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COPING WITH GLOBAL MELTDOWN: INDIA'S EXTERNAL SECTOR

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─Abstract ─

In 2008 the world economy landed itself in the midst of the most severe financial recession which originated in the developed countries and spread to the developing countries which were hit hard through capital reversals, rising borrowing costs, collapsing world trade and commodity prices, and subsiding remittances. India's engagement with the global economy became deeper from the 1990s and this made it inevitable to be affected by the global meltdown. This paper attempts to analyze the impact of the global recession on the external sector of the Indian economy. A pre and post recession (2008) analysis is undertaken to see the impact on trade, capital flows, exchange rates and foreign exchange reserves and external debt. The analysis reveals that while India was adversely impacted due to the slowdown in trade, capital flows and outsourcing; the impact has not been as much as in many other Asian economies. The capital flows were soon back, as India seemed like a save haven for funds with reasonable growth and interest rates. The Indian banking and regulatory system has been credited for following prudential norms and India's huge domestic market and fiscal stimulus have got the economy almost back on track with growth rates looking up again.

Key Words: *Crisis, India, External sector, Export, Capital Flows, Reserves*

JEL Codes: E6, E10, E44, G33, G3, F18

1. INTRODUCTION

With the economic reforms of 1991, India reintegrated into the world economy, with higher trade and capital flows, thus making her more vulnerable to global crises. A resilient economy India did not go unscathed by the recent crisis, although its downside was far better contained than in the developed world. The current phase of dramatic GDP growth of above 9% from 2004-07 has basically come from the external environment and as part of this pattern, India has seen an expanded trade and flood of capital inflows. With the global meltdown and lowered levels of economic activity the challenge before India is to regain this momentum at a time when the global economy is likely to be less hospitable. In this context it would be worthwhile to track the changes in the external sector so as to take the right policy measures. This paper attempts to study these changes around the 2008 recession and analyses the coping up process. The time period taken for analysis is 2000/01 to 2009/10. The study is undertaken in the following sections. This introductory section is followed by Section 2 which analyses the impact of recession on the trade and Current Account Balance (CAB). Section 3, looks into the effect of recession on the capital flows and the Capital Account. Section 4 studies the overall impact of recession on the Balance of Payments (BoP) and Foreign Exchange Reserves (FER). Section 5 tracks the changes in the exchange rate of the rupee while Section 6 looks into the external debt situation. The final Section 7 gives the conclusion.

2. RECESSION AND INDIA’S TRADE

2.1 **Merchandise trade**: During 2002-03, India’s exports of merchandise goods crossed the crucial milestone of US $ 50 bn. With this achievement, India has been able to more than double its exports of merchandise goods in a span of 10 years from 1993/94. The Foreign Trade Policies promoted exports through a number of export promotion measures which paid off and there was an enormous growth of exports at an An. average rate of 24-25% during 2002-08. Since 2008, as the main trading partners of India-US, Europe and Japan- are badly hit by the crisis, it has negatively impacted Indian business and resulted in the steep decline in India’s exports. While exports still account for only 22-24% of the Indian GDP-far short of the 45% norm for Developing Asia-their multiplier effect for economic activity is quite large as the import content is not as high as for eg. in China. This left the biggest challenge for Indian exporters. As can be seen from Table 1, while exports experienced a robust An. average growth of 25% from

2002/03 to 2007/08 the export growth showed decline (13.7%) by 2008/09 and became negative (-3.62) in 2009/10. Exports as a ratio of GDP also slightly declined from a peak of 16% in 2008/09 to nearly 14% in 2009/10. Importers on the other hand had to deal with a volatile and depreciating Rupee leading to increasing costs of imports. While imports saw an An. average growth of 32% during 2003/04 to 2007/08, the growth declined to 19% in 2008/09 and -2.6% in 2009/10. The proportion of imports to GDP also declined from a high of 25% in 2008/09 to 22% in 2009/10.

Table 1: India's Trade and Current Account Balance (US$ million)

Year	A. Merch. Exports, f.o.b.	Exp/ GDP	B. Merch. Imports, c.i.f.	Imp/ GDP	I. Trade balance (A-B)	Trade balance as % of GDP	II. Invisible net	Invisibles as %of GDP	III. Current A/c (I+II)	CAB as % of GDP
2000-01	45452	9.9	57912	12.6	-12460	-2.7	9794	2.1	-2666	-0.6
2001-02	44703 (1.65)	9.4	56277 -(2.82)	11.8	-11574	-2.4	14974 (52.89)	3.1	3400	0.7
2002-03	53774 (20.29)	10.6	64464 (14.55)	12.7	-10690	-2.1	17035 (13.76)	3.4	6345	1.2
2003-04	66285 (23.27)	11.0	80003 (24.1)	13.3	-13718	-2.3	27801 (63.2)	4.6	14083	2.3
2004-05	85206 (28.54)	12.1	118908 (48.63)	16.9	-33702	-4.8	31232 (12.34)	4.4	-2470	-0.4
2005-06	105152 (23.41)	13.0	157056 (32.08)	19.4	-51904	-6.4	42002 (34.48)	5.2	-9902	-1.2
2006-07	128888 (22.57)	13.6	190670 (21.4)	20.1	-61782	-6.5	52217 (24.32)	5.5	-9565	-1.0
2007-08	166162 (28.92)	13.5	257629 (35.12)	21.0	-91467	-7.5	75731 (45.03)	6.2	-15737	-1.3
2008-09	189001 (13.75)	15.6	307651 (19.42)	25.4	-118650	-9.8	89923 (18.74)	7.4	-28728	-2.4
2009-10	182163 (-3.62)	13.9	299491 (-2.65)	22.8	-117328	-8.9	78917 (-12.24)	6.0	-38411	-2.9
2010-11* Ap-Sep	110,518		177,457		-66,939		39,058		-27881	-3.5

Note: Figures in brackets are growth rates. * Partially Revised Figures are taken from BoP account and growth rates are calculated, Source: www.rbi.org

Fortunately for India, as its production and export structure is different from most of its Asian counterparts this reflected in a much smaller proportionate decline in its GDP in 2008. This appears to be because of its smaller export dependence on manufacturing as compared to knowledge intensive services in recent years. The invisible trade has expanded phenomenally and is dealt in the next subsection. After witnessing a turnaround in Oct 2009, India’s export growth has been better than the global recovery, reflecting the diversification of the export basket as well as the export destinations. Imports have also registered strong growth since then and are primarily been led by oil, pearls and semi precious stones. The trade deficit to GDP which was 2.3% during 2000-05 has seen a widening to above 6% since 2005/06 and peaked to nearly 10% in 2008/09. Since then it slightly declined to 9% in 2009/10. Though the growth of exports has outpaced the imports during 2010, the trade deficit has widened in absolute terms.

2.2 Invisible Services: With services contribution to Indian GDP rising to nearly 55%, the increase in exports is predominantly services driven and is attributed to an increase in world demand for services. The growth in export of IT & ITeS, Banking, Insurance & other financial services have seen a phenomenal increase. Amongst all the services, India's main focus is on trade in commercial services and its principal export market is the US. As US recorded a decline in the growth of imports of commercial services, India had to bear the brunt. In absolute terms we see a decline in service exports not in 2008/09 but a year later as a lag is expected, given that contracts in software/BPO services are typically signed for 2-3 years. This sharp slowdown in global trade in services, in areas of India's interest, is a major jolt to the services export sector. The two major items of invisible receipts for India have been software exports and private transfers. Table-2 shows that software exports, which have been growing at an average An. rate of 34% during 2002-07, reduced to 11% in 2009/10. About 30% of the IT industry revenues are estimated to be from financial services which are badly hit and are likely to see lower growth rates in the next 2 years. But, the BPO market, is set to grow at CAGR of 33% to touch revenues of US$7bn by 2013, and evolve into third-party 'transformational out-sourcing' relationships from the existing captive dominated market structure. (IDC India, 2009)

Transfers: Remittances to India have increased by more than a third from its US$38 bn in 2001/02. In the crisis year 2008 India had bettered its position as the leading recipient of remittances, with a record inflow of US$52bn (Table 2). Clearly, remittances were delivering a flow of FE that could serve as a shock absorber in times of crisis when FII were holding back or moving out, exports were slowing and domestic income growth was sluggish. Remittances have been increasing at an An. average rate of about 27% during 2005-08. There had been a slump in the growth of remittances to about 7% in 2008/09 and a revival in growth to 17% in 2009/10. The significance of these flows should not be underestimated. In 2007, remittances to India amounted to 3.3% of GDP. In 2007/08, when the effects of the crisis were yet to be felt, net private transfers brought in US$42bn, which was higher than the US$40 bn earned through net exports of software and just marginally less than the US$45 bn that came in as Foreign Investment. In 2008/09, net private transfers stood at US$44bn whereas net Foreign Investment had collapsed to just US$3.5bn, largely because of the exit of FIIs. Today, while West Asia remains an important source of private transfers, its share has indeed fallen and that of US (44%), followed by West Asia (24%) and Europe (13%) have gone up. This is a result of the impact that the software services export boom had on the nature of Indian migration to the US and Europe where IT services workers providing onsite services to clients of Indian firms increased substantially. These workers saved and transferred a significant share of their earnings either to support families or retain them as savings at home. Even in the midst of the recession in 2009/10 remittances have gone up to US$52bn because workers who lost their jobs abroad and returned home brought their accumulated savings, and this 'windfall effect' could more than compensate for the fall in the remittance due to overseas job losses. Rupee depreciation over 2008 and growing interest rate differentials were likely to have encouraged larger remittances through rupee denominated NRI accounts. Finally, a major part of the increase in remittances in 2008/09 was the result of the redemption of past savings. Remittances have been and remain an important source of strength for the Indian economy and given the accumulated stock of migrants abroad, this is likely to continue.

Table 2: India's Trade in Invisibles (Net Invisible Earnings) (US $ million)

Item/Year	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010/11 Ap-Sep
Net Invisibles (a+b+c)	14974	17035 (13.76)	27801 (63.2)	31232 (12.34)	42002 (34.5)	52217 (24.32)	75731 (45)	89923 (18.74)	78917 (-12.24)	39058
a) Services	3324	3643 (9.6)	10144 (178.4)	15426 (52.1)	23170 (50.2)	29469 (29.2)	38853 (31.8)	49631 (27.7)	34205 (-31.1)	19,510
i) Travel	123	-29	1435	1417	1215	2439	2091	1469	2517	1,250
ii)Transportation	-1306	-736	879	144	-2012	-94	-1500	-1534	-787	-238
iii) Insurance	8	19	56	148	-54	553	595	289	314	156
iv) G.n.i.e.	235	65	28	-10	-215	-150	-45	-404	-86	-129
v) Miscell.	4264	4324	7746	13727	24236	26721	37712	49812	32245	18,471
of which: Software services	6884	8863 (28.75)	12324 (39)	16900 (37.13)	22262 (31.73)	29033 (30.42)	36942 (27.24)	43486 (17.71)	48236 (10.92)	24,309
Business services				-2151	1559	-1322	219	1010	-6981	-2,118
Finan. services				-320	244	115	84	990	-1000	-262
Comm. services				646	1286	1466	1548	1084	-160	235
b) Transfers	15856	16838	22162	20785	24687	30079	41945	44798	52114	26,057
i) Official	458	451	554	260	194	254	239	232	59	-26
ii) Private	15398	16387 (6.42)	21608 (31.86)	20525 (-5)	24493 (19.33)	29825 (21.77)	41706 (39.84)	44567 (6.86)	52055 (16.8)	26,083
c) Income	-4206	-3446	-4505	-4979	-5855	-7331	-5068	-4507	-7404	-6,509
i) Invest. income	-3844	-3544	-3757	-4095	-5262	-6762	-4433	-4023	-6613	-6,056
ii) Comp.of employ	-362	98	-748	-884	-593	-569	-635	-484	-791	-453

Source: www.rbi.org.in Figures in brackets are growth rates

Income: Under Invisibles, Income includes investment income and compensation of employees. This has never been of great consequence in the BoPs and there is a net outflow under this head. However the gap increased during 2009/10 due to the increased differential in interest rates reflecting the lower interest rates abroad. Net invisibles which saw an average growth of 45% during 2005-08, experienced a decline to 18% in 2008/09 and a negative growth of 12% in 2009/10. Net invisibles to GDP ratio also declined to 6% from 7.4% in the previous year.

2.3 Current Account Balance (CAB): Since 2000, the CAB has been positive only during three years i.e, 2001/02 to 2003/04 mainly due to the growth of earnings from Services exports and transfers. The CAB has been worsening since 2004/05 mainly due to the widening trade balance and subdued net invisibles surplus. Bringing the merchandise and invisibles transactions together, the CAB is estimated to have sharply worsened to US$-38.5 bn or nearly 3% of GDP in 2009/10 from US$-29 bn or 2.4% of GDP in 2008/09 (Table 1).The Q1/Q2 results for 2010/11 suggest a further rise of CAD to 3.5 of GDP due to continued stagnation in net invisibles surplus, partly due to the continuing growth imbalance between India and the rest of the world. This level of CAD is one of highest, the previous being 3.2% (1978) and 3% (1991) of GDP

3. Recession and Capital Inflows

Popular resistance to approaching the IMF has encouraged India to shift its source of external financing away from debt and aid flows, to increased trade and private equity flows. Major economic reform initiated in the 1990s saw the liberalisation of regulations and terms of operation of FDI. As a result, successive governments have sought to better past records in terms of the inflow of such investments. From the world’s perspective the main reason for the international financial sector to make riskier investment decisions was the abundance of liquidity and the drive to seek higher returns. Besides, most of the West and Japan have seen declining returns. As a result, India has seen a flood of capital inflows through various channels–FII in the share market, FDI and External Commercial Borrowings (ECBs). There are also inflows in the BoP under the head ‘Other capital’ which indicate that individuals have been bringing in funds for speculation.

3.1 Foreign Direct Investment: India's outstanding economic growth has created a large domestic market that offers promising opportunities for foreign companies. The country's rising competitiveness in many sectors has made it an attractive export base. Table 3 shows that net FDI growth was negative in 2002-04 following the dotcom crash but picked up and showed a robust growth during 2004-08. Further, there have been a large number of cases of foreign firms acquiring wholly Indian ones and inflows on account of these acquisition by NRIs has been substantial. Gross FDI slowed down during 2008-10 following the recession mainly on account of lower FDI inflows under construction, real estate and business & financial services. A major reason for the decline in FDI is reported to have been the environment sensitive policies pursued, as manifested in the recent episodes in the mining sector, the persistent procedural delays, land acquisition issues and availability of quality infrastructure

Table 3: India's Balance of Payments and Foreign Exchange Reserves (US$ millions)

Item/Year	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	Apl-Sep 2010-11
A. Exports	44703	53774	66285	85206	105152	128888	166162	189,001	182,235	110,518
B. Imports	56277	64464	80003	118908	157056	190670	257629	308,521	300,609	177,457
1.Merchandise(A-B)	-11574	-10690	-13718	-33702	-51904	-61782	-91467	-119,520	-118,374	-66,939
2. Invisibles	14974	17035	27801	31232	42002	52217	75731	91,605	79,991	39,058
A. Current A/c(1+2)	**3400**	**6345**	**14083**	**-2470**	**-9902**	**-9565**	**-15737**	**-27,915**	**-38,383**	**-27,881**
Capital A/c										
1.Forgn invest.(a+b)	6686	4161	13744	13000	15528	14753	43326	5,785	51,167	29,137
a) FDI net	4734	3217	2388	3713	3034	7693	15893	19,816	18,771	5,340
b)Portf investment,net	1952	944	11356	9287	12494	7060	27433	-14,031	32,396	23,797
2.Loans (a+b+c)	-1261	-3850	-4364	12222	7909	24490	40653	8,318	13,259	15,716
a)External Asst.	1117	-3128	-2858	1923	1702	1775	2114	2,441	2,893	2,993
b)Commercial borrow.	-1585	-1692	-2925	5194	2508	16103	22609	-344	2,808	5,974
c) Short term	-793	970	1419	3792	3699	6612	15930	2,785	7,558	6,749
3. Banking Cap.	2864	10425	6033	3874	1373	1913	11759	-3,246	2,084	834
4.Rupee debt Ser	-519	-474	-376	-417	-572	-162	-122	-100	-97	-17
5. Other capital	781	578	1699	656	1232	4209	10969	-3,990	-13,016	-9,009
B.Capital A/c (1 to 5)	**8551**	**10840**	**16736**	**28022**	**25470**	**45203**	**106585**	**6,768**	**53,397**	**36,661**
C. E & O	-194	-200	602	607	-516	968	1316	1,067	-1,573	-1,750
D.Overall Bal. A+B+C	**11757**	**16985**	**31421**	**26159**	**15052**	**36606**	**92164**	**-20,080**	**13,441**	**7,030**
Foreign Exch. Reserves	**54106**	**76100**	**112959**	**141514**	**151622**	**199179**	**309723**	**251985**	**279057**	**303,506**
Import Cover in months	11.5	14.2	16.9	14.3	11.6	12.5	14.4	9.8	11.2	-

Note : 1. Data for 2009-10 are preliminary estimates and data for 2008-09 are partially revised.
Source: Department of Industrial Policy & Promotion Ministry of Com & Industry

3.2 Portfolio Investment: India's booming stock market embodies the confidence of investors in the country's corporate sector. India, in the recent past seems to have received a disproportionately large part of its foreign investment inflows via the FIIs in the equity markets. Portfolio inflows have played a key role in fuelling this boom. Between 2003/04 and 2006/07, the net annual inflow of funds by FIIs averaged US$10bn. Another major source of portfolio inflows has been overseas equity issues of Indian companies via GDRs & ADRs, which amounted to

US$3.8bn in 2006/07, a yoy increase of 48%). FII inflow has significantly contributed to the BoPs from 2003/04 to 2006/07 and was the main reason for the sharp increase in the FER of the country. FIIs now own very large stakes in major Indian firms. The FII induced large build-up poses a potential threat of destabilization of the economy as these flows are very volatile, can fly away as easily as they come and leave the domestic currency depreciated. In the crisis ridden year of 2008-09, FIIs pulled out around $10bn from Indian markets, the highest since foreign investors started buying Indian equities, leading to the depreciation of the Indian currency. The huge outflow was largely driven by the subprime mortgage crisis in the US market, which plunged their financial industry. The market value of the FII portfolio in Indian stocks has dropped about three-fourths, or about $190bn, around end-Oct 2008, to below $60bn. But despite the huge outflow in 2008/09, the FIIs were quick to return and by mid 2010 FIIs had already reinvesting US$ 8.50 bn or 87% of the amount that they had pulled out in 2008/09 (CLSA Asia-Pacific Markets). It may be interpreted as a revival of confidence in the Indian market. However, it is this segment of capital inflows, which represents the most volatile component of capital inflows into India.

3.3 Others: Net borrowings and NRI deposits form the other important items on the capital account. Indian companies have borrowed enormous amounts of money overseas to finance investments and acquisitions at home and abroad. This borrowed money has come to India, boosting capital inflows. The ECBs specifically increased in 2006/07 and 2007/08 and stood at US$16.4bn and US$22.6bn resp., though we see a sharp fall during recession in 2008/09 and 2009/10. In Q1/Q2 of 2010/11, ECB approvals, however, increased on the back of strong domestic demand and interest rate differentials. NRI deposits from Indians settled in other countries have also been a major source of capital inflows, with many NRIs investing large amounts in special bank accounts. While NRIs' emotional connection to their home country is part of the explanation for this, the attractive interest rates offered on such deposits also provide an incentive. In 2010/11 net inflows under ECBs and short term trade credits reflected improved access to global financial markets and the need for financing higher demand for imports. NRI deposits continued to be steady, largely reflecting the interest rate differentials. There are also unexplained inflows under the head ‘Other capital’ which indicate that individuals have been bringing in funds for speculation.

3.4 Capital Account: There was a 111% surge in capital flows to India from US$29bn in 2006/07 to about US$62 bn in 2007-08, which was very different from the experience in Asian emerging markets where private foreign investors in equity were pulling out. Net direct and portfolio equity investment into Asian emerging markets fell from US$123 bn in 2006 to an estimated US$58bn in 2008. This implied that India was serving as a hedge when uncertainties were engulfing markets elsewhere. This increased the possibility that exit could be as strong as the inflow of foreign capital. The financial crisis began to affect India from early 2008 through a withdrawal of capital. Capital Account and BoPs saw a substantial decline in net capital inflows in 2008/09 which stood at US$128bn- a fall from US$234bn in the previous year- an 82% decline. There were large outflows of portfolio investment in 2008/09 as there was equity disinvestment. Moreover, ECBs, short-term trade credit and bank borrowings also saw a sharp decline during this period. Capital flows under FDI and ECBs recorded sharp declines of 66% and 56% resp. from the second half of 2008/09. Only inflows under external assistance and NRI deposits continued to rise during this period. However the Capital Account drastically fell from US$106bn to 7bn- so low that it could not offset the negative CAD. Capital flows saw an increase in 2009/10 and regained full buoyancy in 2010/11 driven by large inflows under FIIs along with steady flows under short-term trade credits and ECBs thus giving a signal of an upswing.

4. Balance of Payments and Foreign Exchange Reserves

4.1 Balance of Payments: BoPs data from the Reserve Bank of India (RBI) confirm that the global financial and economic crisis has already taken a very heavy toll on the Indian economy. While capital account suffered right from the beginning of 2008/09, the current account felt the impact only in the second half of 2008/09. In the first half of 2008/09, exports in fact grew strongly at 35%, imports by 45%, net invisible earnings grew by 51%. Things turned adverse dramatically in the second half of 2008/09 as global crisis took its toll on external trade. Capital account of the BoP deteriorated very sharply during the recession, to the point where it could not offset the negative current account. The data reflected a fall in exports of all commodity groups except engineering goods. While exports collapsed, imports continued to grow, although at a much slower rate. Sharp fall in exports vis-a-vis imports resulted in the trade deficit expanding by a whopping 40% to reach $36 bn. In terms of shares of GDP, these are truly stark numbers: a trade deficit of 12.6 % of GDP and a CAD of 5.1 % of GDP for the third quarter of 2008-09, that is Oct-Dec 2008. So the capital account deficit amounted to 1.3 % of GDP, leading to an overall BoP deficit of 6.2 %, the worst such number in more than forty years. This shows how fragile the previous boom was, based as it was on a domestic credit-fuelled expansion encouraged by large inflows of essentially speculative hot money. The problem is that this is associated with a BoP trajectory that is fundamentally unsustainable. It is only the invisibles account (led by remittances from India workers abroad and software and related exports) that kept the BoPs from appearing even more stark. The above analysis of India’s BoPs has brought out that the global financial crisis severely hit the flow of capital into the country and led to one of the highest current account deficits and one of the lowest capital account surpluses for the country.

4.2 Foreign Exchange Reserves (FERs): In mid 1991 FER were down to only around US$1 bn (following the Gulf war) and the country was close to defaulting on its debt repayments. After a brief period of reduction, India's place as a currently favoured destination for internationally mobile capital was reinforced in the past years. The most rapid post-crisis recovery has been in portfolio capital, which fell during the crisis year but surged back to high levels the subsequent year. As data indicates, there has been a worrisome surge in such hot money inflows, of more than US$70 bn in just a few months. This flow is worrisome because it can lead to an unwanted currency appreciation and because it can just as easily flow out again. Table 3 shows that India’s FER stood at US$303.5 bn as on March 18, 2011. This is lower than the historical high of $315 bn in May 2008. The RBI tried to contain the depreciation of the rupee in the second part of 2008 by selling dollars in the open market, reducing its FER to $245 bn in Nov 2008. With reserves at more than 6 times the amount of short-term external debt and an import cover of more than a year, India is comfortably placed on both fronts. Table 3 gives a picture of the FER from 2001/02 to 2011 March and the total import cover of these reserves in months. The crises year 2008-09 saw a fall in reserves from nearly US $ 310bn in 2007/08 to US$ 250bn in 2008/09 but with the capital flowing back in equity markets the reserves have increased to US$ 279bn in 2009/10 and further touched US$ 303bn. showing the return of boom in capital flows. However as much of these FERs constitute the hot money coming from very volatile non-committed capital flows, they either become part of a passive foreign exchange bag of the central bank or are re-exported overseas. India will definitely have to find better ways to manage its FERs

5. External value of the Rupee:

After being floated in 1993 the rupee depreciated dropping from an average An. rate of Rs 31.37:US$1 in the 1993/94 to Rs 48.4:US$1 in 2002/03. Between

2003/04 and 2005/06, however, the rupee appreciated against the dollar by 3% on an average a year. With liberalization of capital flows and low interest rates in US, dollars became more plentiful than before and the value of the rupee started to rise. In the year 2007 the Indian rupee was among the three ‘emerging market currencies’ that appreciated the most, after the Brazilian and Thai currencies. The trend of steady appreciation began in Sep 2006, has been continuous, and is a dramatic departure from past trends. (Table 4). The recession has indeed resulted in a sharp outflow of capital, especially FIIs. We see a sharp depreciation in the value of the rupee against the US$ from an An. average rate of $43 in 2008 to 48 in 2009. The rupee’s earlier appreciation and then depreciation implies that the weakness of India’s BoP and of the Indian rupee stem from the fact that their earlier “strength” was not earned, but merely the result of a capital surge into the country. A second factor for the sharp depreciation of the rupee could be speculative activity in the foreign exchange market based on expectations that the currency’s decline is inevitable. Overall, while a widening CAD would have a role in explaining the depreciation of the rupee, the sharp fall must largely be due to factors reflected in the capital account. This should not be surprising given the extremely important role that capital flows have come to play in India’s BoPs. Though services exports and remittances have helped India keep its CAD low, the large reserves it has accumulated are mainly due to capital inflows.

6. External Debt

As India followed the policy of increased openness to investment and income inflows since 1991, we see a reduced dependence on external debt and Debt/GDP ratio has remained the same between 17-20% (Table 4). In response to the current slowdown, India has further liberalized her foreign investment rules to attract increased capital flows. Inward remittances of income earned by Indian workers abroad, especially in the Persian Gulf region, have increased in importance as a source of foreign currency earnings and further reduced the dependence on debt flows. At end-Sep 2010, India’s external debt was US$ 295.8 of which short-term debt was for 22%. Component-wise, the share of commercial borrowings stood highest at 27.8% followed by NRI deposits (6.9%) and multilateral debt (15.8%). The share of US dollar denominated debt was the highest in external debt at 54%. The recent increase in India’s external debt was mainly on account of higher commercial borrowings and short-term debt which together contributed over 70% of the total increase. Strong domestic demand along with the rising interest rate differentials led to higher net inflows of commercial borrowings. The rising short-term trade credit to India is in line with the increase in imports associated with strong domestic economic activity.

Table 4: Exchange rate and External Debt of India

(Exch rate of Rupees per unit of foreign currency) (External Debt in US$ million)

Year	**Exch. rate Rs:US$**	Gross Total Debt	Short term Debt	Concess. Debt /Total %	Debt / GDP ratio	Debt Service Ratio (%)	FER/ Total Debt
2000	44.9401	98260	3933	38.8	22.0	17.1	41.1
2001	47.1857	101326	3628	35.4	22.5	16.6	54.7
2002	48.5993	98843	2745	35.9	21.1	13.7	72.5
2003	46.5818	104914	4669	36.8	20.3	16.0	101.2
2004	45.3165	112653	4431	35.8	17.8	16.1	106.4
2005	44.1000	134002	17723	30.7	18.5	5.9	109.8
2006	45.3325	139114	19536	28.4	17.3	10.1	115.6
2007	41.2926	172360	28130	23.0	18.2	4.7	138.0
2008	43.4242	224407	46999	19.7	18.1	4.8	112.1
2009	48.3567	224515	49373	18.7	20.5	4.4	106.4
2010		295800	66000	16.8	19.0	5.5	99.0

Source: www.rbi.org.co (as reported on 25th March 2011)

ECBs, mainly by the Indian corporate sector seeking to benefit from the arbitrage between domestic and international interest rates, are an important reason for the rapidly increasing external debt. The debt service ratio, however, remained at a comfortable level of 5.5%. FER ratio to external debt stock provided a cover of 99% which has reduced from a high of 138% in 2007. The ratio of short-term to total debt stood at 22.3% at end-Sep 2010. The ratio of concessional debt to total external debt declined to 15.6%, reflecting the increasing share of non-Government debt. Given the dominance of debt creating flows and volatile FII flows, any unforeseen adverse global developments may pose risks and this warrants close monitoring of the evolving situation.

7. CONCLUSION

India’s reintegration into the world economy has made it more vulnerable to global crises than it was before. However certain inherent factors have minimized the negative impact of the recent crises. India is still much less export-dependent than many Asian economies and its huge domestic demand has kept is going during the recession. India could sustain the slowdown easily because its production and export structure is much lesser export dependent on manufacturing as compared to knowledge intensive services which experienced a much slower decline comparatively. The two major items of invisible receipts- software exports and private transfers- were the saving graces at the time of huge capital pullout. The capital flows, however, were quick to return and this can be interpreted as a revival of confidence in the Indian market although these flows remain volatile. The crises period saw a fall in FERs but with the capital flowing back the reserves have increased. While a widening Current Account Deficit would have a role in explaining the depreciation of the rupee, the sharp fall must largely be due to factors reflected in the capital account. Finally, the increase in India’s external debt, which was mainly on account of higher commercial borrowings and short-term debt, still remains at comfortable level. Overall India’s gradual reform and prudent financial regulations have saved it the day.

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