Balance of Payments

6

CHAPTER

The world economy, led by the buoyant economic activity in emerging economies, is gradually recovering from the crisis. The risks however remain, as advanced economies face large fiscal deficit, high public debt and unemployment levels and tepid aggregate demand, leading to subdued growth. The sovereign debt crisis in the peripheral euro-zone countries is contributing to the uncertainty. At the same time, large capital flows to emerging economies, rising oil and agricultural prices are fueling inflationary pressures that may affect the nascent global recovery. In the backdrop of these developments, the Indian economy continues to exhibit resilience, moving steadily towards the pre-crisis growth path. The current account deficit however, has widened due to robust import demand and lower invisibles surplus. These are being largely financed by the relatively higher capital flows, leading to moderate accretion in reserves. There are however challenges that include volatile nature of foreign institutional investment that is characterized by surge and reversal of capital flows, deceleration in foreign direct investment and the risk of further slowdown in advanced economies that may affect exports and strain balance of payments.

Global Economy

6.2 The world economy is exhibiting signs of recovery, driven largely by the robust growth in emerging economies. Advanced countries however, continue to face uncertainty with large fiscal deficit, high public debt and unemployment levels that together with the deleveraging of banks, corporate entities and individuals, is affecting aggregate demand and impeding the recovery process.

6.3 The risk of sovereign debt crisis in peripheral euro zone economies and the fear that it could spread to the banking and insurance sectors with large sovereign debt exposure, have made the markets nervous. The likely impact on the euro and the risk that the financial sector may take a hit is also responsible for the efforts to avoid haircut on sovereign debt of affected countries through restructuring.

6.4 With investors dithering, Ireland's rescue package under the aegis of the European Financial Stability Facility (EFSF) and the International Monetary Fund (IMF) has not had the desired stabilization effect on the markets. Many also believe that the size of EFSF is not large enough to bail out bigger economies like Spain and the high debt countries such as Italy and Belgium in the event of the crisis spreading to other euro zone countries. The risk is that the crisis could further impair the confidence of investors through contagion channels and delay the incipient recovery of the global economy.

6.5 Investor nervousness is compounded by the high refinancing requirement of sovereign, bank and corporate debts and the fear that there may not be sufficient liquidity in the market to rollover the maturing obligations. There is also the apprehension that the stimulus effort by governments is simply substituting the high private debt before the crisis with public debt, without benefitting the global economy in a major way.

6.6 The investor uncertainty is reflected in high volatility of the currency markets. Moreover, as none of the currencies offers a safe haven, many investors are taking refuge in commodities, facilitated by investor-friendly instruments like Exchange Traded Funds (ETF), commodity indices and the ease of taking positions in the futures market. Together with rising demand from the emerging economies, the trend is reflected in increasing and volatile prices of gold, oil, metals and soft products like foodgrains. The surge in prices of commodities like oil and foodgrains, however is straining the balance of payments of emerging economies and contributing to price rise, affecting their growth prospects.

6.7 The surge in capital flows to emerging economies to take advantage of interest differential (carry trade), higher stock market returns and better growth prospects is another fallout of uncertain growth prospects and low interest environ in advanced countries. The deluge of capital, however, is leading to stock market/ real estate bubbles and appreciation of local currency, with excess liquidity contributing to inflationary pressures.

6.8 Economic theory, at the same time, is at a cross roads. With free market economics discredited and prices no longer regarded an effective signalling mechanism, the confidence in the self-correcting attribute of the market mechanism is abating. The Keynesian approach of deficit financing and high public expenditure is also being doubted, as it has led to the build up of public debt, without successfully addressing unemployment and aggregate demand problems in advanced countries.

6.9 Some of the mainstream financial market theories like the efficient market hypothesis that have been the mainstay of finance are similarly being questioned. The theories based on the risk free nature of sovereign debt that have been the cornerstone of financial market modelling, too have come in for criticism due to the risk of default/ restructuring in peripheral euro zone countries and the build up of public debt to unsustainable levels in many advanced countries. As a result, the bonds of many top notch corporate entities and emerging economies are being priced more competitively vis-a-vis some of the euro zone countries.

6.10 In the ensuing melee, there is an attempt to revisit both economics and finance. In the *first* place, it is being recognized that the markets are subject to boom and bust cycles, which could assume serious proportions due to credit induced asset price bubbles that are characterized by a positive feedback loop. Countercyclical measures and leaning against the wind may, therefore be necessary. *Second*, there is renewed emphasis on integrating behavioural factors with mainstream economics and finance to make theory correspond more closely with the real world situation.

Box 6.1 : BRIC Study Report

The term BRIC stands for Brazil, Russia, India and China. It was coined by Goldman Sachs in 2001 in a paper titled 'Building Better Global Economic BRICs' that looked at the future growth prospects of the four largest emerging economies. BRIC countries have since come to play a major role on the global stage. The BRIC Heads of State and Finance Ministers also periodically meet for increasing cooperation among the BRIC countries.

During the meeting of the BRIC Finance Ministers and Central Bank Governors in London on 4 September, 2009, a decision was taken to commission a study examining the prospects of the world economy and the role of the BRIC countries in the post-crisis world. The communiqué of the meeting also noted that the emerging economies had helped the world economy counter the fallouts of the global crisis by absorbing the impact of the widespread deterioration in trade, credit flows and demand.

Given the increasing importance of the BRIC economies on the global stage and the recognition that they would play a dominant role in the world economy in the coming years, the purpose of the collaborative study is to identify possible areas of co-operation and synergies among the BRIC countries for promoting mutual growth and for collectively harnessing global economic recovery.

It was also decided that India would anchor the study project. A working group, drawing upon government/central bank experts from each of the four countries, was constituted for successfully conducting the study. Members of this group have been collaborating among themselves by identifying best practices and lessons in the individual BRIC countries in wide variety of sectors. The first meeting of the working group was held in New Delhi in September 2010 and was attended by participants from all the four BRIC countries. The meeting finalized the phases of report preparation covering issues relating to mutual sharing of information, identification of crucial challenges and opportunities facing the BRIC economies, and a time frame for preparation of the draft study report.

The first draft of the report has been prepared by the Indian team and is under circulation among the BRIC countries for appraisal and inputs.

6.11 *Third*, there is increasing recognition that a prudent regulatory and supervisory framework is necessary for smooth functioning of the markets. At the same time, coordination among regulatory agencies of different countries is necessary to minimize the risk of regulatory arbitrage. *Fourth*, macro prudential regulation that takes a top down approach to regulation is the new policy buzzword, as is evident from the recently announced Basel III rules that include countercyclical buffer and leverage restrictions on bank capital to ensure macroeconomic stability.

6.12 In the back drop of such uncertainty and efforts at stabilization, most emerging economies continue to perform well with high growth rates that signify a measure of decoupling with the advanced economies. This is mainly because (i) many emerging economies went through an introspection and correction phase after the series of crises in 1980s and 1990s, leading to lowering of external and public debt levels, streamlining of public expenditure and institution building; (ii) emerging economies had minimal exposure to toxic assets that were responsible for the origin and spread of the crisis; and (iii) financial innovations like Collateralized Debt Obligations (CDOs) and credit default swaps that contributed significantly to the crisis, had made limited inroads in emerging economies.

6.13 India has been more fortunate in that (a) its growth was largely domestic economy driven; (b) the calibrated approach to capital account liberalization prevented interest arbitrage seeking surge and reversal of capital flows; (c) strict supervision of banks prevented exposure to toxic assets abroad and excessive lending to the real estate sector that insulated banks from the fallout of pricking of the real estate bubble; (d) credit derivative instruments like credit default swaps that played the key role in precipitating the crisis, are yet to be introduced in the market.

Balance of Payments

6.14 Balance of payment (BoP) comprises current account, capital account, errors and omissions and changes in foreign exchange reserves. Under current account of the BoP, transactions are classified into merchandise (exports and imports) and invisibles. Invisible transactions are further classified into three categories, namely (a) Services–travel, transportation, insurance, Government not included elsewhere (GNIE) and miscellaneous (such as, communication, construction, financial, software, news agency, royalties, management and business services), (b) Income, and (c) Transfers (grants, gifts, remittances, etc.) which do not have any quid pro quo.

6.15 Under capital account, capital inflows can be classified by instrument (debt or equity) and maturity (short or long-term). The main components of capital account include foreign investment, loans and banking capital. Foreign investment comprising foreign direct investment (FDI) and portfolio investment consisting of foreign institutional investors (FIIs) investment, American Depository Receipts / Global Depository Receipts (ADRs/GDRs) represents non-debt liabilities, while loans (external assistance, external commercial borrowings and trade credit) and banking capital including non-resident Indian (NRI) deposits are debt liabilities.

6.16 BoP developments during 2009-10 indicate that despite lower trade deficit, current account deficit widened on account of slowdown in invisible receipts. There was also sharp increase in capital flows, which led to accretion in foreign exchange reserves. The current account deficit of 2.8 per cent of the gross domestic product (GDP) in 2009-10 vis-a-vis 2.3 per cent in 2008-09, however remained well within manageable limits. The net capital flows increased substantially to 3.8 per cent of GDP in 2009-10 as compared to 0.5 per cent in 2008-09. This led to net accretion of US$ 13.4 billion in foreign exchange reserves on BoP basis, as against the net outflow of US$ 20.1 billion in 2008-09.

6.17 BoP in 2009-10 had contrasting ramifications for economic recovery. The decline in exports of goods and services in response to weak global demand had a dampening impact on overall GDP growth. However, a higher current account deficit led to stronger absorption of foreign capital. This implied higher investment activity financed by foreign capital, which partly contributed to the stronger recovery in growth. Major determinants of BoP transactions-such as external demand, international oil and commodity prices, pattern of capital flows and the exchange rate changed significantly during the course of the year. With the turnaround in exports and revival in capital flows, external sector concerns receded gradually in the second half of 2009-10.

6.18 As per the latest data available, the highlights of BoP developments during the first half (H1 – April-September 2010) of 2010-11 were higher trade and

Table 6.1: Balance of Payments : Summary (US$ million)

Sl. No.	Item	2005-06	2006-07	2007-08	2008-09	2009-10^PR	2009-10 H1 (April-Sept. 2009)^PR	2010-11 H1 (April-Sept. 2010)^P
1	2	3	4	5	6	7	8	9
I	**Current Account**							
1	Exports	1,05,152	1,28,888	1,66,162	1,89,001	1,82,235	82,569	1,10,518
2	Imports	1,57,056	1,90,670	2,57,629	3,08,521	3,00,609	1,38,419	1,77,457
3	Trade Balance	-51,904	-61,782	-91,467	-1,19,520	- 1,18,374	- 55,850	- 66,939
4	Invisibles (net)	42,002	52,217	75,731	91,605	79,991	42,511	39,058
	A Non-factor Services	23,170	29,469	38,853	53,916	35,726	19,098	19,510
	B Income	-5,855	-7,331	-5,068	-7,110	-8,040	-3,279	-6,509
	C Transfers	24,687	30,079	41,945	44,798	52,305	26,692	26,057
5	Goods and Services Balance	-28,734	-32,313	-52,614	-65,604	-82,648	-36,752	-47,429
6	Current Account Balance	-9,902	-9,565	-15,737	-27,915	-38,383	-13,339	-27,881
II	**Capital Account**							
1	Capital Account Balance	25,470	45,203	1,06,585	6,768	53,397	22,964	36,661
	i External Assistance (net)	1,702	1,775	2,114	2,441	2,893	1,023	2,993
	ii External Commercial Borrowings (net)	2,508	16,103	22,609	7,862	2,808	728	5,974
	iii Short-term debt	3,699	6,612	15,930	-1,985	7,558	-49	6,749
	iv Banking Capital (net)	1,373	1,913	11,759	-3,246	2,084	1,045	834
	of which:							
	Non-Resident Deposits (net)	2,789	4,321	179	4,290	2,924	2,865	2,163
	v Foreign Investment (net)	15,528	14,753	43,326	5,785	51,167	30,275	29,137
	of which:							
	A FDI (net)	3,034	7,693	15,893	19,816	18,771	12,330	5,340
	B Portfolio (net)	12,494	7,060	27,433	-14,031	32,396	17,945	23,797
	vi Other Flows (net) [a]	660	4,047	10,847	-4,090	-13,113	-10,058	-9,026
III	**Errors and omission**	-516	968	1,316	1,067	-1,573	-92	-1,750
IV	**Overall Balance** [b]	15,052	36,606	92,164	-20,080	13,441	9,533	7,030
V	Reserves [increase (-) / decrease (+)]	(-) 15,052	(-) 36,606	(-) 92,164	20,080	(-) 13,441	(-) 9,533	(-) 7,030

Source: Reserve Bank of India (RBI). PR: Partially Revised. P: Preliminary

[a] includes among others delayed export receipts and rupee debt service.

[b] Overall balance includes total current account balance, capital account balance and errors and omissions.

current account deficits as well as capital flows vis-a-vis the first half of 2009-10 (Table 6.1).

Current Account

Merchandise trade

6.19 India's current account position during 2009-10 continued to reflect the impact of the global economic downturn and deceleration in world trade witnessed since the second half of 2008-09. On a BoP basis, India's merchandise exports of US$ 182.2 billion during 2009-10 posted a decline of 3.6 per cent, as against US$ 189.0 billion in 2008-09, which recorded a positive growth of 13.7 per cent over the exports of US$ 166.2 billion in 2007-08. Similarly, import payments of US$ 300.6 billion also recorded a decline of 2.6 per cent in 2009-10, as compared to US$ 308.5 billion in 2008-09, which was 19.8 per cent higher than the imports of US$ 257.6 billion in 2007-08. Though the decline in exports was relatively higher than that in imports, the merchandise trade deficit in absolute terms decreased marginally to US$ 118.4 billion (8.6 per cent of GDP) during 2009-10 from US$ 119.5 billion (9.8 per cent of GDP) in 2008-09.

6.20 Commodity-wise analysis of India's exports indicated that the share of primary products in total exports increased by 100 basis points from 13.9 per cent in 2008-09 to 14.9 per cent in 2009-10. Similarly, the share of petroleum, crude and products (including coal) increased from 14.9 per cent to 15.8 per cent during the same period. The higher growth rate of 3.8 per cent in primary products in 2009-10 (as against 1.7 per cent in 2008-09) and 2.3 per cent in petroleum (as against negative growth of 3.0 per cent in 2008-09) were responsible for increase in the share of these in 2009-10. The share of manufactured goods, however, decreased from 68.9 per cent in 2008-09 to 67.2 per cent in 2009-10 due to negative growth of 5.9 per cent in 2009-10, as against 23.1 per cent growth in 2008-09. Among import items, the share of petroleum, oil and lubricants (POL) declined to 30.2 per cent in 2009-10, as against 31.3 per cent in 2008-09 on account of negative growth of 7.0 per cent in 2009-10. The other major component of imports was gold and silver, whose share increased by 100 basis points from 9.3 per cent in 2008-09 to 10.3 per cent in 2009-10, because of a higher growth rate of 35.5 per cent in 2009-10 as against 22.3 per cent in 2008-09. The detailed analysis of the trade performance of India is dealt with in the next chapter.

6.21 The widening of India's current account deficit during the first half of 2010-11(April-September 2010) reflects the impact of the growth asymmetry between India and the rest of the world. India's exports and imports growth momentum, which started during the second half of 2009-10, continued during the first half of 2010-11 also. On BoP basis, India's merchandise exports during the first quarter (Q1-April-June 2010) and Q2 (July-September 2010) of 2010-11 recorded a growth of 43.6 per cent and 25.0 per cent respectively, as against a decline of 31.8 per cent and 19.1 per cent in the corresponding quarters of 2009-10. During H1 of 2010-11, exports recorded a growth of 33.8 per cent as against negative growth of 25.7 per cent during the corresponding period of the previous year. Similarly, imports witnessed a growth of 34.2 per cent and 22.8 per cent during the first two quarters of 2010-11, as against a decline of 20.8 per cent and 21.3 per cent recorded during the corresponding quarters of 2009-10. Imports posted a growth of 28.2 per cent during the first half of 2010-11, as compared to negative growth of 21.1 per cent during H1 of 2009-10. The rising imports of oil, pearls, and semi-precious stones have contributed significantly to a burgeoning import bill. Rising crude oil prices, along with growth in quantity of oil imports, has led to a higher oil import bill during the first half of 2010-11. Despite the higher export growth compared to imports during April-September 2010-11, the trade deficit widened in absolute terms by 19.7 per cent to US$ 66.9 billion in the first half of 2010-11, as compared to US$ 55.9 billion during the same period last year.

Invisibles

6.22 The invisibles account of BoP reflects the combined effect of transactions relating to international trade in services, income associated with non-resident assets and liabilities, labour, property and cross-border transfers, mainly workers' remittances. Two components of the current receipts namely software services and workers' remittances, continued to remain relatively resilient in 2009-10, as was the case in 2008-09, despite the global economic meltdown and were mainly responsible for the net invisible surplus.

6.23 Invisibles receipts of US$ 163.4 billion in 2009-10 recorded a decline of 2.6 per cent over US$ 167.8 billion in 2008-09 (as against an increase of 12.7 per cent in 2008-09 over US$ 148.9 billion in 2007-08), mainly due to lower receipts under miscellaneous services such as business, financial, and communication services, together with lower investment income. Receipts under all the components of business services (such as trade-related services, business and management consultancy services, architectural, engineering and other technical services, and services relating to maintenance of offices abroad) showed a decline during 2009-10 reflecting lagged impact of the global crisis. Receipts under investment income declined to US$ 12.1 billion in 2009-10 from US$ 13.5 billion in the previous year on account of significant decline in interest rates abroad.

6.24 Software receipts at US$ 49.7 billion however, showed an increase of 7.4 per cent in 2009-10 (14.9 per cent a year earlier). Private transfer receipts, comprising mainly remittances from Indians working overseas also increased to US$ 53.9 billion in 2009-10 (3.9 per cent of GDP) from US$ 46.9 billion (3.8 per cent of GDP) in the previous year. Private transfer receipts constituted 15.6 per cent of current receipts in 2009-10 (13.1 per cent in 2008-09).

6.25 Invisible payments increased by 9.4 per cent from US$ 76.2 billion in 2008-09 to US$ 83.4 billion in 2009-10 due to increase in payments under all the components except software services, transfers and investment income. As a result, the net invisible balance (receipts minus payments) of US$ 80.0 billion (5.8 per cent of GDP) in 2009-10 posted a negative growth of 12.7 per cent over US$ 91.6 billion (7.5 per cent of GDP) in 2008-09. The net receipts under the services component (travel, transportation, insurance, G.N.I.E. miscellaneous) went down by 33.8 per cent from US$ 53.9 billion in 2008-09 to US$ 35.7 billion in 2009-10. However, software services registered a positive growth of 10.3 per cent during the same period from US$ 43.7 billion to US$ 48.2 billion. The other component of invisibles which posted a positive growth was transfers (private as well as official). The net private transfers of US$ 52.1 billion in 2009-10 were higher by16.8 per cent from US$ 44.6 billion in 2008-09.

6.26 The impact of growth asymmetry between India and the rest of the world was observed in India's invisibles account in the current fiscal 2010-11, leading to moderation in net invisibles balance in H1 of 2010-11(April-September 2010). This moderation was primarily due to the decline in investment income and private transfer receipts and increase in services payments.

6.27 The net invisibles surplus was lower by 8.0 per cent at US$ 39.1 billion during H1 of 2010-11 as against US$ 42.5 billion during the corresponding period of 2009-10, essentially due to higher invisible payments (which recorded a growth of 33.4 per cent as against a decline of 4.1 per cent a year earlier) driven by all major categories of services and decline in gross investment income receipts. Services payments increased by 46.9 per cent (against a decline of 4.7 per cent a year ago) mainly due to higher payments under travel transportation, business and financial services.

6.28 On the other hand, a significant decline in receipts under investment income and private transfers offset, to a large extent, the increase in services exports. Investment income receipts declined sharply by 40.1 per cent (as compared to a marginal decline a year before) mainly due to the persistence of lower interest rates abroad. Private transfer receipts at US$ 27.2 billion also recorded a decline of 1.1 per cent (as against an increase of 4.3 per cent a year earlier). However, services exports witnessed a major turnaround during the period, recording a growth of 27.4 per cent (as against a decline of 16.8 per cent a year earlier) led by all the major components of services such as business, financial, software, travel and transportation services. Reflecting this, invisible receipts recorded a growth of 11.1 per cent as against a decline of 8.9 per cent a year earlier. However, as the growth in invisibles payments was higher than the invisibles receipts, net invisibles surplus stood lower during April-September 2010, as compared with the corresponding period of the previous year. Net invisibles surplus financed about 58.3 per cent of the trade deficit during April-September 2010, as against 76.1 per cent during the same period last year.

6.29 The goods and services balance i.e. trade balance plus services, increased by 25.9 per cent from US$ 65.6 billion (5.4 per cent of GDP) in 2008-09 to US$ 82.6 billion (6.0 per cent of GDP) in 2009-10, on account of the decrease in net services receipts by 33.8 per cent to US$ 35.7 billion in 2009-10 from US$ 53.9 billion in 2008-09. During the first half of 2010-11, the goods and services deficit widened by 28.8 per cent to US$ 47.4 billion from US$ 36.8 billion during the first half of 2009-10, on account of widening of the trade deficit while the net services receipts remained at more or less the same level (Tables 6.1 and 6.2).

Current account balance

6.30 As a consequence of the decline in invisible surplus, despite the lower trade deficit, the current account deficit increased by 37.5 per cent in 2009-10 to US$ 38.4 billion (2.8 per cent of GDP) from US$ 27.9 billion (2.3 per cent of GDP) in 2008-09. Similarly, the lower invisible surplus combined with higher trade deficit during the first half of 2010-11 led to more than doubling of the current account deficit to US$ 27.9 billion from US$ 13.3 billion during April-September 2009-10 (Figures 6.1 and 6.2).

Capital account

6.31 Stronger recovery in India, ahead of the global recovery along with positive sentiments of global investors about India's growth prospects, encouraged a revival in capital flows during 2009-10. The turnaround was mainly driven by large inflows under FIIs and short-term trade credits. The gross capital inflows at US$ 345.7 billion during 2009-10 were 10.2 per cent higher than the US$ 313.6 billion in 2008-09, while gross capital outflows at US$ 292.3 billion were lower by 4.8 per cent from US$ 306.9 billion in 2008-09. As a result, net capital flows at US$ 53.4 billion (3.8 per cent of GDP) were much higher during 2009-10 as compared to US$ 6.8 billion (0.5 per cent of GDP) in 2008-09.

Table 6.2 : Selected Indicators of the External Sector

Sl. No.	Item	2005-06	2006-07	2007-08	2008-09	2009-10PR	2009-10 H1 (April-Sept. 2009)PR	2010-11 H1 (April-Sept. 2010)P
1	2	3	4	5	6	7	8	9
1	Growth of Exports – BoP (%)	23.4	22.6	28.9	13.7	-3.6	-25.7	33.8
2	Growth of Imports – BoP (%)	32.1	21.4	35.1	19.8	-2.6	-21.1	28.2
3	Growth of Non-factor Services (Credit) (%)	33.3	28.0	22.4	17.3	-9.6	-14.2	27.4
4	Growth of Non-factor Services (Debit) (%)	24.0	28.5	16.2	1.1	15.3	-4.7	46.9
5	Exports/Imports—BoP (%)	67.0	67.6	64.5	61.3	60.6	59.7	62.3
6	Exports/Imports of Goods and Services (%)	85.0	86.2	83.0	92.7	90.0	77.5	77.8
7	Import Cover of FER (No. of months)	11.6	12.5	14.4	9.8	11.1	-	-
8	External Assistance (net)/ TC (%)	6.7	3.9	2.0	36.1	5.4	4.5	8.2
9	ECB (net)/TC (%)	9.8	35.6	21.2	116.2	5.3	3.2	16.3
10	NRI Deposits/ TC (%)	11.0	9.6	0.2	63.4	5.5	12.5	5.9
					As per cent of GDPmp			
11	Exports	12.6	13.6	13.4	15.4	13.2	13.9	14.5
12	Imports	18.8	20.1	20.8	25.2	21.7	23.4	23.2
13	Trade Balance	-6.2	-6.5	-7.4	-9.8	-8.6	-9.4	-8.8
14	Invisible Balance	5.0	5.5	6.1	7.5	5.8	7.2	5.1
15	Goods and Services Balance	-3.4	-3.4	-4.2	-5.4	-6.0	-6.2	-6.2
16	Current Account Balance	-1.2	-1.0	-1.3	-2.3	-2.8	-2.2	-3.7
17	ECBs	0.3	1.7	1.8	0.7	0.2	1.0	0.1
18	FDI (net)	0.4	0.8	1.3	1.6	1.4	0.9	1.7
19	Portfolio Investment (net)	1.5	0.7	2.2	-1.2	2.4	3.8	2.5
20	Total Capital Account (net)	3.0	4.7	8.6	0.5	3.8	3.9	4.8

Source: RBI PR: Partially Revised. P: Preliminary
TC: Total Capital Flows (net); ECBs: External Commercial Borrowings;
FER: Foreign Exchange Reserves; GDPmp: Gross Domestic Product at current market prices.

Figure 6.1 Current account balance, goods and services balance, trade balance, invisibles balance and net capital inflows as a per cent of GDP during 2005-06 to 2009-10

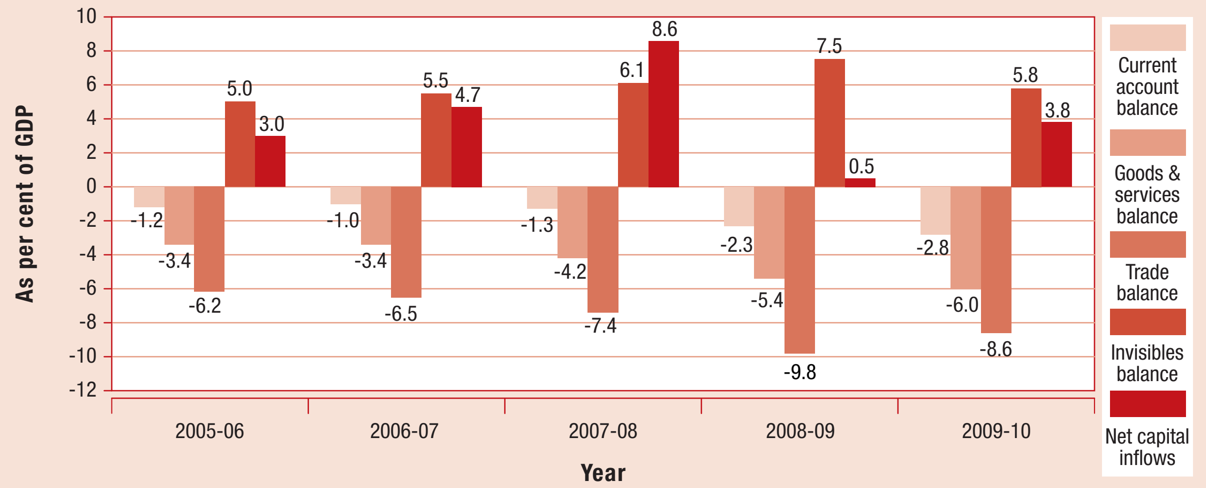
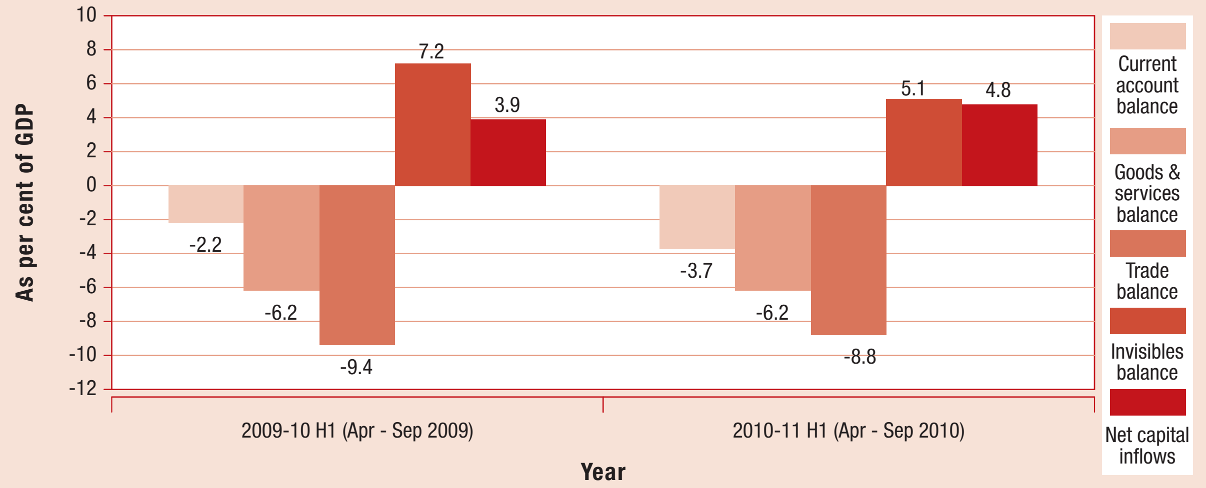


Figure 6.2 **Current account balance, goods and services balance, trade balance, invisibles balance and net capital inflows as a per cent of GDP during H1 of 2009-10 and 2010-11**



6.32 Both inward as well as outward FDI showed declining trend in 2009-10 vis-a-vis 2008-09. The inward FDI declined by 12.4 per cent to US$ 33.1 billion in 2009-10 from US$ 37.8 billion in 2008-09. Similarly, outward FDI declined by 19.6 per cent from US$ 17.9 billion in 2008-09 to US$ 14.4 billion in 2009-10. Consequently, the net FDI (inward FDI minus outward FDI) was marginally lower at US$ 18.8 billion in 2009-10, as compared with US$ 19.8 billion in 2008-09. The FDI was channelled mainly into manufacturing followed by construction, financial services and the real estate sector.

6.33 Portfolio investment witnessed net inflow of US$ 32.4 billion in 2009-10 as against a net outflow of US$ 14.0 billion in 2008-09. The attractive domestic market conditions facilitated net FII inflows of US$ 29.0 billion in 2009-10 (as against net outflow of US$ 15.0 billion in 2008-09). At US$ 3.3 billion, the ADRs / GDRs remained at the same level in 2009-10 as in 2008-09. Net ECBs slowed down to US$ 2.8 billion (US$ 7.9 billion in 2008-09) mainly due to increased repayments.

6.34 The net short-term trade credits to India increased significantly to US$ 7.6 billion in 2009-10 from net outflows of US$ 2.0 billion a year earlier, reflecting international confidence in domestic importers. After recording net inflows under non-resident deposits during the first three quarters, there were outflows during the last quarter of the 2009-10. Overall net non-resident deposits inflows stood lower at US$ 2.9 billion during 2009-10 as compared to US$ 4.3 billion during 2008-09.

6.35 Net capital inflows increased significantly during H1 of 2010-11, mainly due to FII inflows, short-term trade credits and ECBs. Net FII inflows were higher at US$ 22.3 billion during April-September 2010 as compared to US$ 15.3 billion a year earlier reflecting attractive returns in Indian stock markets. Inflows under short-term trade credits and ECBs increased significantly on the back of strong domestic demand and persistence of higher interest rate differentials between India and abroad. Accordingly, short-term trade credits increased to US$ 6.7 billion during April-September 2010 as against a marginal outflow witnessed during the corresponding period of 2009-10. Net inflows under ECBs to India increased to US$ 6.3 billion as compared to US$ 0.8 billion a year earlier. The large increase in these inflows was considerably offset by the moderation in net FDI to US$ 5.3 billion during H1 of 2010-11 as against US$ 12.3 billion during the corresponding period of 2009-10 due to decline in inward FDI. The inward FDI declined by 36.4 per cent from US$ 19.8 billion during H1 of 2009-10 to US$ 12.6 billion during H1 of 2010-11. However, outward FDI remained at more or less the same level at US$ 7.2 billion during H1 of 2010-11, as compared to US$ 7.4 billion in H1 of the previous year. The share of net FDI in net capital flows also declined from 53.7 per cent in H1 of 2009-10 to 14.6 per cent in the first half of the current fiscal. With capital account surplus being higher than the current account deficit, the overall balance was in surplus at US$ 7.0 billion, which resulted in a net accretion to foreign exchange reserves of an equivalent amount during

H1 of 2010-11 as compared to US$ 9.5 billion during H1 of 2009-10.

6.36 As per the latest available information on capital inflows, FDI inflows at US$ 19.0 billion were almost at the same level during April-November 2010 as it was during the corresponding period of the previous year. Portfolio investment including FII inflows, however, increased sharply to US$ 32.8 billion during April-November 2010 from US$ 22.2 billion a year earlier. The surge in FIIs could be attributed to relatively sound economic fundamentals and increased international liquidity due to easy monetary policies followed by many advanced countries.

6.37 The salient features of the BoP during 2009-10 and in the first half of the current fiscal have been higher current account deficit due to lower net invisibles surplus and large net capital inflows mainly on account of higher inflows under portfolio investments and short-term trade credits, leading to net accretion of foreign exchange reserves on BoP basis.

Foreign Exchange Reserves

6.38 Foreign exchange reserves are an important component of the BoP and an essential element in the analysis of an economy's external position. India's foreign exchange reserves comprise foreign currency assets (FCAs), gold, special drawing rights (SDRs) and reserve tranche position (RTP) in the International Monetary Fund (IMF). The level of foreign exchange reserves is largely the outcome of the RBI's intervention in the foreign exchange market to smoothen exchange rate volatility and valuation changes due to movement of the US dollar against other major currencies of the world. Foreign exchange reserves are accumulated when there is absorption of the excess foreign exchange flows by the RBI through intervention in the foreign exchange market, aid receipts, interest receipts, and funding from institutions such as the International Bank for Reconstruction and Development (IBRD), Asian Development Bank (ADB) and International Development Association (IDA). Both the US dollar and the euro are intervention currencies. Foreign currency assets are maintained in major currencies like the US dollar, euro, pound sterling, Australian dollar and Japanese yen. Reserves are denominated and expressed in the US dollar, which is the international numeraire for the purpose.

6.39 The twin objectives of safety and liquidity are the guiding principles of foreign exchange reserves management in India, with return optimization being embedded strategy within this framework. The aftermath of the global financial crisis has, however, triggered a debate on the costs of building up foreign exchange reserves as a self-insurance mechanism. It needs to be acknowledged that foreign exchange reserves have helped insulate India from the worst impact of the crisis. There is an argument that a multilateral option of a pre-arranged line of credit that can be easily and quickly accessed can be a substitute for costly self-insurance. Such a multilateral option, however is necessary but not sufficient, as foreign investors often view the size of foreign exchange reserves as a key input in taking investment decisions.

6.40 In evaluating the level of reserves and the quantum of self insurance of a country, it is also important to distinguish between countries where reserves are a consequence of current account surpluses and economies with current account deficits where reserves are a result of capital inflows in excess of their economy's absorptive capacity. India falls in the latter category, wherein reserves comprise mainly portfolio (FIIs) investment, which are more vulnerable to sudden stops and reversals and borrowings from abroad.

India's foreign exchange reserves

6.41 Beginning from a low level of US$ 5.8 billion at the end of March 1991, India's foreign exchange reserves gradually increased to US$ 25.2 billion by end-March 1995, US$ 38.0 billion by end-March 2000, US$ 113.0 billion by end-March 2004 and US$ 199.2 billion by end-March 2007. The reserves reached their peak at US$ 314.6 billion at end-May 2008, before declining to US$ 252.0 billion at the end of March 2009. The decline in reserves in 2008-09 was *inter alia* a fallout of the global crisis and strengthening of the US dollar vis-à-vis other international currencies. During 2009-10, the level of foreign exchange reserves again increased to US$ 279.1 billion at the end of March 2010, mainly on account of valuation gain as the US dollar depreciated against most of the major international currencies. The component-wise details of foreign exchange reserves from 1950-51 to 2010-11 (up to December 2010) in rupee and US dollar are given in Appendices 6.1(A) and 6.1(B).

6.42 During 2009-10, of the total US$ 27.0 billion increase in foreign exchange reserves, US$ 13.6 billion was on account of valuation gain and balance US$ 13.4 billion was on BoP basis (Table 6.3). The increase in foreign exchange reserves during this period also includes SDR allocations made by the

Table 6.3 : Sources of Variation in Foreign Exchange Reserves on BoP Basis and Valuation Effect

(US$ billion)

Sl. No.	Items	2008-09	2009-10PR	April-September 2009-10PR	April-September 2010-11P
1	2	3	4	5	6
I	**Current Account Balance**	**(-) 27.9**	**(-) 38.4**	**(-) 13.3**	**(-) 27.9**
II	**Capital Account (net) (a to g)**	**7.9**	**51.8**	**22.7**	**33.1**
	a Foreign Investment (i+ii)	5.8	51.2	30.3	29.1
	(i) FDI	19.8	18.8	12.3	5.3
	(ii) Portfolio Investment	(-) 14.0	32.4	17.9	23.8
	of which:				
	FIIs	(-) 15.0	29.0	15.3	22.3
	ADRs/GDRs	1.2	3.3	2.7	1.6
	b External Commercial Borrowings	7.9	2.8	0.7	6.0
	c Banking Capital	(-) 3.2	2.1	1.0	0.8
	of which: NRI Deposits	4.3	2.9	2.9	2.2
	d Short-term Trade Credit	(-) 2.0	7.6	-0.1	6.7
	e External Assistance	2.4	2.9	1.0	3.0
	F Other Items in Capital Account*	(-) 4.1	(-) 13.1	(-)10.2	(-)10.7
	g Errors and Omissions	1.1	(-) 1.6	(-) 0.1	(-)1.8
	h Overall balance (I+II)	(-) 20.1	13.4	9.5	7.0
III	**Reserve Change on BoP Basis [Increase (-) / Decrease (+)]**	**(+) 20.1**	**(-) 13.4**	**(-) 9.5**	**(-)7.0**
IV	**Valuation Change**	**(-) 37.6**	**13.6**	**19.8**	**6.8**
	Total Reserve Change (III+IV)	**(-) 57.7**	**27.0**	**29.3**	**13.8**
	(Increase in reserves (+) / Decrease in reserves (-))				

Source: RBI   PR: Partially Revised.   P: Preliminary

Note: *: 'Other items in capital account' include SDR allocations, leads and lags in exports, funds held abroad, advances received pending issue of shares under FDI and transactions of capital receipts not included elsewhere and rupee debt service. As per the BoP compilation practice, an increase in reserves is indicated by (-) sign and a decrease by (+) sign. For other items (+) sign indicates increase and (-) sign means decrease. Difference, if any, is due to rounding off.

IMF to India in two consecutive tranches of SDR 3,082.5 million (equivalent to US$ 4,821 million) under the general allocation on 28 August, 2009 and SDR 214.6 million (equivalent to US$ 340 million) under special allocations on 9 September, 2009 and purchase of 200 metric tonnes of gold from the IMF by the RBI, under the IMF's limited gold sales programme at the cost of US$ 6.7 billion in November 2009, as part of its foreign exchange reserves management operation.

Figure 6.3 Foreign exchange reserves

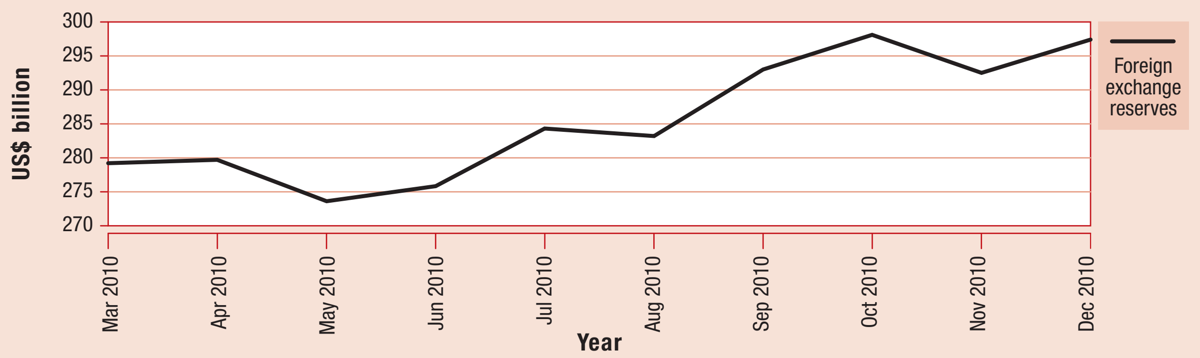


Table 6.4 : Summary of changes in foreign exchange reserves (US$ billion)

Sl. No.	Year	Foreign exchange reserves at the end of financial year (end March)	Total Increase / decrease in reserves over previous period	Increase/decrease in reserves on a BoP basis	Increase/decrease in reserves due to valuation effect
1	2	3	4	5	6
1	2005-06	151.6	+ 10.1	+ 15.0 (148.5)	- 4.9 (- 48.5)
2	2006-07	199.1	+ 47.5	+ 36.5 (76.8)	+ 11.0 (23.2)
3	2007-08	309.7	+ 110.6	+ 92.2 (83.4)	+ 18.4 (16.6)
4	2008-09	252.0	- 57.7	-20.1 (34.8)	- 37.6 (65.2)
5	2009-10	279.1	+ 27.0	+ 13.4 (49.6)	+ 13.6 (50.4)
6	2010-11 (upto Sept. 2010)	292.9	+ 13.8	+ 7.0 (50.7)	+ 6.8 (49.3)

Source: RBI.
Note: Figures in parentheses indicate percentage share in total change.

6.43 In the current fiscal 2010-11, on month-on-month basis, foreign exchange reserves have shown an increasing trend. The reserves increased by US$ 18.2 billion from US$ 279.1 billion at the end of March, 2010 to US$ 297.3 at the end of December, 2010 (Figure 6.3). This level of reserves provides about 10 months of import cover.

6.44 A summary of changes in the foreign exchange reserves since 2005-06, with a breakdown into increase/decrease on BoP basis and valuation effect is presented in Table 6.4.

6.45 Foreign Currency Assets (FCAs) are the major constituent of foreign exchange reserves in India. FCAs increased by US$ 13.1 billion (5.1 per cent) from US$ 254.7 billion at end-March 2010 to US$ 267.8 billion at end-December 2010. The increase was largely attributed to valuation gain, aid receipts and purchase of US dollar by the Reserve Bank of India.

6.46 In line with the principles of preserving the long-term value of the reserves in terms of purchasing power, minimizing risk and volatility in returns and maintaining liquidity, the RBI holds FCAs in major convertible currency instruments. These include deposits of other countries' central banks, the Bank for International Settlements (BIS) and top-rated foreign commercial banks, and securities representing debt of sovereigns and supranational institutions with residual maturity not exceeding 10 years, to provide a strong bias towards capital preservation and liquidity. The annualized rate of return, net of depreciation, on the multi-currency multi-asset portfolio of the RBI declined from 4.2 per cent in 2008-09 to 2.1 per cent in 2009-10.

6.47 Country-wise details of foreign exchange reserves show that India is the fourth largest foreign exchange reserve holder in the world, after China, Japan and Russia (Table 6.5).

Table 6.5 : Foreign exchange reserves of some major countries

Sl. No.	Country	Foreign exchange reserves (US$ billion)
1	2	3
1	China (June 2010)	2,454.3
2	Japan (December 2010)	1,118.8
3	Russia (December 2010)	479.4
4	India (December 2010)	297.3
5	Korea (October 2010)	293.5
6	Brazil (November 2010)	285.5
7	China P R Hong Kong (December 2010)	268.8
8	Singapore (December 2010)	225.8
9	Germany (December 2010)	216.6
10	France (December 2010)	188.3
11	Italy (October 2010)	157.4

Source: IMF except for China;
For China: www.safe.gov.cn.

Table 6.6 : International Comparison of Foreign Exchange Reserves (US$ billion) and Ratio of Reserves to Imports of Goods and Services

Sl. No.	Country / Country Group	2005	2006	2007	2008	2009	2010 (Projection)	2011 (Projection)
1	2	3	4	5	6	7	8	9
I	**Country**							
1	Russia	176.5 (107.4)	296.2 (141.7)	467.6 (165.5)	412.7 (112.3)	417.8 (164.8)	468.7 (152.8)	508.1 (143.8)
2	China	822.5 (115.5)	1069.5 (125.4)	1531.3 (148.0)	1950.3 (158.2)	2348.8 (211.0)	2693.4 (169.6)	3025.6 (157.8)
3	India	132.5 (72.8)	171.3 (75.5)	267.6 (95.1)	248.0 (71.5)	266.2 (81.6)	281.6 (76.2)	295.9 (69.7)
4	Brazil	53.3 (54.4)	85.2 (70.7)	179.5 (113.8)	192.9 (87.6)	237.4 (135.9)	274.9 (117.9)	292.7 (110.0)
5	Mexico	74.1 (30.5)	76.3 (27.4)	87.1 (28.5)	95.1 (28.5)	99.6 (38.7)	119.6 (35.9)	129.6 (36.5)
II	**Country Group**							
1	Developing Asia (excluding China & India)	201.1 (38.6)	248.5 (42.5)	330.0 (49.1)	335.5 (41.8)	393.0 (60.2)	459.4 (58.2)	508.2 (58.4)

Source: World Economic Outlook Database, October 2010.

Note: Reserves are based on official holding of gold valued at SDR 35 an ounce. This convention results in a marked underestimation of reserves for countries that have substantial gold holdings.
Figures in parentheses indicate ratio of reserves to imports of goods and services.

6.48 A comparative picture of foreign exchange reserves and import cover, as measured by the ratio of foreign exchange reserves to import of goods and services for select country groups and countries including India is presented in Table 6.6. Among the country groups, "Developing Asia" and the "Middle East" accumulated reserves during the period 2005-09, leading to steady improvement in the ratio of reserves to import of goods and services.

Exchange Rates

6.49 The exchange rate policy is guided by the broad principles of careful monitoring and management of exchange rates with flexibility, while allowing the underlying demand and supply conditions to determine its movements over a period in an orderly manner. Subject to this predominant objective, RBI intervention in the foreign exchange market is guided by the goals of reducing excess volatility, preventing the emergence of destabilizing speculative activities, maintaining adequate levels of reserves, and developing an orderly foreign exchange market.

6.50 During 2009-10, on the back of capital inflows and positive growth outlook, the Indian rupee generally appreciated against the US dollar, though marked by intermittent depreciation pressures. An easy supply situation in the market also led to moderation in forward premia.

6.51 On a point-to-point basis, the rupee that stood at 50.95 per US dollar on 31 March 2009, displayed a two-way movement with generally appreciating trend in the second half of 2009-10. The appreciation of the rupee in 2009-10 was generally led by FII inflows, driven by strong macroeconomic performance and better return. The growth in exports, continued capital inflows and weakening of the US dollar against some of the major currencies contributed to appreciating pressure on the rupee, taking the rupee-US dollar exchange rate to ₹ 45.14 per US dollar by end-March 2010.

6.52 The Rupee/US dollar exchange rate marginally appreciated by 0.7 per cent to ₹ 44.81 per dollar between 31 March 2010 and 31 December 2010. Over the same period, the rupee has experienced depreciation of 2.5 per cent against

Table 6.7 : Exchange Rates of Rupee per Foreign Currency and RBI's Sale/Purchase of US Dollar in the Exchange Market During 2010-11

Month	Annual/Monthly average exchange rates (₹ per foreign currency)*, US$	Pound Sterling	Euro	Japanese Yen**	RBI Net sale (-) / purchase (+) (US$ million)
1	2	3	4	5	6
2009-10	47.42 (-3.0)	75.89 (3.2)	67.08 (-3.0)	51.10 (- 9.6)	(-) 2,505
March 2010	45.50	68.44	61.77	50.18	
2010-11					
April 2010	44.50 (2.2)	68.24 (0.3)	59.66 (3.5)	47.63 (5.4)	-
May 2010	45.81 (-2.9)	67.23 (1.5)	57.67 (3.5)	49.69 (-4.1)	-
June 2010	46.57 (-1.6)	68.70 (-2.1)	56.90 (1.4)	51.22 (-3.0)	110.0
July 2010	46.84 (-0.6)	71.52 (-3.9)	59.76 (-4.8)	53.43 (-4.1)	-
August 2010	46.57 (0.6)	72.97 (-2.0)	60.14 (-0.6)	54.53 (-2.0)	-
September 2010	46.06 (1.1)	71.68 (1.8)	60.08 (0.1)	54.50 (0.1)	260.0
October 2010	44.41 (3.7)	70.39 (1.8)	61.72 (-2.7)	54.28 (0.4)	450.0
November 2010	45.02 (-1.4)	71.85 (-2.0)	61.50 (0.4)	54.57 (-0.5)	870.0
December 2010	45.16 (- 0.3)	70.46 (2.0)	59.69 (3.0)	54.24 (0.6)	-

Source : RBI

*** FEDAI indicative rate; ** Per 100 Yen.**

Figures in parentheses indicate appreciation (+) and depreciation (-) over the previous month/year.

the Pound Sterling and 12.1 per cent against the Japanese yen, while it appreciated by 1.2 per cent against the euro.

6.53 On annual average basis, rupee depreciated against all major international currencies except the pound sterling in fiscal 2009-10. The annual average exchange rate of the rupee was ₹ 45.99 per US dollar in 2008-09 and it depreciated by 3.0 per cent to ₹ 47.42 in 2009-10. Similarly, the annual average exchange rate of the rupee in 2008-09 was ₹ 65.06 per euro and ₹ 46.20 per 100 Japanese yen, and it depreciated by 3.0 per cent and 9.6 per cent, respectively to ₹ 67.08 and ₹ 51.10 during 2009-10. The annual average exchange rate of the rupee per pound sterling however, showed appreciation of 3.2 per cent from ₹ 78.32 per pound sterling in 2008-09 to ₹ 75.89 in 2009-10.

6.54 The monthly average exchange rate of the rupee has generally been range-bound, moving in the range of ₹ 44-47 per US dollar between April-December 2010. The exchange rate of the rupee (monthly average of buying and selling by the Foreign Exchange Dealer Association of India [FEDAI], depreciated by 1.5 per cent against US dollar from ₹ 44.50 per US dollar in April 2010 to ₹ 45.16 per US dollar in December 2010. Similarly, the rupee depreciated by 3.2 per cent against the pound sterling, and 12.2 per cent against the Japanese yen during the same period.

6.55 The month-wise exchange rate of the rupee against major international currencies and the RBI's sale/purchase of foreign currency in the foreign exchange market during 2010-11 are indicated in Table 6.7.

6.56 Appendix 6.5 presents the exchange rate of the rupee vis-à-vis select international currencies year-wise since 1980-81, and month-wise during 2010-11.

Table 6.8 : Movement of Rupee and NEER and REER Indices during 2010-11

Month/year	Rupee per US Dollar	Appreciation (+)/ depreciation (-) in Rupee per US Dollar over previous month	NEER*	REER*	Appreciation (+)/ depreciation (-) in NEER over previous month	Appreciation (+)/ depreciation (-) in REER over previous month
1	2	3	4	5	6	7
March 2008	40.36		70.94	110.98		
March 2009	51.23	-21.2	60.45	95.44	- 14.8	- 14.0
March 2010	45.50	12.6	66.59	114.49	10.2	20.0
2010-11						
April 2010 (P)	44.50	2.2	68.40	118.92	2.7	3.9
May 2010 (P)	45.81	- 2.9	68.07	120.00	- 0.5	0.9
June 2010 (P)	46.57	- 1.6	67.55	118.78	- 0.8	- 1.0
July 2010 (P)	46.84	- 0.6	65.70	116.18	- 2.7	- 2.2
August 2010 (P)	46.57	0.6	65.66	116.53	- 0.1	0.3
September 2010 (P)	46.06	1.1	66.00	117.54	0.5	-0.9
October 2010 (P)	44.41	3.7	66.68	118.25	1.0	0.6
November 2010 (P)	45.02	- 1.4	66.10	117.48	- 0.9	- 0.7
December 2010 (P)	45.16	- 0.3	66.80	118.71	1.1	1.0

Source: RBI.

* Six-currency Trade-based Weights, Base: 1993-94 (April-March) =100, P: Provisional.

NEER and REER

6.57 The nominal effective exchange rate (NEER) and real effective exchange rate (REER) indices are used as indicators of external competitiveness of the country over a period of time. NEER is the weighted average of bilateral nominal exchange rates of the home currency in terms of foreign currencies, while REER is defined as a weighted average of nominal exchange rates adjusted for home and foreign country relative price differentials. REER captures movements in cross-currency exchange rates as well as inflation differentials between India and its major trading partners. The RBI has been constructing six currency (US dollar, euro, pound sterling, Japanese yen, Chinese renminbi and Hong Kong dollar) and 36 currency indices of NEER and REER.

6.58 On a point-to-point basis, the six-currency trade-based REER (base: 1993-94=100) appreciated by 20.0 per cent between March 2009 and March 2010. In the current fiscal it appreciated by 3.7 per cent between March 2010 and December 2010. This indicates loss of competitiveness against major trading partners, when inflation differentials are taken into account. However, a significant share of India's foreign trade is invoiced and settled in US dollar. REER is less effective indicator of rupee competitiveness to that extent.

6.59 The six-currency trade-based NEER (base: 1993-94=100) appreciated by 10.2 per cent between March 2009 and March 2010 and by 0.3 per cent between March 2010 and December 2010. As compared to this, the monthly average exchange rate of the rupee against the US dollar appreciated by 12.6 per cent between March 2009 and March 2010 and in the current fiscal by 0.8 per cent between March 2010 and December 2010 (Table 6.8 and Appendix 6.6).

US dollar exchange rate in international market

6.60 During 2009-10 (March 2009 – March 2010), the US dollar depreciated against major currencies. It fell by 4.9 per cent against the pound sterling, 1.7 per cent against the euro, 7.4 per cent against the Japanese yen and 23.9 per cent against the Australian dollar. The dollar however, gained some strength against major currencies, especially in

Table 6.9 : Exchange Rate of US dollar against International Currencies

Month/Year	GBP/USD	Euro/USD	USD/JPY	AUD/USD
1	2	3	4	5
March 2009	1.4340	1.3308	98.100	0.6921
March 2010	1.5082	1.3543	90.885	0.9095
US$ Appreciation (+) / Depreciation (-) (end-March 2009 – end-March 2010)	(-) 4.9	(-) 1.7	(-) 7.4	(-) 23.9
2010-11				
April 2010	1.5324	1.3404	93.20	0.9263
May 2010	1.4757	1.2693	91.51	0.8672
June 2010	1.4738	1.2183	90.60	0.8671
July 2010	1.5298	1.2650	87.56	0.8694
August 2010	1.5732	1.2960	85.25	0.8998
September 2010	1.5718	1.3642	83.48	0.9669
October 2010	1.6026	1.3921	80.49	0.9805
November 2010	1.5558	1.2986	83.66	0.9590
December 2010	1.5602	1.3381	81.19	1.0235
US$ Appreciation (+) / Depreciation (-) (end-March 2010 – end-December 2010)	(-) 3.3	1.2	(-) 10.7	(-) 11.1

Source: RBI.

December 2009, on the back of a pickup in economic activity and market conditions turning more conducive to economic growth in the USA. However, between end-March 2010 and end-December 2010, the US dollar depreciated by 3.3 per cent against the pound sterling, 10.7 per cent against the Japanese yen, and 11.1 per cent against the Australian dollar, while appreciating by 1.2 per cent against the euro. The appreciation against the euro could be attributed to the sovereign debt problems in some of the member countries of euro zone (Table 6.9).

External Debt

6.61 India's external debt stock stood at US$ 262.3 billion (₹ 1,184,998 crore) at end-March 2010 recording an increase of US$ 37.8 billion over end-March 2009 level of US$ 224.5 billion (₹ 1,143,951 crore). Of the total increase, long-term debt accounted for 28.7 billion, while short-term debt was higher by US$ 9.1 billion. Appendices 8.4(A) and 8.4(B) present the disaggregated data on India's external debt outstanding for the period from March 1991 to September 2010 in Indian rupee and US dollar terms, respectively.

6.62 At end-September 2010, total external debt increased by US$ 33.5 billion (12.8 per cent) to US$ 295.8 billion (₹ 1,332,195 crore) over end-March 2010. The increase in India's external debt was mainly on account of higher commercial borrowings and short-term debt. Taken together, these two components contributed over 70 per cent of total increase in India's external debt. The valuation effect arising from depreciation of the US dollar against major international currencies contributed to an increase of US$ 6.3 billion to the total increase. Excluding the valuation effect, the increase in external debt would have been US$ 27.2 billion.

6.63 The maturity profile of India's external debt indicates the dominance of long-term borrowings. At the end of September 2010, the short-term debt at US$ 66.0 billion accounted for 22.3 per cent of total external debt, while the remaining 77.7 per cent was long-term debt (Table 6.10).

6.64 The long-term components, such as commercial borrowings, NRI deposits and multilateral borrowings constitute a significant share of external debt. Taken together, these components accounted for 60.5 per cent of total external debt at the end of September 2010, while the remaining 17.2 per cent was accounted by other components (i.e., bilateral borrowings, export credit, IMF and rupee debt). The share of commercial borrowings continued to be the highest at 27.8 per cent in total external debt followed by NRI deposits (16.9 per cent) and multilateral debt (15.8 per cent) (Table 6.11).

Table 6.10 : India's External Debt Stock

At end-March	In US$ million			In ₹ crore		
	Long-term	Short-term	Total	Long-term	Short-term	Total
1	2	3	4	5	6	7
2005	116,279	17,723	**134,002**	508,777	77,528	**586,305**
2006	119,575	19,539	**139,114**	533,367	87,155	**620,522**
2007	144,230	28,130	**172,360**	628,771	122,631	**751,402**
2008	178,669	45,738	**224,407**	714,409	182,881	**897,290**
2009 PR	181,185	43,362	**224,547**	923,044	220,907	**1,143,951**
2010 PR	209,873	52,471	**262,344**	948,168	236,830	**1,184,998**
2010 (end-June) PR	215,069	57,841	**272,910**	1,001,809	269,483	**1,271,292**
2010 (end-Sept.) QE	229,837	66,010	**295,847**	1,035,647	296,548	**1,332,195**

Source: Ministry of Finance and RBI.
PR: Partially Revised; QE: Quick Estimates.

Table 6.11 : Composition of External Debt (Per cent to total external debt)

Sl. No.	Component	March 2009 PR	March 2010 PR	June 2010 PR	September 2010 QE
1	2	3	4	5	6
1	Multilateral	17.6	16.3	16.4	15.8
2	Bilateral	9.2	8.6	8.4	8.3
3	IMF	0.5	2.3	2.2	2.1
4	Export credit	6.4	6.4	6.4	6.2
5	Commercial Borrowings	27.8	27.4	27.3	27.8
6	NRI Deposits	18.5	18.3	17.6	16.9
7	Rupee Debt	0.7	0.6	0.6	0.6
8	Long-term debt (1 to 7)	80.7	80.0	78.8	77.7
9	Short-term debt	19.3	20.0	21.2	22.3
10	Total External Debt (8+9)	100.0	100.0	100.0	100.0

Source: Ministry of Finance and RBI.
PR: Partially Revised; QE: Quick Estimates.

6.65 The currency composition of India's total external debt shows that US dollar denominated debt accounted for 53.9 per cent of total external debt at end-September 2010, followed by the Indian Rupee (18.8 per cent), Japanese Yen (11.8 per cent), SDR (9.8 per cent) and Euro (3.6 per cent). The currency composition of Government debt indicates pre-dominance of SDR denominated debt (39.9 per cent), which is attributable to borrowing from International Development Association (IDA) i.e., the soft loan window of the World Bank under the multilateral agencies and SDR allocations by the International Monetary Fund (IMF). The share of US dollar denominated debt was 28.1 per cent at the end of September 2010 followed by Japanese yen denominated (19.4 per cent) (Table 6.12).

6.66 The composition of India's external debt has undergone change over the years with shares of both multilateral and bilateral components showing a declining trend in long-term debt. There is increasing share of private players in India's total external debt. Government (sovereign) external debt

Table 6.12 : Currency Composition of India's External Debt and Sovereign External Debt

Sl. No.	Currency	Total external debt March 2009PR	March 2010PR	June 2010PR	Sept. 2010QE	Sovereign external debt March 2009PR	March 2010PR	June 2010PR	Sept. 2010QE
1	2	3	4	5	6	7	8	9	10
1	US Dollar	54.1	53.4	54.9	53.9	29.6	26.5	28.8	28.1
2	SDR	9.8	10.7	10.1	9.8	39.5	41.7	39.8	39.9
3	Indian Rupees	15.4	18.6	18.1	18.8	5.7	8.9	8.9	8.6
4	Japanese Yen	14.3	11.4	11.5	11.8	19.9	18.6	18.7	19.4
5	Euro	4.1	3.6	3.3	3.6	5.2	4.3	3.8	4.0
6	Pound Sterling	2.0	1.8	1.7	1.7	0.1	0.0	0.0	0.0
7	Others	0.3	0.5	0.4	0.4	0.0	0.0	0.0	0.0
	Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source : Ministry of Finance and RBI.

PR : Partially Revised. QE : Quick Estimates

stood at US$ 72.3 billion, while non-Government debt amounted to US$ 223.6 billion at end-September 2010. The share of Government debt in total external debt declined from 25.6 per cent at end-March 2010 to 24.4 per cent at end-September 2010. The ratio of Government external debt to GDP has remained around 5.0 per cent in the last four years.

6.67 Sovereign external debt is a small proportion of the overall public debt of the Government of India. The bulk of sovereign debt is from domestic sources. In the domestic debt category also, a significant share of dated securities is owned by commercial and co-operative banks and insurance companies. Given the composition of public debt and the fact that a sizeable share of banking and insurance is in the public sector, the refinancing risk that has been at the root of the euro zone crisis, is at best minimal (Box 6.2).

Box 6.2 : India's Sovereign Debt: Specific Attributes

There have been concerns about the level of public debt, with consolidated debt (Centre and State) at 78.8 per cent of GDP as at end March 2010 (13th Finance Commission). For determining the vulnerability level of public debt, it is important however to look at the composition, refinancing requirements and the investor base. Following issues highlight the specific attributes of Central Government public debt, which place it in a *distinct* class, making it less vulnerable to market risks, as experienced in many advanced countries:

a) The share of sovereign external debt in total public debt was 10.8 per cent at end-September 2010. The bulk of the debt was from multilateral and bilateral creditors with FIIs investment in Government securities accounting for less than 1 per cent of total public debt. As India does not access international capital markets as a sovereign entity, the refinancing risk due to foreign commercial investors, which significantly contributed to the euro area sovereign debt crisis, is therefore largely absent;

b) Domestic debt accounts for 89.2 per cent of the total Central Government sovereign debt. Out of this, 11.5 per cent is in *non-marketable* categories like securities issued to the National Small Savings Fund. The remaining 77.7 per cent is marketable securities with 73.4 per cent in dated securities (long term) and 4.3 per cent in Treasury Bills (short term);

c) In the dated securities category, banks (including co-operative banks) accounted for 51.9 per cent and insurance companies (mainly Life Insurance Corporation) 22 per cent of the total debt. Given the Statutory Liquidity Ratio (SLR) requirement for banks and the fact that a significant share of banking and insurance sector remains in the public sector, the refinancing risk, is at best minimal;

d) The average maturity of Central Government securities is nearly 10 years, making it less vulnerable to refinancing risk.

Despite the fact that the sovereign debt carries minimal refinancing and speculative risk, concerted efforts are underway to lower the public debt levels to sustainable benchmarks through setting fiscal targets and the Medium Term Fiscal Policy Statement that are part of the Annual Budget of the Government of India.

Table 6.13 : India's key External Debt Indicators (per cent)

Year	External Debt (US$ billion)	Total External Debt to GDP	Debt-Service Ratio	Foreign Exchange Reserves to total External debt	Concessional Debt to Total External Debt	Short-term External Debt* to Foreign Exchnage Reserves	Short-term Debt* to total Debt
1	2	3	4	5	6	7	8
1990-91	83.8	28.7	35.3	7.0	45.9	146.5	10.2
1995-96	93.7	26.9	26.2	23.1	44.7	23.2	5.4
2000-01	101.3	22.5	16.6	41.7	35.4	8.6	3.6
2005-06	139.1	16.8	10.1#	109.0	28.4	12.9	14.0
2006-07	172.4	17.5	4.7	115.6	23.0	14.1	16.3
2007-08	224.4	18.0	4.8	138.0	19.7	14.8	20.4
2008-09	224.5	20.5	4.4	112.1	18.7	17.2	19.3
2009-10PR	262.3	18.1	5.5	106.4	16.7	18.8	20.0
End-June 2010 PR	272.9	-	3.9	101.0	15.9	21.0	21.2
End-Sept.2010 QE	295.8	-	3.8	99.0	15.6	22.5	22.3

Source: Ministry of Finance and RBI.

PR: Partially Revised. QE: Quick Estimates.

- : Not worked out for the broken period. * : Short-term debt is based on original maturity.

#: Works out to 6.3 %, with the exclusion of India Millennium Deposits (IMDs) repayments of US$ 7.1 billion and pre-payment of US$ 23.5 million.

Note: Debt-service ratio is the proportion of gross debt service payments to External Current Receipts (net of official transfers).

6.68 The key debt indicators show that India's external debt to GDP ratio was 18.1 per cent (20.5 per cent in 2008-09) and debt service ratio 5.5 per cent during 2009-10 (4.4 per cent in 2008-09). India's foreign exchange reserves provided a cover of 99 per cent to the external debt stock at end-September 2010 (106.4 per cent at end-March 2010). The ratio of short-term external debt to foreign exchange reserves was 22.5 per cent at end-September 2010 as compared to 18.8 per cent at end-March 2010. The ratio of concessional debt to total external debt declined steadily and worked out to 15.6 per cent at end-September 2010 as against 16.7 per cent at end-March 2010. The key external debt indicators are presented in Table 6.13.

6.69 The external debt management policy of the Government of India continues to focus on raising sovereign loans on concessional terms with longer maturities, regulating ECBs through end-use and all-in-cost restrictions, rationalizing interest rates on NRI deposits and monitoring long as well as short-term debt.

International comparison

6.70 A cross country comparison of external debt of twenty most indebted developing countries, based on the data given in the World Bank's "Global Development Finance, 2010", showed that India was the *fifth* most indebted country, after the Russian Federation, China, Turkey, and Brazil, in 2008 in terms of stock of external debt. The ratio of India's external debt stock to gross national income (GNI) as of 2008 at 19.0 per cent was the *fourth* lowest with China having the lowest ratio at 8.7 per cent. The element of concessionality in India's external debt portfolio was *fourth* highest after Pakistan, Indonesia and the Philippines (Table 6.14).

6.71 In terms of the cover of external debt provided by foreign exchange reserves, India's position was *fourth* highest at 111.6 per cent after China, Thailand and Malaysia. A comparison of the share of short-term debt in total external debt across countries reveals that India's position was *tenth* lowest with Pakistan having the lowest ratio.

Table 6.14 : International Comparison of Top Twenty Developing Debtor Countries, 2008

Sl No.	Countries	Total External debt stock (US $ million)	Total debt to Gross National Income (per cent)	Short-term to total external debt (per cent)	Foreign Exchange Reserves to Total Debt (per cent)	Concessional to total external debt (per cent)
1	2	3	4	5	6	7
1	Russian Federation	402,453	25.8	13.6	106.1	0.5
2	China	378,245	8.7	49.5	514.5*	10.8
3	Turkey	277,277	35.3	18.3	26.6	2.7
4	Brazil	255,614	16.2	14.3	75.8	1.4
5	India	230,611	19.0	19.6	111.6	20.5
6	Poland	218,022	42.1	29.8	28.5	0.2
7	Mexico	203,984	19.1	12.0	46.7	0.5
8	Indonesia	150,851	30.4	17.6	34.2	27.9
9	Argentina	128,285	39.9	29.2	36.2	1.6
10	Kazakhstan	107,595	95.0	9.9	18.5	1.1
11	Romania	104,943	54.7	29.7	37.9	1.5
12	Ukraine	92,479	51.7	22.1	34.1	1.6
13	Malaysia	66,182	35.1	34.5	139.3	6.5
14	Philippines	64,856	35.0	10.8	57.8	23.1
15	Thailand	64,798	32.0	37.4	171.3	11.1
16	Chile	64,277	41.3	23.2	35.9	0.3
17	Venezuela	50,229	16.0	33.8	85.7	1.0
18	Pakistan	49,337	28.7	2.8	18.3	60.6
19	Colombia	46,887	20.2	12.1	50.5	2.1
20	Latvia	42,108	127.3	33.5	12.5	0.3

Source: World Bank's Global Development Finance, 2010.

***: Foreign exchange reserves data are sourced from State Administration of Foreign Exchange, Government of China.**

Note: Countries are arranged based on the magnitude of debt presented in column no.3 in the Table.

THE G20

6.72 The Group of Twenty (G20) was established in 1999 to bring together Finance Ministers and Central Bank Governors of systemically important industrialized and developing economies to discuss key issues relating to the global economy and financial stability. By contributing to the strengthening of the international financial architecture and providing opportunities for dialogue on national policies, international co-operation, and international financial institutions, the G-20 helps to support growth, financial stability and development across the globe.

6.73 Since its inception, the G20 has held annual Finance Ministers and Central Bank Governors' meetings and discussed measures to promote financial stability in the world and achieve sustainable economic growth and development.

6.74 In the wake of the global financial and economic crisis in 2008, the G20 was elevated to a Leaders Summit. It was designated as a premier forum for international economic cooperation in 2009, effectively replacing the G8 as a forum for steering the global issues. The move was considered a milestone in reforming global governance, making it more inclusive since this forum comprises both emerging as well as industrialized economies (Box 6.3).

6.75 Several landmark reforms of international financial institutions were initiated at the behest of

Box 6.3 : G 20: Basic facts

- The G20 comprises 19 countries - namely - Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, the Republic of Korea, Turkey, the United Kingdom, the United States of America and the European Union which is represented by the rotating Council presidency and the European Central Bank as the 20th member.
- It represents 90 per cent of the global gross national product, 80 per cent of the world's trade and two-third of the world's population.
- Five Summits at the level of G20 leaders or Head of State have been held since breakout of the global economic crisis in 2008.

Sl. No.	Summit's Venue	Month/ Year
1	Washington DC, USA	15 November, 2008
2	London, UK	2 April, 2009
3	Pittsburgh, USA	24-25 September, 2009
4	Toronto, Canada	26-27 June, 2010
5	Seoul, South Korea	11-12 November, 2010

- The next G 20 Summit will be held in Cannes, France on 3-4 November, 2011.

Box 6.4 : India and G 20

India is a member of the G20 since it was established as Finance Ministers Forum in 1999. India is the only G20 member country from South Asia and one of the important emerging market member countries in the G20.

Some important landmarks in India's involvement in the G20 are:

- G20 chair in 2002 and hosted G20 Finance Ministers and Central Bank Governors meeting in that year.
- Co-chaired (represented by Deputy Governor, RBI) the G20 Working Group on Enhancing Sound Regulation and Strengthening Transparency (after the November 2008 Washington Summit).
- Currently co-chair of the Working Group on G20 Framework for Strong, Sustainable and Balanced Growth along with Canada.
- India is contributing to various thematic issues being deliberated in G20 such as:
  - ✓ Financial sector regulatory reforms
  - ✓ Climate change
  - ✓ IFIs reform
  - ✓ Growth and Fiscal Consolidation
  - ✓ Enhancing shareholding in forums such as FSB, IASB
  - ✓ Issues pertaining to Non-Cooperative Jurisdiction (Global Forum, FATF etc.)

the G20 which heightened the expectation for bringing about fundamental changes in the functioning of the global institutions and in the global governance structure. India as a member of the G20 has been actively engaged in global economic governance and in shaping the world order (Box 6.4).

Main Issues/Outcomes of G20 Summits

6.76 The most concerted response to the global economic crisis came from the platform of the G20 countries. G20 Leaders Summits have set the agenda rolling for both short and medium-term actions to meet the crisis.

6.77 The first G20 Summit was held in November 2008 in Washington DC under the shadow of the greatest financial crisis in the post-war era. Its significant achievements were in the form of high level commitments to: reform international financial regulation; to expand the Financial Stability Forum and other major standard setting bodies; and to give greater voice and representation to emerging and developing countries in International Financial Institutions.

6.78 Four months later, G20 Leaders met again in London in April 2009, wherein they pledged to do whatever was necessary to restore confidence, growth and jobs, promote global trade and investment and reject protectionism. They also agreed to undertake unprecedented and concerted fiscal expansion and monetary easing, and reached an agreement to provide over a trillion US dollar of additional resources to the global economy through the International Financial Institutions, of which 750 billion US dollar was for the IMF.

6.79 The Third G20 Leaders' Summit was held in Pittsburgh, USA, on 24-25 September, 2009. The major outcomes related to (a) timelines for voice and quota reforms in the World Bank and the IMF, (b) timelines for regulatory reform in the Financial Sector (c) launching of a Framework for Strong Sustainable and Balanced Growth, (d) resolve to phase out and rationalize inefficient fossil fuel subsidies, while protecting the interests of the poorest, and (e) designating the G20 as the premier multilateral forum for cooperation on economic issues.

6.80 The fourth G 20 Leaders' Summit was held at Toronto, Canada, on 26-27 June, 2010. Building on G20 achievements in addressing the global economic crisis, leaders agreed on the next steps that the G20 countries should take to ensure a full return to growth with quality jobs, carry out growth friendly fiscal consolidation, reform and strengthen financial systems, and create strong, sustainable and balanced global growth. Advanced economies committed to fiscal plans that will, at least halve deficits by 2013 and stabilize or reduce government debt-to-GDP ratios by 2016. In addition, there was agreement on (i) strengthening social safety nets, enhancing corporate governance reform, financial market development, infrastructure spending, and greater exchange rate flexibility in some emerging markets; (ii) pursuing structural reforms across the entire G-20 membership to increase and sustain growth prospects; and (iii) making more progress on rebalancing global demand. The leaders also agreed to renew for three years (until end 2013) the G20 commitment to refrain from raising barriers or imposing new restrictions on trade in goods and services, imposing new export curbs or implementing WTO inconsistent measures to stimulate exports. Besides, the leaders agreed to support bringing the Doha Development Round to a balanced and ambitious conclusion as soon as possible.

6.81 The fifth G 20 Summit was held in Seoul, South Korea, on 11 and 12 November, 2010. The summit was notable for the increasing economic and political influence of the emerging economies and may well be indicative of the rebalancing of the global economy. The earlier G-20 finance ministers' meeting played an important role in mollifying the concern of a possible currency war by pledging to move towards more market determined exchange rate systems that reflect underlying economic fundamentals and refrain from competitive devaluation of currencies (Box 6.5).

Box 6.5 : Highlights of the Leaders' Declaration of G 20 Summit held in Seoul, South Korea in November, 2010

- **Adoption of the Seoul Action Plan** included country specific actions, to move closer to the shared objectives of stronger, sustainable and balanced growth. The Plan includes commitment to:
  a) Undertake macroeconomic policies, including fiscal consolidation to ensure ongoing recovery and sustainable growth and enhance the stability of financial markets, in particular moving towards more market determined exchange rate systems, and refraining from competitive devaluation of currencies. Advanced economies, including those with reserve currencies, will be vigilant against excess volatility and disorderly movements in exchange rates;
  b) Implement a range of structural reforms that boost and sustain global demand, foster job creation, and increase the potential for growth; and
  c) Enhance the Mutual Assessment Process (MAP) to promote external sustainability. To strengthen multilateral cooperation to promote external sustainability and pursue the full range of policies conducive to reducing excessive imbalances and maintaining current account imbalances at sustainable levels. The leaders have tasked the G 20 Framework Working Group (of which India is a co-chair along with Canada) with technical support of the IMF and other international organizations to develop indicative guidelines composed of a range of indicators that would serve as a mechanism to facilitate timely identification of large imbalances that require preventive and corrective actions to be taken. Indicative Guidelines will then be put up for consideration of the G20 Finance Ministers and Central Bank Governors in their April 2011 Ministerial.
- **Adoption of the Seoul Consensus for Development** based on six principles (*Focus on Economic Growth, Global Development Partnership, Global or Regional Systemic Issues, Private Sector Participation, Complementarity and Outcome Orientation*) and nine pillars (*Infrastructure, HRD, Trade, Private Investment in job creation, Financial Inclusion, Growth with Resilience, Food Security, Governance and Knowledge sharing*), including a multi-year action plan, and setting up of a High Level Panel (HLP) on Infrastructure.
- **Endorsement of the new instruments of the IMF for Global Financial Safety Nets**, and the recent IMF work on improving global capacity to cope with shocks of a systemic nature, including working with regional financing arrangements (RFAs). It also endorsed, amongst others, the use of macro prudential measures as a response to volatile capital flows.
- **Endorsement of the Gyeongju G20 Finance Ministers and Central Bank Governors agreement on IMF reforms** of a 6 per cent shift in quota in favour of under-represented and emerging market and developing countries (EMDCs), and a comprehensive review of quota formula by 2013 to better reflect the economic weights of EMDCs and completion of the next general review of quotas by January 2014.
- **Endorsement of the core elements of the new financial regulatory capital and liquidity framework (Basel III)**, and measures to better regulate the SIFIs on which work will continue. It was also agreed to work further on macro prudential policy frameworks, strengthen regulation and oversight of shadow banking, and regulate commodity derivates markets.
- **Recommit to resist all forms of protectionism**, while recognizing that 2011 was a critical window of opportunity to intensify engagement to conclude the Doha Development Round.
- Adopt the **G20 Anti Corruption Action Plan**.

Challenges

6.82 The continuing sovereign debt risk in peripheral euro-zone countries and fear that it could spread to the financial sector, together with the high fiscal and public debt in several advanced countries, poses a risk to global recovery. In the event of the crisis spreading, it could have fallout for the Indian economy through reversal of capital flows and slowdown in exports.

6.83 Second, the fragile global recovery and the robust domestic growth have led to higher current account deficit in 2009-10 and 2010-11 (April – September), which is a matter of some concern. The problem may be further aggravated by the rising international oil prices.

6.84 Third, the periodic surge in capital flows could lead to problem of absorptive capacity in the economy, fuelling asset price bubbles, currency appreciation and stoking inflation. The challenge is in managing such surge in capital flows.

6.85 Fourth, the FDI inflows that are stable and productive in nature, have declined from US$ 37.7 billion in 2008-09 to US$ 33.1 billion in 2009-10 and US$ 19.0 billion in the current fiscal (up to November 2010). Moreover, the majority of the capital inflow is in the form of FIIs, which are volatile in nature. Steps have to be taken to encourage FDI inflows vis-à-vis other forms of capital.