amounted to US$ 2 billion. With other residual capital of the order of US$ 2.1 billion, total net flows under Other Capital head was of the order of US$ 6 billion.

Debt flows

External commercial borrowings

6.52 Management of debt flows, including of the private flows like ECBs, have been guided by the overarching principles of prudent external debt management. This focuses on keeping the maturities long and servicing cost low. ECBs were approved within an overall annual ceiling that were revised upwards progressively and subject to a hierarchy of priorities for projects/sectors. Thus any inter-temporal trend analysis would be somewhat misleading. With relative stability and strong capital inflows, liberalization of the external commercial borrowings (ECBs) norms have been in the nature of allowing corporations to borrow up to a certain limit under the "automatic route".

6.53 On a gross basis, from a low base, ECBs have grown in the last three years at high and relatively stable rates of 73.8 per cent, 57.8 per cent and 46.2 per cent, respectively, in 2004-05, 2005-06 and 2006-07. In the same period, repayments have been relatively unstable with decline of 52.3 per cent, followed by high growth of 204.2 per cent owing to a one-off effect of the redemption of India Millennium Deposits (IMD) and followed by a decline of 59.3 per cent. Thus, net inflows under ECBs have been uneven — rising by 544.1 per cent in 2006-07, following a decline of 51.7 per cent in the previous year. In 2006-07, net ECBs accounted for 34.8 per cent of total capital account net flows. In the first six months of the current financial year, gross ECBs rose, year-on-year, by 81.1 per cent to reach US$ 14 billion. Based on a periodic comprehensive review of the ECB guidelines, a notification was issued in August 2007. The new guidelines stipulate certain end-use restrictions and foreign currency expenditure conditionality for borrowing above the threshold of US$ 20 million per borrower per financial year and requiring RBI approval for borrowing up to US$ 20 billion for rupee expenditure. ECB inflows in the recent past have been enabled by favourable global liquidity conditions, rising credit needs, interest differential and currency expectations.

External assistance, short-term credits and non-resident deposits

6.54 While ECBs were the dominant source and constituted 56.0 per cent of the debt flows in 2006-07, the other debt flows comprising non-resident deposits, short-term loans and external assistance were important as they had specific functional roles in the financing of trade and development. As a proportion of total capital flows, post-reforms, external assistance had exhibited a declining trend. With payments exceeding receipts under this head, external assistance (net) after being negative in 2003-04, has since risen and grew by 3.8 per cent to reach US$ 1.8 billion in 2006-07. In 2007-08 (April-September), external assistance (net) was placed at US$ 729 million as against US$ 386 million for the corresponding period in 2006-07, indicating a growth of 88.9 per cent. With the inclusion of short-term credit up to 180 days, short-term trade credit (net) was at US$ 5.7 billion in April-September 2007, of which the suppliers' credit (net) up to 180 days amounted to US$ 1.9 billion during April-September 2007.

6.55 Non-resident deposits, an important source of capital flows earlier, in the face of pick up in investment and commercial loans subsequently, have become smaller in relative terms, but more stable. The outstanding balance on account of the various schemes was of the order of US$ 41.2 billion as at end-March 2007 (Table 6.15). As with any debt flows, the NR deposits are critically affected by interest differentials. With reduction in deposit rates there was a negative flow in the first six months of the current financial year.

Utilization of foreign aid

6.56 Information available with the Controller of Aid, Accounts and Audit (Ministry of Finance) indicates that, as on March 31, 2007, the total foreign aid available in the pipeline was Rs. 89,805 crore (US$ 20.6 billion), comprising loans of Rs. 80,724 crore (US$ 18.5 billion) and grants of Rs. 9,081 crore (US$ 2.1 billion). The amount of loans and grants to be utilized by the Government

Table 6.15 Non-resident deposits outstanding under different schemes

Panel A: Outstanding balances under different schemes*

(Rs. million)

	As at the end of							
	March 2001	March 2002	March 2003	March 2004	March 2005	March 2006	Mar-07 (PE)	Nov-07 (PE)
Foreign currency non-resident (banks)	9076	9673	10199	10961	11452	13064	15129	15293
Non-resident external rupee accounts	7147	8449	14923	20559	21291	22070	24495	26041
Non-resident (non repatriable)	6849	7052	3407	1746	232	—-	—-	—-
Rupee deposits	—-	—-	—-	—-	—-	1148	1616	2109
Total	**23072**	**25174**	**28529**	**33266**	**32975**	**36282**	**41240**	**43443**

B: Net flows under non-resident deposits[a]

(US$ million)

Schemes	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	Apr-Nov (PE)	
							2005-06	2006-07
FCNR(B)	594	526	762	492	1612	2065	1181	164
NR(E)RA[b]	1626	6195	4695	84	1177	1830	1560	-915
NR(NR)RD	508	-3745	-1816	-1538	—	—	—	—
NRO					930	426	230	318
Total	**2728**	**2976**	**3641**	**-962**	**3719**	**4321**	**2971**	**-433**

Source: RBI

PE: Provisional Estimates.

[a] All figures are inclusive of accrued interest.

[b] The inflows into NR(E)RA deposits from the year 2002-03 onwards may partly be due to crediting of maturity proceeds of the NR(NR)R deposits which were discontinued with effect from April 1, 2002.

Note: Inflows/outflows have been calculated by taking the monthly variation in rupee denominated deposits and converting those by monthly average exchange rate. All figures are inclusive of interest and valuation changes arising on account of fluctuation in non-dollar currencies against US dollar.

account was Rs. 84,503 crore (US$ 19.4 billion) and by the non-Government sector Rs. 5,302 crore (US$ 1.2 billion).

6.57 A major part of aid available in the pipeline pertained to infrastructure sector which was Rs. 57,222 crore (US$ 13.1 billion) or around 64 per cent of total aid available in the pipeline. Within infrastructure, aid available for development of roads was 23 per cent, urban development 27 per cent and power sector 14 per cent of the total undrawn balance as at the end of March 2007. In terms of the share of the Centre and States in the total undrawn balance at end-March 2007, the Centre accounted for Rs. 28,822 crore (US$ 6.6 billion) and States Rs. 55,681 crore (US$ 12.8 billion). Amongst States, six States (Karnataka, Tamil Nadu, West Bengal, Maharashtra, Madhya Pradesh and Andhra Pradesh) accounted for 35 per cent of undrawn balance at end-March 2007.

6.58 While the country is basically an aid recipient, at the same time limited amounts of aid are given to friendly developing countries, which appear on the debit side of external assistance. Until 2003-04, the loans given by India were in the form of Lines of Credits (LOC) and in the nature of government to government transactions. Accordingly, the whole amount of loan assistance was provided for in the Union Budget. The amount outstanding under the loans extended by the Government to foreign governments stood at Rs. 3,502 crore (US$ 802 million) at the end of March 2007 as per the revised budget estimates.

6.59 Since 2003-04, LOC are extended to foreign governments through EXIM Bank of India which are supported by the Government. The EXIM Bank extends such LOC on concessional terms – in rate of interest and repayment period. The interest differential is made good by the Government. The rate of interest charged by the EXIM Bank and the repayment period of the loans

vary among different categories of recipients, which are classified into Heavily Indebted Poor Countries (HIPC), Low Income High Level of Debt (LIHD) Countries, Middle Income High Level of Debt (MIHD) Countries and Middle Income Low Level of Debt (MILD) Countries by the World Bank. So far, the Government supported LOC through EXIM Bank of India for about US$ 3.2 billion have been approved.

6.60 In addition to loans, the Government also extends grants to the needy developing countries mainly in the nature of technical assistance under the Colombo Plan. Under this programme, the Government provides comprehensive and integrated training to personnel for strengthening their human resources. At present, the training programme has been extended to 18 countries. Towards this end, the Union Budget has made a provision of Rs. 5.5 crore for the year 2007-08.

Management of capital flows

6.61 The excess of capital inflows (reserve change on BoP basis) over the current account deficit has been on a clear uptrend since 2003-04 rising to 7.72 per cent of GDP in the first half of 2007-08 (Figure 6.7). There was a small dip below trend in 2004-05 and 2005-06 because of special conditions — a reversion to deficits on the current account and the maturing and repayment of IMD bonds. Such high levels of reserve change were due to a combination of factors including the strong growth performance and potential together with high returns on equity, robust financial markets, interest differential, and rising expectations including on the value of the rupee.

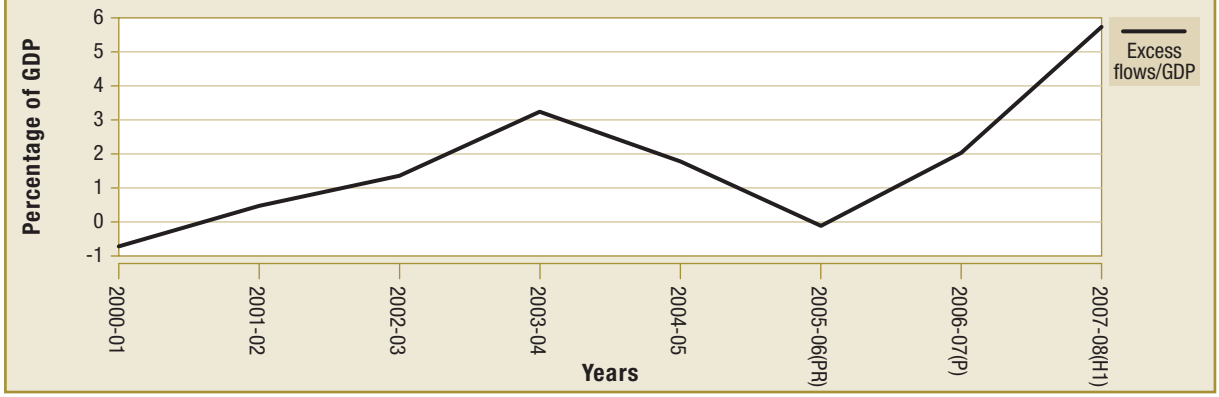
6.62 Both investment and debt flows have surged in 2006-07. Such net flows into India were 18.2 per cent of the total net capital flows to emerging market economies in Asia in 2006. Though, unlike other economies in the region running huge surpluses, the Indian economy had moderate levels of current account deficit, these excess flows posed some new challenges (Box 6.2).

6.63 Rapid capital inflows have implications on the macroeconomic policy setting. Given the RBI's policy of intervening to dampen volatility and maintain orderly conditions in the foreign exchange market, the capital inflows have also reflected in the growth in net foreign exchange assets (NFA) of the RBI. As a part of its monetary management, RBI has been sterilizing a part of the rupee funds consistent with its monetary policy stance. RBI's overall monetary policy stance factors in the objective of price stability, reducing inflationary expectations while remaining supportive of growth, ensuring regular flow of credit and maintaining orderly conditions in financial markets. The extent of sterilization in two of the last three years above 75 per cent of RBI's purchases of foreign currency indicates the policy stance (Table 6.16).

Foreign exchange reserves

6.64 In the wake of surge in capital flows and build-up of current account surpluses, foreign exchange reserves comprising external assets like foreign currency assets (FCA), gold, SDRs and Reserve Tranche Position in the IMF that are readily available to and controlled by monetary authorities for management of BoP, scaled new

Figure 6.7 Excess of capital flows over current account deficit



Box 6.2 Management of capital flows

The excess of net capital inflows over the current account deficit posed newer problems in macroeconomic management, particularly that of managing the contradictions in the trilogy of objectives. The policy response was a mix of intervention to smoothen volatility, the build up of the level of reserves and appropriate liquidity management with a focus on maintenance of healthy financial market conditions with financial stability. Sterilization operations were resorted to after an assessment of the nature and extent of surplus foreign exchange flows involving considerations like trade-offs between the short term and the long term; judgement on whether capital flows are temporary or enduring; as well as on the operation of self-correcting mechanisms in the market and market responses in terms of sentiments.

As capital flows are reversible at a future date and in view of the potential volatility embedded in certain types of flows, the liquidity at risk rule and the monetary policy considerations weighed on the level of intervention and reserves. Volatile flows, defined as short-term credit and portfolio investment were 76.3 per cent and 46.7 per cent of the total capital flows in 2003-04 and 2004-05. The proportion subsequently declined to 29.9 per cent in 2006-07 and was placed at 47 per cent in 2007-08 (April-September). The "Annual Report on Exchange Arrangements and Exchange Restriction 2007" of the IMF indicated this as a global trend and stated, "While capital inflows are often beneficial to recipient countries and an indicator of increased integration of these economies in the global market, the sheer magnitude of the flows, their more volatile nature, and recent episodes of market turbulence have led to some concerns about the risks. Risk are seen as arising not so much from growing foreign direct investment, but from significant surges in short-term and more volatile flows, particularly portfolio equity investment flows, and in certain countries, bank's foreign borrowings". A second feature that weighed in the policy responses was the fact that exchange rates were increasingly determined by gross flows and expectations. The steady supply and lumpy demand conditions, and lack of appropriate depth in foreign exchange markets also were factors that were considered. In the event, with considerable appreciation of the rupee, the pass through of capital flows to the monetary sector was partial.

In view of the rapid pace of accretion to reserves and the high levels of appreciation of the rupee, liquidity management requirements set in motion the higher limits for outstanding balances under the market stabilization scheme. This was progressively raised. The fiscal costs of sterilization of flows mounted and the supplementary demand for grants placed the outgo for 2007-08 at Rs. 8,200 crore. The current policy mix to resolve the contradictions in a relatively open capital account, monetary policy independence and flexible exchange rate remain contextual policy responses. The commitment to greater openness and fuller convertibility remains; but the movement in this direction would continue to be gradual, sequenced and calibrated. A number of measures have been taken already in this regard like: liberalization of outflows; due compensation for sections affected by the flows like exporters; prudential norms for market participation; and a rejigging of the hierarchy of conditions on ECBs. A view has been expressed by some analysts that certain measures are harking back to capital controls, which could send wrong market signals. The only measure that could be construed as controls is the end-use conditions on ECBs, which were not fully liberalized in the first place and which had periodically been reviewed and regulated. The end-use conditions on ECBs notified in August 2007 modified the pre-existing controls or limits by only prioritizing the use of such an option for rupee expenditure beyond a threshold limit.

Table 6.16 Foreign exchange flows and sterilization

(Rs. crore)

Items	2004-05	2005-06	2006-07	2007-08
1. Forex flows	1,28,081	1,02,969	2,02,235	
2. Forex purchased by RBI	91,105	32,884	1,18,994	1,58,206
				US$ 38.7 billion (April-Sep.)
3. Sterilization				
a. MSS	64,211	-35,149	33,912	80,376 (Up to Oct 5)
b. RBI OMO	2,899	3,913	4,901	N.A.
c. CRR impound	19,108	34,077	53,161	33,320 (April-Sep.)
Total Sterilization (a+b+c)	**86,218**	**2,841**	**91,974**	

Source: Calculations based on RBI data.

Table 6.17 Sources of foreign exchange reserves accretion

(US$ billion)

Items	2005-06	2006-07	April-September 2006-07	April-September 2007-08
I. Current account balance	**-9.2**	**-9.6**	**-10.3**	**-10.7**
II. Capital account (net) a to f	**24.3**	**46.2**	**18.9**	**51.1**
a. External assistance	1.7	1.7	0.4	0.7
b. External commercial borrowings	2.7	16.1	5.7	10.6
c. Foreign investment	17.2	15.5	6.1	22.2
d. Short-term credit	1.7	3.3	3.9	5.7
e. Banking capital	1.4	2.1	3.3	5.3
Of which : NRI deposits	*2.8*	*3.9*	*2.2*	*-0.1*
f. Other items in capital account	-0.4	7.5	-0.5	6.6
III. Valuation change	**-5.0**	**10.9**	**5.1**	**8.2**
Total (I+II+III)	**10.1**	**47.5**	**13.7**	**48.6**

Source: Reserve Bank of India.

highs in recent years. India's levels of accretion were higher in comparison with many countries, but not unique.

6.65 Foreign exchange reserves of India, denominated in US dollars, rose from a level of US$ 151.6 billion in end-March 2006 to reach a level of US$ 199.2 billion, implying a reserve increase of the order of US$ 47.6 billion. Though there is no one-to-one correspondence between sources of capital flows and reserves, the major sources of capital inflows (and implicitly of reserve accretion excluding valuation gains) were ECBs and foreign investment in 2006-07. The appreciation of other major currencies against the US dollar resulted in a valuation gain of the stock of reserves of the order of US$ 10.9 billion in 2006-07. The downturn in the securities market and net outgo of FII flows in the initial months and later again in March 2007 moderated the otherwise rapid pace of accretion to reserves in 2006-07. As per the BoP data released by the RBI for the current financial year (April-September), reserves rose by US$ 48.6 billion including a valuation gain of US$ 8.2 billion (Table 6.17).

6.66 The sources of reserves were broad-based. Foreign exchange reserves on stock basis at the end of Febuary 8, 2008 were US$ 290.9 billion, implying an accretion of US$ 91.6 billion in the current financial year so far over end-March 2007. Of the four items that constitute the foreign exchange reserves, FCA continued to be the main variable. The annualized return on the multi currency-multi asset portfolio of the RBI was 4.6 per cent in 2006-07. The fiscal costs of sterilization went up and against a budget estimate of Rs. 3,700 crore for 2007-08, the supplementary demand for

Figure 6.8 Exchange rate of Rupee vis-a-vis major curren cies (2005-06 = 100)

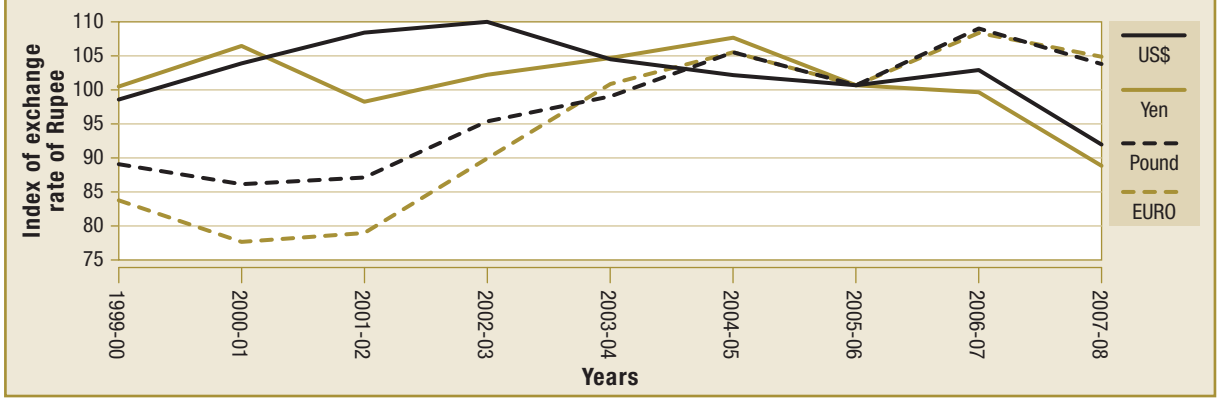
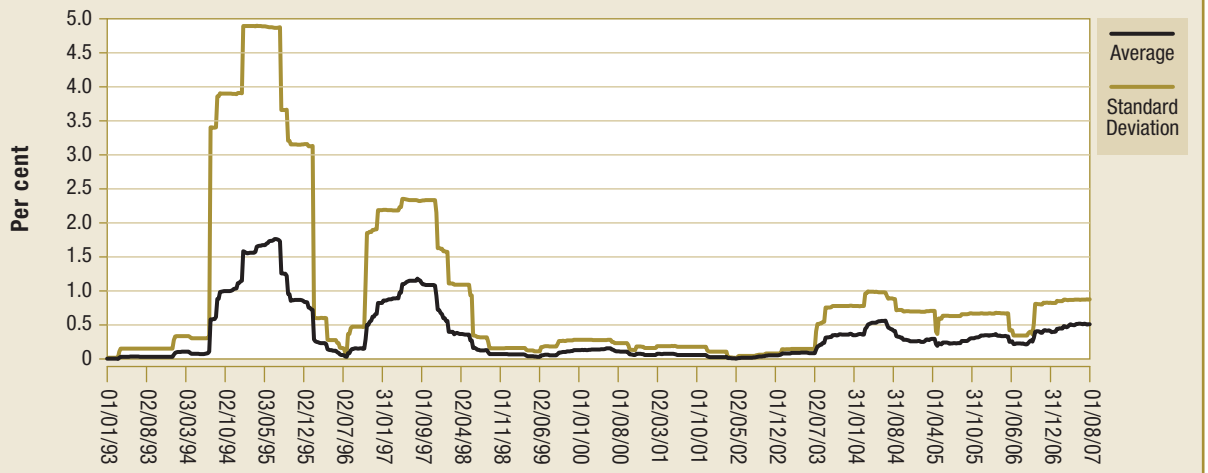


Figure 6.9 Weekly % change in exchange rate squared: moving average of 52 weeks



grants revises this upwards to Rs. 8,200 crore. While fiscal costs are indicated by the benchmark G-sec yield, the cost to the exchequer would be the difference between this and the return on deployment of FCA. The level of foreign exchange reserves at present provides an import cover of over 13 months.

Exchange rate developments

6.67 The dynamic nature of the relationship between a nation's balance of payments and its foreign exchange rate, as enunciated by the balance of payments approach to exchange rate determination, showed up in a nascent form late last year. It was fully in evidence in 2007-08 with the exchange rate of the rupee appreciating sharply in tandem with rising capital flows (Figure 6.8). With the demand for foreign exchange (debit side of BoP) not keeping pace with the supply of foreign exchange (credit side of BoP), the rupee appreciated against the US dollar by 4.5 per cent in April 2007 (over March 2007) and by 3.4 per cent in May 2007 over April 2007. The rupee also appreciated against other major currencies in the same period. Subsequently, two-way movement in the exchange rates was evident (Figure 6.8). In fact, against other major currencies the rupee depreciated in the later months after the strong bout of appreciation in the initial months.

6.68 The extent of appreciation or depreciation of the rupee varies according to the time horizons as reference period. The rupee appreciated by 9.8 per cent against the US dollar during the current financial year between April 3, 2007, and January 16, 2008. The rupee appreciation against the US dollar over the past 12 months on year-on-year basis (December 2007 over December 2006) was a higher 13.2 per cent. The appreciation of the rupee against other major currencies was much less than against the US dollar (Table 6.18). It even depreciated marginally against the Euro during the financial year (till January 16, 2008).

Table 6.18 Rupee appreciation vis-à-vis major currencies[a]

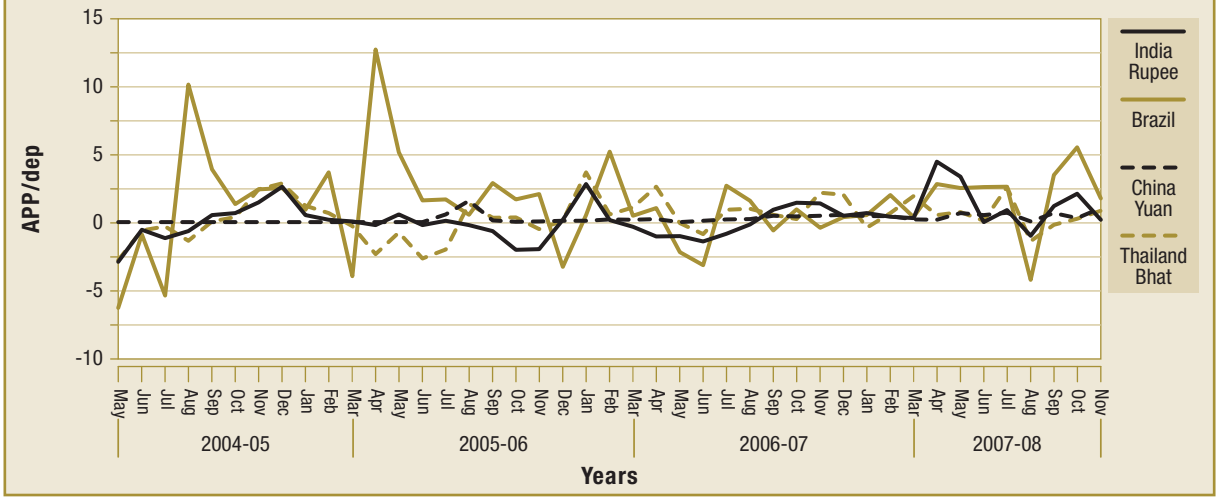
	FY 2007-08 (April 3, 2007- Jan 16, 2008)	Annual (Dec 2006 to Dec 2007)
US dollar	9.8	13.2
U.K. pound	11.0	9.9
Japanese yen	1.8	8.4
Euro	-0.1	2.6

Source: RBI
a Based on average buying and selling rates reported by FEDAI.

6.69 The appropriateness of the extent of rupee appreciation has come into sharp focus with the exporting community facing potential competitive loss, which was amplified by the fact that some of the competitor countries' currencies were depreciating against US dollar in the current financial year. The movements in nominal exchange rates of select countries indicate that major emerging market economies' currencies had appreciated even earlier (Figure 6.10).

6.70 In the extant classification of the exchange rate policies of countries by the IMF, India is classified as a country with managed float without

Figure 6.10 Cross country comparison of appreciation against US dollar (annual M-o-M)



any fixed target or band. An analysis of the historical data on weekly movements in exchange rates of the rupee against the US dollar using data of the Federal Reserve of the US, reveals that after low levels of volatility (in change in exchange rate squared) between 1999-2000 and 2002-03, there has been some large changes since 2003-04 (Figure 6.9).

6.71 While currencies of some competitor countries may be depreciating reflective of their respective country contexts, replication of such policies in India would engender risks of a painful exit. The bout of appreciation of the rupee against the US dollar in evidence since the second half of 2006-07 could be attributed to the effect of depreciation of the US dollar against all major currencies and the surge in capital inflows. The appreciation of major currencies against the US dollar was highest in the period March 2006–November 2007. The Euro appreciated by 22.2 per cent; UK pound appreciated by 18.8 per cent; and Japanese yen appreciated by 5.5 per cent. The levels of appreciation were lower on a longer time frame (March 2005-November 2007). Major currencies of emerging markets have appreciated against the US dollar. Brazilian real appreciated by 21.6 per cent in the period March 2006-November 2007. The Thai baht appreciated by

Box 6.3 Exchange rate and competitiveness

With increased capital inflows and appreciating rupee, concerns about possible overvaluation of the currency and consequential loss of long-term competitiveness of exports in traditional and goods sectors – popularly known as the "Dutch disease," have arisen. The exchange rate policy addresses such concerns with an ability to intervene to smoothen volatility, prevent the emergence of destabilizing speculative activities, help maintain adequate level of reserves, besides developing an orderly foreign exchange market.

The impact of exchange rate appreciation/depreciation on the balance of goods and services is sometimes used to derive a benchmark exchange rate that is consistent with a nil balance on this account. A recent IMF staff research using a model of the "Consultative Group on Exchange Rates" indicates that Indian rupee is close to its equilibrium level. From a medium- to long-run perspective, the key to sustainable growth of industry/services sector exports lies in productivity growth. The growth literature emphasizes the key role played by total factor productivity in the growth process.

It is, however, difficult to establish a relationship between aggregate exports and the real exchange rate in the short term. A large unexpected appreciation of the exchange rate can make it difficult for some sectors to adjust or adapt to it. While, there could be some competitive loss for some sections of exporters, the recourse to corner solutions for protecting competitiveness of exporters from the vagaries of capital flows through greater intervention in the foreign exchange markets on the one side and greater flexibility to deepen the process of integration as has been suggested on the opposite side of the spectrum, do not have any empirical anchoring as nations in transitional processes had tailored policies to specific contexts. The Government's response has been to provide due relief to such sections in the export sectors and facilitate the process of adjustment towards greater competitiveness via productivity gains.

15.1 per cent in the same period. The rupee appreciation at 12.8 per cent in the same period (In the first 8 months of the current financial year it was at 11.6 per cent) followed the general trend in emerging market economies. While the extent of appreciation was one of the largest among the major economies in the eight months of the current financial year, over a longer period it followed the trend in emerging market economies with large capital inflows. In the period March 2006 to November 2007, the Chinese yuan appreciated by 8.24 per cent as against an appreciation of 12.79 per cent in the Indian rupee. The period from April 2004 to November 2007 was one of the periods over which the cumulative appreciation of the two countries was similar but yuan appreciation was relatively gradual (Figure 6.10).

6.72 There are other competitor countries that have evidenced depreciation against the US dollar even as major economies' currencies appreciated. Any comparison of the exchange rate movement across currencies needs to factor the changing dynamics of the process of determination of the exchange rate. An important determinant of the exchange rates in the current emerging markets has been the extent of capital flows. Where net capital flows were far in excess of the financing needs, a reversal in the medium-term or short-term exchange rate movements is a distinct possibility. Furthermore, capital flows in gross terms are often much higher than net flows. Thus day to day exchange rate changes can entail considerable overshooting in underdeveloped markets. The gross volume of turnover in the inter-bank foreign exchange market, which has considerable bearing on the day to day indicative exchange rates of Foreign Exchange Dealers Association of India, has risen substantially and exceeded US$ 7.4 billion on spot basis on November 30, 2007. Besides, transactions like swaps have overtaken spot deals in terms of turnover in the inter-bank market in November 2007. The latter points to the adaptation by market participants to the appreciating rupee. With lumpy nature of demand and stable supplies, short-run forces sustaining even a higher value of the rupee than what long-term structural and medium-term cyclical influences would suggest could not be fully ruled out.

6.73 An analysis of the data shows that in the first eight months of the current financial year (average exchange rate of November 2007 over average exchange rate of March 2007), while Brazil and India had higher nominal appreciation than China and Thailand, the real appreciation was higher in Brazil and China. A longer time frame changes the position to some extent (Tables 6.19 and 6.20).

6.74 While the magnitudes of appreciation or depreciation in nominal terms are indicative, the real impact on the economy is often assessed through the nominal effective exchange rate (NEER) and real effective exchange rate (REER) indices. The REER index of the Bank for International

Table 6.19 Appreciation in select currencies against US dollar

Reference period	Brazil reals	China yuan	Hong Kong dollar	Mexico pesos	Pakistan rupee	Singapore Sing $	Thailand baht	Indian rupee
Mar 05/Nov 07	52.85	11.49	0.28	2.46	-3.04	12.69	13.93	10.69
Mar 06/Nov 07	21.59	8.24	-0.23	-1.47	-1.61	12.07	15.05	12.79
Mar 07/Nov 07	18.03	4.25	0.46	2.39	-0.45	5.38	3.48	11.64

Source: International Financial Statistics, IMF.

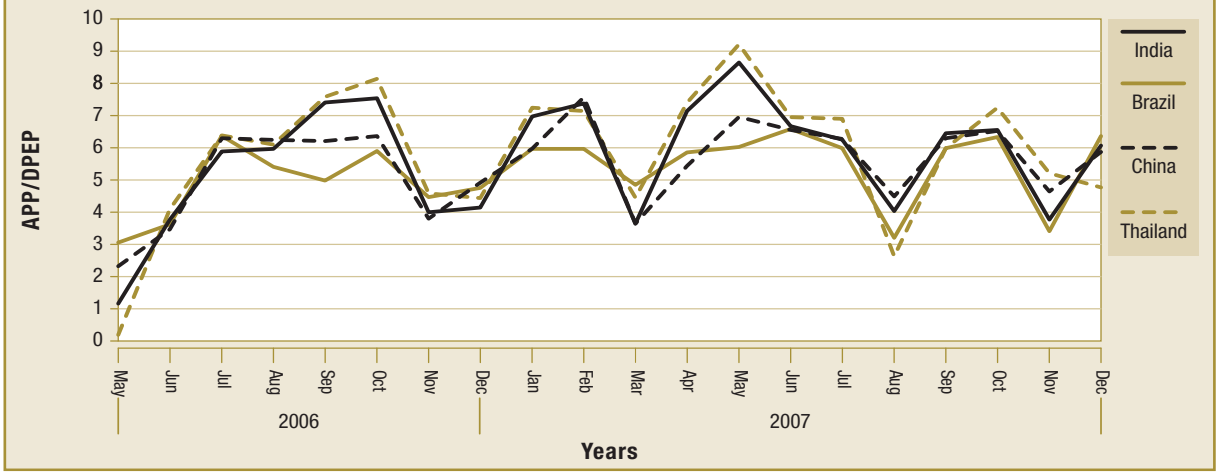
Table 6.20 Movements in select currencies of the region against dollar

Month/Year	Bangladesh taka	Indonesia rupiah	Korea won	Malaysia ringgit	Philippines pesos	Sri Lanka rupees
Mar. 06/Nov 07	2.40	0.23[a]	6.36	9.47	18.51	-7.09
Mar. 07/Nov 07	0.48	0.60[a]	2.86	3.25	12.26	-1.06

Source: International Financial Statistics, IMF.

[a] October instead of November.

Figure 6.11 REER of selected countries



Settlements (BIS) provides details of the average bilateral exchange rates adjusted by relative consumer prices for 52 economies including India. The broad trends in appreciation of major emerging market currencies against the US dollar were similar (Figure 6.11). High correlations of the indices also attest to the effect of a general depreciation of the US dollar against the currencies of emerging market economies.

6.75 The RBI, after a review of the effective exchange rate indices, replaced its earlier series of five country effective exchange rates with six currency indices in December 2005. The weights of the index were revised and problems related to the sharp uptrend in the data of price indices of China for some years were adjusted (details in RBI Bulletin, January 2008). The NEER of the Indian rupee (six currency trade-based weights), which is the weighted average of bilateral nominal exchange rates of the home currency in terms of foreign currencies, of the RBI depreciated by 4.6 per cent in 2006-07 – higher than the levels indicated by headline exchange rate of the rupee against the US dollar. In the current financial year (as on December 20, 2007), the NEER appreciated by 6.8 per cent. The NEER (36 currency, Base 1993-94) as per the export-based weight-based index also evinced a similar pattern. The REER (six currency, trade-based weights) that indicates the real competitiveness by factoring the relative price levels of competitors, after depreciating in 2006-07, appreciated by 7.2 per cent in 2007-08 (Table 6.21). Any real impact of the rupee appreciation on exports needs to reckon the loss in REER terms.

Table 6.21 Appreciation/depreciation of rupee as per NEER/REER

Index	2006-07	2007-08
6 currency indices	Base:1993-94	
NEER trade based	-4.63	6.76
REER trade based	-1.71	7.21
36 currency indices		
NEER export based	-4.07	9.08
REER export based	-3.08	8.10

Source: RBI.
Note: 1. Data for 6 currency indices up to December 20, 2007.
2. Data for 36 currency indices up to October 2007 .

Rupee appreciation and export performance

6.76 The gradual improvements in overall productivity, resulting after a variable lag, from the wide and deep reforms of the 1990s have

Table 6.22 Appreciation and export growth

Year	Apprn (+) / Deprn(-)	Exports in US$ billion	Growth rate (per cent dollar terms)	Growth rate (per cent) rupee terms
2001-02	-4.2	43.8	-1.6	2.7
2002-03	-1.5	52.7	20.3	22.1
2003-04	5.3	63.8	21.1	15.0
2004-05	2.3	83.5	30.8	27.9
2005-06	1.5	103.0	23.4	21.6
2006-07	-2.2	126.4	22.6	25.3
2007(April-Dec.)	12.3[a]	111.0	21.6	7.7

[a] April-January 2007-08.

contributed to the growth of exports. The favourable international environment in recent years has also been a factor. In the current year, however, there was concern about the impact of dollar depreciation/ rupee appreciation on exports. There is no one to one correspondence between appreciation of rupee and overall export performance, because of the effect of other factors, including the slowdown of world imports (Table 6.22).

6.77 In April-December 2007 exports grew by 21.6 per cent in dollar terms. In rupee terms the growth of exports was 7.7 per cent during the same period, which is a reflection of the exchange rate changes.

6.78 With almost 70 per cent of India's external trade invoiced in dollars, any change in the dollar's rupee value has a disproportionate effect on the various stakeholders in the rupee's external value such as importers, exporters, borrowers, lenders and consumers of imported goods in the short run. However, after an adjustment period, India's exports to countries other than the United States, such as the European Union, the United Kingdom, Japan, etc. (even if invoiced in US$), will be affected by the exchange rate of the currencies of these countries vis-à-vis the rupee and the currencies of India's competitors in these markets.

6.79 Some of the major factors that affect India's exports are:

(i) The rate of growth of economy and of imports of our important export markets.

(ii) The relative price of India's exports which in turn is affected by the nominal exchange rate and inflation rates in India and the countries that are our important export markets.

(iii) The relative prices of competing countries which depend on the same factors as in (ii) for market economies.

(iv) However for a non-market economy it can depend critically on hidden subsidies such as those through a nationalized or the Government-controlled banking system and subsidies provided through lower prices of intermediate goods (produced by the public sector) and public services (provided by municipalities).

On an industry level a greater (lower) impact of appreciation is to be expected for:

(i) Industrial products with high (low) domestic value added,

Box 6.4 Relief measures for exporters

As there was concern on possible adverse impact of rupee appreciation on labour-intensive exports, the Government announced several relief measures among which were the following:

- Enhancement by 3 per cent of the Duty Entitlement Pass Book (DEPB) rates for nine sectors i.e., textiles (including handloom), ready-made garments, leather products, handicrafts, engineering products, processed agricultural products, marine products, sports goods and toys; and by 2 per cent for others.
- Reduction in Export Credit Guarantee Corporation (ECGC) premium by 10 per cent.
- Release of around Rs. 600 crore to clear all arrears of terminal excise duties and Central Sales Tax (CST) reimbursement.
- Enhancement of the rates of duty drawback by around 10 per cent to 40 per cent. The drawback was increased in most of the cases which have been made effective retrospectively from April 1, 2007. In few cases, such as primary steel, dyes and chemicals where the drawback rates have been reduced, this has been done prospectively from July 18, 2007.
- Interest subvention of 2 per cent for pre-shipment and post-shipment credit for the nine sectors and all exporters from the SME sector which was further extended from December 31, 2007, to March 31, 2008. Additional subvention of 2 per cent from November 1, 2007, to March 31, 2008, for pre-shipment and post-shipment credit for leather and leather manufacturers, marine products, handicrafts and all categories of textiles under existing scheme including ready-made garments and carpets but excluding man-made fibre.
- Refund of service tax to exporters for use of services not in the nature of "input services".
- Provision to pay interest on Exchange Earner's Foreign Currency (EEFC) balances for outstanding balances.
- Widening the list of interest subvention of 2 per cent for pre-shipment and post-shipment credit to include jute textiles and carpets; processed cashew, coffee and tea; solvent extracted de-oiled cake; and plastics and linoleum.
- Raising the revenue ceiling for Vishesh Krishi and Gram Udyog Yojana by Rs. 300 crore (from Rs. 200 crore to Rs. 500 crore).
- Reduction in customs duty on some items relating to textiles sector.

(ii) Export markets whose national exchange rate has shown greater (lower) depreciation against the rupee,

(iii) Industries/products in which our major competitors are countries whose currencies have depreciated or appreciated less than the rupee, and

(iv) Productivity levels, which are influenced by fiscal policies and regulations affecting product and labour markets.

6.80 Sectors such as textiles and handicrafts, which have low import intensity, have experienced lower export growth, while sectors with high import intensity, like POL, have witnessed higher export growth. Since appreciation has a stronger effect on export sectors with low import intensity, the Government announced various relief measures, to mitigate the effect of appreciation of the rupee on select sectors (Box 6.4).

External debt

6.81 At the end of March 2007, India's external debt stock stood at US$ 169.6 billion (Rs. 7,40,099 crore), reflecting an increase of US$ 31.5 billion over the year, of which US$ 3 billion was contributed by the valuation change arising out of the weakening of the US dollar against major international currencies and the Indian rupee. There was a further increase of US$ 20.9 billion during the first half of 2007-08, of which US$ 7 billion was on account of valuation change. The total external debt of the country stood at US$ 190.5 billion (Rs. 7,57,967 crore as per revised figures, which include suppliers' credits up to 180 days under short-term external debt) at the end of September 2007 (Table 6.23). Increases in external commercial borrowings, non-resident Indian deposits and short-term debt contributed to the rise in total external debt. Of the total external debt at end-September 2007, long-term debt at US$ 159.7 billion accounted for 83.8 per cent. Correspondingly, short-term debt accounted for 16.2 per cent (US$ 30.8 billion) of the total external debt. The component-wise break-up of total external debt is depicted here under (Figure 6.12).

6.82 Component-wise, commercial borrowings accounted for the highest share of 27.2 per cent in total external debt outstanding at end-September 2007. As a proportion of the total external debt, non-resident Indian deposits

Table 6.23 India's external debt

Components	End-March			End-Sept.
	(US $ billion)			
	2005 R	2006 R	2007 R	2007 QE
1	2	3	4	5
Long-term debt	115.3	118.5	143.4	159.7
Short-term debt	17.7	19.6	26.2	30.8
Total external debt	**133.0**	**138.1**	**169.6**	**190.5**
	(Rs. crore)			
Long-term debt	5,04,274	5,28,840	6,25,111	6,34,668
Short-term debt	77,528	87,287	1,14,988	1,23,299
Total external debt	5,81,802	6,16,127	7,40,099	7,57,967
Debt sustainability indicators		(Ratio as per cent)		
External debt to GDP	18.5	17.2	17.9	-
Short-term debt to total External debt	13.3	14.2	15.5	16.2
Short-term debt to foreign currency assets	13.1	13.5	13.7	12.8
Debt service ratio	6.1[a]	9.9[b]	4.8	4.5
Concessional Debt to Total Debt	**30.9**	**28.6**	**23.3**	**21.4**

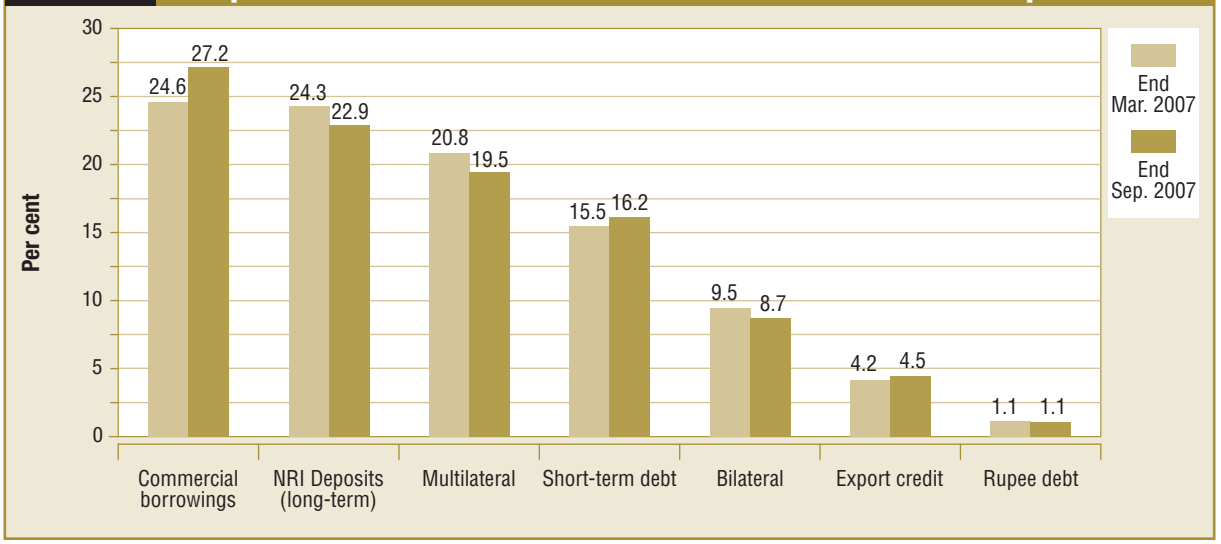
[a] Works out to 5.7 per cent with the exclusion of pre-payment of US$ 381 million.

[b] Works out to 6.3 per cent, with the exclusion of India Millennium Deposits (IMDs) repayments of US$ 7.1 billion and pre-payment of US$ 23.5 million.

Note: NRO deposits are included under NRI deposits from 2005-06 onwards . Suppliers' credits up to 180 days and FII investment in short-term debt instruments are included under short-term external debt since 2004-05.

R: Revised QE: Quick Estimates - : Not computed for the broken year

Figure 6.12 Composition of external debt as at end-march 2007 and end-september 2007



accounted for 22.9 per cent of the total debt at end-September 2007, followed by multilateral debt at 19.5 per cent and bilateral debt at 8.7 per cent. Export credit and rupee debt accounted for 4.5 per cent and 1.1 per cent, respectively. In respect of short-term debt, the coverage is now made more comprehensive, with the inclusion of (i) suppliers' credits up to six months and (ii) investment by Foreign Institutional Investors (FII) in short-term debt instruments.

6.83 The short-term external debt, defined to include all loans and credits with an original maturity of one year or less, did not so far cover (i) suppliers' credits maturing in less than six months in India's external debt statistics, as such loans and credits were mainly import-related, and since payments for such imports were normally allowed up to six months which rendered the estimation of the credit element embedded in imports somewhat difficult, and (ii) investment by FIIs in Treasury Bills and other debt instruments of up to one year maturity for want of details.

6.84 A number of committees such as the high-level Committee on Balance of Payments (1993), Technical Group on External Debt (1998 and 2006), World Bank Project Report on Short-term Debt (2000) and Committee on Fuller Capital Account Convertibility (2006) recommended that suppliers' credits up to 180 days be included in short-term debt data. Furthermore, the growing volume of such credits on the back of burgeoning imports, the significance of short-term debt in terms of being an important variable in measuring a country's vulnerability to liquidity risks, best international practices, and a cross-country experience underscored the importance of inclusion of such trade credits in measuring short-term debt. Accordingly, the RBI, which monitors India's short-term debt on a regular basis, evolved an estimation procedure to work out trade-related credits up to six months' maturity by taking into account the difference between the date of shipment and the date of payment for imports. The external debt statistics released for end-September 2007 therefore contain the new series on short-term debt beginning quarter ended March 2005. However, suppliers' credits of this variety prior to this period were estimated to be relatively small.

6.85 Similarly, FII investment in debt securities, comprising investment in G-secs, Treasury Bills and corporate bonds, was not disaggregated into long-term and short-term as similar details were not available. Instead such investments were lumped together and shown under long-term securitized borrowings. Internationally recommended procedure and inter-country comparison (Box 6.5) suggested that FII investment in debt instruments could be appropriately classified according to maturity. As Securities and Exchange Board of India has since made available the break-up of FII investment by maturity, according to which FII investment can be classified as long-term and short-term in the new series beginning March 2005, this has been included in the data released for end-September 2007.

Box 6.5 Short-term suppliers' credits and FII investment in debt securities – Recommended practice and cross-country experience

Recommended practice

The IMF recommended methodology for compilation and presentation of external debt statistics is articulated in the "External Debt Statistics: Guide for Compilers and Users, IMF 2003". The Guide recommends that external debt should be compiled and presented with explicit maturity breakdown – short-term and long-term – in order to provide a clear picture of emerging vulnerabilities to solvency and liquidity risks.

Cross-country experience

- *Suppliers' credits:* Cross-country experience shows that no uniform treatment is accorded to short-term trade-related credits. While the majority of industrialized countries is reported to have been included in all the varieties of trade-related credits, experience varies across the emerging economies. A BIS survey (2002) indicated that out of the sample of 32 countries, six countries including India and China did not appear to have a comprehensive coverage of such trade credits. The latest observation made from IMF's SDDS website and other country sources reveal that China includes delayed import payments of more than 180 days and above US$ 2,00,000 in short-term external debt. While Malaysia excludes trade credits of one year or less from short-term debt, Indonesia appears to include only trade credits of more than six months under short-term debt.
- *FII investment:* A number of countries, which allow FII investment in debt papers, compile and present such investment broken down by maturity. These include Ireland, Greece, Hungary, the Philippines and Lithuania. It is, however, noted that while many countries have significant external government debt reported under the long-term debt securities, very few countries report external government debt under the short-term debt securities (money market instruments), the main reason being that FII investments are not significantly channelled into this category of assets. An internal survey of select emerging economies indicates that most of the countries covered under the survey (Argentina, Brazil, Hong Kong, Korea, Singapore and Thailand) classify foreign portfolio investment in debt securities separately under long-term and short-term external debt.

6.86 The total external debt at end-September 2007 considered in terms of sovereign debt (US$ 51.3 billion) and private debt (US$ 139.2 billion) was in the ratio of 26.9:73.1. Total multilateral and bilateral debt, which are accumulated for the most part out of the loans received by the Government of India for development purposes under external assistance programme, accounted for 28.2 per cent.

6.87 Notwithstanding the increase in external debt in absolute terms, the major indicators of debt sustainability showed gradual improvement over the last few years (Figure 6.13).

6.88 According to the Global Development Finance Online Database of the World Bank, among the top 10 debtor countries of the developing world, India's position was *fifth* in 2006 in terms of the quantum of external debt, after China, Russian Federation, Turkey and Brazil (Table 6.24). India had the second lowest debt service ratio among the top 10 debtor countries amongst the developing economies.

6.89 India's external debt to Gross National Income (GNI) ratio at 17.9 per cent in 2006 was the second lowest after China. The element of concessionality in India's external debt portfolio was the second highest after Indonesia. The ratio of India's short-term debt to forex reserves at 13.2 per cent in 2006 was the second lowest among the top 10 debtor countries.

Figure 6.13 India's external debt, ratio of external debt to GDP and debt service ratio

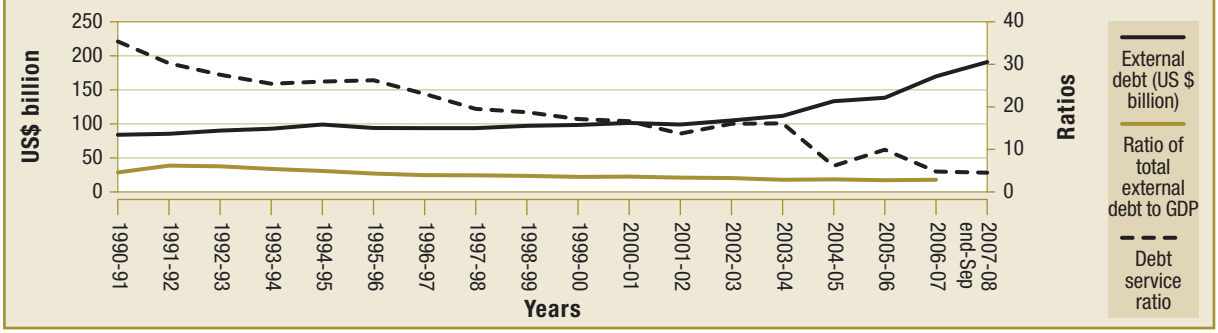


Table 6.24 International comparison of top 10 debtor countries, 2006

Sl. No.	Country	External debt (US $ million)	Ratio of concessional debt to total debt (per cent)	Ratio of short-term debt to total debt (per cent)	Ratio of short-term debt to forex reserves (per cent)	Ratio of external debt to GNI (per cent)	Debt service ratio (per cent)
1.	China	322,845	10.9	53.7	16.0	12.0	3.1[a]
2.	Russian Federation	251,119	0.6	16.1	13.3	26.2	13.1
3.	Turkey	207,854	2.0	20.4	66.7	51.7	39.1[a]
4.	Brazil	192,053	1.3	10.6	23.7	18.5	44.8[a]
5.	**India**	**169,629**	**23.3**	**15.5**	**13.2**	**17.9**	**4.8**
			(second highest)	*(fourth lowest)*	*(second lowest)*	*(second lowest)*	*(lowest)*
6.	Mexico	160,700	0.9	4.6	9.6	19.3	18.9
7.	Indonesia	130,956	27.1	25.2	76.8	37.6	-
8.	Poland	125,831	0.9	17	44.1	38.7	24.8
9.	Argentina	122,190	1.1	28.7	109.4	58.6	31.8
10.	Hungary	107,677	1.1	13.9	69.2	102.2	33.6

Source: Data for India are as published by national authorities for 2006-07 and those for other countries are as at end-December 2006 as available on World Bank's Global Development Finance Online Database.
GNI: Gross National Income. -: Not available.
[a] Debt-Service pertains to 2005.

Table 6.25 Composition of exports by major markets

Commodity Group		Percentage share				CAGR	Growth rate[a]			
				April-September		2000-1 to			April-September	
		2000-01	2006-07	2006-07	2007-08	2004-05	2005-06	2006-07	2006-07	2007-08
Total exports	USA	100.0	100.0	100.0	100.0	10.3	26.1	8.7	14.7	4.7
	EU	100.0	100.0	100.0	100.0	14.2	27.6	15.0	16.3	20.8
	Others	100.0	100.0	100.0	100.0	20.4	21.2	29.2	34.9	19.7
Manufactured goods	USA	90.6	92.5	92.6	89.8	10.3	23.6	12.9	20.5	1.5
	EU	86.8	83.4	84.6	82.0	13.6	20.0	19.9	19.5	17.1
	Others	70.9	58.2	57.4	58.0	18.3	18.0	17.0	16.6	20.9
Textile incl. RMG	USA	33.5	21.3	21.5	19.6	-2.1	38.6	1.5	10.7	-4.7
	EU	29.2	21.6	22.6	17.6	6.0	41.2	3.5	9.0	-5.9
	Others	19.8	7.5	7.7	7.2	3.8	-3.3	11.0	104.8	11.8
Gems & jewellery	USA	13.2	25.2	24.2	24.8	34.7	8.0	8.8	9.2	7.0
	EU	11.5	7.6	8.0	8.3	5.0	33.5	1.7	4.0	24.5
	Others	13.9	11.4	11.4	12.1	24.5	11.5	0.3	-5.8	26.3
Engineering goods	USA	16.0	24.2	25.4	23.4	16.9	21.0	35.7	54.5	-3.8
	EU	14.0	25.2	24.3	27.2	16.4	68.3	46.1	33.7	35.0
	Others	17.2	22.4	21.7	22.3	29.1	13.6	35.9	52.2	23.3
Chemicals and related products	USA	11.1	9.6	8.8	9.1	0.6	38.1	24.1	30.8	7.6
	EU	9.7	11.0	11.1	10.7	11.6	47.3	24.2	26.2	15.9
	Others	12.5	11.7	11.6	10.6	25.1	8.0	16.7	28.7	8.9
Leather & leather manufactures	USA	13.1	1.7	1.7	1.6	-30.8	11.7	0.6	-5.1	-3.8
	EU	11.4	7.2	7.4	7.0	2.9	22.0	14.6	12.2	15.7
	Others	1.6	1.0	1.0	0.9	18.7	-8.1	11.3	3.6	12.5
Handicrafts (incl. Carpet-handmade)	USA	5.0	2.8	2.9	2.1	-3.1	30.6	-3.1	-0.1	-24.9
	EU	4.4	2.1	2.4	1.5	-1.6	21.8	7.0	13.4	-25.3
	Others	0.8	0.3	0.3	0.3	-9.2	56.8	15.3	-1.2	41.7
Primary products	USA	9.4	6.0	6.4	5.8	5.3	9.4	-3.5	-2.3	-4.9
	EU	13.1	9.1	9.3	8.7	7.8	13.6	13.0	13.2	13.6
	Others	19.8	19.2	16.6	16.5	20.9	20.9	23.2	21.9	19.3
Petroleum products and coal	USA	0.0	1.5	1.0	4.4	234.9	277.4	-60.8	-73.1	351.4
	EU	0.0	7.5	6.1	9.3	0.0	206.0	-19.4	-12.8	84.2
	Others	7.9	20.5	23.5	23.5	33.5	41.1	91.9	144.2	19.5

[a]Growth rate in US dollar terms.

Table 6.26 Textiles & clothing exports: India and its competitors

	Share in world exports (%)			Growth rate (%)	
	2004	2005	2006	2005	2006
World	100.0	100.0	100.0	5.9	9.7
China	20.9	23.8	27.2	20.9	25.0
Hong Kong, China	8.6	8.5	8.0	4.4	2.9
India	3.0	3.7	3.7	29.6	10.5
Turkey	3.9	3.9	3.7	7.3	3.0
Korea, Republic of	3.1	2.7	2.3	-8.8	-5.2
Pakistan	2.0	2.2	2.1	16.8	6.4
Taipei, Chinese	2.6	2.3	2.1	-6.0	-1.0
Indonesia	1.6	1.7	1.8	14.7	11.9
Bangladesh	1.5	1.7	N.A.	22.6	NA
Mexico	2.1	2.0	1.6	-1.2	-9.8
Thailand	1.4	1.4	1.3	4.6	4.1

Source: WTO.

Trade direction and composition

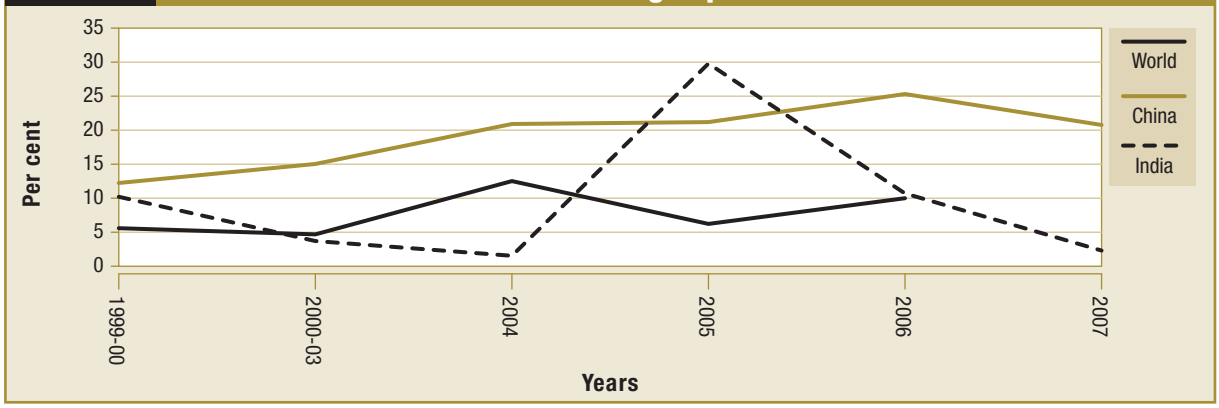
6.90 A comparison of the commodity-wise growth of major exports to the United States, the European Union and other countries shows the possible effect of a U.S. slowdown on India's exports of both primary and manufactured exports in 2006-07 and the first half of 2007-08. The appreciation of the rupee vis-à-vis the dollar was also a factor since the last quarter of 2006-07. The effects can be seen most clearly in exports of manufactured goods, which decelerated sharply to the United States and marginally to the European Union (last 5 columns of Table 6.25). In contrast there was a marginal acceleration in manufactured exports to the "rest of the world" (world - US & EU) in the first half of 2007-08. Disaggregated data for India's exports to the United States shows that textiles, leather and manufacturers and handicraft exports performed poorly in 2006-07 and all subcategories including engineering goods and chemicals have decelerated in the first half of 2007-08. In the case of EU, the sharp deceleration in textiles and poor performance in handicrafts was substantially offset by reasonable growth in other manufactures in 2006-07 and the first half of 2007-08. Leather and leather manufactures exports have performed well in the case of exports to the world, EU and other countries, though they registered a negative growth to the United States. Handicrafts' shares have been steadily declining and the high growth of more than 30 per cent in 2005-06 was just a blip in an otherwise declining trend in this decade, a trend which may have been accentuated by rupee appreciation. Thus there seems to be a greater co-relation between the demand in partner country and the bilateral exchange rate on the one hand, and India's bilateral exports at a disaggregated level than is visible for total Indian exports to the world, on the other.

6.91 There is also a compositional change in the export basket to these major markets. While the share of manufactures in India's export basket has declined due to the relative rise in the share of exports of petroleum products, this trend has not affected the composition of India's export basket to the United States. The rise in the share of petroleum products exports to the United States (4.4 per cent) has been less sharp than that to the world (13.6 per cent).

Textiles and clothing

6.92 The 1 per cent growth of textiles and clothing (T&C) exports and the negative growth in major markets like the United States and the

Figure 6.14 Growth rate of textiles and clothing exports



Source: Till 2006, WTO and for 2007, calculated from World Trade Atlas data.

Note: Growth rate for the year 2007 for India, is from January to May 2007 and for China, January to November 2007.

European Union in the first half of 2007-08 are matters of concern. In this sector, important in terms of both output and employment, China and India were considered to be the main beneficiaries of the dismantling of the textiles quota system in 2005. Though the growth in our T&C exports to the world accelerated sharply to 30 per cent in 2005, it reverted back to the trend levels in 2006 with a disappointing 10.5 per cent. China in contrast continued to raise its already high share of global T&C exports, with growth accelerating from 21 per cent in 2005 to 25 per cent in 2006, despite restrictive quotas by the United States and EU on China (Figure 6.14).

6.93 Though the 0.7 per cent point increase in India's share of global T&C exports between 2004 and 2006 was modest compared to the 6.3 percentage point increase of China (Table 6.26) it was significantly more than some other gainers, including Indonesia which raised its share by 0.2 percentage points and Pakistan by 0.1 percentage point. However, as per the WTO, Bangladesh and Vietnam performed very well in the U.S. and Europe markets in 2006. The growth rate of China and Indonesia was faster than that of India in 2006. A possible structural change in the direction of world textiles and clothing trade is indicated by a number of factors including, declining intra-NAFTA trade, stagnating intra-EU trade and loss of market share of advanced developing countries in East Asia. In addition, there has been a decline in exports of major developing suppliers in Central America and the Mediterranean region, which process textiles originating from developed countries. These changes have not affected the rising shares of China and some small Asian countries in the global textile market.

6.94 Indonesia, Vietnam, Cambodia and Bangladesh have outperformed India in 2006 in both the United States and EU clothing markets, while China and Pakistan have outperformed only in the United States. However, Hong Kong grew faster in the EU clothing market and part of China's

Table 6.27 Textile and clothing imports of major importers by sources-growth rate (percentage)

Textiles	2005	2006	Clothing	2005	2006
USA from			**USA from**		
World	9.0	4.0	World	6.0	4.0
China	32.0	15.0	Mexico	-9.0	-13.0
India	14.0	11.0	China	47.0	15.0
Pakistan	15.0	12.0	Indonesia	20.0	27.0
Mexico	4.0	0.0	India	33.0	5.0
Bangladesh	-3.0	-3.0	Vietnam	6.0	18.0
Vietnam	-11.0	28.0	Bangladesh	20.0	23.0
Malaysia	-11.0	10.0	Cambodia	20.0	25.0
			Pakistan	9.0	13.0
EU (25) from			**EU (25) from**		
World	-2.0	5.0	World	5.0	8.0
EU (25)	-4.0	2.0	China	43.0	12.0
China	25.0	21.0	Turkey	4.0	2.0
Turkey	3.0	11.0	Bangladesh	-5.0	31.0
India	3.0	9.0	India	27.0	16.0
Pakistan	-12.0	13.0	Hong Kong	-13.0	46.0
Romania	5.0	22.0	Indonesia	-10.0	18.0
Egypt	2.0	11.0	Bulgaria	2.0	12.0
Bangladesh	1.0	27.0	Pakistan	-12.0	13.0
Vietnam	-7.0	33.0	Vietnam	8.0	50.0
			Thailand	-9.0	12.0
			Sri Lanka	-2.0	21.0
			Cambodia	-8.0	17.0
Textiles and clothing, January-November 2007					
USA from					
India			2.01		
China			20.5		

Source: WTO and calculated from World Trade Atlas.

exports are routed through it. India's clothing exports to Japan have grown at 29 per cent in 2005 and 23 per cent in 2006 the highest and third highest rate (after Myanmar and Tunisia), respectively, among top 20 suppliers. In the case of textiles, though China, Pakistan and Vietnam's exports to both the United States and EU have grown faster than India's in 2006, for the last two it was merely a recovery from negative growth in the previous year (Table 6.27). However, India's textiles exports to Japan have made little progress since 2004. Thus India's comparative export performance in textiles and clothing in different markets in 2006 is mixed.

6.95 In 2006-07 and 2007 (April-September), India's textiles and clothing exports grew only by 5.7 per cent and 1.2 per cent, respectively, while that of China grew by 21.4 per cent in 2007 (January-November). In 2007 (January-November), while U.S. imports of textiles and clothing from the world grew by only 3.8 per cent, affecting imports of T&C from India which grew by only 2 per cent, imports of T&C from China continued to grow at a robust 20.5 per cent.

6.96 Reasons for India's recent sluggish export performance in textiles and clothing include:

(i) Slowdown in demand from some major importers.

(ii) The depreciation of the US dollar, resulting in an appreciation of the rupee vis-à-vis competitor countries that were partially or wholly pegged to the US dollar.

(iii) *Labour laws and scale economies:* Countries like China have historically had high labour flexibility in their export zones and/or export-oriented units. Even Bangladesh had high labour flexibility. This has allowed them to achieve large scale in terms of the labour force employed in each manufacturing facility and to reap the benefit of scale economies and use of the latest/ most advanced machinery from developed countries. India, in contrast, because of fragmentation of units and small scale (to avoid labour laws applicable to employees above 100 and procedural biases and rigidities), has purchased relatively less of such advanced machinery.

(iv) *Logistical delays and costs:* Though the national highways are improving, this is not true of connectivity to all sources and destinations. The recent introduction of competition into railway container transport will gradually improve services. However, the traditional monopoly of railway freight services and internal container depots results in inordinate delays and costs that are not acceptable to importers. The turnaround time in major ports of India and movement of cargo between ships and source/destination within India is still plagued by monopolistic bureaucratic structures with little accountability and incentives for efficient service delivery to the exporter/importer.

(v) High cost of power in India which is 1.5-2 times higher than in competing nations.

Box 6.6

Adjustment assistance for textiles industry

The measures taken to tide over the effect of unexpected appreciation include:

- Revision in drawback rates and Duty Entitlement Pass Book (DEPB) rates.
- Additional subvention of 2 per cent (besides the 2 per cent subvention given earlier) in pre-shipment and post-shipment credit to textiles including ready-made garments and carpets but excluding man-made fibre.
- Concessional customs duty on items relating to textiles sector like textile machinery items of spinning, weaving, processing and ready-made garment at 5 per cent and 10 per cent as against normal customs duty of 12.5 per cent.
- Reduction in customs duty on intermediates for PSF and PFY, viz., polyester chips, DMT, PTA & MEG from 7.5 per cent to 5 per cent and on paraxylene (a raw material for PTA) from 2 per cent to nil.
- De-reservation of the hosiery and knitwear from the SSI sector.
- More than doubling of disbursements for more than triple the number of applicants in 2006-07 under the Technology Upgradation Fund Scheme (TUFS).
- Approval for the two flagship schemes, the TUFS and the Scheme for Integrated Textile Parks (SITP) for continuation in the Eleventh Five Year Plan and substantial scaling up of the TUFS in 2006-07

6.97 Textile industry has a market size of US$ 52 billion and accounts for 26 per cent of the manufacturing sector, 20 per cent of industrial production and 18 per cent of industrial employment. It contributes 15 per cent to gross export earnings and 4 per cent to national GDP. Its market size potential for the industry is envisaged at US$ 115 billion by 2012. It provides direct employment to about 35 million persons. Besides, another 50 million people are engaged in allied activities. The textiles industry is estimated to create 12 million job opportunities — 5 million direct jobs in textile industry and 7 million jobs in allied sectors during the Eleventh Five Year Plan, 2007-12.

6.98 To tide over any difficulties emanating from the unexpectedly steep upsurge in rupee value, the Government announced relief to exporters with focus on labour-intensive, high value-added sectors like textiles (Box 6.6).

Export diversification

6.99 In 2006, India had a global export share of 1 per cent or more in only 36 out of a total of 99 commodities at the two-digit level. In these 36 items, India had a significant world export share of 5 per cent or more only in eight items. Five of these have had an increase of global share by 0.5 per cent point or more between 2002 and 2006, while three have lost global share (Table 6.28). The former are carpets and other textile floor coverings, lac, gums, resins, vegetable saps and extracts not elsewhere specified (n.e.s.); ores, slag and ash; other made textile articles, sets, worn clothing; vegetable plaiting materials and vegetable products n.e.s. The latter are silk, pearls, precious stones, etc.; and cotton.

6.100 A comparison of the top 59 items of world imports at three-digit SITC (Rev. 2) level with a share of 0.5 per cent and above with similar exports of India and China shows the following:

(i) The CAGR (2006/2001) for these top 59 world imports is high and generally above 10 per cent.

(ii) In the top 59 items of world imports in 2006, India had a share of 1 per cent and above in 17 items, with significant shares of 4 per cent and above in only 4 items, while China had a share of 1 per cent and above in all but 6 items and significant shares of 4 per cent and above in 35 items;

6.101 The ranking of these items by the gap between China's world export share and India's, with a cut-off at 7.3 per cent (the gap in total export shares) can help in identifying potential avenues for diversification. Table 6.29 reveals a number of labour-intensive items like outer garments, sound recording equipment, toys, games and sporting goods, ADP machines,

Table 6.28 Share of India's major exports (with ≥ 1% share) in world exports and change in share
(only items with either 5 per cent share in 2006 or increase in share of 0.5 per cent are shown here)

HS rev.1	Product	2002	2005	2006	Change
57	Carpets and other textile floor coverings	7.3	9.6	11.1	3.8
26	Ores, slag and ash	4.1	6.4	6.8	2.7
14	Vegetable plaiting materials, vegetable products n.e.s.	3.9	5.7	6.4	2.5
67	Bird skin, feathers, artificial flowers, human hair	2.0	3.7	3.8	1.9
46	Manufactures of plaiting material, basketwork, etc.	0.3	0.1	2.0	1.7
23	Residues, wastes of food industry, animal fodder	1.4	3.8	3.0	1.5
79	Zinc and articles thereof	0.2	0.5	1.7	1.4
13	Lac, gums, resins, vegetable saps and extracts n.e.s.	10.0	11.4	11.3	1.3
68	Stone, plaster, cement, asbestos, mica, etc articles	2.0	2.3	2.8	0.8
63	Other made textile articles, sets, worn clothing etc.	6.1	7.1	6.8	0.7
41	Raw hides and skins (other than furskins) and leather	2.2	2.4	2.8	0.6
29	Organic chemicals	1.3	1.8	1.9	0.6
64	Footwear, gaiters and the like, parts thereof	1.3	1.6	1.8	0.5
50	Silk	12.9	12.3	10.2	-2.7
71	Pearls, precious stones, metals, coins, etc.	7.6	8.2	6.4	-1.2
52	Cotton	5.9	6.3	5.4	-0.5

Source: Calculated from NCTI data based on UN-ITC Trade Map Data, 2006.

Table 6.29 World Imports with 0.5 per cent share and large gap between shares of India and China in 2006

Rank in World imports	Product	Product Name	World imports			Share in world exports 2006 (%)		Share of India minus China
			Value (US$ billion)	CAGR 2006/ 2001 (%)	Share in world imports (%)	India	China	
34	845	Outer garments and other articles, knit	80.7	7.6	0.7	1.7	38.8	-37.1
45	763	Gramophones, dictating, sound recorders, etc.	65.5	17.2	0.6	0.0	34.5	-34.5
28	894	Baby carriages, toys, games and sporting goods	91.5	9.0	0.8	0.2	33.5	-33.3
42	851	Footwear	72.4	8.7	0.6	1.6	34.2	-32.6
8	752	Automatic data processing machines	302.7	8.7	2.6	0.1	31.3	-31.2
35	843	Outer garments, women's, of textile fabrics	78.3	8.9	0.7	4.5	30.1	-25.6
39	775	Household type, electrical & non-electrical equipments	73.8	12.8	0.6	0.2	25.1	-24.9
46	871	Optical instruments and apparatus	63.0	38.8	0.5	0.0	24.7	-24.7
59	846	Undergarments knitted or crocheted	52.8	9.5	0.5	4.4	27.9	-23.5
6	764	Telecommunications equipment and parts	395.0	14.1	3.4	0.1	20.2	-20.1
20	821	Furniture and parts thereof	116.8	12.7	1.0	0.4	19.6	-19.2
54	771	Electric power machinery and parts thereof	56.8	9.8	0.5	1.2	20.0	-18.8
36	761	Television receivers	76.4	22.7	0.6	0.1	17.1	-17.0
11	759	Parts of and accessories suitable for 751 or 752	218.2	9.3	1.9	0.1	15.7	-15.6
24	893	Articles of materials described in division 58	101.8	12.1	0.9	0.6	13.6	-13.0
14	778	Electrical machinery and apparatus, nes	158.8	11.1	1.3	0.3	12.7	-12.4
27	699	Manufactures of base metal, n.e.s.	96.2	13.4	0.8	0.8	12.0	-11.2
38	741	Heating & cooling equipment and parts	74.3	12.7	0.6	0.5	11.0	-10.5
52	716	Rotating electric plant and parts	58.7	11.2	0.5	1.1	10.9	-9.8
41	773	Equipment for distributing electricity	72.5	12.7	0.6	0.6	10.2	-9.6
13	772	Electrical appliances such as switches, relays, etc.	160.7	12.7	1.4	0.4	9.7	-9.3
51	673	Iron and steel bars, rods, angles & shapes	58.7	20.5	0.5	1.2	9.6	-8.4
55	678	Tubes, pipes and fittings, of iron or steel	56.5	19.8	0.5	2.3	10.0	-7.7
40	672	Ingots and other primary forms, of iron or steel	72.6	22.9	0.6	2.3	9.8	-7.5
		Total of items with 0.5% share in world exports	**9676.3**	**13.8**	**81.8**	**0.9**	**8.2**	**-7.3**

Source: Prepared from NCTI data based on UN-ITC Trade Map Data, 2006.

Table 6.30 India's trade and export/import ratio with major trading partners

Trd		Share in total trade (per cent)						Export/Import ratio[a]			
						April-September				April-September	
Rnk	Country	2001-02	2002-03	2005-06	2006-07	2006-07	2007-08	2001-02	2006-07	2006-07	2007-08
1	USA	12.3	13.5	12.8	9.8	9.7	8.9	2.7	1.5	1.9	1.5
3	UAE	3.6	3.8	6.2	6.6	7.1	7.4	2.7	1.4	1.4	1.2
7	UK	5.0	4.6	4.3	3.1	3.1	3.0	0.8	1.3	1.4	1.2
5	Singapore	2.4	2.5	4.2	3.7	4.2	3.6	0.7	1.1	1.3	0.9
12	Belgium	4.4	4.7	3.6	2.4	2.4	2.5	0.5	0.8	0.8	0.8
6	Germany	4.0	4.0	4.6	3.7	3.7	3.6	0.9	0.3	0.5	0.5
10	Australia	1.8	1.6	2.7	2.5	2.6	2.7	0.3	0.1	0.1	0.1
11	Nigeria	0.7	0.5	0.5	2.5	2.9	2.3	6.5	0.1	0.1	0.1
9	Iran	0.6	0.8	0.9	2.9	3.1	3.2	0.9	0.2	0.2	0.3
8	Switzerland	3.4	2.4	3.3	3.1	2.8	3.5	0.1	0.1	0.1	0.0
2	China	3.1	4.2	8.4	8.3	7.7	8.9	0.5	0.5	0.4	0.3
4	Saudi Arabia	1.4	1.3	1.6	5.1	5.6	5.3	1.8	0.2	0.2	0.2
	Total (1 to 12)	**42.6**	**43.7**	**53.0**	**53.8**	**55.0**	**54.8**	**1.0**	**0.6**	**0.6**	**0.5**

Source: Computed from DGCI&S data.

a The coefficient of export import ratio between 0 and 1 implies that India's imports are greater than exports and if the coefficient is greater than one, India exports more than what it imports.

household equipment, furniture and television receivers. Other potential areas for diversification include, optical instruments, telecom equipment, electrical machinery and heating and cooling equipment. The top items in world imports with high CAGRs include passenger motor cars, telecommunications equipment, medicinal and pharmaceutical items, automatic data processing machines, electrical appliances and machinery and furniture.

Direction of trade

6.102 The directional pattern of India's trade has changed during the decade. Trade with the top 12 trading partners increased by over 11.2 percentage points since 2001-02 to 53.8 percentage of total in 2006-07. The share of the United States, the largest trading partner, declined by 2.5 percentage points to 9.8 per cent in 2006-07, while that of the United Kingdom and Belgium declined by 1.9 and 2 percentage points, respectively (Table 6.30). China became the second largest partner in 2006-07 with its share increasing by 5.2 per cent points over the decade. China's trade share during April-September 2007 is ahead of the United States.

6.103 With rising POL prices, and India's rising exports of refined POL products, the United Arab Emirates (UAE) and Saudi Arabia have emerged as the third and fourth largest trading partners of India. There is a perceptible change in the share of India's trade with Iran and Nigeria (due to rise in import of mineral fuel and oil, etc.) and Australia (due to rise in import of precious stones, metals, mineral fuel and oil, and ores), while the share of Singapore after increasing in some years has moderated.

6.104 Despite India's large overall trade deficit, there was a large (but declining) trade surplus with the United States and UAE, and a small surplus with the United Kingdom and Singapore till 2006-07. The surplus with the first three countries continued in 2007-08. The largest trade deficits are with Saudi Arabia, China and Switzerland. The trade deficit with China has increased further in April-September 2007.

6.105 In terms of export destination, the United States continued to be the principal destination accounting for 14.9 per cent of India's total exports in 2006-07, followed by UAE (9.5 per cent), China (6.6 per cent), Singapore (4.8 per cent) and U.K. (4.4 per cent). Region-wise, over half of India's exports in April-September 2007 were to Asia (including ASEAN), up from around 40 per cent in 2001-02. During this period exports to Africa grew by 33.9 per cent, to Asia (including ASEAN) by 16.5 per cent, to Europe by 23.2 per cent and to the United States by only 5 per cent. India's merchandise exports to South Asian countries increased by 16.6 per cent in 2006-07 compared to the 20.5 per cent growth in 2005-06. Growth in exports to Iran, Saudi Arabia, Belgium and Japan was good. Exports to Singapore have declined by 13.1 per cent in April-September 2007.

6.106 In 2006-07, Asia and ASEAN continued to be the major source of India's imports accounting for 57.5 per cent of total imports. Country-wise, imports from China recorded high growth of 60.1 per cent over and above the 53.1 per cent growth in the previous year. Growth of imports from EU-27 (with a share of 18.3 per cent) was high at 33.8 per cent. Growth of imports from North America (with a share of 7.4 per cent) was also high at 36.1 per cent. In recent years, India witnessed a major change in its direction of trade in general and with China in particular. India's export to China, in US dollar terms, was growing at the rate of 20.4 per cent and 22.7 per cent for the years 2005-06 and 2006-07, respectively. The main items of exports to China are iron ore, primary and semi-finished iron and steel, non-ferrous metals, plastic and linoleum products, dyes, intermediate coal tar chemicals, drugs, pharmaceuticals and petroleum products. Of these items, the share of iron ore, plastic linoleum products, and primary and semi-finished iron and steel has been declining, while the shares of dyes, intermediate coal tar chemicals, and petroleum products have been increasing.

6.107 India's imports from China has increased at a faster rate of 53.1 per cent and 60.1 per cent in 2005-06 and 2006-07, respectively. The principal items of imports are electronic goods, machinery except electrical and electronic, organic chemicals, iron and steel, coal coke and briquettes, etc. Of these items, the share of machinery has increased from 4.5 per cent in 2003-04 to 10.6 per cent in 2006-07. Similarly, the share of iron and steel increased from 0.8 per cent to 8.5 per cent for the same period, while the share of electronic goods, organic chemicals and inorganic chemicals are

declining. India's export policy with respect to China needs to be carefully planned as the current exports are tilted towards a single item, i.e., iron ore (44 per cent share in April-September 2007-08) which needs to be conserved for future development. The other major item is non-ferrous metals (6 per cent share). Besides the demand for these items may fall once the major sports activities like Olympics come to an end in 2008. Thus there is a need for diversification in India's exports to China.

Trade policy

Recent trade policy measures

6.108 Recent trade policy measures include reduction in peak rate of basic customs duties from 12.5 per cent to 10 per cent, reduction in the customs duty on polyester fibres and yarns, cut and polished diamonds and rough synthetic stones, etc., raw materials such as DMT, PTA and MEG, textiles machinery, etc., announced in the Union Budget 2007-08 and subsequently. The Mid-term Review of Annual Policy for the Year 2007-08 of RBI has also permitted all exporters to earn interest on their Exchange Earners Foreign Currency (EEFC) accounts as a temporary measure. The range of hedging tools available to the market participants has been further expanded keeping in view the changes in the foreign exchange market. To make exports an effective instrument of economic growth by giving thrust to employment generation particularly in semi-urban and rural areas, in the Annual Supplement to Foreign Trade Policy (FTP) 2004-09 in 2007, initiatives have been announced which include broadening the scope of Vishesh Krishi and Gram Udyog Yojana (VKGUY) by inclusion of forest-based products like artistic wooden furniture, etc., and a number of new agricultural products. The Foreign Trade Policy measures also include the inclusion of new markets and products under the Focus Market Scheme (FMS) and the Focus Product Scheme (FPS), respectively, exemption/ refund of service tax on services related to exports whether in India or rendered abroad, duty free import of tools, machinery and equipment for handicrafts and gems and jewellery sector, and enhancement in the limit of duty free import of samples to Rs. 75,000 per annum.

6.109 A new scheme was launched for duty free import of capital goods related to infrastructure meant for agro processing to promote agricultural exports and provide employment. On the technology front, to harness the potential of skilled manpower, high-tech products scheme was initiated allowing duty free credit as an incentive against such exports. EPCG Scheme has been rationalized and the tiny and cottage sector has been provided extended export obligation facility. Provision has also been made for waiver of export obligation because of *force majeure* or other unforeseen circumstances/reasons leading to the inability of exporters to fulfill export obligations. Issue of EPCG for import of spares, tools, spares and refractory was also allowed for existing imported plant and machinery (whether earlier imported under EPCG Scheme or not).

6.110 To promote exports from 100 per cent export-oriented units, incentives in the form of VKGUY, FMS and FPS have been extended to such units not availing of IT benefits. DEPB Scheme's validity was extended up to March 31, 2008. The scheme has been modified to allow reimbursement of the cost of duty on fuel and special additional duty by way of notifying brand rate of DEPB for such products. On the trade facilitation front, a number of measures have been taken to further reduce transaction cost. These include dispensing with the requirement of double

Table 6.31 Exports by state of origin of export goods during 2005-06 and 2006-07

	(US$ million)	Share (%)	Growth rate (%)
State	**2006-07**	**2006-07**	**2006-07**
Maharashtra	36143	28.6	13.0
Gujarat	24209	19.2	66.1
Tamil Nadu	13097	10.4	29.4
Karnataka	12676	10.0	13.8
Andhra Pradesh	5479	4.3	35.9
Delhi	4880	3.9	-7.2
West Bengal	4011	3.2	12.6
Haryana	3792	3.0	16.1
Uttar Pradesh	3632	2.9	7.2
Rajasthan	3356	2.7	20.3
Kerala	2293	1.8	16.1
Punjab	2148	1.7	-8.9
Madhya Pradesh	1993	1.6	-25.0
Orissa	1971	1.6	35.5
Grand Total	**126360**	**100.0**	**22.6**

Source: DGCI&S.

Note: The above data has been generated by "state of origin of export goods" as reported in the DTRs by the customs.

verification at customs for EPCG and advance authorization schemes, downsizing of the application forms required for availing of various schemes, and removing uncertainty regarding taxation for EOU units.

6.111 All the above policies announced in the budget, the subsequent policy announcement by the RBI and the Foreign Trade Policy, 2004-09 in April 2007 helped India's merchandise exports to grow at more than 20 per cent during the first nine months of this fiscal, despite appreciation of the rupee.

State-wise exports

6.112 State-wise exports are reflected in data on state of origin of export goods which at present is the only available comparable data for State-wise exports. Maharashtra followed by Gujarat, Tamil Nadu and Karnataka were the major merchandise exporters with a share of 68.2 per cent in total exports in 2006-07. In 2006-07, export growth was high in the case of Gujarat, Andhra Pradesh, Tamil Nadu and Orissa (Table 6.31).

6.113 To encourage exports among States, allocation under the Assistance to States for Development of Export Infrastructure and Allied Activities (ASIDE) scheme has been increased from Rs. 400 crore in 2005-06 to Rs. 440 crore in 2006-07. Under ASIDE, projects aimed at balancing of critical infrastructure for exports are approved viz. creation of new Special Economic Zones and augmenting facilities in existing ones, equity participation in infrastructure projects, development of complementary infrastructure such as roads connecting production centres to ports, setting up Inland Container Depots (ICDs) and Container Freight Stations, stabilizing power supply, etc. States have shown keen interest in funding projects under ASIDE scheme and the funding pattern of the projects shows a healthy mix of ASIDE funds, State Government funds and private sector participation, in a ratio of 4:4:2 indicating successful leverage of funds. States like Maharashtra, Tamil Nadu, Orissa, Karnataka and Gujarat have sanctioned quite a large number of projects under the ASIDE scheme. While 13 States have used ASIDE funding to an extent of more than 80 per cent of the project cost and have not leveraged any private sector funds or State Government funds, States have also leveraged funds from other sources.

Special Economic Zones

6.114 Another major policy issue in the trade sector which created a lot of heat was that of SEZs. The SEZ Act, 2005, supported by SEZ Rules, came into effect on February 10, 2006. The main objectives of the SEZ Act are generation of additional economic activity, promotion of exports of goods and services, promotion of investment from domestic and foreign sources, creation of employment opportunities and development of infrastructure facilities. Various incentives and facilities are offered to both – units in SEZs for attracting investments into SEZs (including foreign investment) as well as for SEZ developers. These incentives and facilities are expected to trigger a large flow of foreign and domestic investment in SEZs, particularly in infrastructure and productive capacity, leading to generation of additional economic activity and creation of employment opportunities. The SEZ Rules provide for different minimum land requirements for different classes of SEZs. Every SEZ is divided into a processing area where alone the SEZ units are set up and a non-processing area where the supporting infrastructure is to be created. The SEZ Rules also provide for simplified procedures for development, operation and maintenance of the SEZ and setting up units in SEZs, single window clearance both relating to Central as well as State Governments for setting up of an SEZ and units in a SEZ and simplified compliance procedures/documentation with emphasis on self-certification.

6.115 Consequent upon the SEZ Rules coming into effect from February 10, 2006, 439 formal approvals where granted, of which 195 Special Economic Zones have been notified and are in various stages of operation. These approvals are spread over 22 States and Union Territories and over 23 sectors. The benefits derived from SEZs is evident from the investment, employment, exports and infrastructural developments additionally generated (Box 6.7).

Customs duty exemptions

6.116 The Indian customs tariff regime was strewn with concessional duty notifications in the pre-1991 period, sometimes more than 500 in a year with the result that the schedule rate was practically inoperative. The exemption rate by notification ruled the tariff. The reduction of the

Box 6.7 Special Economic Zones: Some facts

Exports from Special Economic Zones have been showing steady increase. As compared to exports of Rs. 22,840 crore made by SEZs in 2005-06, exports to the tune of Rs. 34,615 crore have been effected in the year 2006-07, registering a growth of 52 per cent. Projected exports for 2007-08 from Special Economic Zones is Rs. 67,088 crore.

In the SEZs which have been setup/notified prior to the coming into force of the SEZ Act, 2005, at present there are 1,277 units in operation, providing direct, employment to over 2 lakh persons (about 40 per cent of whom are women). Out of this, 36,463 persons are in the private/State Government SEZs, most of which had come up after February 2006. The newly notified SEZs, which have come up after February 10, 2006, have provided direct employment to 61,015 persons.

Private investments in the 19 SEZs which were set up prior to coming into force of the SEZ Act, 2005, is of the order of about Rs. 7,104 crore. Investment of the order of Rs. 67,347 crore has already been made in the newly notified SEZs which came up after February 10, 2006.

Apprehensions have been expressed on misuse of the scheme and relocation of existing industries into SEZs. However, experience has shown that these apprehensions are ill founded and fresh investments and employment have been flowing into the Special Economic Zones. For example, Nokia electronics hardware SEZ in Sriperumbudur is already providing employment to 6,637 persons, majority of whom are women. Hyderabad Gems SEZ has already employed 2,000 persons after providing training to them, out of which 1,200 are girls. They have projected direct employment of about 30,000 persons. Apache SEZ, being set up in Andhra Pradesh, is expected to employ 20,000 persons to manufacture 10,00,000 pairs of shoes every month. Current employment in Apache SEZ is 4,500 persons. Brandix Apparels, a Sri Lankan FDI project, is expected to provide employment to 60,000 workers over a period of three years. Even in the services sector, 12.5 million sq metres space is expected to be created in the IT/ITES SEZs which is estimated to translate into 12.5 lakh jobs. The benefits derived from multiplier effect of the investments and additional economic activity in the SEZs along with the employment generated is estimated to far outweigh the revenue losses on account of tax exemptions given to the SEZs. These SEZs are freshly developed industrial clusters and are not relocated from elsewhere.

Concerns have also been expressed regarding acquisition of agricultural land for setting up SEZs. The State Governments have been advised by the Centre that in case of land acquisition for Special Economic Zones, first priority should be for acquisition of waste and barren land and if necessary single-crop agricultural land could be acquired for the SEZs. If perforce a portion of double-cropped agricultural land has to be acquired to meet the minimum area requirements, especially for multi-product Special Economic Zones, the same should not exceed 10 per cent of the total land required for the SEZ. Various issues related to setting up of SEZs in the country, including issues raised by various political parties, have been addressed by the Empowered Group of Ministries (EGOM). Pursuant to the decision taken by the EGOM, all State Governments have been informed that the Board of Approval will not approve any SEZs where the State Governments have carried out or propose to carry out compulsory acquisition of land for such SEZs after April 5, 2007.

peak tariff rate has made many exemptions redundant and simplified tariffs to an extent. However, exemptions including those given under special circumstances such as sudden increase in prices to provide relief to consumers, are still an important part of the customs tariff. As on January 1, 2008, there were 527 cases of duty exemptions industry/category-wise, the highest exemption (17.6 of the total) was for machinery. Exemptions under project imports where the duty ranges from Nil to 5 per cent as against the normal 7.5 per cent are important under the machinery head. The IT Agreement (ITA) signed at WTO under the "zero for zero" negotiations is another major category under exemptions. Under ITA, there are 82 entries in the exemption notifications covering some 217 lines for zero duty import. Agriculture is the third major sector under exemptions and this category along with edible oils has the highest exemption rates.

Box 6.8 Types of customs duty exemptions

	Numbers
■ **Industry groups exemptions**	
● Exemptions without documentation or end-use/user conditions	348
● Exemption with documentation or end-use/user condition	174
● Exemptions based on tariff rate quotas	5
Total industry group exemptions	**527**
■ **Thematic exemptions**	
● Inputs for exports (raw material, components, consumables, machinery)	84
● Country preferences	26
● Government imports (defence)	2
● Disaster relief	2
● Personal imports and baggage	14
Total thematic exemptions	**128**
Total exemptions	**655**

Source: Based on BIGs Easy Reference Customs Tariff 2007-08 and a study.

6.117 Formally, inter-budget tariff rate changes are also made through so-called "exemption notifications." Thus, for instance, a sharp rise in wheat prices may induce a reduction in import duty to zero. This change in duty is to be distinguished from a duty exemption that applies only if the wheat is imported by a designated agency or only for supply to a designated user. There are many types of customs exemptions serving different purposes (Box 6.8). Exemptions result in distortions and discriminations in the economic structure resulting in tax arbitrage, rent seeking and a rise in transaction and administrative costs. There is a need for a systematic policy to weed out exemptions on both basic and additional duty. The ideal system is to adopt a low tax regime supplemented with very few exemptions in special cases. Each exemption notification could have a sunset clause which would trigger automatic review of the exemptions.

Contingency trade policy and non-tariff measures

6.118 Contingency trade policy and non-tariff measures (NTMs) continue to act as significant barriers to exports from developing countries, but with somewhat reduced intensity. Such barriers are considerably stiffer for products with lower value addition and lower technological content (for example, agriculture, textiles, and leather products),

Table 6.32 Investigations initiated by top 10 users of anti-dumping measures, 1995-2007

Country	1995	2000	2001	2002	2003	2004	2005	2006	2006 Jan-June	2007 Jan-June	1995-June 2007
India	6	41	78	81	46	21	28	34	20	13	474
United States	14	47	75	35	37	26	12	7	0	2	375
European Community	33	32	28	20	7	30	25	35	17	0	363
Argentina	27	43	26	14	1	12	12	15	5	3	220
South Africa	16	21	6	4	8	6	23	3	2	3	203
Australia	5	15	23	16	8	9	7	10	9	0	189
Canada	11	21	25	5	15	11	1	7	4	0	141
Brazil	5	11	17	8	4	8	6	12	3	4	138
China PR	0	6	14	30	22	27	24	11	3	4	138
Turkey	0	7	15	18	11	25	12	8	0	0	109
All countries	**157**	**290**	**364**	**312**	**232**	**213**	**200**	**200**	**87**	**49**	**3097**

Source: WTO.

which are of major interest to developing countries like India. With its diversified manufacturing and export base, India has been one of the major users as well as one of the major targets of anti-dumping measures in the world (Table 6.32). During January-June 2007, WTO members reported initiating a total of 49 new investigations. India reported the highest anti-dumping initiations with 13 new initiations (taking each country as one case), though it was lower than corresponding previous period, followed by Brazil (4) and China (4).

6.119 Countries use many mechanisms to restrict imports. Till the beginning of 1970s, tariffs were the principal mode of protectionism. But with successive rounds of GATT negotiations, there was a large drop in the average tariff levels of manufactured goods in the developed country markets. When tariffs paled into insignificance, NTMs were resorted to by a number of these countries. Despite the provisions under the various agreements and ministerial decisions for eliminating or disciplining NTBs, they continue to be largely non-transparent, ad hoc and complex. While direct NTBs (such as quantitative restrictions, tariff quota, voluntary export restraints, orderly marketing arrangement, export subsidy, export credit subsidy, government procurement and import licensing, etc.) are explicitly designed and implemented for purposes of restrictive trade, indirect NTBs (such as health and safety regulations, technical standards, environment controls, customs valuation procedures, rules of origin, labour laws, anti-dumping duties, countervailing duties, regional subsidization and subsidization of public enterprise, etc.) are notionally implemented to meet some other policy target but affect the trade flows in the process. While some NTBs are genuine, others are intended to restrict imports, insulating domestic producers from the effect of world prices. Of late, the nature of NTBs are changing with declining importance of traditional NTBs and growing importance of knowledge-based NTBs embodied in SPS (sanitary & phyto-sanitary) and TBT (technical barriers to trade) measures.

6.120 A significant proportion of exports of developing countries like India is affected by single or multiple NTMs imposed by developed countries on account of health safety, environmental and other concerns. Indian exports, in general, faced NTBs relating to (i) packaging and labeling regulations, (ii) standards, (iii) uniformity requirements, (iv) labour standards, (v) documentation and related procedures, and (vi) company and product registration. Compliance cost with the regulatory requirements is severe for smaller firms than bigger firms. India has been actively negotiating at multilateral and bilateral levels for removal of NTMs. However, India also has to improve its own standards related to SPS and TBT which can lessen the impact of these NTBs. Greater FDI and useful FTAs with major trading partners can also lessen the impact of NTBs. There is also a need to build up and update regularly the empirical database on NTBs which can provide inputs for arriving at suitable policies for negotiations at multilateral and bilateral levels and also help in the preparation of export strategies and policies.

WTO negotiations and India

6.121 After the suspension in negotiations during July 2006 due to the wide gaps in the positions of WTO Members, especially on agricultural domestic support and market access, there was a soft resumption of negotiations on November 16, 2006. Subsequently there was full-scale resumption of negotiations on February 7, 2007, on the principles that it preserves the architecture of the negotiations, inclusiveness, and the progress made so far, and leads to an outcome that is balanced, ambitious and pro-development.

6.122 While safeguarding the interests of India's low income and resource poor agricultural producers (which cannot be traded off against any gains elsewhere in the negotiations) remains paramount for India, making real gains in services negotiations where it is a demander is no less important. In the case of industrial tariffs, India's growth and development concerns need to be addressed where India has taken a stand along with NAMA-11 coalition. These concerns are reflected in India's position on different WTO issues for negotiations (Box 6.9).

India's regional & preferential trading arrangements

6.123 In the past, India had adopted a very cautious and guarded approach to regionalism.

Box 6.9 India's stand on various issues

Agriculture

- Overall tariff reductions on bound rates for developing countries of not more than 36 per cent.
- Thresholds of the four band tariff formula with linear cuts to be adequately higher for developing countries to take into account their ceiling bindings.
- Self-designation of an appropriate number of special products (SP) guided by indicators based on the three fundamental and agreed criteria of food security, livelihood security and rural development needs. The G-33 has proposed 20 per cent agricultural tariff lines as special products, of which 40 per cent must be exempted from any tariff cut. India cannot accept TRQ commitments on SPs since it would entail necessarily going below current applied rates on the most sensitive products, viz. SPs.
- An operational and effective Special Safeguard Mechanism (SSM) to check against global price dips and import surges, which is more flexible than the existing safeguard mechanism available mainly to developed countries. The G-33 and India remain firm that *a priori* exclusion of any product, particularly SPs from the ambit of the SSM cannot be justified or accepted.
- Substantial and effective cuts in overall trade-distorting domestic support by the United States (70-75 per cent cut) and by the European Union (75-80 per cent cut), including resolving the issue of product-specific caps on Aggregate Measurement of Support (AMS) and in the new Blue Box.

Non-agricultural market access

- Choice of Swiss coefficients that ensures less than full reciprocity (LTFR) in percentage reduction commitments from bound rates. The current numbers in the chairman's draft modalities, namely coefficients of 19-23 for developing countries and 8-9 for developed countries does not meet LTFR.
- A fair markup on the unbound tariff lines.
- Flexibilities that are adequate and appropriate to address the sensitivities of developing countries.

Services

- Commitments by the developed countries on substantial openings for India's contractual service suppliers (CSS) and independent professionals (IPs) in Mode 4 relating to movement of natural persons.
- Development of disciplines in Domestic Regulations in Mode 4 involving qualifications and licensing requirements and procedures

Rules

- Strengthening of disciplines in anti-dumping include mandatory application of lesser duty rule, prohibition of zeroing, stronger rules on reviews, including sunset review.
- Against the enlargement of the scope of the Agreement on Subsidies and Countervailing Measures (ASCM) and/or limit existing flexibilities for the developing countries.
- Effective special and differential (S&D) treatment in any new disciplines on fisheries subsidies, particularly in the light of employment and livelihood concerns for small, artisanal fishing communities and for retaining sufficient "policy space".

Recognizing that Regional and Preferential Trading Agreements (RTAs) would continue to feature prominently in world trade, India began concluding in principle agreements and moving in some cases even towards Comprehensive Economic Cooperation Agreements (CECAs). Some of the recent developments related to major FTAs/RTAs/CECAs are the following.

(i) *India-EU Trade and Investment Agreement Negotiations:* A High Level Trade Group (HLTG) was set up as mandated by the India-EU Summit in New Delhi on September 7, 2005. Commencement of negotiations on a broad-based bilateral Trade and Investment Agreement was accepted by India and EU and negotiations commenced in June 2007. The third round of negotiations was held in Brussels in December 2007.

(ii) *India-Japan EPA/CEPA Negotiations:* During the visit of the Indian Prime Minister to Japan in December 2006, it was decided to launch negotiations for concluding an Economic Partnership Agreement (EPA/ CEPA) between the two countries. The Joint Task Force (JTF) constituted for this purpose held its first meeting from January 31 to February 2, 2007, in New Delhi. The terms of reference for negotiations were agreed upon in this meeting and negotiations are being held on FTA in goods, services, investment and other areas of cooperation. So far, five rounds of talks have been held and negotiations are likely to be concluded by 2008.

(iii) *India-Korea Comprehensive Economic and Cooperation Partnership Agreement (CECPA):* India and Korea are negotiating a CECPA covering goods, services and investment and nine rounds of negotiations have been held.

(iv) *Framework Agreement on the BIMSTEC FTA:* The Framework Agreement on the BIMSTEC (Bay of Bengal initiative for Multi-sectoral Technical & Economic Cooperation) Free Trade Area was signed in February 2004 by Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka and Thailand. The FTA in goods, services and investment is under negotiations.

(v) *Asia Pacific Trade Agreement (APTA):* The Asia Pacific Trade Agreement (APTA) including Bangladesh, Republic of Korea, Sri Lanka, China, Lao PDR and India had three rounds of negotiations and implemented the third round concessions from September 1, 2006. The Second Session of the Ministerial Conference was held in Goa in October 2007, and the ministers declared launching of the fourth round of trade negotiations.

(vi) *Global System of Trade Preferences (GSTP):* Two rounds of negotiations were held under GSTP signed in April 1998 with 44 developing countries having acceded to this agreement. The third round of negotiations, launched in June 2004, was expected to conclude by the end of 2007.

(vii) *India-Chile Framework Agreement on Economic Cooperation:* A Framework Agreement on Economic Cooperation was signed between India and Chile on January 20, 2005. The Agreement on PTA was signed on March 8, 2006, and has been implemented in August 2007.

6.124 PTA/CECPA between India & Mauritius, Framework Agreement with South Africa Customs Union (SACU), India-Israel Preferential Trade Agreement, Framework Agreement on CECA between ASEAN and India are at different stages of negotiations and implementation. Besides the Joint Task Force between India and China, Joint Study Groups (JSGs) have also been set up for examining feasibility of CECA between India-Brazil-South Africa; India-Russia; and India-Malaysia. The reports of the JSGs are at various stages of completion.

6.125 In India's PTAs/FTAs/RTAs, the neighbouring countries of India like Bangladesh, Sri Lanka, Bhutan and Nepal figure again and again. In the case of most of the RTAs/FTAs which have been implemented, value of exports is generally higher than imports. Import and export growth rates have increased immediately after the RTAs/FTAs were implemented due to unshackling of restrictions though import growth was generally higher. Studies also show that import growth of preferential items were higher than export growth of preferential items. However, there are other benefits like greater opportunities for investment and services exports. This is also an indication that India has to move more towards CECAs which are FTA plus arrangements.

6.126 One of the important types of preferential trading of India with developed countries is the Generalised System of Preferences (GSP). In 2006, the value of Indian exports to the United States enjoying the GSP benefits was US$ 5.67 billion. On the basis of an annual review of the items enjoying GSP benefits, the United States withdrew duty free treatment under GSP with effect from July 1, 2007 for a few Indian products, including gold jewellery and brass lamps. The erosion of concessions under GSP for countries like India, also points to the need for successful conclusion of more beneficial CECAs with one or two major developed countries/country groups which could help in greater inflow of FDI, removal of non-tariff

barriers in goods and gain greater market access in services.

E-commerce

6.127 The growth in e-commerce has added a new dimension to trade policy which countries have to take account of by formulating rules to keep abreast of the fast growing technological developments. The WTO General Council agreed on the comprehensive working definition of electronic commerce as "the production, distribution, marketing, sale or delivery of goods and services by electronic means". Electronic transactions involve three stages namely searching, ordering/making payment, and delivery of products. Electronic delivery of goods is by far the most challenging aspect from a policy perspective as such trade is compounding rapidly without any global regulatory framework and hardly any national or international legislation.

6.128 In recognition of the growing importance of electronic commerce in international trade, the Second Ministerial Declaration of the WTO at Geneva adopted a declaration on global electronic commerce on May 20, 1998, which directed the WTO General Council to establish a comprehensive work programme to examine all trade related issues arising from electronic commerce. The work programme includes issues like characterization of electronic transmission as goods or services or something else; market access involving the method of application of customs duties to electronic transmission; classification of digitized products under the existing Harmonized System (HS) of trade classification; rules of origin; standardization; development dimensions involving the effect on revenue and fiscal positions of developing countries in future; etc. The 1998 declaration also included a so-called moratorium stating that "members will continue their current practice of not imposing customs tariffs on electronic transmission". The work programme was adopted by the WTO General Council on September 25, 1998.

6.129 The quiet but quick growth in e-commerce has implications for tax and trade policy (Box 6.10). There is also an urgent need to make a quantitative assessment of the hitherto non-e-trade which has become e-trade and the likely non-e-trade which may become e-trade in the near future. This needs to be done both for B2B and B2C e-

Box 6.10

E-commerce: Tax and trade policy implications

E-commerce comprises of business among enterprises (B2B) and enterprises to consumers (B2C), and the former accounts for large proportion of such trade globally. The penetration of B2C trade is more important for developing countries. Ban on customs duty is applicable to digitized products (DP) which mostly fall in the category B2C and correspond to specific HS codes. While DPs defined as goods were transported through carrier media in the form of CDs, diskettes, tapes, etc., and subjected to customs duty in the importing country in the past, these products are now sent through the electronic network without being subject to customs duty. DPs are generally traded in five broad categories as: (i) printed matter, (ii) software, (iii) music and other media, (iv) film, and (v) video games. With trade in this segment growing rapidly, most of the developing countries are becoming net importers of digitized products.

Developed and developing countries are equally concerned on the revenue implications of e-commerce, though they differ in terms of the type of tax which can be addressed to stop erosion of revenue. For developed countries, consumption tax is an important source of tax revenue, and therefore the OECD countries decided to impose VAT on e-commerce in Ottawa (1998), while developing countries are more dependent on customs duty, and moratorium on customs duty has caused revenue losses to them. Since e-commerce differs from normal trade in goods, there is a need for developing a specific trade policy for e-commerce as trade policy requirement differs for transactions involving digital transmission. The matter is more complex because e-commerce is linked with several other WTO agreements, and compatibility is required between these agreements and other new legislations concerning e-commerce.

India's position on non-imposition of customs duty on electronic transmission has been that given the inherent advantage India has in e-commerce, it can maintain a liberal regime on electronic transmissions at present. However, this must not preclude its options for possible methods of taxation since the future course of growth in e-commerce is impossible to visualize. As and when viable methods of levying duties and taxes can be found, there should be freedom to impose customs duties, excise duties, sales tax, etc., on electronic transmissions.

Source : Based on a study.

commerce as greater FDI and inter-corporate transfers could increase the scope of B2B form of e-commerce also for developing countries. There may also be a need for review of national commitments of GATS in the light of growing importance of e-commerce.

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 moderate rise 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.