India's External Sector*

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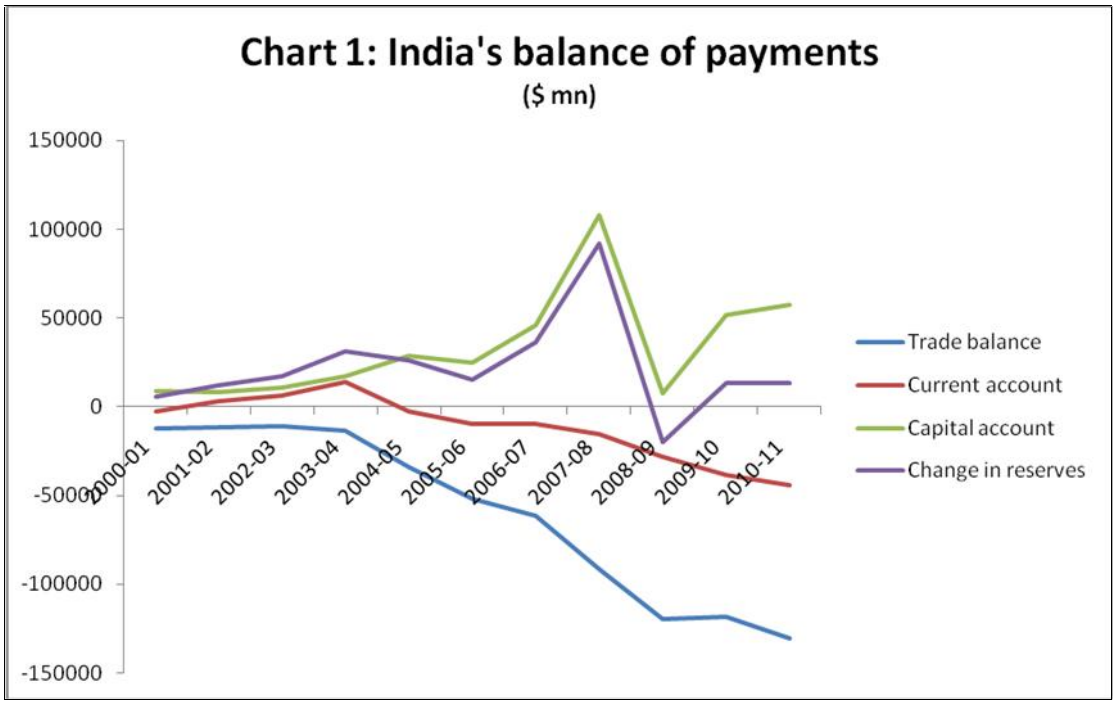
Portents for the global economy are gloomy at best. And recent events have already shown that the Indian economy will be also be affected by adverse developments in the rest of the world, whether through the impact of mobile capital flows, or through exports being dragged down by the recession in Europe and the economic uncertainty in the US.

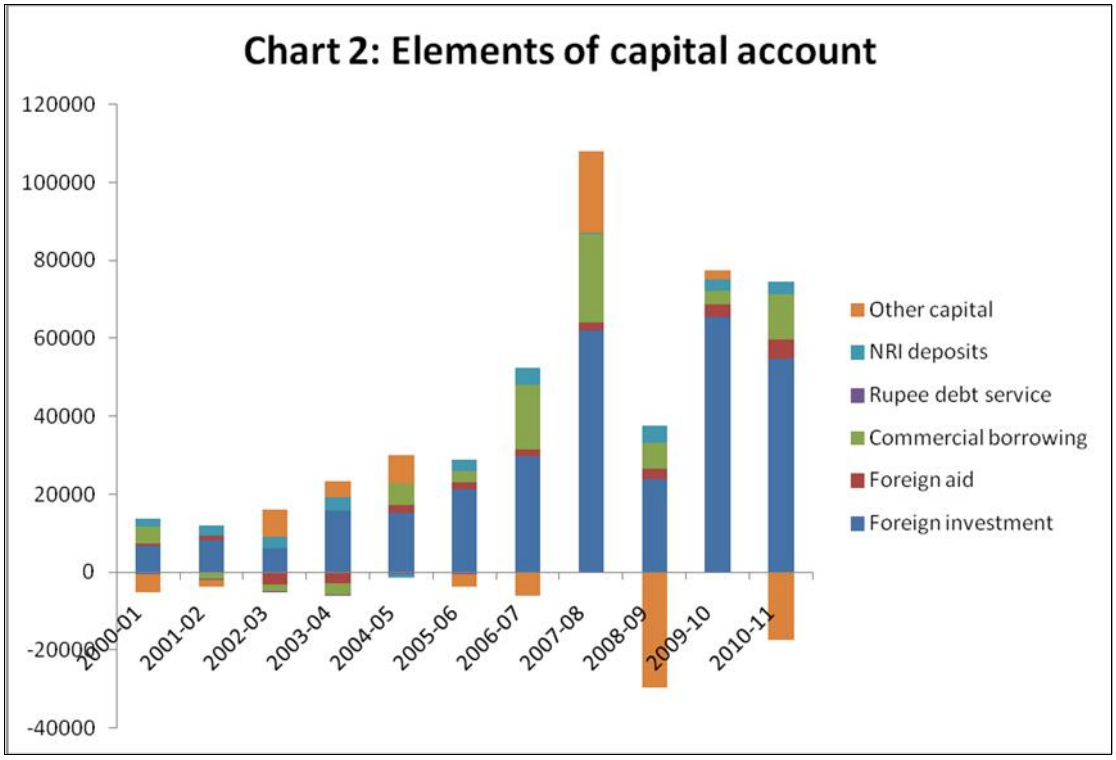
How resilient is the Indian economy at present, in the face of these negative global forces? In terms of domestic demand, it is certainly possible for the government to think of ways of rejuvenating the economy, ideally through more broad-based employment-led growth. But externally, the recent pattern of growth has been crucially related to India's greater global integration, and therefore it has created patterns of dependence on international markets and international capital. This makes the economy significantly more vulnerable, especially because the growth has been reliant on capital inflows to generate domestic credit-driven bubbles, rather than trade surpluses.

Chart 1 describes the main elements of India's balance of payments. (All data in this and the following charts are from the Reserve Bank of India's online statistical database, accessed on 6 January 2012.) Several features of importance emerge from this chart. First, the trade balance has been negative and progressively worsened over the course of the decade. Second, in the early years of the decade, this impact could be kept in check because remittance inflows and software exports ensured that the current account was either in surplus or ran small deficits. But in the second half of this period, even large remittance inflows could not prevent a substantial deterioration of the current account. Third, despite this, external reserves have kept growing, except for the crisis year 2008-09. Fourth, this was entirely because of capital inflows, which increased over the decade except in the crisis year, and the capital account peaked in 2007-08 with more than $100 billion net inflow.



What this suggests is that India's external reserves were effectively borrowed rather than earned, as they were largely growing because of capital inflows that were dominated by portfolio inflows and external commercial borrowing. This is confirmed by Chart 2, which shows that – especially in the second half of the decade – foreign investment and external commercial borrowing were dominantly responsible for the inflows on capital account.

In this context, another recent feature of foreign investment is worth noting. In the past, it made a lot of sense to separate portfolio inflows from direct foreign investment, on the grounds that the former are typically more short-term in orientation and more likely to be volatile and therefore exit the country in periods of downswing. However, the emergence of private equity, especially after 2000, has changed this considerably, since this is typically included in FDI. Private equity is also essentially short term in orientation, since it seeks to make relatively rapid capital gains on the acquisition of domestic assets. A significant proportion of inward FDI into India in the recent past has been in the form of private equity. As a result, a significant proportion of inward FDI is also effectively short term, and cannot be assumed to be in for the long haul, any more than explicitly portfolio inflows.



There is a widespread perception that the rupee has depreciated significantly in recent times. Certainly, in nominal terms vis-à-vis the major currencies, there is evidence of substantial decline in value. Chart 3 shows the rupee relative to the US dollar, Euro and Japanese Yen. Nominal depreciation has been particularly evident over much of 2011, which has not been captured in this chart.

However, it should be noted that this was also a period in which inflation in India was significantly higher than in many if not most of its trading partners. As a result, the real effective exchange rate, shown in Chart 4, barely changed very much over the entire course of the decade. The net barter terms of trade declined until 2007, especially because of high world oil prices, but then improved, so that even in terms of this variable there was not much change by the end of the decade.

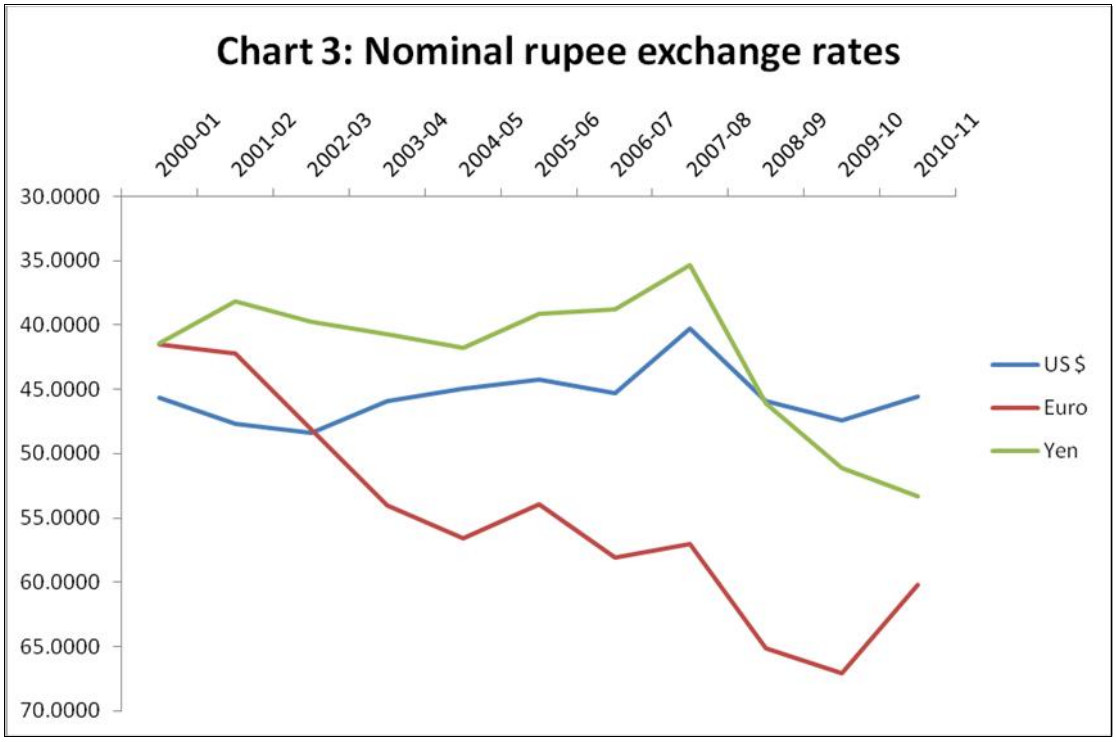


Chart 3: Nominal rupee exchange rates
2000-01
2001-02
2002-03
2003-04
2004-05
2005-06
2006-07
2007-08
2008-09
2009-10
2010-11
30.0000
35.0000
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45.0000
50.0000
55.0000
60.0000
65.0000
70.0000
US $
Euro
Yen

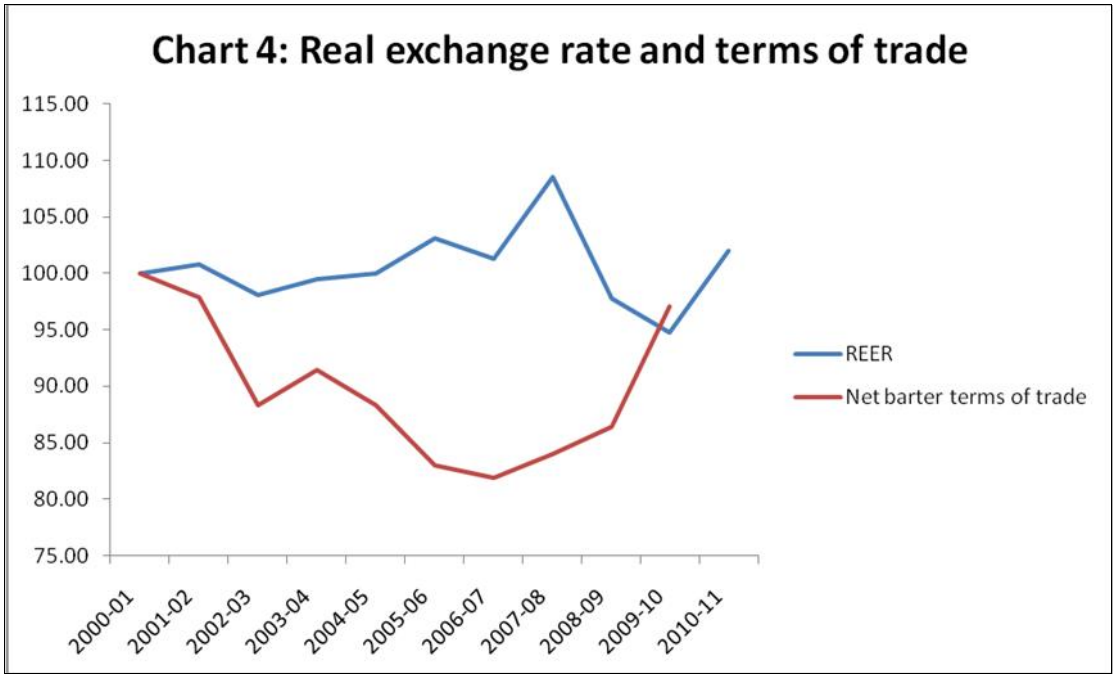


Chart 4: Real exchange rate and terms of trade
115.00
110.00
105.00
100.00
95.00
90.00
85.00
80.00
75.00
2000-01
2001-02
2002-03
2003-04
2004-05
2005-06
2006-07
2007-08
2008-09
2009-10
2010-11
REER
Net barter terms of trade

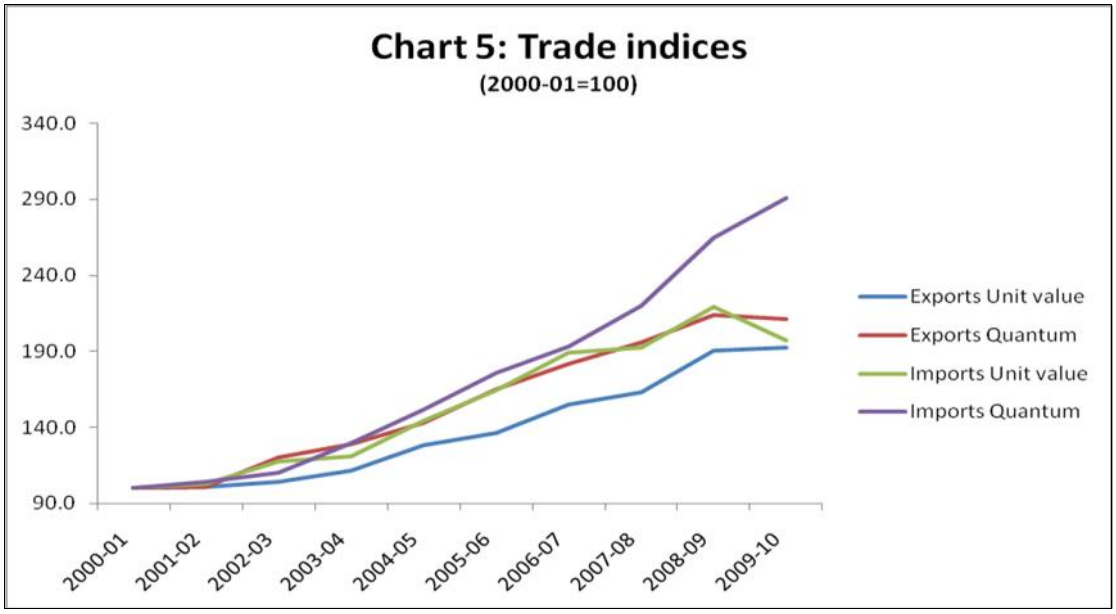
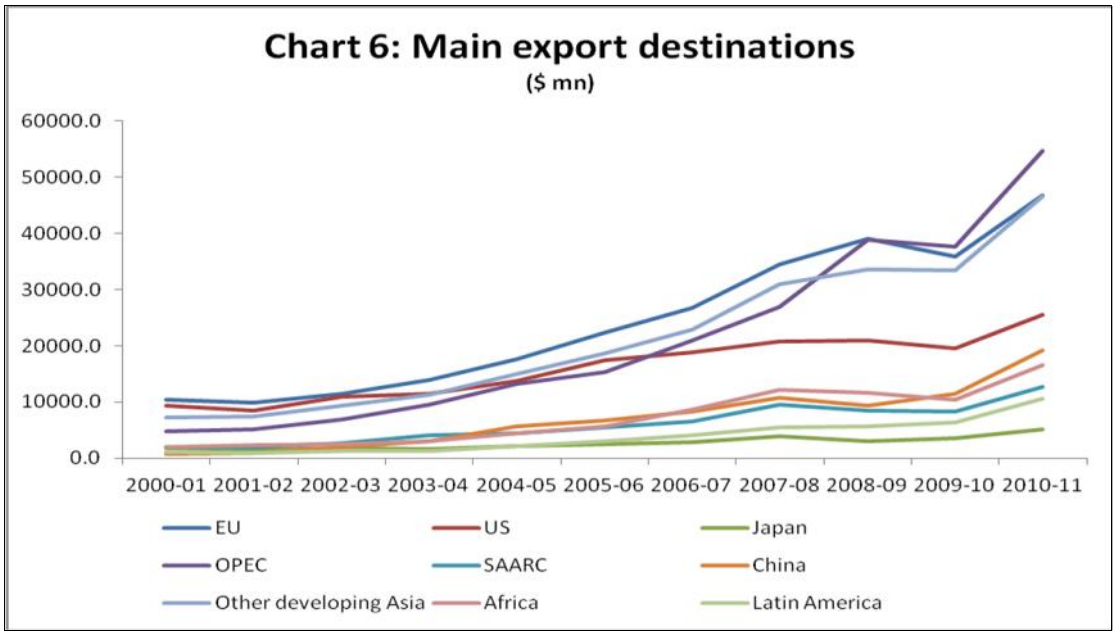


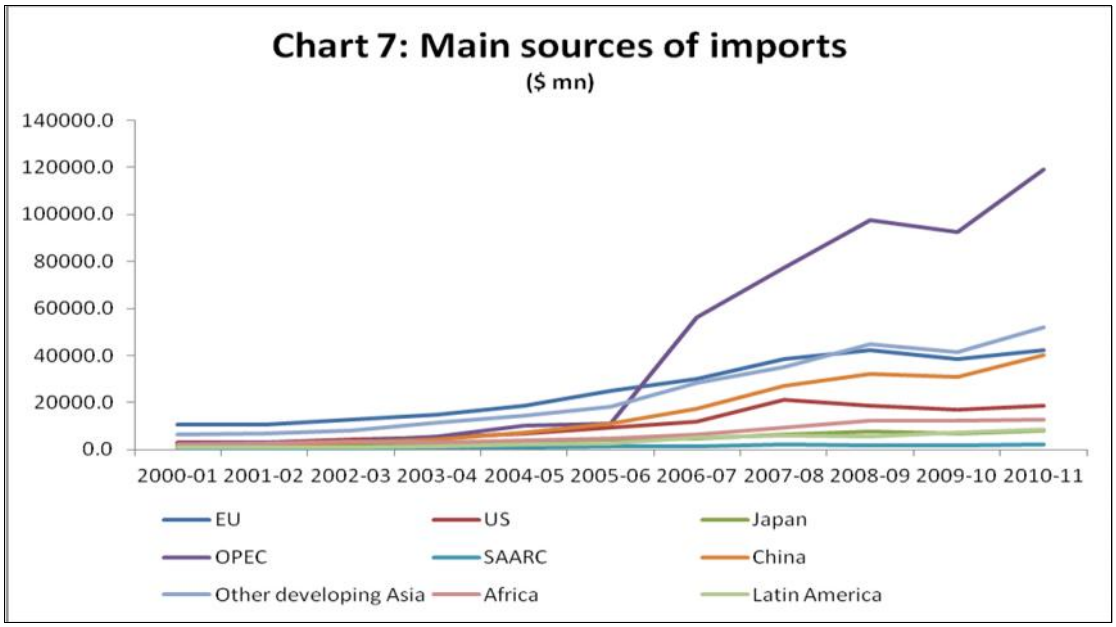
Chart 5 describes the indices of trade in terms of quantum and unit value, separately for exports and imports. This is an extremely significant chart, because it highlights that the quantum index for imports moved up much more rapidly than all the other indices. Further, it does not seem to have been at all affected by the global crisis. So it would be unwise to blame high oil prices alone for the high and growing total import bill – clearly import liberalisation has resulted in a significantly increased propensity to import within the economy.

This also has another implication: the domestic impact is greater than would be evident from just the total value of imports, since significantly greater quantities of imports are entering the country. This has direct effects on import-competing activities, on employment and livelihood particularly of small producers. The slow growth of non-agricultural employment despite rapid aggregate GDP growth may be at least partly related to the impact of substantially increased import volumes of a wide range of manufactured commodities.

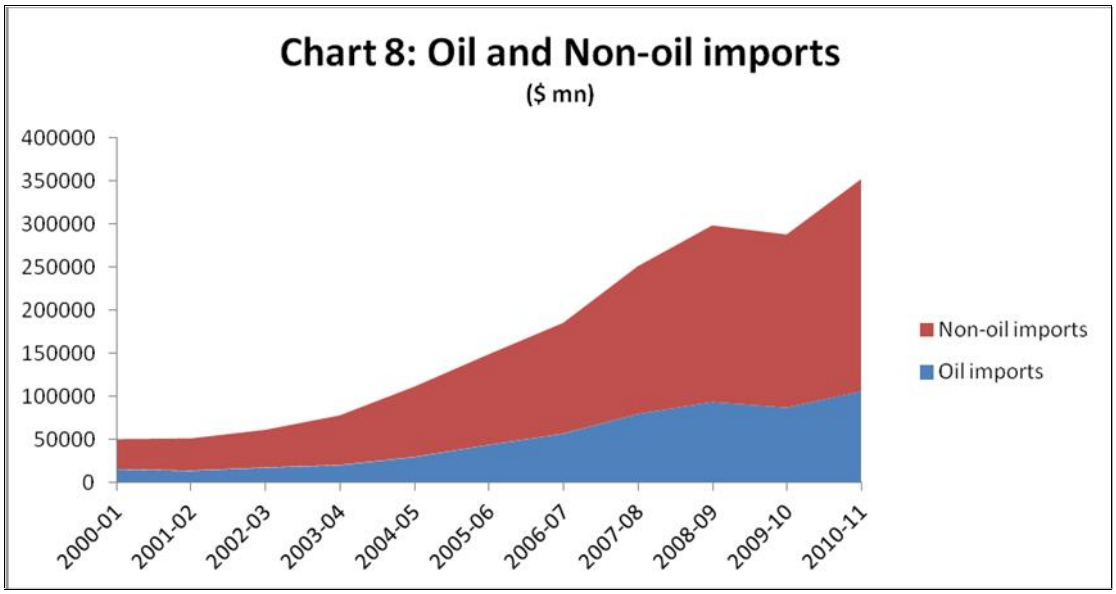


In terms of direction of trade, it is evident from Chart 6 that the European Union remains an extremely important destination for exports. This is bad news, given the likely recession in Europe which is also bound to affect their imports. OPEC as a group recently overtook the EU in becoming the grouping to receive the largest amount of India's exports (in value terms) but it is worth noting that China and other developing countries in Asia have become increasingly significant as export markets for India.

Chart 7 shows that in terms of imports, the global increases in oil prices propelled OPEC countries dramatically to the top of the groupings in terms of sources of imports in the second half of the decade. But once again, it is important to note that China and other developing Asia have become major sources of imports, exhibiting the fastest rate of growth for non-oil imports.



These non-oil imports have in fact been growing very sharply. Chart 8 makes it clear that the recent increases in the total import bill cannot be ascribed to oil prices alone, because non-oil imports have been growing much faster in value terms.



So recent trends in the external sector were already cause for concern, even before the latest impact of the ongoing global economic crisis can be felt. It is not just high energy dependence which is a strategic problem for India. The rapid expansion of non-oil imports suggests an economy that (despite two decades of liberalising "reforms") is becoming less externally competitive and generating trade patterns that are likely to continue to have adverse employment effects. Most of all, a trajectory of growth based on capital inflows that generate domestic finance-driven consumption, including significantly high imports and worsening trade balances, is obviously not sustainable. We do not need a global crisis to recognise these danger signals.

(This article was published in the Business Line on January 9, 2012)