04

CHAPTER

EXTERNAL SECTOR: STABILITY AMID PLENTY

India's external sector remained strong amidst ongoing geopolitical headwinds accompanied by sticky inflation. Though merchandise exports moderated owing to lower demand from major trading partners, services exports continued to perform well, cushioning the overall trade deficit from USD 121.6 billion in FY23 to USD 78.1 billion in FY24. Lower prices of imported commodities, including crude oil, also helped.

The moderation in merchandise imports and rising services exports have improved India's current account deficit (CAD). Amongst services exports, software/IT services have driven an increase in overall exports; at the same time, business services exports have also been rising, supported by India emerging as a hub for Global Capability Centres (GCCs).

India is moving up the global value chains (GVCs), with the share of GVC-related trade in gross trade rising to 40.3 per cent in 2022 from 35.1 per cent in 2019. The improvement in GVC participation is also reflected in increased pure backward GVC participation. Aided by government measures on trade facilitation and reduction in logistics cost, India's rank in the World Bank's Logistics Performance Index improved by six places, from 44th in 2018 to 38th in 2023 out of 139 countries.

India witnessed positive net foreign portfolio investment (FPI) inflows in FY24 of USD 44.1 billion, supported by strong economic growth, a stable business environment, and increased investor confidence. Rising FPI inflows kept the Indian Rupee in a manageable range of ₹82 to ₹83.5/USD in FY24. The Rupee emerged as the least volatile currency among its emerging market peers and a few advanced economies in FY24. The shock absorbers of India's external sector - forex reserves, sustainable external debt indicators, and market-determined exchange rate, are in place to cushion the global headwinds.

In the future, the changing composition of India's export basket, enhancement in trade-related infrastructure, enhanced quality consciousness and product safety considerations in the private sector and stable policy environment are expected to play a significant role in driving India's rise as a global supplier of goods and services.

INTRODUCTION

4.1 Since the COVID-19 pandemic, the global economy has been buffeted by several shocks - the Russia-Ukraine conflict, developments in the Middle East and the Red Sea crisis, leading to supply dislocations in several commodities and a considerable rise in inflation in many countries. Moreover, citizens of about 64 countries (plus the European Union), about 49 per cent of the world population, will exercise their franchise in 2024. This adds to the policy uncertainty confronting the global economy, especially in the context of international trade and immigration policies. Foreign investments, which drive international trade and commerce, have slowed down recently due to these uncertainties, higher interest rates in the developed world, and the pursuit of active industrial policies by developed countries. For example, the Inflation Reduction Act of the United States of America not only incentivised investment capital to stay at home but also lured capital from elsewhere.[1]

4.2 As per the United Nations Conference on Trade and Development (UNCTAD)[2], global foreign direct investment (FDI) decreased marginally by 2 per cent to USD 1.3 trillion in 2023 from USD 1.4 trillion in 2022. Global trade, too, has been on a slow path, with the value of world merchandise trade declining by 5 per cent in 2023. External debt as a percentage of GDP of Emerging Market and Developing Economies (EMDEs) increased from 26.2 per cent in 2012 to 29.8 per cent in 2023. After witnessing a deficit in their current account balance in 2022, Advanced Economies (AEs) saw a surplus in 2023. For EMDEs, the current account balance has been in surplus in 2022 and 2023, albeit a moderation from 1.5 per cent of the GDP in 2022 to 0.6 per cent of GDP in 2023.[3]

4.3 Against this backdrop, the chapter deals with India's performance on external sector-related parameters. Section 1 discusses prevailing global trade dynamics and the impact of ongoing geopolitical headwinds on trade. Section 2 focuses on India's international trade sector, presenting some specific case studies on industries that have shown remarkable export performances while also dwelling on the general trends. It also presents the outcomes of some of India's latest Free Trade Agreements (FTAs). The section further presents some analytical understanding of the exposure of our exports to imports from various countries and the need for preparedness in the wake of any external unforeseen supply shocks. Section 3 presents in some detail the trends in capital flows into the country and draws some insights from the trends. Section 4 presents the country's balance of payments (BoP) situation, comparing it with some peer countries. It also presents the position of our foreign exchange reserves (FER) and international investment position (IIP), which buffer the economy from an uncertain external environment turning adverse. Section 5 dwells on India's external debt trends and how it has been deftly managed. Section 6 concludes with the outlook for the external sector while mentioning the key challenges to tackle.

1 'How the US Mopped Up a Third of Global Capital Flows Since Covid', Bloomberg, 16 June 2024 (https://tinyurl.com/39y8kt85 - accessed 22 June 2024)
2 UNCTAD World Investment Report 2024-Investment Facilitation and Digital Government; https://tinyurl.com/3ycsh79c
3 As per the IMF World Economic Outlook Database

CHANGING GLOBAL TRADE DYNAMICS

4.4 Trade is a key pillar of an economy, spurring investment, job creation, economic growth, and raising living standards. Global trade patterns are reconfiguring. In 2023, Mexico became the largest goods trade partner of the US, surpassing China and Canada, with a total trade of USD 798 billion.[4] Vietnam's trade with China and the US has recently seen an increase. US imports from Vietnam more than doubled from USD 46 billion in 2017 to USD 114 billion in 2023. During the same time, Vietnam's imports from China rose from USD 58 billion to USD 111 billion.[5] In another instance, European economies are shifting their energy imports from Russia to Norway and the US. EU's pipeline gas imports from Russia declined from 150.2 billion cubic meters in 2021 to 42.9 billion cubic meters in 2023. During the same time, its pipeline gas imports from the US rose from 18.9 billion cubic meters to 56.2 billion cubic meters.[6] These shifts reflect the emergence of new practices in international trade such as 'decoupling', 'derisking', 'reshoring', 'nearshoring', and 'friend sharing' and the growing narrative of de-globalisation.[7]

4.5 However, there is an argument that while the growth of trade as a percentage of GDP has stalled since the global financial crisis, the slowdown of global trade seems a natural development following its earlier fast growth (Chart IV.2).[8] The de-globalisation trends are highly heterogeneous across countries. While the US and China are gradually decreasing their reliance on global markets, this does not seem true for the rest of the world.[9] Research by the Bank for International Settlement (BIS) shows that despite its policies, the US remains reliant on Chinese inputs. In fact, the rise in trade through Mexico and Vietnam is a result of Chinese firms re-routing their supply through these countries (or by locating themselves in these countries). Further, China's overwhelming dominance in the supply of processed critical minerals and materials for energy transition renders a true decoupling between the two nations neither easy nor likely.

4.6 As can be seen in Chart IV.1, global trade volume contracted by 1.2 per cent in 2023 after recording a 3 per cent expansion in 2022 following the outbreak of the Russia-Ukraine conflict.[10] The value of world merchandise trade fell by 5 per cent in 2023, indicating the effect of lower prices. This decline was offset mainly by a substantial increase in trade in commercial services, which rose by 9 per cent to USD 7.5 billion in 2023. Commercial services trade was lifted by

4 India-Mexico Trade and Commercial Relations, para 3, https://tinyurl.com/5h4v96jp,

5 Source: Vietnam Customs Office and US Census Bureau, https://www.customs.gov.vn/index.jsp?pageId=4964, https://www.census.gov/en.html

6 Source: European Commission based on ENTSO-G and Refinitiv, https://www.consilium.europa.eu/en/infographics/eu-gas-supply/#0

7 As per the World Economic Forum, friend-shoring refers to rerouting supply chains to countries perceived as politically and economically safe or low-risk to avoid disruption to the flow of business. Nearshoring refers to a company relocating business operations to a nearby country, often with a shared border. Reshoring is when a business transfers operations back to its home country.

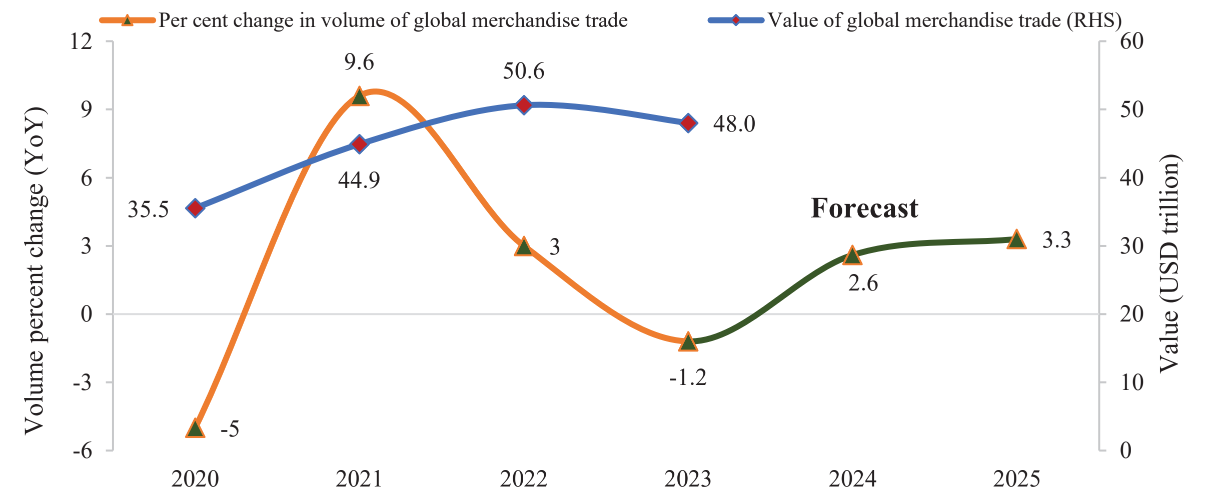
8 Goldberg, P. K., & Reed, T. (2023). Is the Global Economy Deglobalizing? And if so, why? And what is next? (No. w31115). National Bureau of Economic Research, https://www.nber.org/papers/w31115

9 Qiu, H., Shin, H. S., & Zhang, L. S. Y. (2023). Mapping the realignment of global value chains (No. 78). Bank for International Settlements

10 WTO Global Trade Outlook and Statistics (April 2024), https://www.wto.org/english/res_e/booksp_e/trade_outlook24_e.pdf

recovering international travel and increasing digitally delivered services. Global exports of digitally delivered services rose by 9 per cent to USD 4.3 trillion in 2023, accounting for 13.8 per cent of the world exports of goods and services.

Chart IV.1: Growth in global merchandise trade: Actual and forecast



Source: WTO, UNCTAD

4.7 The adverse trade environment in 2023 is expected to ease somewhat this year and next, boosting goods trade in 2024 and 2025.[11] World merchandise trade volume is expected to grow at 2.6 per cent and 3.3 per cent in 2024 and 2025, respectively, as demand for traded goods rebounds. The evidence of a rebound in global trade in 2025 is visible in the latest report released by UNCTAD.[12] As per the report, global trade trends turned positive in the first quarter of 2024, with the value of trade in goods increasing by around 1 per cent quarter-over-quarter and services by about 1.5 per cent. The growth was primarily driven by increased exports from China (9 per cent), India (7 per cent) and the USA (3 per cent). However, geopolitical tensions and policy uncertainty could limit the scope of any trade rebound. While export growth is expected to improve in many economies as external demand for goods picks up, food and energy prices could again spike due to geopolitical events and climate disturbances. Further, restrictive trade practices increasingly adopted by many countries are leading to higher prices because supply chains have become increasingly complex.[13]

4.8 The resilience of global trade is being tested by disruptions on two of the world's leading shipping routes, viz the Panama Canal and the Suez Canal. The Panama Canal handles 6 per cent of global trade and over 70 per cent of traffic destined for or originating from the US. It is presently operating at partial capacity due to freshwater shortages, with restrictions likely to remain in place for some time. Meanwhile, the Suez Canal handles about 12 per cent of global trade and about one-third of container shipping between Asia and Europe.[14] The traffic

11 Ibid, Note 10
12 UNCTAD report, 'Global trade growth resumes in first quarter of 2024', https://tinyurl.com/3hefazed
13 World Bank blog dated 22 February 2024, 'Global trade has nearly flatlined. Populism is taking a toll on growth', https://tinyurl.com/4h6enb43
14 Ibid, Note 10

diversion from the Red Sea and around the Cape of Good Hope has added ten days to Asia-Europe journeys while also increasing fuel costs. Although global shipping costs returned to pre-pandemic levels by the middle of last year, container shipping rates have risen again. Extended detours around the Cape of Good Hope have led to a significant surge in ocean freight rates, reaching up to USD 10,000 per 40-foot container. Moreover, the Suez Canal Authority has declared a 5-15 per cent hike in transit fees for ships passing through the Panama Canal.[15]

4.9 Amidst these prevailing geopolitical dynamics, India is expected to benefit from its strong trade relations across countries, as the analysis in the subsequent sections shows. India has broad and diversified trade relationships with Asia, Europe, and the US. The following section discusses India's trade performance.

INDIA'S TRADE: RESILIENCE AMIDST GLOBAL TURMOIL

4.10 International trade has contributed to India's economic growth. Over time, through concerted reforms and facilitative measures to enhance trade, there has been a significant increase in the share of trade (goods and services) in GDP. The trade openness indicator[16], which rose from 37.5 in FY05 to 45.9 in FY24, has contributed significantly to economic growth as it facilitated an efficient allocation of resources through comparative advantage. The share of trade (excluding petroleum products exports and crude oil imports) in GDP rose from 32.3 per cent in FY05 to 40.8 in FY23. India's trade has been catching up with global levels, as reflected in Chart IV.2 below.

Chart IV.2: Rising trade openness indicator

Source: World Bank database, MoSPI for India
Note: Data for World is as of 2022, and for India is as of 2023

15 GEP Intelligence Drives Innovation blog on 'Red Sea Crisis: How rerouting is impacting shipping costs', https://www.gep.com/blog/mind/red-sea-crisis-how-rerouting-is-impacting-shipping-costs

16 Trade openness indicator is calculated by taking the sum of exports and imports of goods and services as per cent of nominal GDP.

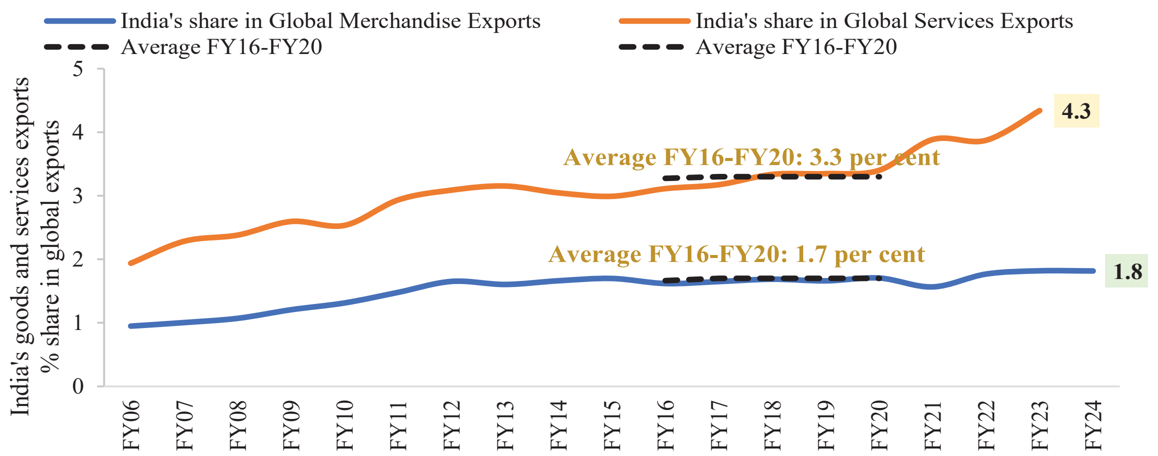
Table IV.1: Key aspects of India's trade (Calendar year-wise)

	2020	2021	2022
Export performance (in per cent)			
Share in World Merchandise Exports	1.6	1.8	1.8
Share in World Commercial Services Exports	4.1	4.0	4.4
Share in World Merchandise Plus Services Exports	2.1	2.2	2.4
Import Performance (in per cent)			
Share in World Merchandise Imports	2.1	2.5	2.8
Share in World Commercial Services Imports	3.3	3.5	4.0
Share in World Merchandise Plus Services Imports	2.3	2.7	3.0
India's rank in world trade			
Merchandise Exports	21.0	18.0	18.0
Merchandise Imports	14.0	10.0	9.0
Services Exports	7.0	8.0	7.0
Services Imports	10.0	10.0	8.0

Source: DGFT, Monthly Bulletin on Foreign Trade Statistics, April 2024

4.11 Chart IV.3 indicates that India is gaining market share in global exports of goods and services. Its share in global goods exports was 1.8 per cent in FY24, against an average of 1.7 per cent during FY16-FY20. Similarly, its share in global services exports rose to 4.3 per cent in FY23 from an average of 3.3 per cent during FY16-FY20.

Chart IV.3: India's rising share in global goods and services exports

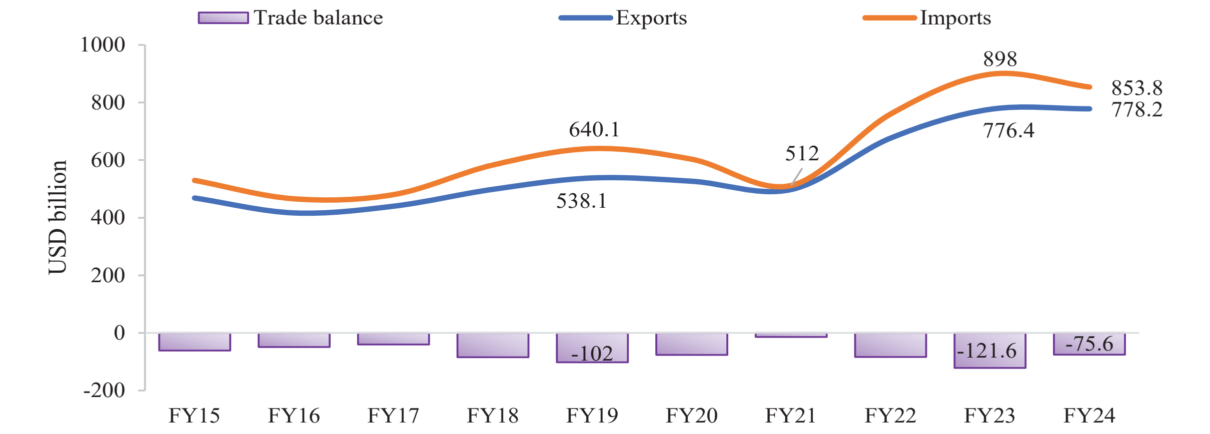


Source: UNCTAD

India's Overall trade

4.12 India's overall exports (merchandise and services) have been growing on a secular basis since FY17 for almost three years. However, FY20 saw an economic slowdown, aggravated by the outbreak of the global pandemic, which halted this trend. FY22 marked a significant turnaround. A similar trend has been observed in overall imports (merchandise and services). The positive momentum extended into FY23, with India's overall exports crossing USD 776 billion. Overall imports also increased to USD 898 billion in FY23 compared to USD 760.1 billion in FY22. Despite persistent global challenges, overall exports in FY24 surpassed the FY23 record, growing by 0.23 per cent, and overall imports in FY24 declined by 4.9 per cent despite robust domestic demand. During the first two months of FY25, overall exports increased to USD 133.6 billion, compared to USD 122.4 billion in the corresponding period of the previous year. During the same time period, overall imports also increased from USD 136.4 billion to USD 149.9 billion, leading to a widening of the overall trade deficit from USD 14 billion to USD 16.3 billion.

Chart IV.4: India's overall trade performance in the last ten years



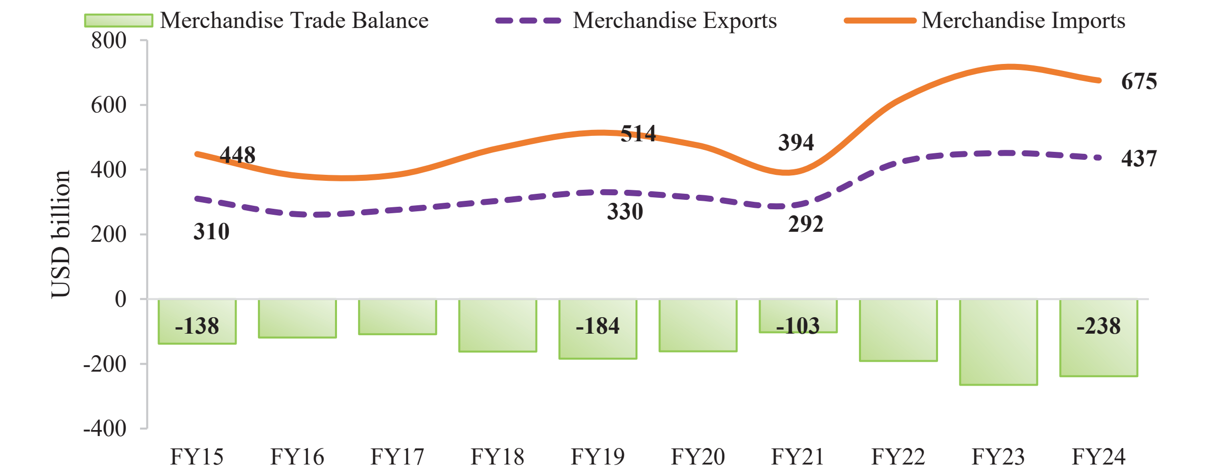
Source: Export Import Data Bank (Annual), Trade Statistics, Ministry of Commerce and Industry, India's International Trade in Services, RBI

Merchandise Trade: Enduring the global headwinds

Merchandise exports

4.13 Affected by ongoing geopolitical tensions, India's merchandise exports witnessed contraction in H2 of FY23 and H1 of FY24. However, there is evidence of a trend reversal in H2 of FY24, with merchandise exports registering positive growth. Box IV.1 discusses the sectors that have shown remarkable export performance in the past few years. With rising exports, imports also witnessed positive growth in H2 of FY24. However, despite registering positive growth in H2 FY24, merchandise exports and imports contracted in FY24 compared to FY23. The decline in merchandise exports was mainly on account of a slowdown in India's major exporting partners (especially the EU, whose real GDP grew barely by 0.6 per cent in 2023, compared to 3.6 per cent growth in 2024), along with the lagged impact of monetary tightening carried out by many countries to control rising inflation. While the volume of imports did not decline in FY24, the overall value of merchandise imports declined due to a fall in global commodity prices. Owing to a larger decline in imports than exports, the merchandise trade deficit narrowed to USD 238.3 billion in FY24 compared to USD 264.9 billion in the previous year. The non-petroleum and non-gems and jewellery merchandise exports have shown resilience with a sustained uptick in the last few months, resulting in exports worth USD 320.2 billion in FY24, 1.5 per cent higher than the previous year. At the same time, non-petroleum, non-gems & jewellery imports (gold, silver & precious metals) saw a contraction of (-)3.5 per cent in FY24.

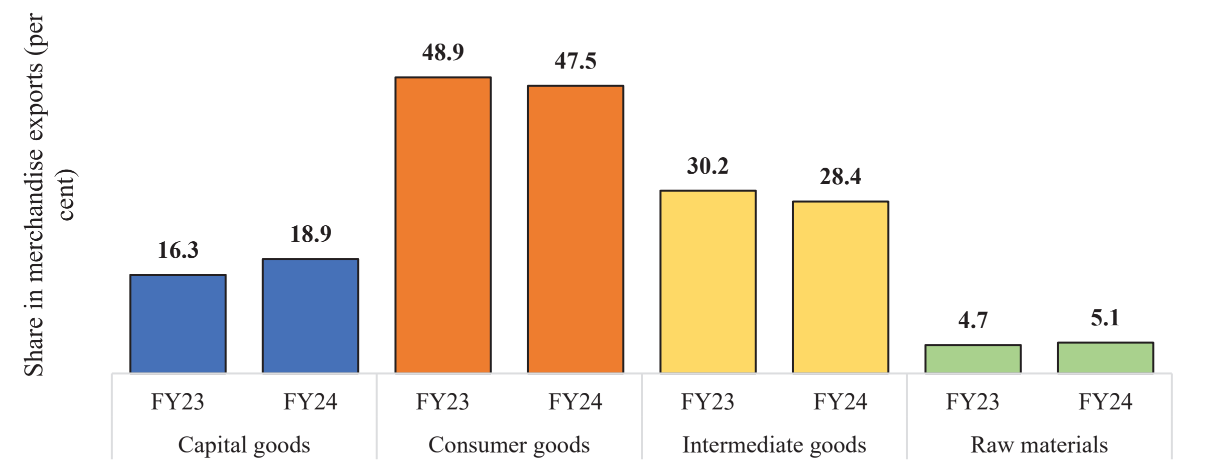
Chart IV.5: India's merchandise trade performance



Source: Export Import Data Bank (Annual), Trade Statistics, Ministry of Commerce and Industry

4.14 A decline in inflationary pressures in advanced economies has led to an increase in global demand for exports in the first two months of FY25. Accordingly, India's merchandise exports rose to USD 73.1 billion during April-May 2024 from USD 69.6 billion in the corresponding period of the previous year.

Chart IV.6: Composition of merchandise exports across various classifications



Source: DGCI&S[17]

17 Classification of commodities at the 6-digit HS level has been taken from 'Standard Product Groups' from World Integrated Trade Solution (WITS) and 'Broad Economic Categories (BEC Revision 5)' from the United Nations Statistics Division (UNSD). Some unclassified commodities have been categorised based on the nature of similar product groups. On aggregate, the classified commodities cover 99.9 per cent of the export basket and 99.8 per cent of the import basket in both FY23 & FY24

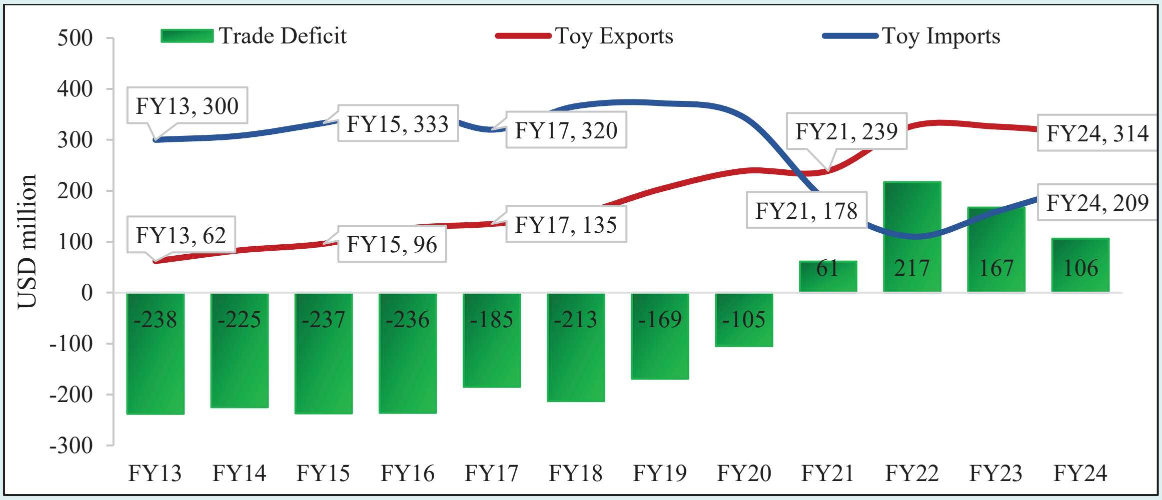
4.15 From FY23 to FY24, there appears to be a shift in the composition of exports across various classifications. Notably, the share of capital goods in merchandise exports rose substantially from 16.3 per cent in FY23 to 18.9 per cent in FY24. This increase suggests India's improved supplies of machinery, equipment, and other durable goods used in production processes, reflecting potential expansions or upgrades in its industrial capacities. Conversely, the share of consumer goods in merchandise exports declined slightly from 48.9 per cent in FY23 to 47.5 per cent in FY24, indicating a marginal dip in the export of finished products intended for direct consumption. The share of intermediate goods also declined from 30.2 per cent to 28.4 per cent.

Box IV.1: Product specific success stories of boosting exports

A series of measures undertaken by the Government have shown a remarkable increase in product-specific exports. Some of the success stories are mentioned below: -

Toy Exports: India's toy industry has long faced challenges in the global trade landscape, consistently being a net importer of toys for many years. However, the industry's exports experienced notable growth in 2023. As per the Directorate General of Commerce Intelligence and Statistics (DGCI&S) data, India's toy exports have shown a rising trend, registering a Compound Annual Growth Rate (CAGR) of 15.9 per cent between FY13 and FY24.[18] Rising exports, coupled with declining imports, transformed India from a deficit to a surplus nation in the trade of toys. For over a decade, India heavily relied on China for around 76 per cent of its toy imports. India's import bill for toys from China dropped from USD 214 million in FY13 to USD 41.6 million in FY24, leading to a decline in China's share in India's toy imports from 94 per cent in FY13 to 64 per cent in FY24,[19] indicating India's competitiveness in the international toy market.

Chart IV.7: Trend in India's exports and imports of toys



Source: Export Import Data Bank (Annual), Trade Statistics, Ministry of Commerce and Industry

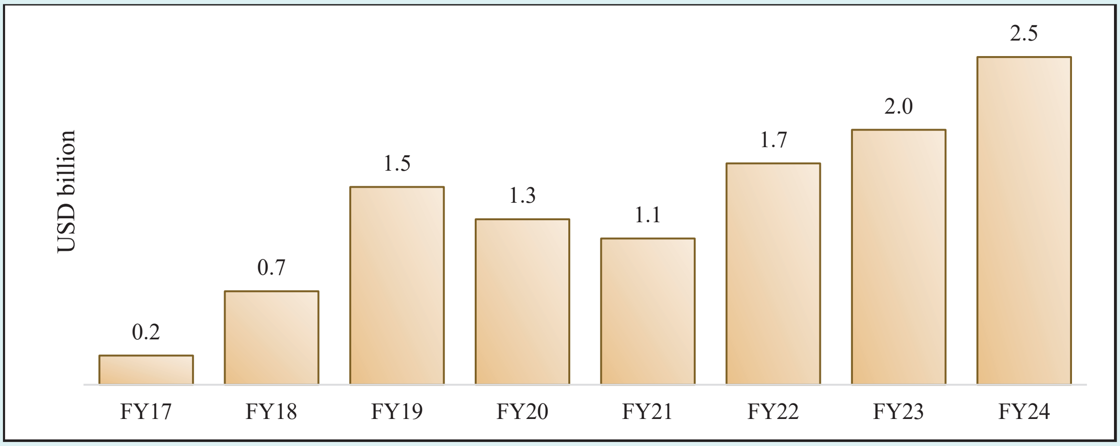
18 Trade data is reported for HS Codes 9503, 9504 and 9505
19 Trade data is reported for HS Code 9503, as it accounts for more than 80 per cent of toys imports from China

Over the period 2014 to 2020, focused efforts by the Government resulted in the number of manufacturing units doubling, dependence on imported inputs reducing from 33 per cent to 12 per cent, the gross sales value growing by a CAGR of 10 per cent, and an overall rise in labour productivity.[20]

The measures taken by the Government for the toy industry include the formulation of a comprehensive National Action Plan for Toys with 21 specific action points, an increase in basic customs duty on toys, sample testing of each import consignment by the Directorate General of Foreign Trade (DGFT) to curb sub-standard imports, issuance of a Quality Control Order for toys, and support through cluster-based approaches. India's emergence as a toy exporting nation can be further attributed to its integration into the global toy value chain and zero-duty market access for domestically manufactured toys in critical countries such as the UAE and Australia.[21]

Defence Exports: India's defence production grew substantially from ₹74,054 crore in FY17 to ₹108,684 crore in FY23, boosting defence exports.[22] Between 2015 and 2019, India held the distinction of being the world's second-largest arms importer. The narrative, however, has changed. India has transitioned from an arms importer and found a place in the list of the top 25 arms exporter nations. The defence industry, including the private sector and Defence Public Sector Undertakings (DPSUs), has made tremendous efforts to achieve the highest-ever defence exports. In addition, there has been a rise in the number of export authorisations issued to the defence exporters. From 1,414 export authorisations in FY23, the number has increased to 1,507 in FY24. About 100 domestic companies are exporting a wide range of defence products and equipment such as aircraft like Dornier-228, artillery guns, Brahmos Missiles, PINAKA rockets and launchers, radars, simulators, and armoured vehicles.

Chart IV.8: Rising defence exports



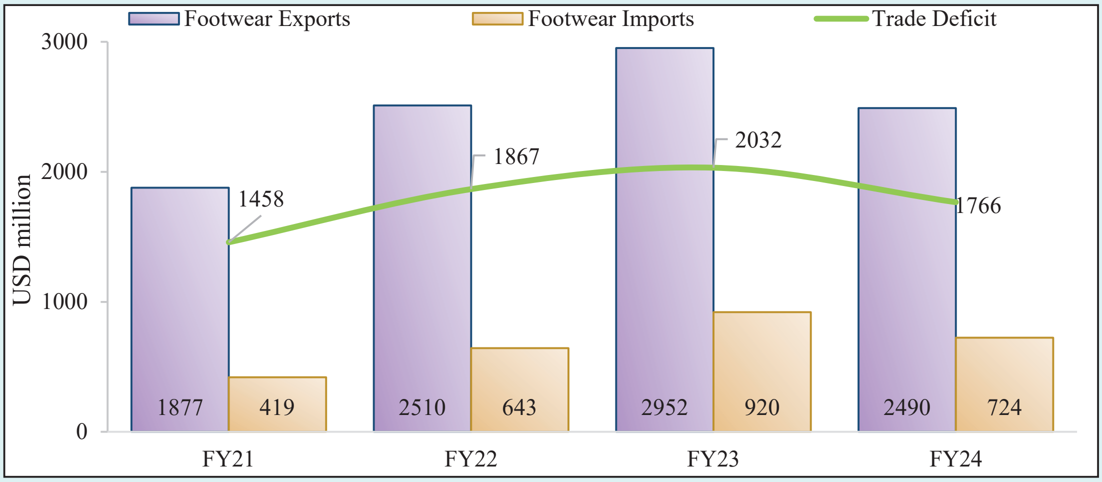
Source: Ministry of Defence

20 PIB release of Department of Commerce dated January 4, 2024, https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1993109
21 Ibid.
22 PIB release of Ministry of Defence dated 24 February 2024, https://pib.gov.in/PressReleasePage.aspx?PRID=2008632

To give a push to defence exports, the Government has taken several policy initiatives over the past ten years. Export procedures have been simplified and made industry-friendly, with end-to-end online export authorisation curtailing delays and facilitating ease of doing business. Further, the Aatmanirbhar Bharat initiatives have helped the country by encouraging indigenous design, development and manufacture of defence equipment, thereby reducing dependency on imports in the long run.

Footwear Exports: The Indian footwear and leather industry is an important foreign exchange earner. India is the second-largest global producer of footwear after China, accounting for 13 per cent of global footwear production and 2.2 per cent of global exports. India is the ninth-largest global footwear exporter.[23] As per DGCIS, India's footwear exports have increased from USD 1.9 billion in FY21 to USD 2.5 billion in FY24.[24]

Chart IV.9: Trend in footwear exports



Source: Export Import Data Bank (Annual), Trade Statistics, Ministry of Commerce and Industry

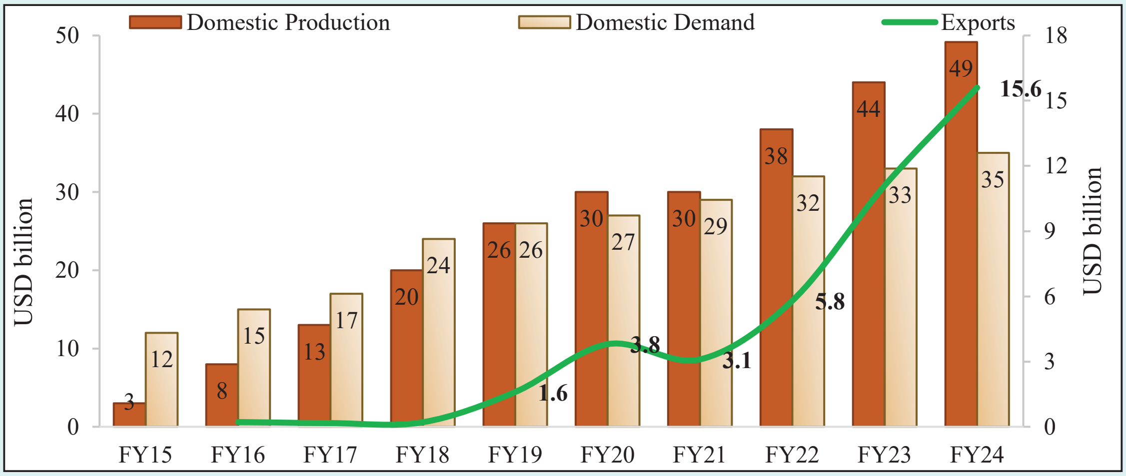
The Government has undertaken various measures to boost footwear exports. These include the issuance of three Quality Control Orders for the footwear and leather sector after consultation with the Bureau of Indian Standards, relaxation in the creation of testing facilities by allowing outsourcing of the majority of the tests which are carried out less frequently, creating awareness amongst footwear manufacturers of footwear across India, among others. The Government has approved the continuation of the 'Indian Footwear and Leather Development Programme' till 31 March 2026. The leather and footwear sector can avail benefits of export promotion schemes under the Foreign Trade Policy 2023 and other benefits provided under the Market Access Initiatives Scheme, Trade Infrastructure for Export Schem, Interest Equalisation Scheme, etc.[25] The Indian footwear market, valued at USD 26 billion, is expected to reach USD 90 billion by 2030. This growth will be driven by increased non-leather footwear demand and a possible shift in leather shoe production

23 A GTRI report, 'India's Footwear Revolution: Marching towards a $90 billion Future', https://tinyurl.com/yvbzadwr.
24 HS Code-6401, 6402, 6403, 6404, 6405 and 6406
25 DPIIT Rajya Sabha Unstarred Question 1818 answered on 4 August 2023, https://tinyurl.com/yumj98fb

from small-scale cottage industries to large corporates.[26] Changing market dynamics, mainly fuelled by evolving shopping habits, rapid urbanisation, greater brand awareness, the development of retail precincts/malls, and rising discretionary budgets, are contributing to this trend.

Smartphone exports: India's domestic production and exports of smartphones have been increasing steadily, with significant changes achieved, especially since the launch of the Production Linked Incentive (PLI) scheme in 2020. FY20 marked the first-time domestic production exceeded domestic demand, and smartphones became one of India's top export categories. Exports now provide the primary stimulus for the growth of the sector. A 42.2 per cent increase in exports in FY24 (on a YoY basis) enabled smartphones to rank among India's top five export items considered at six-digit HS product categories.[27]

Chart IV.10: Rising domestic production, domestic demand and exports of smartphones



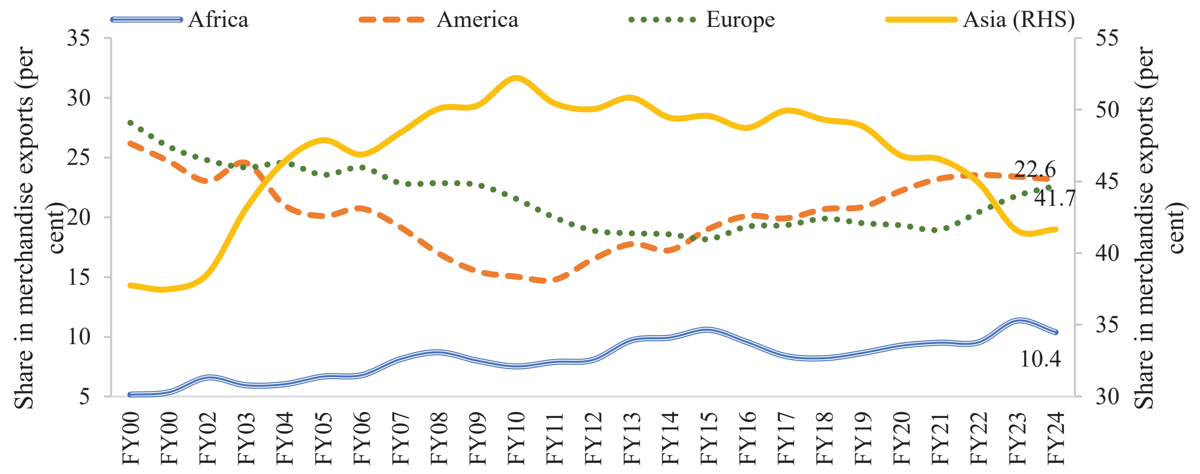
Source: ICEA, Export Import Data Bank (Annual), Trade Statistics, Ministry of Commerce and Industry

India also became the world's sixth-largest smartphone exporter in 2022, from the 23rd-largest smartphone exporter in 2014.[28] This high export growth has led to an increase in the ratio of exports to production, with exports being above 31 per cent of the total output of smartphones in India in FY24.

4.16 India is adding more export destinations, signalling regional diversification of exports. Calculations based on DGCIS data reveal that the share of the top 10 countries in India's merchandise exports has registered a declining trend, falling from a high of 61.9 per cent in FY2000 to 50.5 per cent in FY24. Further, the Regional Herfindahl Index (an estimate of the concentration of exports across countries)[29] for the top 10 countries declined from 0.071 in FY2000 to 0.046 in FY24.

26 Global Trade Research Institute (GTRI) report dated 7 January 2024-India's Footwear Revolution: Marching Towards a USD 90 Billion Future, https://tinyurl.com/bd7rdub5
27 (HS 6 Code-851713)-Smartphones
28 As per the latest data available on ITC Trade Map
29 Regional/Sectoral Herfindahl Index (RHI)=∑Si2, where Si refers to the share of Country/Region 'i' in India's export basket in case of regional diversification

Chart IV.11: India's export destination



Source: Export Import Data Bank (Annual), Trade Statistics, Ministry of Commerce and Industry

4.17 Post-FY2000, Asian, African and Middle Eastern nations, such as the UAE, Singapore, Hong Kong, and China, have emerged as export destinations, replacing traditional export partners like the UK, Germany, Belgium, etc. The combined share of the developing regions viz. Asia and Africa in India's total exports rose from around 42.9 per cent in FY2000 to 52 per cent in FY24. In FY24, UAE, Singapore, China, Russia, and Australia emerged as India's major export partners.

Sectoral trends

4.18 A bifurcation of merchandise exports into POL and non-POL products shows that exports across both categories have declined in FY24. The fall in POL exports can be attributed mainly to a decline in global petroleum product prices. Even though the volume of POL exports increased from 99 million tonnes in FY23 to 108 million tonnes in FY24, the value of exports declined by 13.7 per cent, from USD 97.5 billion to USD 84.2 billion during the same period. However, in the last six years, POL exports increased by 80.8 per cent from USD 46.6 billion in FY19 to USD 84.2 billion in FY24, with the share in global POL exports (HS 2710 to 2713) exports rising from 4.3 per cent in 2018 to 4.8 per cent in 2022.[30]

4.19 Under non-POL products, exports of engineering goods, electronic goods and drugs & pharmaceuticals increased in FY24 on a YoY basis. In contrast, agriculture and allied products, chemicals, plastics and textiles have witnessed a decline in exports. Over the past six years, the composition of exports across these categories has changed. Engineering goods dominated the merchandise exports in FY19, accounting for 25.3 per cent of the total exports. This trend remained the same, with engineering goods exports reaching USD 109.3 billion in FY24, with the share being the same at 25 per cent. Agri and allied products also maintained a steady

30 Based on the ITC Trade Map

share. From USD 36.6 billion in FY19, their exports peaked at USD 52.7 billion in FY23 before slightly declining to USD 48.3 billion in FY24, holding around 11 per cent share in merchandise exports. Chemical and plastic exports experienced notable growth, rising from USD 31 billion in FY19 to USD 37.5 billion in FY24. Despite this increase in value, their share declined from 9.4 per cent in FY19 to 8.6 per cent in FY24. The textile sector witnessed a relative decline in prominence. Along with a decline in their exports from USD 37.5 billion in FY19 to USD 34.8 billion in FY24, their share in total exports also dropped significantly from 11.4 per cent to 8 per cent during the same period. This reduction, apart from reflecting the shifting priorities and emerging sectors within India's export framework, is also likely reflective of underlying challenges in the sector that need addressing.

4.20 India's share in world electronics exports (captured by incorporating HS chapters 84, 85, and 90) has improved from 0.63 per cent in 2018 to 0.88 per cent in 2022[31]. As such, India's rose from 28th in 2018 to 24th in 2022 in global electronics exports. The share of electronics goods in merchandise exports of India rose from 2.7 per cent in FY19 to 6.7 per cent in FY24.

4.21 India maintained a strong foothold in the drugs and pharmaceuticals sector. The share of the sector in India's exports grew from 5.8 per cent in FY19 to 6.4 per cent in FY24, with exports rising from USD 19.1 billion in FY19 to USD 27.9 billion in FY24.

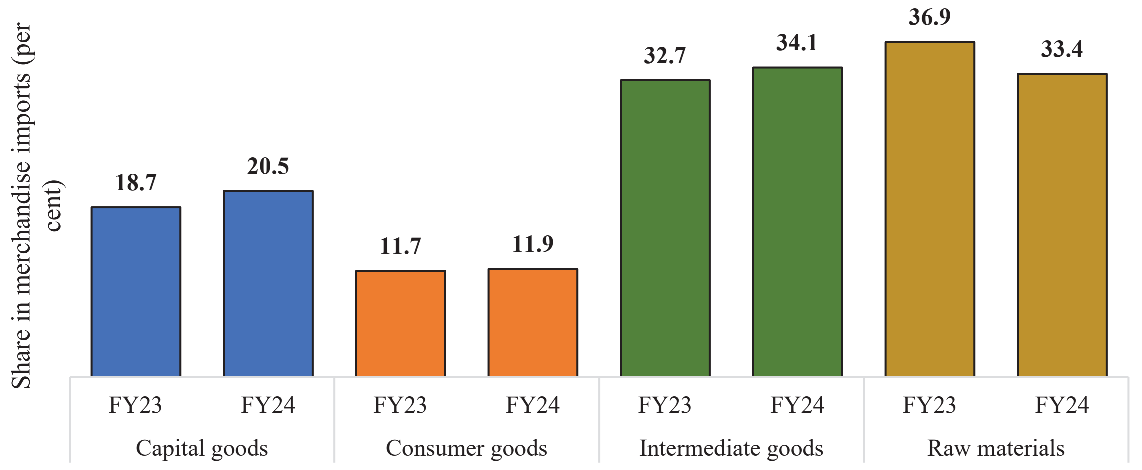
Merchandise imports

4.22 Despite high domestic demand due to the relatively strong growth of India's economy, merchandise imports contracted by 5.7 per cent in FY24, from USD 716 billion in FY23 to USD 675.4 billion in FY24. The moderation in merchandise imports was primarily driven by petroleum, crude and products, fertilisers, pearls, precious and semi-precious stones, organic and inorganic chemicals, and textile yarn fabric, among others. Owing to a rise in domestic demand, merchandise imports rose from USD 106.5 billion during April-May 2023 to USD 116 billion during April-May 2024.

4.23 Several important shifts in the composition of imports between FY23 and FY24 could be seen. Imports of capital goods saw an increase, which is welcome as it indicates a heightened demand for machinery, equipment, and other durable goods used in production processes, suggesting potential investments in industrial infrastructure or technological upgrades. A marginal uptick in the share of consumer goods in merchandise imports reflects a stable but limited increase in the importation of finished products for direct consumption. The share of intermediate goods in merchandise imports also slightly rose in FY24, reflecting a continued need for semi-finished products, components, or materials used in further manufacturing processes.

31 Based on the ITC trade Map

Chart IV.12: Composition of merchandise imports across various classifications



Source: DGCI&S[32]

Services as a shining star in exports

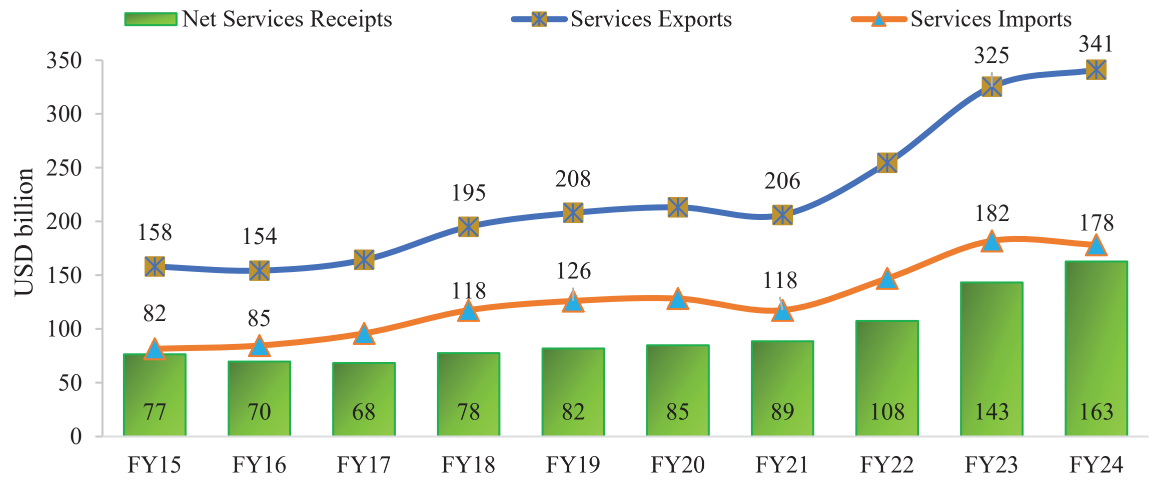
4.24 India's services export in US Dollars terms expanded at a robust CAGR of more than 14 per cent over the last 30 years (between 1993 and 2022), significantly higher than India's merchandise export growth (10.7 per cent) and world services export growth (6.8 per cent). Accordingly, the share of India's services exports in world services exports has risen remarkably from 0.5 per cent in 1993 to 4.3 per cent in 2022. India is now the seventh-largest services exporting country globally, with a phenomenal rise from its 24th position in 2001. India ranks 2nd in the world in telecommunication, computer, and information services exports, 6th in personal, cultural and recreational services exports, 8th in other business services exports, 10th in transport services exports, and 14th in travel services exports. As noted by the RBI, healthy and steady growth in services exports has imparted strength to India's BoP position by offsetting a significant part of the country's merchandise trade deficit.[33]

4.25 India's deep integration into the value chains of the global software industry has led to a change in the composition of its services exports basket. While the early 2000s was a period of business process outsourcing (BPOs) that provided cost-cutting back-end IT services, India now looks beyond such services. Data from the Asian Development Bank (ADB) shows that India went from providing back-end services in law, IT, and management in 2010 to providing upstream and high-value-added services in these fields by 2020.[34] The Russia-Ukraine conflict and global inflation pressured wages encouraged global players to look towards India to set up their back-office operations to balance their cost model. This gave rise to a sudden proliferation of the Global Capability Centres (GCCs). The growth in GCCs is reflected in the services BoP, with 'Other Business Services' being the second-largest contributor in services exports in FY24 (26 per cent), after IT services (48 per cent). The rising contribution of other business services

32 Ibid footnote 17
33 'What drives India's Services Exports?' RBI Bulletin dated 22 April 2024, https://tinyurl.com/4vjerjex
34 Asian Infrastructure Finance 2021, 'Sustaining Global Value Chains', https://tinyurl.com/yfzj6tkm

to overall services exports is shown by their achieving a CAGR of 18 per cent between FY20 and FY24. The share of software exports in overall services exports declined from 50 per cent in FY21 to 48 per cent in FY24.[35] Box IV.2 discusses the growth of GCCs in India in some detail.

Chart IV.13: Remarkable performance of India's services trade in the last ten years



Source: India's International Trade in Services, RBI

Table IV.2: Resilient performance of service trade (Values in USD billion)

Sectors	FY23		FY24	
	Exports	Imports	Exports	Imports
Total services	**325.3**	**182.0**	**341.1**	**178.3**
Manufacturing services on physical inputs owned by others	1.5	0.2	1.4	0.1
Maintenance and repair services n.i.e.	0.2	1.9	0.2	1.5
Transport	36.1	40.6	29.2	29.3
Travel	27.0	28.4	33.7	33.7
Construction	3.8	2.8	4.6	2.8
Insurance and pension services	3.3	2.3	3.3	2.9
Financial services	7.8	5.7	8.1	4.6
Charges for the use of intellectual property n.i.e.	1.3	10.6	1.6	15.0
Telecommunications, computer, and information services	152.3	19.8	163.6	20.9
Other business services	80.4	59.7	88.6	59.3
Personal, cultural, and recreational services	3.9	5.5	4.4	6.3
Government goods and services n.i.e.	0.7	1.0	0.6	1.1
Others n.i.e.	7.1	3.4	1.8	0.8

Source: Statistics, India's Overall Balance of Payments-US Dollars, RBI
Note: P stands for Provisional

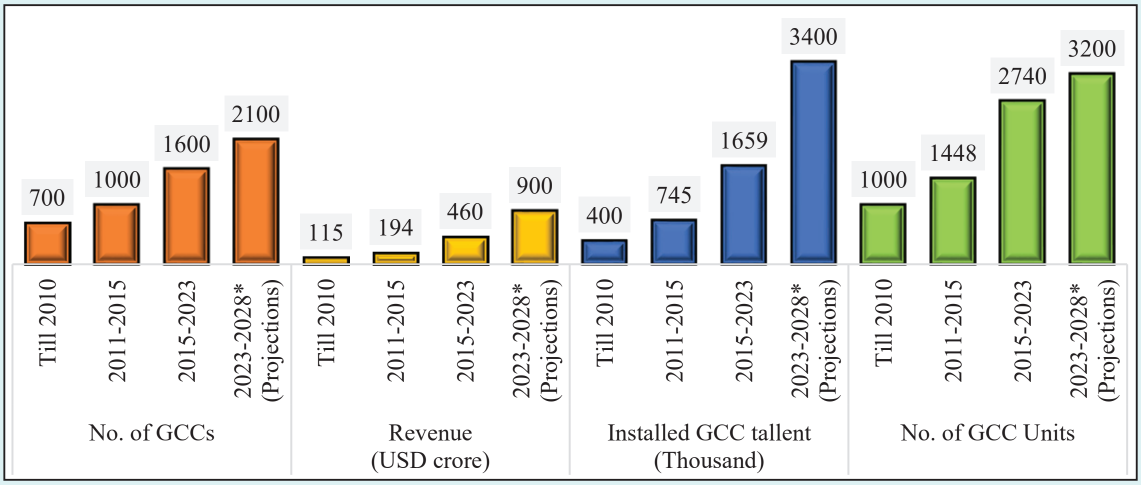
35 Based on RBI's quarterly Balance of Payments (BoP) data

Box IV.2: Journey of Global Capability Centres in India

Origin of GCCs: In the last couple of years, more than 150 multinationals have set up their GCCs in India.[36] Starting with the humble beginning of offshoring by Texas Instruments by setting up its office in Bengaluru in 1985, India has come a long way to being at the epicentre of GCC growth.[37] In the 1990s, other companies followed suit, and many airlines and technology companies started their operations in India. These were called 'captive centres' earlier and have now come to be addressed as GICs (global in-house centres) or GCCs. In 2012, about 760 GCCs were operating out of India. In 2016, that number went over 1000, and as of March 2023, India houses over 1,600 GCCs.

Various agencies have projected that the number of GCCs would grow in the coming years, creating jobs as well. According to a PwC report, by 2028, the country is poised to have 2100 GCCs, with the market size of the centres touching USD 90 billion.[38] As per a study by Wizmatic[39], GCCs presently employ 32 lakh people, primarily engineers and scientists. They generated a combined revenue of USD 46 billion in 2023 and are estimated to generate a total revenue of USD 121 billion by 2030, roughly 3.5 per cent of India's GDP. Out of this, USD 102 billion will represent export earnings.

Chart IV.14: Remarkable growth of GCCs in India



Source: PwC report 'Six imperatives to scale up the global capability centre market in India'

Role of GCCs: GCCs provide bespoke services in operation, product development and innovation. Today, GCCs operate across all IT, BPO, engineering, and software product development service lines, delivering complex work that requires a significant understanding of business context and imperatives. They have made a mark in key industry verticals such as banking and financial services, software, telecom and semiconductors, with a growing concentration in aerospace, automotive, oil and gas, healthcare and pharma.

36 June 2023: Nasscom and Zinnov: India Redefining Globalisation Blueprint. https://tinyurl.com/3za5cj3j
37 https://tinyurl.com/mvcx8tdm
38 PwC report 'Six imperatives to scale up the global capability centre market in India', https://tinyurl.com/4ehuhu6m
39 The Economist (23 May 2024), 'Global firms are Tapping India's Workers like never before', https://tinyurl.com/37psdw3s

Government support for GCCs: Strategic interventions under various initiatives like 'Digital India' and policies for easing doing business have streamlined online approvals and licensing processes for GCCs. Initiatives like streamlined tax regulations and compliance procedures for foreign companies for setting up GCCs, flexible labour laws, and single-window clearance systems for faster approvals have eased the business process. Improved digital infrastructure (high-speed internet, data centres) has been a boon for GCC operations.

Various States are undertaking a multi-pronged approach to boost the GCC ecosystem by identifying high-potential industries. For example, State Governments of Karnataka, Telangana and Tamil Nadu have launched research and development (R&D) policies to expand the GCC landscape in sectors such as auto and electric vehicles, electronics, pharma and life sciences in the states. These policies aim to develop innovation hubs in the States by leveraging the existing industry presence and the academic and R&D ecosystem. For instance, Telangana contributes to over 30 per cent of India's pharma production and is home to more than 1,000 life sciences companies and over 200 FDA-approved sites for producing innovative and generic medicines.[40] The Karnataka Digital Economy Mission (KDEM)[41] aims to increase the State's contribution to India's digital economy to USD 300 billion by 2026 by enabling holistic growth of the tech sectors and start-ups by deepening partnerships with industry players and developing tech clusters beyond the State's capital to achieve higher contribution. Consequently, leading technology companies have started operations in Mysuru, Mangalore and Hubballi clusters, generating employment for more than 5,000 people.

Partnership with Startups to support global technology needs: As per a NASSCOM report, GCCs are leveraging India's vital engineering research and development service provider community, its mature start-ups, and its peer-GCC ecosystem. They have established more than 15 incubators, over 40 accelerators, and multiple partner programmes to drive collaboration with Indian start-ups.[42] Healthcare and pharma GCCs have witnessed an increased partnership with start-ups and academia to access newer technology. The GCCs have explored various forms of collaboration, such as innovation labs, hackathons and start-up incubators.

Expansion to Tier-II cities: GCCs are increasingly evaluating tier-II towns to expand their operations, influenced by the reverse migration seen during the pandemic and the cost arbitrage offered by such relatively under-penetrated markets. The recent thrust on infrastructure development in these cities has also added to their appeal. As per a CBRE research report, [43], during H1 of 2023, about 22 per cent of GCC centres were set up in tier-II cities, driven by the availability of existing and fresh talent.

40 Telangana Life Sciences: Vision 2023, https://tinyurl.com/4ws4a3ub
41 Karnataka Digital Economy Mission, https://karnatakadigital.in/about-us/
42 NASSCOM report dated 4 October 2021-Evolving GCC Ecosystem in India, https://tinyurl.com/4y3zstj5
43 CBRE Research report dated November 2023-India's Global Capability Centres: Charting A New Era, https://tinyurl.com/4bmadaxy

Rising global demand for India: While US and Europe-based MNCs have been establishing their capability centres for a long time, international players from the Asia Pacific region, especially Japan and South Korea, have begun setting up their R&D/ innovation centres in India over the past few years. Although other countries with GCC presence have emerged recently, India remains a GCC favourite in a highly competitive global environment due to its ample talent endowment and cost advantage.

The way forward: Today, GCCs contribute to their parent organisations' success and propel India's economic growth. They account for more than 1 per cent of the country's GDP, and the share is expected to grow further.[44] As more global players eye India to set up their GCC operations, the government has a crucial role in facilitating their entry. Government support for identifying new business models for partnerships, simplifying the entry process, and emphasising trust and data security, among others, will further encourage the location of GCCs in India.

India's rising Global Value Chains (GVC) participation

4.26 GVCs refer to international production sharing, where operations are spread across national borders (instead of being confined to the exact location), producing a complex product. In what has come to be called a period of 'hyperglobalisation'[45], the early 2000s saw rapid GVC expansion worldwide. This led to exponential gains in trade, reductions in supply chain costs and deep interlinkages in trade across nations. A dramatic shift from "hyperglobalisation" to "slowbalisation"[46] occurred following the 2008 global financial crisis (GFC). Concerns about the risks and uncertainties surrounding GVCs were further amplified with shocks such as the China-USA trade war, the COVID-19 pandemic, and the Russia-Ukraine conflict. More recently, this trend has begun to see a reversal. WTO's GVC Development Report 2023[47] showcases recovery in GVCs, underscored by a rise in the share of foreign export inputs and enhanced participation rates of economies worldwide.

4.27 In line with the global trend, India's GVC participation rose steadily through the 1990s and 2000s before the GFC, after which it started declining. For instance, the foreign value-added content of India's exports rose from 10 per cent in 1995 to 22 per cent in 2009 (the second highest amongst BRICS nations, after China), reflecting increased fragmentation of production and integration into GVCs.[48] After the lull seen in the years succeeding the global financial crisis, India's GVC participation has begun to rev up again on the back of incentives provided through schemes such as the PLI and Districts as Exports Hub (DEH) initiative. Box IV.3 discusses

44 SCMP Plus blog on 'India's rise as 'world's back office' in spotlight as service sector booms', https://tinyurl.com/3b4wex69
45 Subramanian, A.,et.al (2023). Trade hyperglobalization is dead. Long live? Peterson Institute for International Economics Working Paper, (23-11). https://www.piie.com/sites/default/files/2023-11/wp23-11.pdf
46 Kononenko, V., et.al (2020). Slowing down or changing track? Understanding the dynamics of Slowbalisation', https://tinyurl.com/j43864ja
47 https://www.wto.org/english/res_e/publications_e/gvc_dev_rep23_e.htm
48 OECD India Policy Brief dated November 2014, https://www.oecd.org/india/India-Enhancing-Global-Value-Chain-Participation.pdf.

in detail the trend in India's GVC participation and change in sectoral composition. Box IV.4 highlights the success stories of DEH.

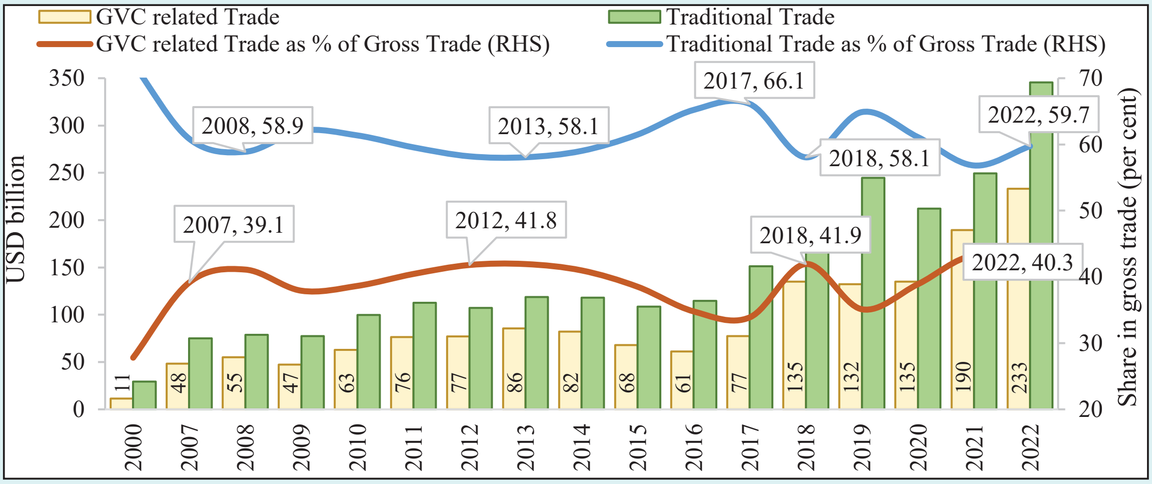
4.28 The evidence of India's enhanced global supply chain participation is reflected in increased investment by foreign firms in electronics, apparel and toys, automobiles and components, capital goods and semiconductor manufacturing in India. India's large domestic consumer market is an added attraction for firms setting up shop here. For example, Apple assembled 14 per cent of its global iPhones in India in FY24. Foxconn invested in the states of Karnataka and Tamil Nadu to set up new manufacturing plants for components.

4.29 Asia is the primary beneficiary of shifting supply chains. India has received the most interest from firms (28 out of 130 firms) regarding setting up or expanding production facilities, followed by Vietnam, Mexico, Thailand, Malaysia and Indonesia.[49]

Box IV.3: The trend in India's GVC participation and change in the sectoral composition

The WTO's World Integrated Trade Solutions (WITS) database shows that India's GVC-related trade[50] increased nearly four times from USD 62.9 billion in 2010 to USD 233.1 billion in 2022. Essential products driving India's GVC participation include coal and petroleum, business services, chemicals, and transport equipment. India's GVC trade grew at a CAGR of 14.6 per cent between 2018 and 2022. This is higher than the CAGR of 13.3 per cent between 2014 and 2018 and 6.9 per cent between 2010 and 2014.

Chart IV.15: Rising share of GVC-related trade in gross trade[51]



Source: WTO WITS database

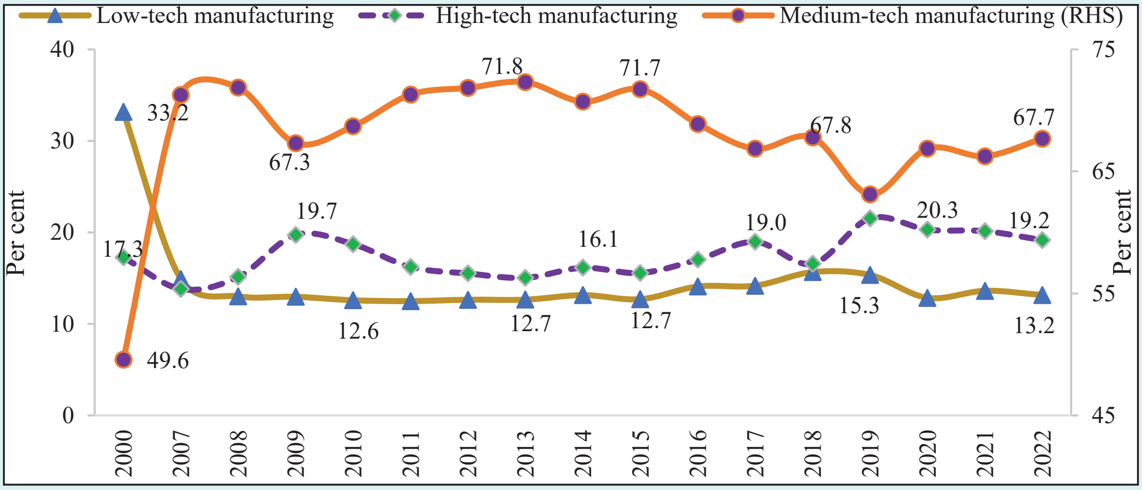
49 Nomura Global Market Research 28 May 2024, 'Asia's new flying geese'

50 According to the WITS database, GVC-related trade refers to the value of the trade which crosses more than one border, https://wits.worldbank.org/gvc/gvc-output-table.html

51 Gross trade is the sum of GVC-related trade and traditional trade. Traditional trade refers to the trade which crosses the border only once.

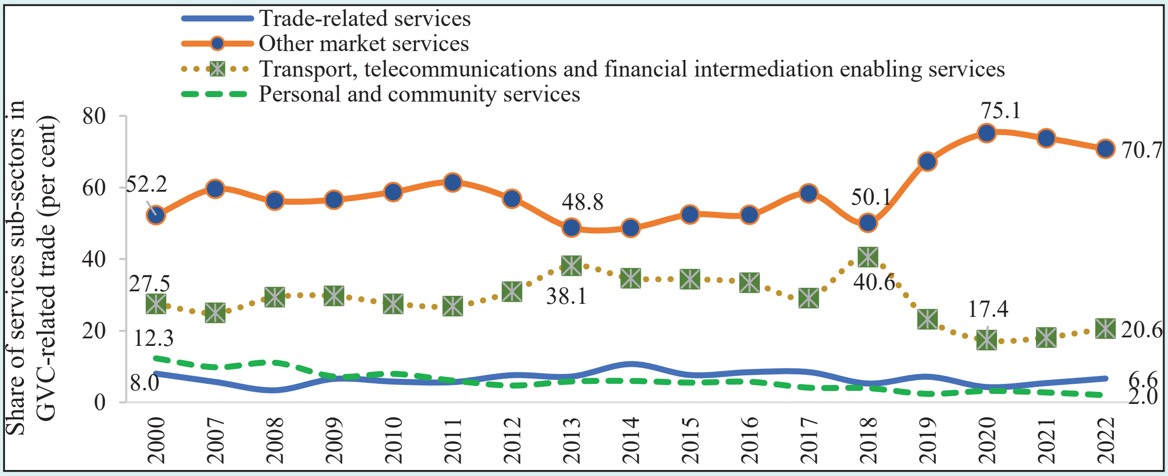
Over the years, the sectoral composition of India's GVC-related trade has changed markedly. Within the manufacturing sector, the share of low-technology manufacturing[52] has declined over the years, while the share of medium[53] and high-technology manufacturing[54] has been rising. The increase in medium technology manufacturing can also be seen in the shift toward industries such as coke and petroleum, transport equipment and primary and fabricated metals, which have a significant share in India's GVC-related trade.

Chart IV.16: Share of different manufacturing sub-sectors in GVC-related trade



Source: WTO WITS database

Chart IV.17: Share of different services sub-sectors in GVC-related trade



Source: WTO WITS database

Exports of IT and technology-enabled services lead India's GVC services exports. Further, GVC participation in services has gradually matured from low-value-added business process

52 Low-technology manufacturing includes food, beverages and tobacco; textiles and textile products; leather, leather products and footwear; wood and products of wood and cork and pulp; paper, paper products; printing and publishing

53 Medium-technology manufacturing includes coke, refined petroleum and nuclear fuel, chemicals and chemical products, rubber and plastics, other non-metallic minerals, basic metals and fabricated metal and machinery.

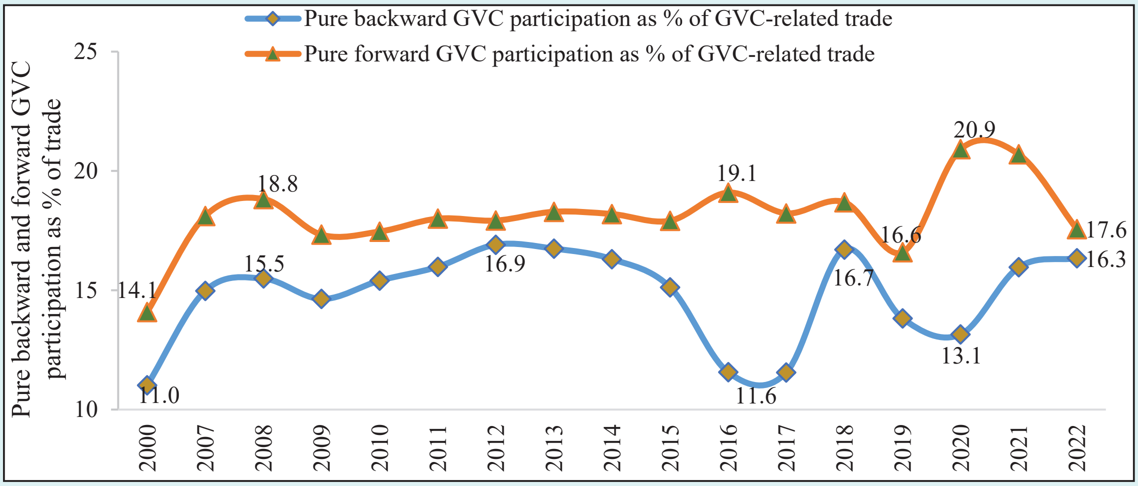
54 High-technology manufacturing includes electrical and optical equipment, transport equipment and manufacturing, nec, and recycling.

outsourcing (BPO) services to high-value-added services, such as those provided by global capability centres (GCCs).

Previously, India's GVCs involved a higher level of forward participation, which resulted in lower value-addition for exports within the country. However, in recent years, India has begun to move downstream and export finished goods to the rest of the world.[55] This can be seen in the rise in the share of pure backward GVC participation from 13.8 per cent in 2019 to 16.3 per cent in 2022. Sectors such as food and beverages, electrical and optical equipment, and financial intermediation, among others, have witnessed a remarkable increase in backward GVC participation. Even by stricter estimation, i.e., excluding coke, refined petroleum and nuclear fuel, the share of pure backward participation in gross trade increased from 12.1 per cent in 2019 to 14 per cent in 2022. In contrast, the share of pure forward GVC participation (or upstream participation) in trade has declined from 19.1 per cent in 2016 to 17.6 per cent in 2022 in sectors such as retail trade, coke, refined and nuclear fuel, chemicals and primary and fabricated metals, among others.

Rising backward GVC participation bodes well for India. The latest research by Professor Veeramani and Dhir[56] shows that greater backward GVC participation results in higher absolute levels of gross exports, domestic value-added, and employment.

Chart IV.18: Rise in the share of pure backward GVC participation



Source: WTO WITS database

Despite so much progress, India's GVC participation (GVC-related trade as per cent of gross trade at 40.3 per cent in 2022) is still lower not only in comparison to large economies such as the USA (43.7 per cent), UK (47.8 per cent) and Japan (46.6 per cent), but also its Asian counterparts, such as South Korea (56.2 per cent) and Malaysia (60 per cent). To further embrace

55 Forward participation of a country refers to producing and shipping raw materials and intermediate inputs (for example, yarn) for further processing and exporting by other countries (fabric). In contrast, backward participation refers to using imported intermediate inputs (imported fabrics) to produce goods that are exported (apparel).

56 Veeramani, C., & Dhir, G. (2022). Do developing countries gain by participating in global value chains? Evidence from India. Review of World Economics, 158(4), 1011-1042, https://shorturl.at/jixnb

GVCs and enhance participation, there is a need to develop quality trade infrastructure, integrate micro, small and medium enterprises in the GVC network, simplify procedures for entry and exit of small businesses, and work towards trade facilitation measures.

Finally, it is worth noting that India's GVC expansion is taking place in an era that is not particularly conducive to GVCs. Countries worldwide are embracing mercantilism. Nonetheless, despite the rise in mercantilism, there is scope for collective country blocs to trade intensively with one another. In this context, GVCs can help build self-reliance and promote shared trade gains amongst these country blocs.

Box IV.4: Indian Districts as Export Hubs

Each district in the country holds economic potential comparable to that of a small country. They can become export hubs using their unique identities and prospects in the global marketplace. To take this forward, the Districts as Export Hubs (DEH) initiative was launched in August 2019 to foster balanced regional development across all districts of the country. The objective was to select, brand, and promote the sale of products from each district in the domestic and international markets. Through the DEH initiative, the Government aims to boost manufacturing and exports from urban areas while focusing on generating interest and economic activity in the rural hinterland. India's Foreign Trade Policy 2023 reiterated the role of DEH in India's export efforts.

As part of its recent initiative under DEH - Focus @ 75 initiative, the Government has identified 75 districts across India to provide targeted support for boosting exports. Key events include Vanijya Saptah, a series of workshops aimed at educating and empowering local exporters, and participation in the Dubai Expo 2020, where Indian products were showcased to a global audience. A notable success of the expo is the introduction of Ladakh's apricots to Dubai supermarkets. Additionally, the Marine Buyer-Seller Meet connected Indian marine product exporters with international buyers, while marketing and branding workshops helped exporters enhance their product presentation.

The DEH initiative provides a broad base to promote financial inclusion and facilitate logistical and infrastructural support to engage all districts of the country in developing at least a commodity for the global market and thus promoting exports. The bottom-up approach helps India establish a direct link between production units and meet national export obligations.

All States/UTs have established an institutional mechanism by constituting State Export Promotion Committees (SEPC) and District Export Promotion Committees (DEPC). District Export Action Plans have been prepared and updated from time to time by the DEPCs to identify bottlenecks and necessary interventions to support exporters and manufacturers in promoting the export of identified products/services. So far, 567 Districts have prepared their Export Action Plans (DEAPs). Districts have identified 304 unique products spanning across 13 sectors across the country. Notably, 14 out of these 304 unique products have been identified as services strategically distributed across over 100 districts.

The Government is also promoting e-commerce exports through its DEH initiative, collaborating with relevant e-commerce partners, Export Promotion Councils, and relevant Government departments. The initiative focuses on educating MSMEs about e-commerce exports, enabling them to sell globally, and includes training and handholding on imaging and digital cataloguing of products. As a result of these collaborations, 10 outreach events were organised in Districts export outreach events in Faridabad, Moradabad, Ludhiana, Jodhpur, Bangalore, Ahmedabad, Hyderabad, Mumbai, Jamshedpur, and Varanasi during the first quarter of 2024. These events, organised with leading e-commerce partners, provided valuable hand-holding, capacity-building, and training sessions for participating businesses, offering key insights and support to help them succeed in global markets.

The Government is taking further steps to enhance the performance of the scheme. For instance, the Directorate General of Foreign Trade (DGFT) has partnered with Exim Bank to boost exports under the ODOP (One District, One Product) and DEH initiative. This

collaboration stems from an Exim Bank study that identified 59 middle export districts with export potential. Under the collaboration, the DGFT will be working with Exim Bank in 20 districts. These districts will receive support through Exim Bank's GRID program (Grassroots Initiatives for Development). The program aims to address sector-specific challenges and identify suitable beneficiaries for support. Exim Bank aims to prepare a detailed proposal outlining challenges and solutions for collaborative implementation.

Changing landscape of India’s global trade arrangements

4.30 Global economic growth and international trade are passing through a particularly challenging phase of uncertainty, as detailed in paras 4.4 to 4.8 above. In this context, open, inclusive, predictable, non-discriminatory, and mutually beneficial trade can provide an impetus to economic growth. India advocates for a rule-based international trading system with these attributes with WTO at its core. In this spirit, India considers Free Trade Agreements (FTAs) an instrument of trade liberalisation and a complement to the multilateral trading system under WTO. Accordingly, the country has engaged with its trading partners/blocs to expand its export markets while ensuring better terms for essential imports to meet domestic demand in a cost-competitive manner.

4.31 After a gap of nearly 10 years, four new FTAs have been signed over the period 2021 to 2024.[57] These FTAs are with Mauritius (signed in February 2021), the UAE (February 2022), Australia (April 2022) and the European Free Trade Association or EFTA (March 2024). All

57 Before 2021, the last FTA signed was with Japan in February 2011, which came into force in August 2011.

these FTAs have come into force except the last one. Having signed FTAs with most East-Asian partners, these new trade engagements focus on gaining access to the Western and African markets, as well as potential partners having trade complementarity. India's young demography and growing middle-class population provide an attractive market for its Western FTA partners.

4.32 One of the major criteria for engaging with an FTA partner is to ensure that the trading partner is a natural partner in terms of trade complementarity. Academic literature on natural trading partners identifies factors that would promote robust trade between FTA partners and facilitate deeper economic integration. The initial trade volume, geographic proximity, and trade complementarity are prominent among them.[58]

India-Mauritius CECPA

4.33 Since 2005, India has been among the largest trading partners of Mauritius. India's exports to Mauritius stood at USD 462.7 million in FY23, while Mauritius's exports to India were USD 91.8 million, taking the total trade to USD 554.5 million. Trade has grown by 168 per cent in the last 17 years, from FY06 to FY23. Petroleum products were the largest export item for India between 2007 and 2019 until the Mangalore Refinery and Petrochemicals Limited supply contract was terminated in mid-2019. Other Indian exports to Mauritius include pharmaceuticals, cereals, cotton, shrimps, prawns and bovine meat. Main Mauritian exports to India are vanilla, medical devices, needles, aluminium alloys, scrap paper, refined copper, men's cotton shirts, etc.[59]

4.34 India and Mauritius signed the Comprehensive Economic Cooperation and Partnership Agreement (CECPA) in February 2021. The CECPA is the first trade Agreement signed by India with an African country. The agreement covers trade in goods, rules of origin, trade in services, Technical Barriers to Trade, Sanitary and Phytosanitary measures, etc. The Agreement covers 310 export items for India, including foodstuffs and beverages, agricultural products, etc. Mauritius benefits from preferential market access to India for its products such as frozen fish, speciality sugar, biscuits, fresh fruits, juices, mineral water, etc.

4.35 As regards trade in services, Indian service providers have access to around 115 sub-sectors from the 11 broad service sectors such as professional services, computer-related services, research & development, other business services, telecommunication, construction, distribution, education, environmental, financial, tourism & travel related, recreational, yoga, audio-visual services, and transport services. India has offered trade access to around 95 sub-sectors from 11 broad services sectors, including professional services, R&D, other business services, telecommunication, financial, distribution, higher education, environmental, health, tourism and travel-related, recreational, and transport services.[60]

58 Kandogan, Y. (2008). Regionalism versus Multilateralism: Evidence for the Natural Trade Partners Theory from the Euro-Mediterranean Region? Journal of Economic Integration, 23(1), 138–160, https://www.jstor.org/stable/23001115
59 India-Mauritius bilateral relations, https://www.mea.gov.in/Portal/ForeignRelation/Mauritius_2023.pdf
60 PIB press release of Ministry of Commerce and Industry dated 31 March 2021, https://tinyurl.com/24cjb5sv

India-UAE CEPA

4.36 The UAE can be classified as a natural trading partner, having been featured among India's top three trade partners for the past two decades. UAE has been India's largest export market for gems and jewellery, cereal, and fuel. Through the UAE CEPA (Comprehensive Economic Partnership Agreement), these labour-intensive products will receive preferential access.[61]

4.37 The bilateral trade between India and the UAE in FY24 was USD 83.7 billion. The UAE is India's second-largest export destination, with approximately USD 35.6 billion in exports in FY24. The UAE is also the eighth largest investor in India, with an estimated investment of USD 18 billion, whereas Indian investments in the UAE are estimated at around USD 85 billion[62]. The CEPA is expected to increase the bilateral trade in goods to USD 100 billion within five years of the signing and increase trade in services to USD 15 billion. The India-UAE CEPA is likely to benefit about USD 26 billion worth of Indian products that are subjected to 5 per cent import duty by the UAE. UAE can also become a hub for sourcing India's capital goods and intermediates for further value-added exports to other African and European destinations. Also, for the first time in any Trade Agreement, a separate Annex on pharmaceuticals has been incorporated to facilitate access to Indian pharmaceutical products, especially automatic registration and marketing authorisation in 90 days for products approved by developed country regulators, namely the United States (USFDA), the United Kingdom (UKMHRA), the European Union (EMA), and Japan (PMDA).

4.38 Further, India has included digital trade within the ambit of its FTA with UAE for the first time, which will help leverage India's advantage in digital payment and e-commerce services. The agreement also involves government procurement and data usage provisions, while completely safeguarding the provisions of General Financial Rules and the Orders issued thereunder, including Preference for 'Make in India' Order and MSME Preference policies.

India-Australia ECTA

4.39 Unlike UAE, Australia did not have as large an initial trade volume with India. Even so, Australia's trade basket with India has a substantial complementarity, thus classifying it as a natural trading partner.[63] India imports resources and primary products from Australia and exports finished goods.

4.40 Australia was India's 13th largest trading partner in FY24, and India was Australia's 5th largest trading partner in 2023. India-Australia bilateral merchandise trade increased from USD 25 billion in FY22 to USD 26 billion in FY23. The India-Australia Economic Cooperation

61 PIB Press release of Ministry of Commerce and Industry dated 27 March 2022, https://pib.gov.in/PressReleasePage.aspx?PRID=1810279.

62 India-UAE CEPA (FAQs), Question 3, https://www.nsez.gov.in/Resources/Trade/FAQs%20on%20CEPA.pdf

63 The trade complementarity index indicates to what extent the export profile of the reporter matches or complements the import profile of the partner. A high index may suggest that two countries would benefit from increased trade (WITS, World Bank). The TCI for Australia and the UK were 60 and 67 per cent in 2021 for India.

and Trade Agreement (ECTA) estimated bilateral trade in goods and services for both countries to rise from USD 27.5 billion in 2021 to USD 45 billion in 5 years.[64]

4.41 The Agreement is likely to benefit various labour-intensive sectors of India, which were otherwise subjected to Australia's 5 per cent import duty on the majority of products earlier. It will result in immediate market access at zero duty to 98.3 per cent of tariff lines accounting for 96.4 per cent of India's exports to Australia in value terms. India is Australia's third largest services export market. Regarding market access to services, Australia has offered 135 sub-sectors to India, and India has offered 103 sub-sectors to Australia. The Agreement opens avenues for investment in computer-related services, telecom, construction, health & environmental services.[65]

India-EFTA TEPA

4.42 The thrust of the India-EFTA Trade and Economic Partnership Agreement (TEPA) is deeper economic engagement with the EFTA countries- Switzerland, Norway, Iceland, and Liechtenstein. This is the first FTA of India with any European country. The successful conclusion of an FTA with this set of developed countries, is a significant positive signal to the world, showcasing India's firm commitment to trade liberalisation at a time of rising protectionism across both developed and developing countries. It is an innovative and well-balanced pact that covers two-way trade in goods and services as well as bilateral investments.

4.43 Further, India is also presently engaged in FTA negotiations with some of its trading partners; notable among these FTA negotiations are – (i) India-UK FTA, (ii) India-EU FTA, (iii) India-Australia Comprehensive Economic Cooperation Agreement (CECA), building on Ind-Aus ECTA, (iv) India-Peru Trade Agreement, covering goods, services, and investment, (v) India-Eurasian Economic Union (India-EAEU) FTA and (vi) India-Sri Lanka Economic and Technical Cooperation Agreement (ECTA). The Government reviews FTAs based on extensive inter-ministerial and industry consultations. Accordingly, reviews of its existing FTAs, namely, the India-South Korea CEPA and the ASEAN-India Trade in Goods Agreement (AITIGA), have been initiated.

Government initiatives on trade facilitation measures and reduction in logistics cost

4.44 The Government has undertaken various measures to enhance production capacity, promote exports and reduce logistics costs involved in international trade. These include setting export targets and monitoring these targets followed by course correction, provision of export credit insurance services for short-term as well as medium and long-term exports, and encouraging banks to provide affordable and adequate export credit to micro, small and medium enterprises (MSME) exporters, enabling them to explore new markets and diversify

64 India Australia ECTA-FAQ, https://commerce.gov.in/wp-content/uploads/2022/09/FAQs-for-IndAus-ECTA-2.pdf
65 PIB press release of Ministry of Commerce and Industry dated 8 January 2023, https://tinyurl.com/286udedz

existing products competitively, among others. The Government has also streamlined trade processes, enhancing transparency and promoting cooperation among stakeholders through initiatives such as Turant,[66] Customs,[67] Single Window Interface for Facilitation of Trade (SWIFT),[68] pre-arrival data processing, e-Sanchit,[69] Coordinated Border Management, etc.

4.45 The Central Board of Indirect Taxes and Customs (CBIC) has undertaken various technological initiatives to facilitate trade. These include the phased implementation of an electronic cash ledger,[70] enabling electronic clearances at Land Customs Stations, online submission of IFSC Code, use of Electronic Certificates of Origin, and Electronic Repairs Services Outsourcing to prolong the life of faulty or damaged electronic goods, among others. Department of Posts (DoP) has developed a Postal Bill of Export Automation System for the electronic filing and processing of PBE, under which an exporter is not required to visit a Foreign Post Office and present an export parcel. In a transformative partnership, the CBIC and the DoP launched the Hub and Spoke Model, simplifying the export process, promoting small-scale exporters, and leveraging India's extensive global trade postal network. This scheme harnesses the vast postal network of 1.54 lakh post offices, using digital technology and apps, and eliminates intermediaries for seamless exports via postal services.

4.46 To boost efficiency and lower logistics costs, the Government launched the PM GatiShakti National Master Plan and the National Logistics Policy (NLP) in October 2021 and September 2022, respectively. Digital reforms, such as the Unified Logistics Interface Platform (ULIP)[71] and the Logistics Data Bank,[72] are additional measures taken towards improving logistics. Initiatives, such as railway track electrification, reduced release times by the Land Ports Authority of India (LPAI), and the launch of NLP Marine for port-related logistics were also undertaken. Since the launch of the NLP, over 614 industry players have registered on ULIP, 106 private companies have signed Non-Disclosure Agreements (NDAs), 142 companies have submitted 382 use cases to be hosted on ULIP and 57 applications have been made live as of September 2023.[73]

4.47 As a result of these initiatives, there has been an improvement in India's performance in the United Nations Economic and Social Commission for Asia Pacific's (UNESCAP) Global Survey on Digital and Sustainable Trade Facilitation.[74] In the survey, India scored 93.5 per

66 'Turant' is a Hindi word which means 'speedy'

67 Turant customs is the contactless customs initiative, which leverages technology to obviate the physical interface between customs authorities and importers/exporters/customs brokers/other stakeholders.

68 SWIFT provides importers and exporters the facility to lodge their clearance documents online at a single point only.

69 e-Sanchit allows the trader to upload all supporting documents digitally for obtaining clearances, eliminating the need for the trader to approach PGAs (Participating Government Agencies) to obtain various clearances

70 The Electronic Cash Ledger (ECL) has enabled the importer, exporter, or any person liable to pay duty, fees, etc., to deposit an advance with the Government instead of transaction-wise payment as being done at present, which could be used to pay his liabilities under this Act or under any other law for the time being in force.

71 ULIP is designed to enhance efficiency and reduce the cost of logistics in India by creating a transparent, one-window platform that can provide real-time information on cargo movements to all stakeholders.

72 Logistics Data Bank integrates the information available with various agencies across the supply chain to provide detailed real-time information related to containerised EXIM logistics within a single window.

73 PIB Press Release of Ministry of Commerce dated 14 September 2023, https://pib.gov.in/PressReleseDetail.aspx?PRID=1957407.

74 The Survey covers the WTO Trade Facilitation Agreement (TFA) along with a set of nearly 60 trade facilitation measures categorised into eleven sub-groups. A three-step data collection and validation approach is generally followed and implemented over 6 months every two years. A lower score represents an improvement in trade facilitation measures. https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1938008

cent in 2023 vis a vis 90.3 per cent in 2021. India scored 100 per cent in four key areas: Transparency, Formalities, Institutional Arrangement and Cooperation, and Paperless Trade. Further, the country has witnessed a substantial improvement in the score for "Women in Trade Facilitation" component from 66.7 per cent in 2021 to 77.8 per cent in 2023, indicating a commitment to gender inclusivity and women's empowerment in the trade sector.

4.48 Another evidence of the success of trade facilitation measures is reflected in the National Time Release Study (2023)[75] conducted by the CBIC. The study shows that the overall average import release time[76] has improved by 20 per cent in 2023 over 2022. The maximum improvement in the average release time was reported by Mundra (33 per cent) among seaports, Hyderabad (44 per cent) among Air Cargo Complexes (ACCs), and Tughlakabad (23 per cent) among Inland Container Depots.

4.49 The reduction in logistics cost is reflected in an improvement in India's rank on the World Bank's Logistics Performance Index (LPI),[77] which improved by six places to 38th in 2023 from 44th in 2018 out of 139 countries. With the introduction of cargo tracking, dwell time[78] in the eastern port of Visakhapatnam fell from 32.4 days in 2015 to 5.3 days in 2019. Additionally, India's position in international shipments climbed to 22 in 2023 from 44 in 2018 due to its modernisation and digitalisation efforts. India moved up five places in infrastructure score and four places up to 48th in logistics competence and equality. The Government aspires to secure a position within the top 25 countries on the index, which comprises 139 countries, by 2030.[79] Indian Ports' "Median Turn Around Time" has reached 0.9 days, which is better than the USA (1.5 days), Australia (1.7 days) and Singapore (1.0 days), as per the World Bank's Logistics Performance Index (LPI) Report 2023.[80]

4.50 The Sagarmala scheme has promoted port-led development by harnessing India's 7,500 km long coastline, 14,500 km of potentially navigable waterways and strategic location on key international maritime trade routes. The Ministry for Ports, Shipping and Waterways estimates India's total port capacity to increase from 2,600 MTPA (million tonnes per annum) to more

75 Available at: https://old.cbic.gov.in/resources/htdocs-cbec/implmntin-trade-facilitation/national-time-release-study15062023.pdf. National Time Release Study (NTRS) 2023 covers the import and export release time for 15 major ports, representing the four-port categories. The study covers 4 Seaports, 6 ACCa, 3 Inland Container Depot and 2 Integrated Check Posts; these geographically well-distributed ports cumulatively account for approximately 80 per cent of the bills of entry and 70 per cent of the shipping bills filed in the country.

76 Cargo release time is the time taken from the arrival of the cargo at the customs station to its out-of-charge for domestic clearance in case of imports and arrival of the cargo at the customs station to the eventual departure of the carrier in case of exports.

77 The LPI is an interactive benchmarking tool created to help countries identify the challenges and opportunities they face in their performance on trade logistics and what they can do to improve their performance, https://lpi.worldbank.org/sites/default/files/2023-04/LPI_2023_report_with_layout.pdf

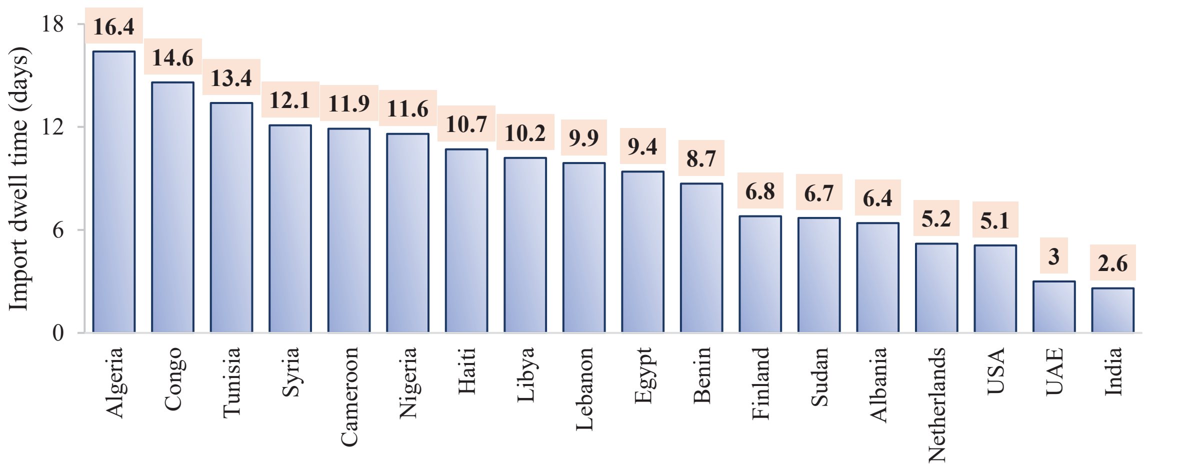
78 As per the World Bank LPI Glossary, dwell time refers to the time spent at the same location from container arrival to departure. Dwell time applies to port, exports, import, or inland terminal facilities. Consolidated import and export dwell time is defined as the sum of dwell times at port and intermediate inland locations after the ship's unloading (imports) or before the container's loading on the ship (exports).

79 PIB Press Release of Ministry of Commerce and Industry dated 17 September 2022, https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1860230

80 Lead time data from supply chain tracking datasets, Appendix 2, page 37 of World Bank Logistics Performance Index report 2023, https://lpi.worldbank.org/sites/default/files/2023-04/LPI_2023_report_with_layout.pdf

than 10,000 MTPA in 2047.[81] From April to November 2023, cargo of 86.5 MMT moved through waterways as compared to 80.4 MMT during April to November 2022, i.e. an increase of 7.5 per cent.[82] The Government also aims to operationalise 23 waterways by 2030.

Chart IV.19: Decline in dwell time for India



Source: World Bank Logistics Performance Report: 2023

4.51 The Goods and Services Tax (GST) has played a remarkable role in reducing logistics costs. The 'One Nation, One Tax' regime has ensured that trucks do not have to wait for hours on state borders, which has reduced travel time by up to 30 per cent. This has reduced the logistics cost and increased the average distance trucks travel from 225 km before GST to 300-325 km, as per a Ministry of Road Transport and Highways report.[83] This has been a great value, adding to the ease of doing business and the growth of manufacturing in the country. An NCAER study of December 2023 has shown that the logistics cost in the economy has declined by 0.8 to 0.9 percentage points of GDP between FY14 and FY22.[84]

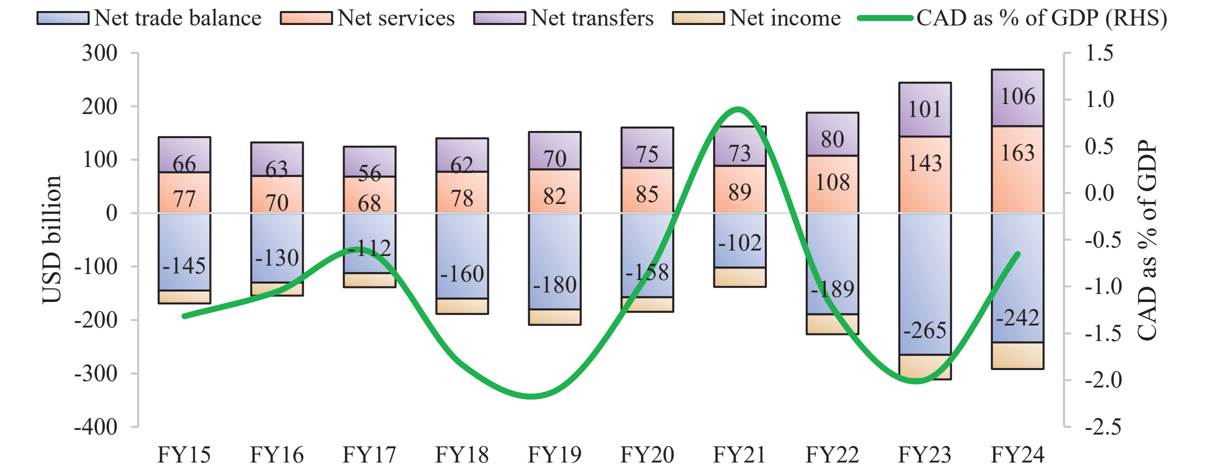
4.52 The improvement in India's logistics performance is also reflected at the State level. The 2023 Logistics Ease Across Different States (LEADS) highlights a positive shift in stakeholders' perception across all three pillars of logistics performance services, infrastructure and regulatory environment in 2023 over 2019, empowering State Governments by providing region-specific insights for informed decision-making and comprehensive growth.[85] A positive shift in stakeholder perception is attributed to multiple reform measures initiated by States and UTs over the past couple of years to improve their logistics eco-system, including formulation of logistics policy, development of supporting infrastructure and enhancing regulatory ease.

81 PIB Press Release of Ministry of Ports, Shipping and Waterways dated 19 August 2023, https://tinyurl.com/2n68d6em
82 PIB Press Release of Ministry of Ports, Shipping and Waterways dated 2 January 2024, https://tinyurl.com/572j5mnn
83 Ministry of Road Transport and Highways booklet on GST, https://morth.nic.in/sites/default/files/Booklet_on_GST.pdf
84 National Council of Applied Economic Research Report on 'Logistics Cost in India-Assessment and Long-term Framework, https://www.ncaer.org/wp-content/uploads/2023/12/NCAER_Report_LogisticsCost2023.pdf
85 LEADS is a stakeholders' survey and uses the World Bank's Logistics Performance Index (LPI) methodology. The State LPI is arrived at using a ranking methodology for stakeholder engagement based on a series of meetings and online surveys in the key areas of logistics- infrastructure, services timelines, traceability, competitiveness, security, operating environments, and efficiency of regulation. https://drive.google.com/drive/folders/17bWqWyvprnVwxyQUgQYpwloKhopNuubj?usp=sharing

FAVOURABLE CURRENT ACCOUNT BALANCE

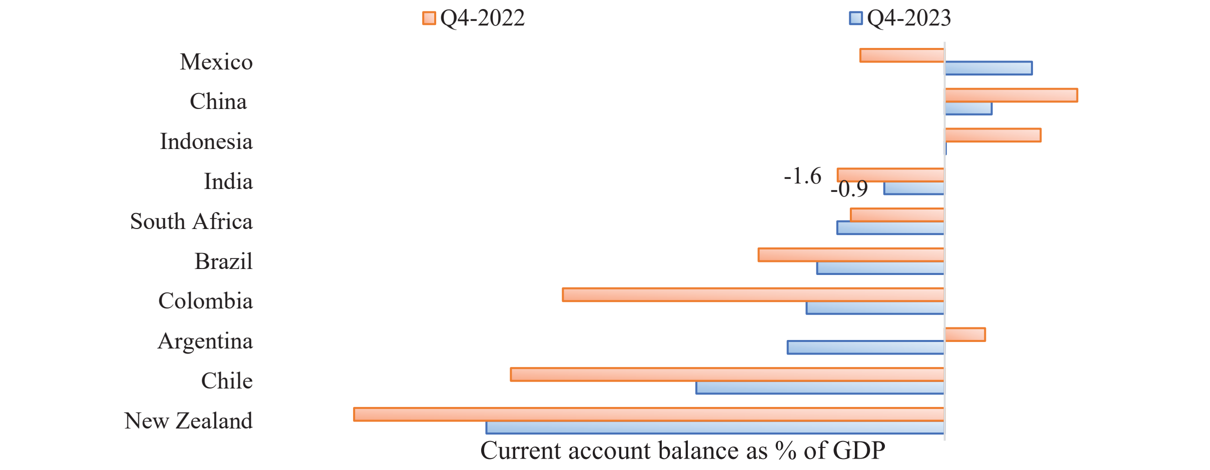
4.53 The current account is a record of a country's international transactions with the rest of the world. Trade is the dominant component of India's current account. As discussed in para 4.13, the narrowing of the overall trade deficit and increasing remittances (refer to para 4.54 below) contributed to an improvement in the CAD in FY24. India's CAD narrowed to USD 23.2 billion (0.7 per cent of GDP) in FY24 from USD 67 billion (2 per cent of GDP) during the previous year. The improvement in CAD in FY24 is supported by the surplus in CAD recorded in Q4 of FY24 on the grounds of a decline in merchandise trade deficit, rising net services exports and increasing remittances. An analysis of India's CAD in relation to other nations reveals that India's CAD is relatively low (Chart IV. 21)

Chart IV.20: Improvement in CAD during FY24



Source: Table No. 196, 'India's Overall Balance of Payments-Quarterly-USD Dollars', External Sector, Handbook of Statistics on the Indian Economy, RBI

Chart IV.21: Current account balance as a percentage of GDP: India vs select countries



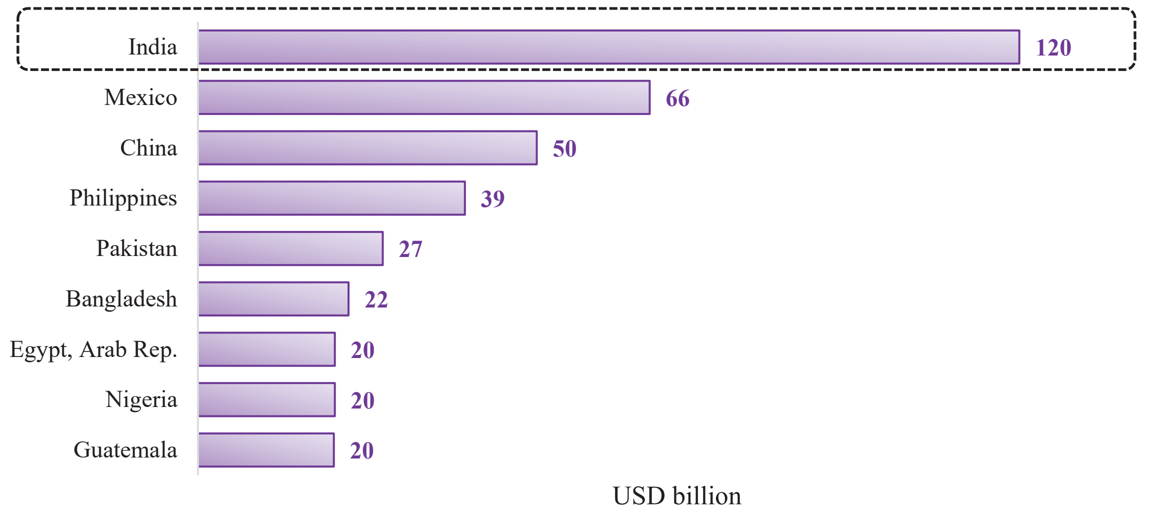
Source: OECD Economic Outlook database 115

Invisibles

4.54 Net services receipts increased from USD 143.3 billion during FY23 to USD 162.8 billion in FY24, primarily on account of rising exports of software, travel and business services. Similarly, the net private transfer receipts, mainly representing remittances by Indians employed overseas, was USD 106.6 billion in FY24, against their level of USD 101.8 billion during the previous year. Net services exports and remittances contributed to the surplus on the invisible account, which cushioned the merchandise trade deficit.

4.55 Remittances are the second largest source of external financing after service exports, which contributes to narrowing the CAD and has always been a stable constituent of the BoP. According to the World Bank, India has the largest emigrant population and is the top remittance recipient country, with remittances reaching a milestone of USD 120 billion in 2023.[86] The increase in remittances was driven mainly by declining inflation and strong labour markets in the United States and Europe, the largest destination for India's skilled migrants, and other OECD destinations, as well as positive demand for skilled and less-skilled workers in the GCC countries (which, together, are the second largest destination for Indian migrants).

Chart IV.22: India emerged as the top remittance recipient in the World in 2023



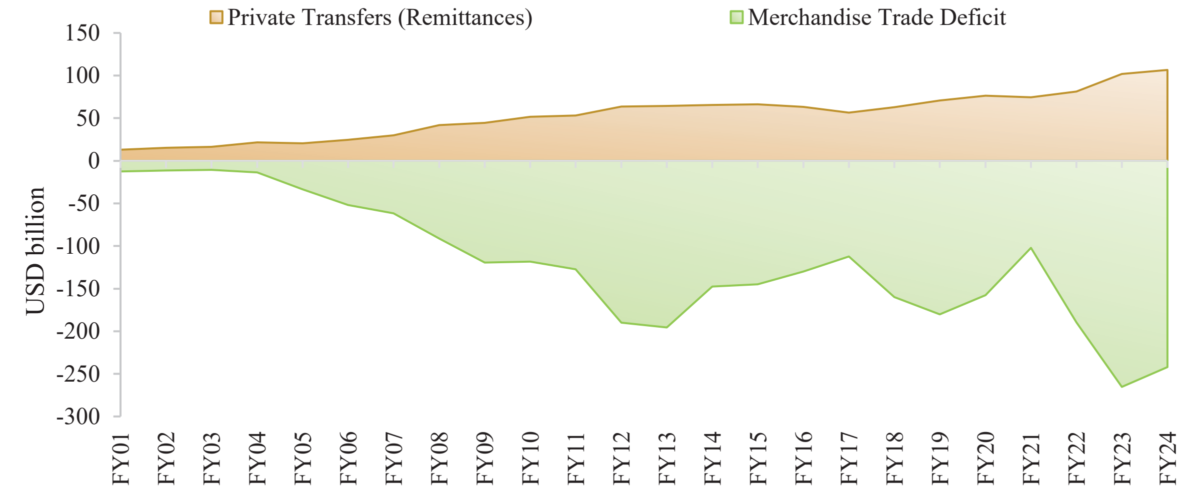
Source: World Bank

4.56 The remittance flows have also benefited from the agreement with the UAE to promote the use of Dirhams and Rupees for cross-border transactions. Remittances to India are forecasted to grow at 3.7 per cent to USD 124 billion in 2024 and at 4 per cent to reach USD 129 billion in 2025. India's share in South Asian remittances increased to 64.5 per cent in 2023 from 63 per cent in 2022.[87]

86 Migration and Development Brief 40, June 2024, https://www.knomad.org/sites/default/files/publication-doc/migration-and-development-brief_40.pdf
87 Ibid

4.57 Remittances differ from FDI, which companies disinvest during financial uncertainties. In times of economic downturn, FDI is considered pro-cyclical and destabilising. Remittances are a stable source of finance that will remain in the economy and are directly used by recipients, contributing to the nation's growth. From a BoP perspective, remittances are permanent foreign currency inflows and help finance merchandise trade deficits, contributing to the narrowing of the CAD. For net importers such as India, higher remittances partially offset the goods trade deficit and stabilise the CAD.

Chart IV.23: Higher remittances offsetting the goods trade deficit and stabilising CAD



Source: Table No. 196, 'India's Overall Balance of Payments-Quarterly-USD Dollars', External Sector, Handbook of Statistics on the Indian Economy, RBI
Table No. 192, 'India's Foreign Trade-USD Dollars', External Sector, Handbook of Statistics on the Indian Economy, RBI
Note: Private transfers are assumed as remittances in BoP data released by RBI

Box IV.5: Factors influencing inward remittances

The robust recovery of job markets in the high-income countries of the Organisation for Economic Co-operation and Development (OECD) following the onset of the COVID-19 pandemic has been the key driver of remittances, particularly as employment growth during the recovery was more rapid for immigrants than for the native-born. However, the remittance growth was 7.5 per cent in 2023 compared to a historic peak of 24.4 per cent in 2022.

Some key factors influencing the extent of inward remittances to India are discussed below.

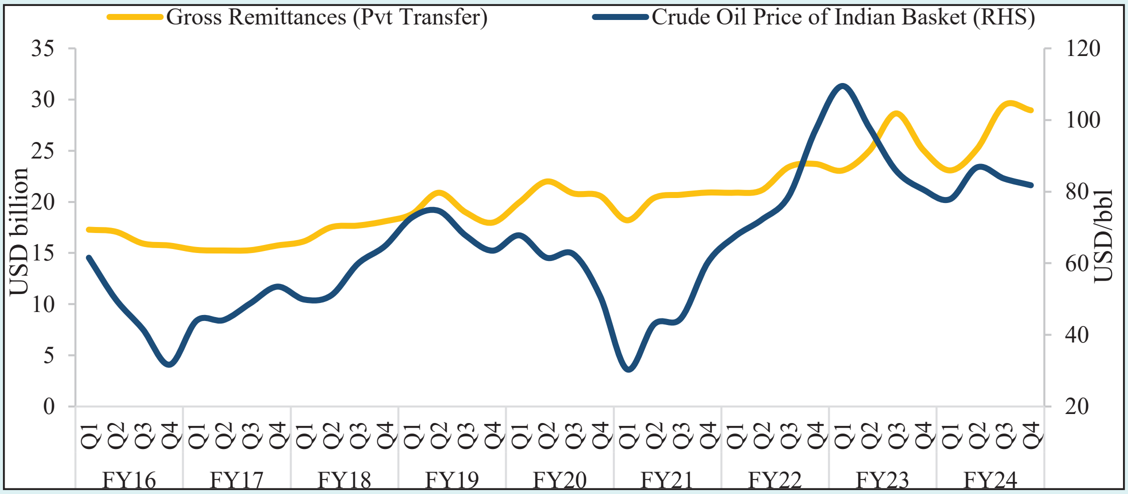
Remittances and oil prices: India meets a large part of its crude oil demand from imports, and a rise in global oil prices is a negative shock to the economy as it leads to a widening of CAD, an increase in inflation, and a weaker rupee. As reported in the Monetary Policy Report (October 2018), "it is estimated that for every USD 1 increase in the price of a barrel of crude, India's current account deficit could widen by USD 0.8 billion". However, the rise in global oil prices generally positively impacts the remittances received by the country, as

India's primary source of remittances is oil-exporting countries. An analysis of quarterly data on remittances and oil prices shows that there exists a positive correlation of 75.4 per cent between the two for India.

Chart IV.24 further corroborates this correlation, as periods of rise in oil prices are associated with higher remittances.

The plausible mechanism is as follows: an increase in oil prices (positive shocks) can generate a sizable amount of oil revenues, leading to higher investments and growth in oil-producing countries. As a result, the demand for migrant workers increases, translating into higher remittance outflows.[88] On the other hand, persistently low oil prices (adverse shocks) can hamper economic activities in oil-exporting economies by decreasing oil revenues. Correspondingly, the demand for migrant workers decreases, which in turn can reduce remittance outflows to migrant worker countries.

Chart IV.24: Association between gross remittances and crude oil price of Indian Basket



Source: Table No. 196, 'India's Overall Balance of Payments-Quarterly-USD Dollars', External Sector, Handbook of Statistics on the Indian Economy, RBI
Crude Oil FOB Price (Indian Basket), Petroleum Planning and Analysis Cell (PPAC)

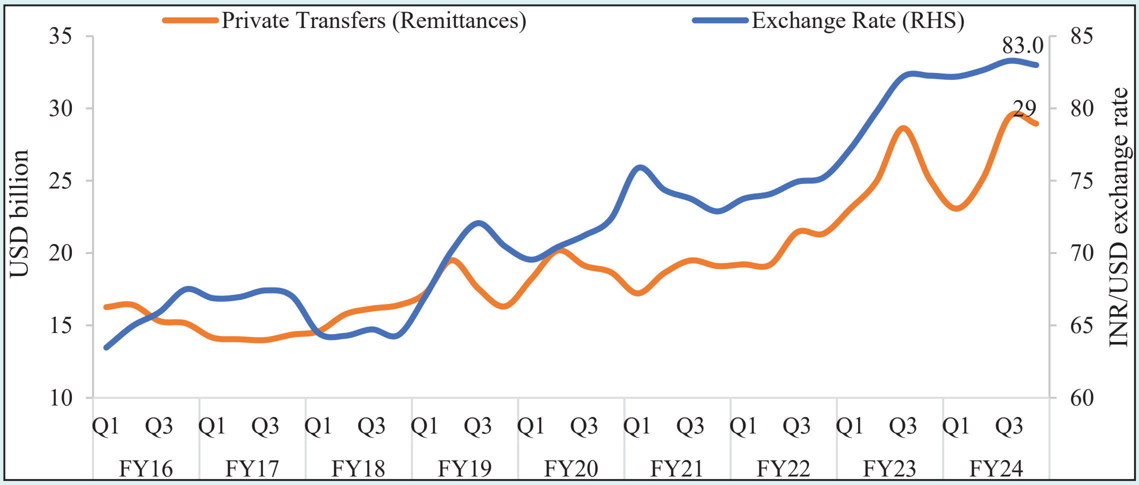
Remittances and exchange rate: A higher CAD results in an increase in the demand for foreign currency and an increase in the supply of domestic currency as firms and consumers buy more imports. This applies downward pressure to the exchange rate. On the other hand, remitters get better value in rupee terms when it depreciates in terms of foreign currencies, be it for UAE's Dirham, the US Dollar, the British Pound, or any other currency.

For every one USD a worker earns in distant lands, he returns an augmented amount after necessarily being converted according to the foreign land he works in. Hence, remittances exhibited a positive association with the exchange rate movement. An analysis of quarterly

88 Ibid footnote 86

data on remittances and exchange rate shows that there exists a positive correlation of 91 per cent for India. Chart IV.25 further corroborates this correlation, as periods of exchange rate depreciation are associated with higher remittances.

Chart IV.25: Positive association of INR/USD and remittances



Source: Table No. 196, 'India's Overall Balance of Payments-Quarterly-USD Dollars', External Sector, Handbook of Statistics on the Indian Economy, RBI
Table No. 200, 'Exchange Rate of the Indian rupee vis-à-vis the SDR, US Dollar, Pound Sterling, Euro and Japanese Yen, External Sector, Handbook of Statistics on the Indian Economy, RBI

Outlook: The outlook for remittance in India for 2024 is strong, with the expectation that remittance growth will moderate to 3.7 per cent, taking remittance levels to USD 124 billion in 2024. The diversification of India's migrant pool between a large share of highly skilled migrants employed mostly in high-income OECD markets, and the less-skilled migrants employed in the GCC markets is likely to lend stability to migrants' remittances in the event of external shocks. India's efforts to link its Unified Payments Interface (UPI) with source countries such as the United Arab Emirates and Singapore are expected to reduce costs and speed up remittances.[89]

CAPITAL ACCOUNT BALANCE

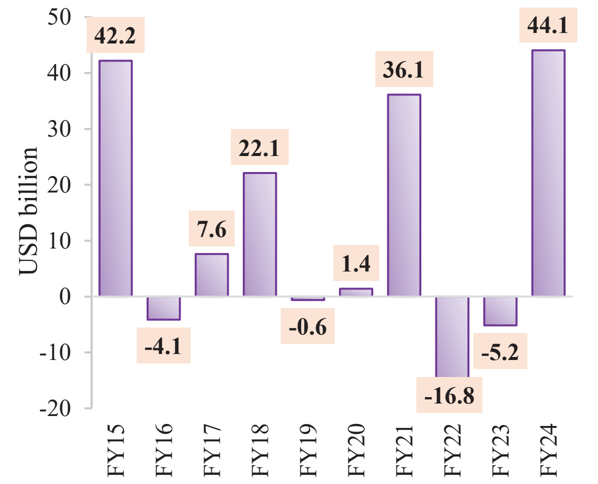
4.58 Stable capital inflows continue to finance the CAD. During FY24, net capital flows stood at USD 86.3 billion against USD 58.9 billion during the previous year, primarily driven by FPI flows and net inflows of banking capital (including NRI deposits).

4.59 The net FPI flows saw a significant turnaround in FY24. Supported by optimism surrounding India's growth story, progressive policy reform, economic stability, fiscal prudence and attractive investment avenues, India witnessed robust FPI inflows in FY24. Net FPI inflows stood at USD 44.1 billion during FY24 against net outflows in the preceding two years. This is the highest level of FPI inflow after FY15. India received the highest equity inflows among

89 Migration and Development Brief 40, World Bank

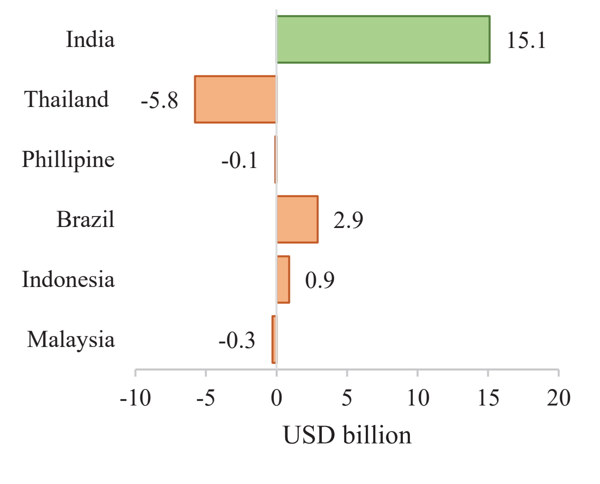
emerging market peers during FY24. Financial services, automobile and auto components, healthcare, and capital goods were the significant sectors attracting equity inflows during FY24. The recent inclusion of India's Sovereign Bonds in the JP Morgan Government Bond Index-Emerging Markets[90] is expected to contribute to higher debt inflows going forward and will likely spur demand for further exposure to India.

Chart IV.26a: Net FPI inflows into India



Source: Balance of Payments statistics, RBI

Chart IV.26b: Net Equity inflows among emerging market peers during FY24



Source: Bloomberg

4.60 The UNCTAD World Investment Report 2024[91] highlights that global FDI declined marginally by 2 per cent to USD 1.3 trillion in 2023 from USD 1.4 trillion in 2022. Weakening growth prospects, economic fracturing trends, trade and geopolitical tensions, industrial policies and supply chain diversification are reshaping FDI patterns, causing some multinational enterprises (MNEs) to adopt a cautious approach to overseas expansion. International project finance and cross-border mergers and acquisitions (M&As) were especially weak in 2023. M&As, which mostly affect FDI in developed countries, fell by 46 per cent in value. Project finance, important for infrastructure investment, was down 26 per cent. Tighter financing conditions, investor uncertainty, volatility in financial markets and tighter regulatory scrutiny were the principal causes of the decline. However, Greenfield investment project announcements provided a bright spot, with the number of projects increasing by 2 per cent, with the growth concentrated in manufacturing.

90 On September 21, 2023, JPMorgan announced the inclusion of the Indian government bonds to its benchmark emerging-market index, i.e., JPMorgan Government Bond Index-Emerging Markets- starting June 28, 2024.

91 UNCTAD World Investment Report 2024-Investment Facilitation and Digital Government, https://unctad.org/system/files/official-document/wir2024_overview_en.pdf

Chart IV.27a: Moderation in net FDI inflows in FY24 owing to a rise in repatriation

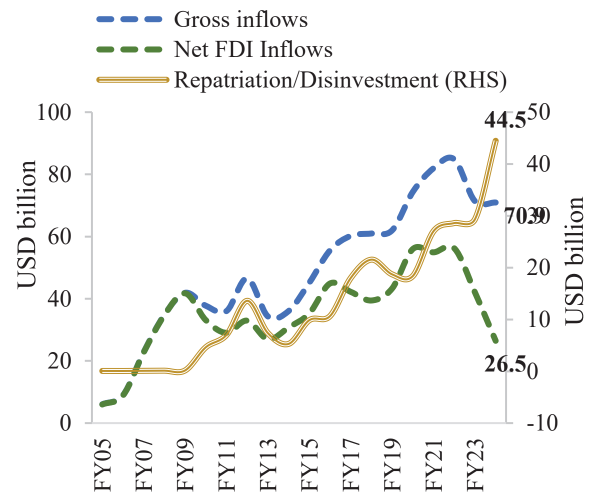
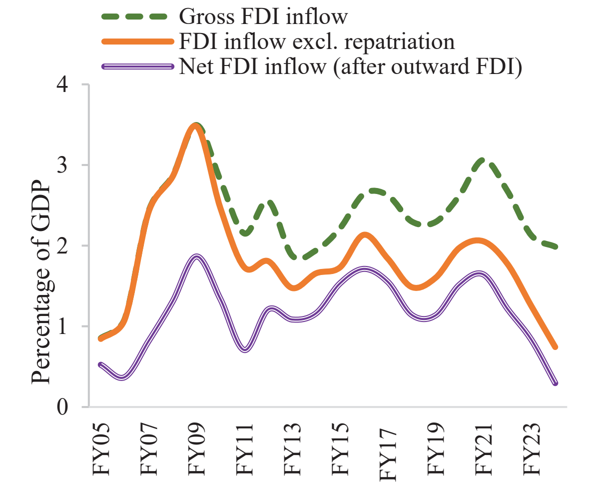


Chart IV.27b: Decline in net FDI inflows as per cent of GDP



Source: Balance of Payments statistics, RBI[92]

4.61 The decline in global FDI flows has also impacted FDI flows to India. Net FDI inflows[93] to India declined from USD 42.0 billion during FY23 to USD 26.5 billion in FY24. However, gross FDI inflows moderated only by 0.6 per cent from USD 71.4 billion in FY23 to just under USD 71 billion in FY24. In other words, there was no change in investor interest in India. The contraction in net inflows was primarily due to a surge in repatriation/disinvestment due to many profitable exits. A market that allows investors to take profits and exit their investments is a healthy one. That is why the repatriation of investment increased from USD 29.3 billion in FY23 to USD 44.5 billion in FY24. The decline in FDI inflows in recent years is also attributable to higher interest rates in developed countries and attractive exits out of India due to the buoyant stock market.

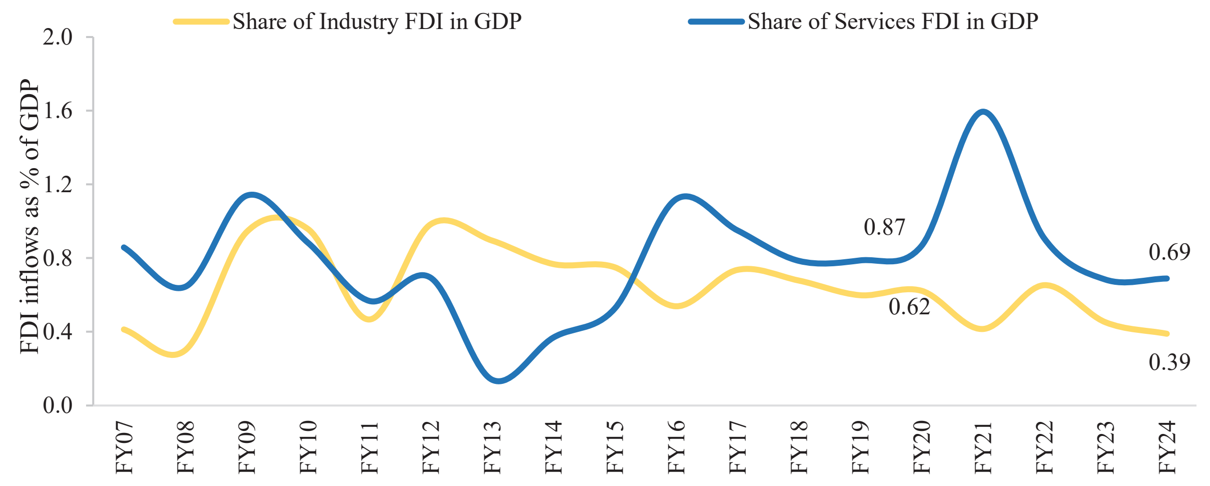
An examination of change in trend and composition of FDI flows

FDI in the industry vs services sector

4.62 A close examination of the FDI equity inflows into major sectors reveals that FDI inflow into the industry and services sectors[94] has weakened in recent years. In fact, for both these sectors, the FDI-to-GDP ratio has dipped below pre-pandemic levels. The share of industry sectors' FDI in GDP declined from 0.62 per cent in FY20 to 0.39 per cent in FY24. During the same period, the share of the services sector in GDP fell from 0.87 per cent to 0.69 per cent.

92 RBI data has been used here as DPIIT does not give data on Repatriation/Disinvestment
93 Net FDI inflows=Gross FDI Inflows-Repatriation/Disinvestment
94 Industry includes sectors such as drugs and pharmaceuticals, automobile industry, chemical, construction, electronics, etc. Services include sectors such as computer software and hardware, banking and insurance services, telecommunications, consultancy services, etc.

Chart IV.28: Trends in FDI equity inflows to both Industry and Services



Source: FDI Statistics, DPIIT

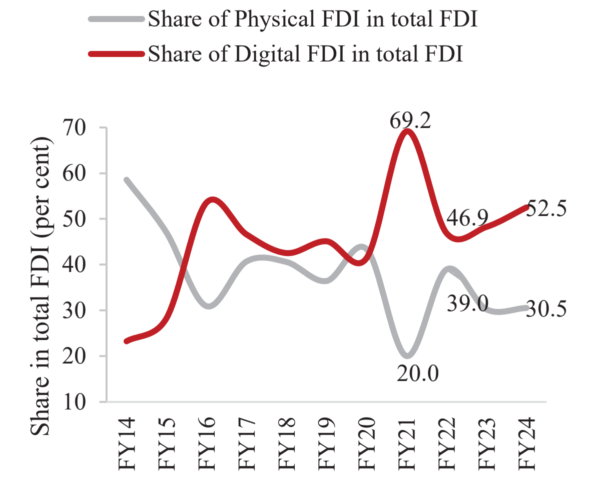
Physical FDI vs Digital FDI

4.63 FDI inflows can be divided into physical and digital for further analysis. Physical FDI includes sectors such as automobiles, pharmaceuticals, and construction, while digital FDI includes computer services, telecommunications, consultancy services, and information and broadcasting.[95] A few years ago (FY14), physical FDI was about three times the value of digital FDI. Owing to a rise in foreign investment in sectors such as software and hardware, consultancy services, and telecommunications, among others, digital FDI witnessed an increase, coupled with a relative decline in physical FDI.

4.64 Nomura's Global Market Research May 2024, 'Asia's New Flying Geese', highlights that rising protectionism and geopolitical tensions have triggered the stagnation of physical FDI. One factor exacerbating this trend is the growing prevalence of non-equity modes of international production, such as contract manufacturing, third-party outsourcing or franchising. Under these scenarios, while economies may become more integrated into GVCs, this may not be reflected in the FDI data. During the pandemic, there was a surge in the share of digital services in total FDI owing to the prevalence of work-from-home culture and the availability of efficient digital infrastructure. As a result, the share of digital FDI in total FDI rose from 46.6 per cent in FY17 to 69.2 per cent in FY21. However, both digital and physical FDI have been falling in recent times. The fall in digital FDI has much to do with tech start-ups. Following a big increase during the pandemic, global flows into tech start-ups have fallen, a global trend in flows that is mirrored in India as well.

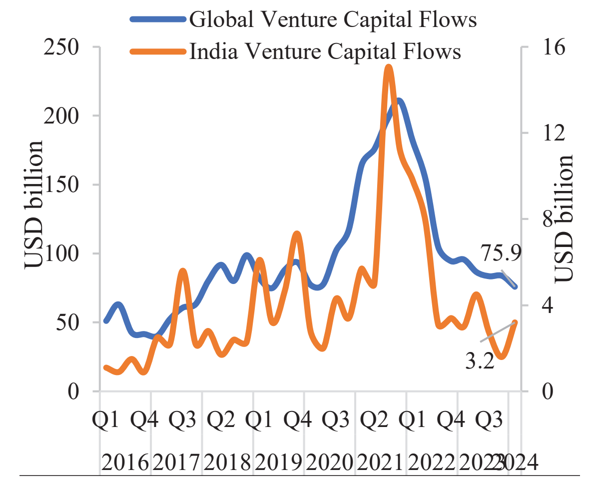
95 Reference: HSBC Global Research: India's FDI Mystery, Shifting Frontiers, https://www.hsbc.co.in/wealth/insights/market-outlook/india-economics/2024-01/

Chart IV.29a: Share of physical and digital FDI in total FDI



Source: FDI Statistics, DPIIT

Chart IV.29b: Global capital flows in tech start-ups

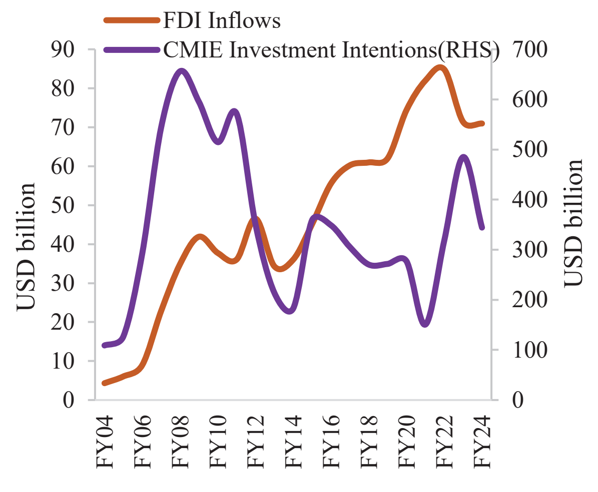


Source: KPMG Venture Pulse Report

Actual FDI vs intentions

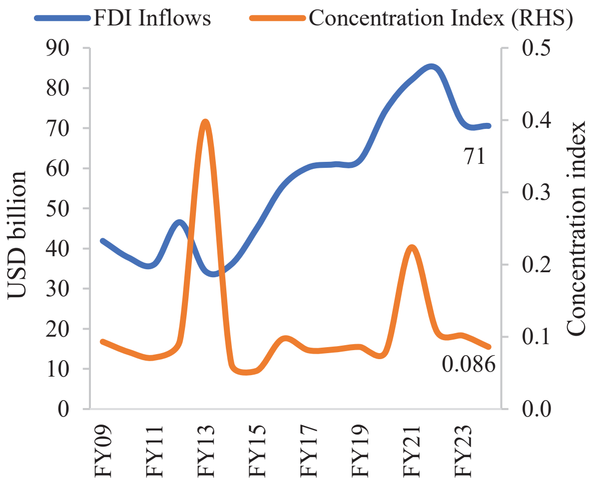
4.65 The declining FDI flows to India are at odds with India gaining market share in global trade in goods and services exports. In this context, an exercise was undertaken to understand the relationship between FDI inflows and investment intentions. Two data sources have been used to estimate intentions. One is the UNCTAD data on announced greenfield FDI projects; the other is CMIE's announced foreign private sector projects.[96]

Chart IV.30a: Investment intention as a predictor of future FDI inflows



Source: CMIE for FDI Intentions, DPIIT for FDI inflows

Chart IV.30b: Positive correlation between FDI inflows and concentration of FDI across sectors



Source: DPIIT and own calculations

96 The UNCTAD data only refers to greenfield investments, while the CMIE database includes different sectors. UNCTAD records data when there is a clear indication that jobs and new capex will be created, while CMIE includes projects even before essential licenses or land has been obtained/acquired or the funding has been tied up.

4.66 Over time, there has been a significant change in the trend in investment intentions across sectors. While investment intentions in industries such as computers and chemicals have softened, investment intentions in new and futuristic sectors are increasing.[97] In recent quarters, investment intentions in new and futuristic sectors, such as renewables, artificial intelligence, data centres, EVs and batteries, green hydrogen, and semiconductors, have rapidly risen. India was a leading destination for AI-related FDI in 2022, receiving 122 AI-related FDI projects in 2022, with multinational companies such as ABB, Accenture, Deloitte, IBM, and Microsoft announcing investments in the country.[98] According to research by NASSCOM, India is an attractive destination for AI investment due to its relatively low operating costs and the world's second-largest pool of highly skilled AI, machine learning, and big data workers.[99]

4.67 A detailed examination of CMIE Investment Intentions and UNCTAD data on greenfield projects reveals that a strong correlation of more than 56 per cent exists between these data sources. Chart IV.30a shows that investment intentions have been a good predictor of future FDI inflows. FDI inflows followed the same direction as CMIE Investment Intentions till FY15; however, in FY16, the trend diverged.

4.68 An estimation of FDI concentration using the Hershman-Herfindahl Index (HHI)[100] highlights a positive correlation between total FDI inflows and the concentration index, which implies that in years in which the Indian economy witnessed a surge in FDI inflows, FDI was concentrated in a few sectors only and was not broad-based across sectors, and vice-versa.

4.69 India has a well-established infrastructure to attract FDI in select sectors, i.e., greenfield projects such as renewables, digital services such as telecommunications, software and hardware, and consultancy services. However, this may be different across the board. Therefore, where investment intentions are high, the sectors must be made more accessible for investments. Notably, the focus must remain on improving the ease of doing business across sectors and extend beyond sectors attractive to FDI alone. While several low-hanging fruits with respect to the 'Ease of Doing Business' have been plucked already over the years, further work may lie in details across all levels of government – national, state and local - and across regulators.

4.70 An article in Bloomberg in April 2024[101] noted that India was not competing with other developing nations only to attract FDI. It is competing with advanced nations who now actively and aggressively pursue industrial policies that privilege domestic investment by dangling subsidies to businesses to prevent them from investing abroad and to entice other overseas investors who might otherwise consider emerging nations like India. Educated labour and a skilled workforce coupled with a vibrant R&D culture are important magnets, apart from

97 As per the CMIE investment intentions data sector-wise
98 Global trends for FDI in AI, https://www.investmentmonitor.ai/features/what-are-the-global-trends-for-fdi-in-ai/?cf-view
99 NASSCOM Strategic Report-resilience to Resurgence: Technology Sector in India 2022, https://nasscom.in/knowledge-center/publications/technology-sector-india-2022-strategic-review
100 Hershman Herfindahl Index has been calculated by taking the sum of squares of the share of each sector in total FDI inflows
101 'Biden Trumps Modi In Fight for Foreign Investment', Bloomberg, 4 April 2024 (https://www.bloomberg.com/news/newsletters/2024-04-04/modi-vs-biden-why-foreign-investment-into-india-is-still-declining)

political stability, policy predictability and stability, reasonable duties and taxes, dispute resolution mechanisms and ease of repatriation. India has made considerable progress in many of these areas over the years. There may be unfinished work in other areas. But, above all, the route to sustained investor interest and consequent accumulation of knowledge and know-how in India may lie through better educational and skill outcomes.

4.71 The box below discusses how increased FDI inflows from China can help in increasing India's global supply chain participation along with a push to exports.

Box IV.6: China Plus One strategy

Over the last five years, a seismic change has occurred in the global manufacturing realm, with major multinational companies, including Apple and others, looking to 'de-risk' themselves from China, which was traditionally known as the 'world's factory'. This shift is primarily due to disruptions caused by COVID-19, growing tensions between the US and China, and rising costs of doing business in China. As a result, several companies have adopted a 'China plus one strategy' to reduce their reliance on China for high-tech electronic products and components. This approach involves supply chain decisions to decrease their risk exposure to China. For example, over 90 per cent of manufacturers in North America surveyed by the Boston Consulting Group in 2023 moved some or all of their production to other countries like Mexico, Thailand, and Vietnam, suggesting a move away from China.[102]

Can India benefit from this 'China plus one' strategy? The appeal of India lies in its large domestic consumer market, which makes it attractive for companies to set up operations there. In the electronics sector, there is a focus on smartphone manufacturing and assembly. The Government's PLI scheme, including tax breaks and subsidies, plays a significant role in attracting companies. The rise in India's domestic smartphone demand is also a key factor in companies' decisions to invest there. For instance, Apple assembled USD 14 billion worth of iPhones in India during FY24, constituting 14 per cent of its global iPhone production.[103] Foxconn has started production of Apple mobile phones in Karnataka and Tamil Nadu.[104]

While India may not be an immediate beneficiary of the trade diversion from China, it has witnessed a substantial increase in its electronic exports over time. The implementation of the PLI scheme has been a key driver of this growth. For instance, India's electronic exports to the US have transitioned from a trade deficit of USD 0.6 billion in FY17 to a trade surplus of USD 8.7 billion in FY24, underscoring a significant increase in value addition. Within the electronics sector, the category that has experienced the most growth is mobile phones, with exports to the US rising from USD 2.2 billion in FY23 to USD 5.7 billion in FY24.

As India looks to deepen its involvement in Global Value Chains (GVCs), it will look to the successes and strategies of East Asian economies. These economies have typically pursued

102 Boston Consultancy Group article, 'Harnessing the Tectonic Shifts in Global Manufacturing', https://tinyurl.com/bnrcrddz.
103 India Briefing, 'Apple's Contract Manufacturers and Component Suppliers in India', dated 17 April 2024, https://tinyurl.com/357mv7hy
104 Ibid

two main strategies: reducing trade costs and facilitating foreign investment. Given that GVCs are designed to minimise costs, countries like Malaysia, Vietnam, and Taiwan have focused on lowering their trade costs over time. For India, improving logistical efficiency has been a key focus, as evidenced by a noticeable rise in India's score on the World Bank's LPI (as discussed in para 4.49). The second strategy, focused on investment facilitation, includes actions to increase and stabilise foreign investment. The PLI scheme, for example, encourages high-quality foreign investment by offering a market-linked incentive system for companies to comply with.

Over the medium term, India is focusing on integrating its value chain with that of the West, particularly in sectors like renewable energy and advanced technology, including artificial intelligence, semiconductors, and next-generation telecommunications. This strategy is being pursued through agreements such as the Australia-India Free Trade Agreement and the US-India Clean Energy Initiative. As a result, the trading patterns within these sectors are starting to develop. For example, the tariff classifications for environmentally friendly technology, such as solar water heaters, waste recycling devices, and wind turbines, show an increase in exports to the USA from USD 199.2 million in FY20 to USD 326.9 million in FY24[105]. Further, leading American and European companies in the renewable energy sector, such as First Solar, Vesta, and Scatec, have established their operations in India to take advantage of the growing demand for green technologies.

Will China plus one result in a total movement of trading relations away from China? This may not be the case. Take, for example, nations like Mexico, Vietnam, Taiwan and Korea, which were direct beneficiaries of the US's trade diversion from China. Even while these nations increased their share of exports to the US, they also displayed a concomitant rise in Chinese FDI.[106] Therefore, the world cannot completely look past China, even as it pursues China plus one.

India faces two choices to benefit from China plus one strategy: it can integrate into China's supply chain or promote FDI from China. Among these choices, focusing on FDI from China seems more promising for boosting India's exports to the US, similar to how East Asian economies did in the past. Moreover, choosing FDI as a strategy to benefit from the China plus one approach appears more advantageous than relying on trade. This is because China is India's top import partner, and the trade deficit with China has been growing. As the US and Europe shift their immediate sourcing away from China, it is more effective to have Chinese companies invest in India and then export the products to these markets rather than importing from China, adding minimal value, and then re-exporting them. Further,

105 HS Code-8402, 8406 and 8414.

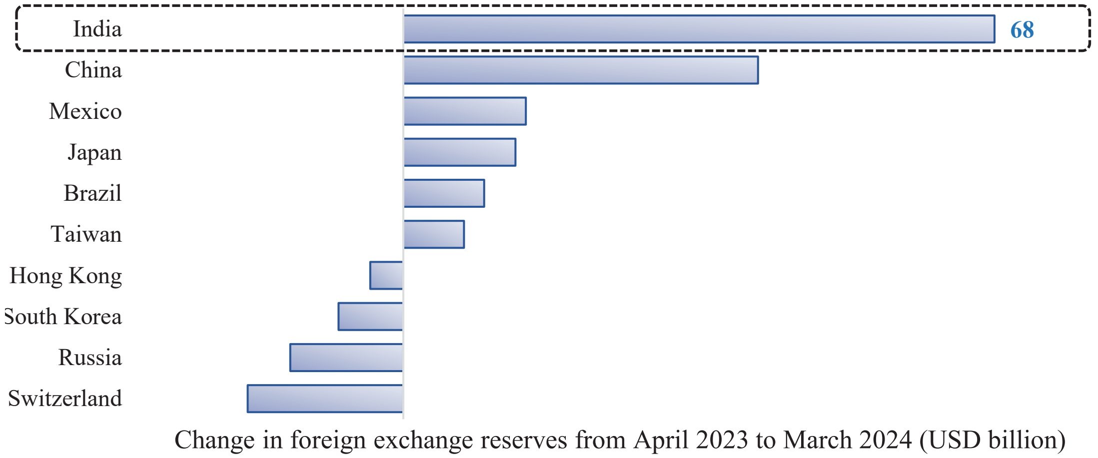
106 Sourced from the presentation made by Pierre-Olivier Gourinchas, Economic Counsellor and Director of Research Department, IMF at NCEAR, India Policy Forum on 2 July 2024, 'CRACKS IN THE SYSTEM: How Geo-Economic Fragmentation is Re-shaping the World'

a recent research note from the Rhodium Group points out, "China's dominance over so many product categories creates, first and foremost, a risk of economic coercion, where the government restrains access to crucial inputs for political leverage."[107] The same brief also notes, "Brazil and Turkey have raised barriers to imports of Chinese EVs, but enacted measures to attract Chinese FDI in the sector." European nations, too, have decided to follow a similar approach[108]. Hence, it is imperative that India finds the right balance between importing goods from China and importing capital (FDI) from China.

Comfortable Foreign Exchange Reserves

4.72 A moderation in the CAD amidst large capital inflows enabled the addition of foreign exchange reserves (FER) in FY24. The buffer of FER insulates domestic economic activity from global spillovers. These reserves act as a cushion and provide liquidity, ensuring India can meet its external obligations. During FY24, India's FER increased by USD 68 billion, the highest increase among major foreign exchange reserves-holding countries. FER stood at USD 653.7 billion on 21 June 2024, enough to cover more than 10 months of imports projected for FY25 and more than 98 per cent of total external debt outstanding at the end of March 2024.

Chart IV.31: India witnessed the most significant increase in foreign exchange reserves holdings in FY24



Source: Bloomberg, RBI for India (Handbook of Statistics on Indian Economy, Foreign Exchange Reserves, Weekly, RBI)

107 How China's Overcapacity Holds Back Emerging Economies', Rhodium Group, 13 June 2024 https://tinyurl.com/y9d6rpna.
108 'Europe's Response to China Shock 2.0: Hold China Closer', Wall Street Journal, 23 June 2024 https://tinyurl.com/j8trksxv

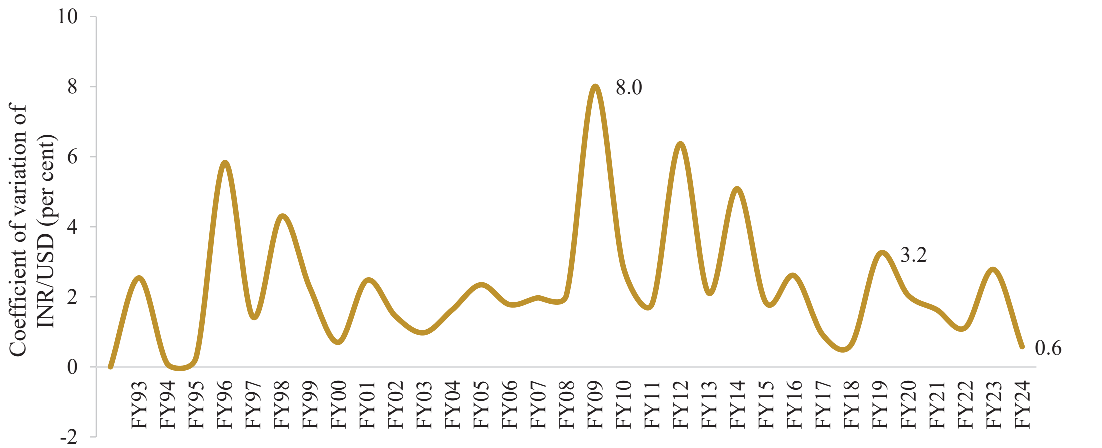
Chart IV.32: Adequacy of India's forex reserves (in terms of number of months of annual imports): A cross-country perspective

Source: IMF (forex reserves) and WTO (for import data)

Exchange Rates

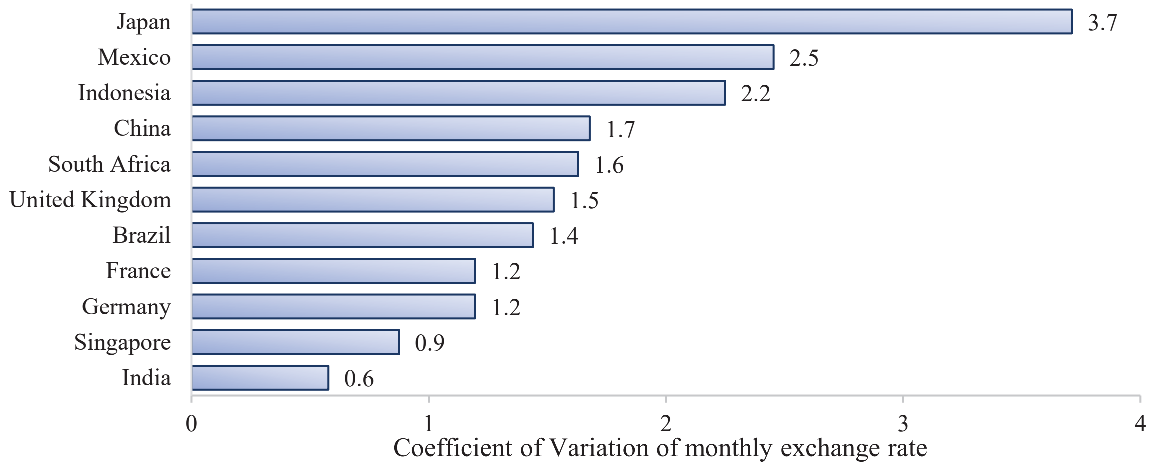
4.73 Despite FY24 being marked by geopolitical risks, rising interest rates and volatile commodity prices, the US economy exhibited resilience with positive economic indicators such as a tight labour market and upbeat consumer sentiments. These factors contributed to drawing global funds to US treasury markets as there was a higher demand for greenback on safe-haven appeal. In FY24, the US Dollar gained against virtually every major peer. The Rupee also came under depreciation pressure. However, INR was one of the least volatile major currencies. Further, it exhibited the lowest volatility in FY24 compared to the previous years. An estimation of volatility using the coefficient of variation (CV) highlights that CV was 0.58 during FY24, much lower than in the past years. The relative stability of the rupee, despite a stronger US dollar and elevated US treasury yields, reflects the strength of the Indian economy's sound macroeconomic fundamentals, financial stability, and improvements in external position. In the future, robust foreign inflows and comfortable trade deficits are expected to keep the rupee within a comfortable range.

Chart IV.33: Volatility of Rupee/USD exchange rate



Source: Own calculations based on Table No. 200, 'Exchange Rate of the Indian rupee vis-à-vis the SDR, US Dollar, Pound Sterling, Euro and Japanese Yen, External Sector, Handbook of Statistics on the Indian Economy, RBI

Chart IV.34: Exchange rate volatility of other countries w.r.t USD in FY24

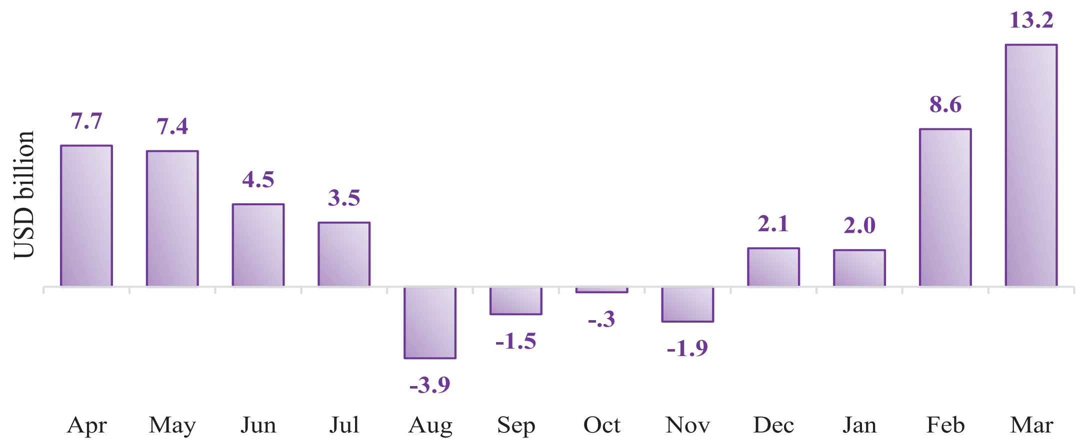


Source: Data on Bilateral Exchange Rate from BIS data portal and own calculations
Note: Exchange Rate volatility has been calculated using the Coefficient of Variation

4.74 The Rupee/USD exchange rate was in the range of ₹82-83.5/USD in FY24, depreciating against USD by only 2.9 per cent during FY24. The Rupee depreciated by 6.9 and 6.8 per cent against Pound Sterling and Euro, respectively, in FY24. However, it appreciated by 3.5 per cent against Japanese Yen during the period.

4.75 The exchange rate of the INR is market-determined. The RBI regulates the foreign exchange market to ensure its orderly functioning and development and intervenes only to curb undue volatility in the INR. It has managed to contain INR volatility and keep foreign exchange markets stable. Recently, it announced various measures to diversify and expand the sources of forex funding to mitigate exchange rate volatility and dampen global spillovers. For example, the regulatory regime relating to FPI investment in debt flows has been revised to encourage foreign investment in Indian debt instruments.

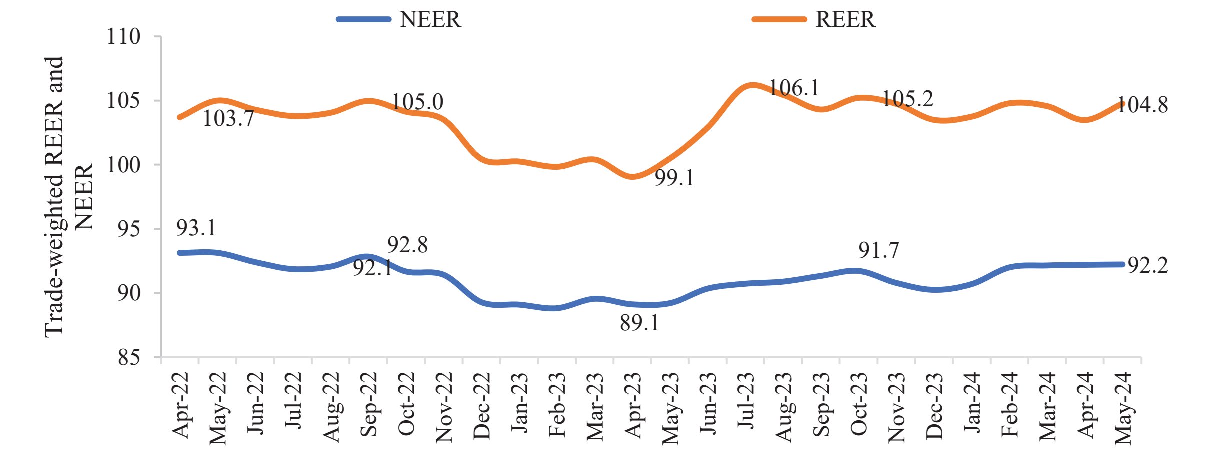
Chart IV.35: Trends in net purchase (+) and sale (-) of foreign currencies by RBI during FY24



Source: Table No. 206, 'Sale and Purchase of US Dollar by Reserve Bank of India', External Sector, Handbook of Statistics on the Indian Economy, RBI

4.76 The indices of Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) are used as indicators of external competitiveness.[109] In terms of 40-currency (trade-weighted), NEER depreciated by 0.6 per cent in FY24. However, REER appreciated by 0.8 per cent in FY24. In May 2024, NEER at 92.2 and REER at 104.7 recorded appreciation of 0.03 per cent and 1.2 per cent, respectively.

Chart IV.36: Movement of index of 40-Currency NEER and REER (trade-based weight) (Base year 2015-16 = 100)



Source: Table No. 202, 'Indices of Real Effective Exchange Rate (REER) and Nominal Effective Exchange Rate (NEER) of the Indian Rupee (40-currency bilateral weights, monthly average), External Sector, Handbook of Statistics on the Indian Economy, RBI

4.77 The box below discusses the impact of exchange rate changes on the Indian economy through the trade channel as well as the financial channel.

Box IV.7: Trade and Financial channels of the Exchange rate

Historically, a depreciated currency has been a key driver of export growth. The Marshal Lerner conditions, if met, suggest that currency depreciation can stimulate an increase in net exports by reducing export costs and increasing import prices. This 'trade' channel of the exchange rate has been well-documented for India. However, the exchange rate also influences the external sector through a 'financial' channel. Theory suggests that the financial channel of the exchange rate can potentially counterbalance the gains (or losses) made through the trade channel.

A weak Rupee can affect the Balance of Payments (BoP) by changing the supply and cost of foreign funding. For instance, depreciation can reduce the creditworthiness of local borrowers if they have Rupee-denominated assets and borrow in foreign currencies. This could raise the cost of foreign lending and lead to a net capital outflow. Globally, appreciation in domestic currencies (against the dollar) has increased cross-border banking capital flows.[110] However, Kearns and Patel (2016) show that the financial channel of the exchange rate is generally more potent in EMEs, where unhedged foreign currency exposures are more likely to be present.[111]

109 NEER is the weighted average of bilateral nominal exchange rates of the home currency in terms of foreign currencies. The REER is defined as a weighted average of nominal exchange rates adjusted for relative price differential between domestic and foreign countries.

110 Bruno, V., & Shin, H. S. (2015). Capital flows and the risk-taking channel of monetary policy. Journal of monetary economics, 71, 119-132.

111 Banerjee, R., Hofmann, B., & Mehrotra, A. N. (2020). Corporate investment and the exchange rate: The financial channel.

Over the last two decades, India's FDI and equity portfolio inflows have totalled about 2.5 per cent of GDP annually (IMF, 2023).[112] In general, inflows to the capital account increased by 65 per cent between FY-14 and FY-24. Therefore, in the context of India's large and growing financial account with the rest of the world, whether the Rupee should remain competitive is a question to ponder.

To answer this question, the two different channels of the exchange rate were estimated using a trade-weighted exchange rate and a debt-weighted exchange rate. The trade-weighted Nominal effective exchange rate (NEER) provided by the RBI is used to capture the trade channel. The financial channel is captured by a debt-weighted exchange rate (DWER), which is constructed as an arithmetic average of the Rupee against major foreign currencies, weighted by their share in the composition of external debt.

In theory, the net BoP must equate to zero as trade surpluses (deficits) equate to capital account deficits (surpluses). However, in practice, countries report net Bop deficits/surpluses with rare instances of BoP equilibrium. Literature explains BoP disequilibria as a monetary disequilibrium and as the result of excess supply or demand for currency.[113] Therefore, to study the extent to which the two channels (trade and financial) counteract the other in the presence of currency movement, the dependent variable used here is net BoP.

An auto-regressive distributed lag (ARDL) model is deployed to capture the separate channels of a Rupee depreciation/appreciation on net Balance of Payments (BoP). The problem of endogeneity is controlled for in an ARDL framework in the absence of autocorrelation of errors. Further, multicollinearity is also not a significant issue as lags and differences of the variables are used.

$$\Delta \ln BoP_t = \gamma_i \Delta BoP_{t-1} + \delta i \sum \Delta DWER_t + \beta_i \sum \Delta NEER + \theta X_t + \varepsilon_t$$

The data used is at a quarterly frequency between Q1 of FY12 to Q3 of FY24. The dependent variable is the net balance of payment in nominal terms calculated as Ln (BoP Credit)/(BoP Debit); DWER represents the debt-weighted exchange rate. The coefficients δ_i and β_i indicate the elasticity of net BoP to changes in the debt channel of the exchange rate and the trade channel of the exchange rate. X_t includes control variables such as World imports, repo rate, commodity prices, domestic demand, GDP deflator and a dummy for the COVID-19 years (March 2020 to March 2022). Optimal lags for the regressors are chosen according to the AIC criterion.

Dependent variable – Net BoP

Regressor	Long run Elasticity
DWER	0.16*
NEER	-0.7*

'*' denotes significance at the 10 per cent level

The results indicate that India's trade channel is stronger than the financial channel. Over the long run, the net effect of an appreciation is negative (-0.7 + 0.16). Thus, a per cent appreciation of the Rupee results in a net decline in the BoP by 0.54 per cent.

112 IMF, 2024 India's Financial System: Building the Foundation for Strong and Sustainable Growth

113 See for instance, Frenkel, J., & Mussa, M. (1985). Asset Markets, Exchange Rates and the Balance of Payments, Handbook of International Economics, Volume II (eds.), Ronald Jones and Peter Kenen; Johnson, H, G. (1958). Towards a General Theory of the Balance of Payments.

In addition to conducting post-estimation checks for serial correlation and parameter stability (CUSUM test), robustness checks were performed by studying the variables in a dynamic OLS framework. The result of the robustness check is provided below:

Dependent variable – Net BoP

Regressor	Long run Elasticity
DWER	0.12**
NEER	-1.01**

'**' denotes significance at the 5 per cent level

The results outline that a competitive Rupee continues to boost the BoP as the benefits received through the trade channel outweigh the costs incurred in the financial channel. As noted by Longaric 2022, India's high trade openness and low share of external debt mean that the trade channel effect of currency fluctuations dominates the financial channel effect. This contrasts with other EMEs, such as Brazil and the Philippines, whose financial channel effect dominates the trade effect.

INTERNATIONAL INVESTMENT POSITION (IIP)

4.78 The Net IIP[114] position determines whether a country is a net creditor or debtor nation by measuring the difference between its external assets and liabilities. As of the end of March 2024, Indian residents' overseas financial assets at USD 1,028.3 billion were higher by USD 109.7 billion or 11.9 per cent compared to the level as of March 2023, mainly due to a rise in reserve assets, currency and deposits, overseas direct investment, trade credit and advances and loans. Reserve assets at USD 646.4 billion, accounting for around 62.9 per cent of India's international financial assets, increased by 11.8 per cent over the same period.

Improvement in India's net IIP in end-March 2024

Chart IV.37a: Net IIP and as a percentage of GDP

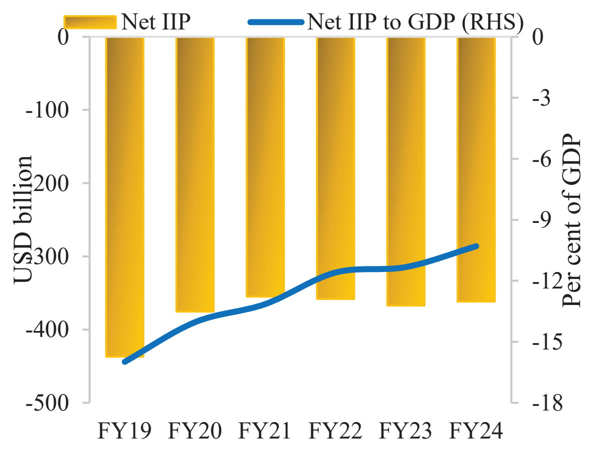
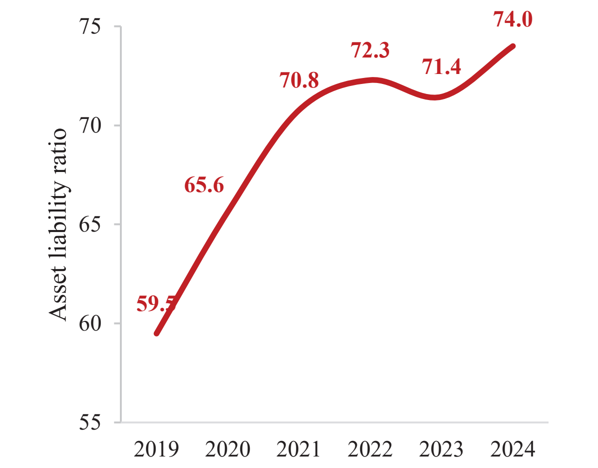


Chart IV.37b: Asset liabilities ratio (in per cent)



Source: 'International Investment Position of India', Statistics, External Sector, International Finance, RBI

114 According to the IMF, Balance of Payments and International Investment Position Manual, IIP is a statistical statement that shows at a point in time the value and composition of (a) financial assets of residents of an economy that are claims on non-residents and gold bullion held as reserve assets, and (b) liabilities of residents of an economy to non-residents. The difference between an economy's external financial assets and liabilities is the economy's net IIP, which may be positive or negative.

4.79 International liabilities at USD 1,390 billion as of the end of March 2024 were higher by USD 104.3 billion (8.1 per cent) as compared to the level in March 2023. The rise was attributed mainly to an increase in portfolio investment, loan, direct investment and other accounts payable. The share of debt liabilities in total external liabilities was 51.1 per cent as of March 2024.

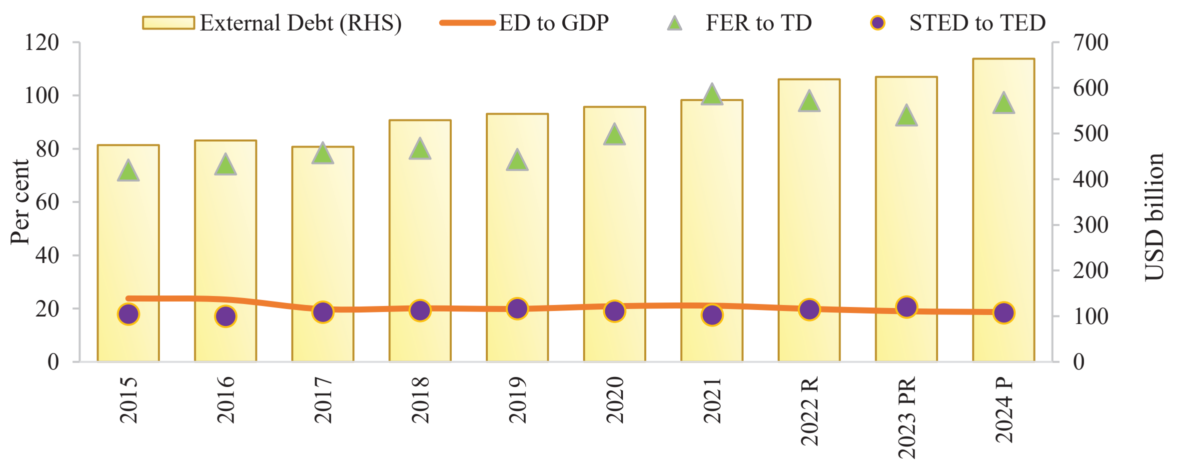
4.80 Thus, the net claims of non-residents in India, valued at USD 361.7 billion as of the end of March 2024, declined by USD 5.5 billion over the level of March 2023. India's international financial assets covered 74 per cent of international financial liabilities as of the end of March 2024.

STABLE EXTERNAL DEBT POSITION

4.81 The current account can also be expressed as the difference between national (both public and private) savings and investment. A current account deficit may, therefore, reflect a low level of national savings relative to the desired level of investment. External debt, by supplementing domestic savings, helps countries grow faster. In developing economies, high economic growth is typically associated with high external debt and vice-versa. However, an unsustainable large stock of external debt can potentially create vulnerabilities and dent growth prospects.

4.82 India has managed its external debt prudently with the overarching objective of keeping the current account deficit within sustainable limits and encouraging non-debt creation of external finance. India's external debt has been sustainable over the years, as evident in chart IV.38 below. The external debt to GDP ratio declined to 18.7 per cent at the end of March 2024 from 19.0 per cent at the end of March 2023. The share of short-term debt (with original maturity of up to one year) in total external debt declined to 18.5 per cent at the end of March 2024 from 20.6 per cent at the end of March 2023. The ratio of FER to total debt stood at 97.4 per cent as of March 2024.

Chart IV.38: India's stable external debt position and vulnerability indicators



Source: 'External Debt of India-Quarterly and India's External Debt-US Dollars (End March)', Statistics, External Sector, External Debt-RBI
Note: R-Revised, PR-Partially Revised, P-Provisional; ED–External Debt, FER-Foreign Exchange Reserves, TED–Total External Debt, STED-Short Term External Debt

4.83 Comparing various debt vulnerability indicators of India with peer countries for 2022 indicates that India is in a better position with relatively low levels of total debt as a percentage of Gross National Income (GNI) and short-term external debt as a percentage of total external debt. The comfortable level of FER offers additional comfort.

Table IV.3: India's key external debt indicators: A snapshot of stability

(Per cent, unless indicated otherwise)

End-March	External Debt (USD billion)	External Debt to GDP	Debt Service Ratio	Foreign Exchange Reserves to Total Debt	Concessional Debt to Total Debt	Short-Term Debt to Foreign Exchange Reserves	Short-Term Debt (original maturity) to Total Debt
2018	529.3	20.1	7.5	80.2	9.1	24.1	19.3
2019	543.1	19.9	6.4	76.0	8.7	26.3	20.0
2020	558.4	20.9	6.5	85.6	8.8	22.4	19.1
2021	573.4	21.1	8.2	100.6	9.0	17.5	17.6
2022 R	618.8	19.9	5.2	98.1	8.3	20.0	19.7
2023PR	624.1	19.0	5.3	92.7	8.2	22.2	20.6
2024 P	663.8	18.7	6.7	97.4	7.5	19.0	18.5

Source: Ministry of Finance
R: Revised, PR: Partially Revised; P: Provisional

OUTLOOK AND CHALLENGES

4.84 Though ongoing geopolitical headwinds impacted India's merchandise exports, lowering international commodity prices ensured a lower trade deficit in FY24 than in FY23. A narrowing merchandise trade deficit and rising service exports have improved the CAD, ending with a surplus of 0.6 per cent of GDP in Q4 of FY24. In the coming years, India's trade deficit is expected to decline further as the PLI scheme is expanded and India creates a globally competitive manufacturing base in several product categories. Further, the recently signed FTAs are expected to increase the global market share of the country's exports. Various international agencies and RBI expect the CAD to GDP to moderate to below one per cent for FY24, driven by growing merchandise and services exports and resilient remittances.

4.85 However, the risks to the performance of India's external sector are on the downside due to the persistence of current geopolitical tensions and policy uncertainty. Some of the challenges are mentioned below: -

- **Fall in demand from major trading partners:** As per the DGCIS data, the US was India's second-largest trading partner in FY24 after China. However, the USA's overall import volume declined by 1.7 per cent in 2023 compared to a growth of 8.6 per cent in 2022, as per OECD. This significantly influenced export growth in trading partners, including

India.[115] Rising protectionism is another risk that could undermine trade recovery in 2024 and 2025.

- **Rise in trade cost:** Attacks on shipping in the Red Sea and drought in the Panama Canal have resulted in trade flows being re-routed, increasing journey time and costs as mentioned in para 4.8 above. India's merchandise trade relies heavily on maritime trade, so disturbances in major shipping routes can impact its economy. A CRISIL report[116] highlighted that the Red Sea crisis has impacted the Middle East's fertiliser exports to India as imports of the Muriate of Potash from Jordan and Israel have been affected.

- **Commodity price volatility:** Fluctuations in commodity prices, especially for critical imports like oil, metals, and agricultural products, can impact India's trade balance and inflation levels. Disappointing global growth presents a downside risk, especially for industrial commodities. Additional trade restrictions could push food prices higher.

- **Trade policy changes:** Changes in trade policies by major trading partners or geopolitical developments can affect India's export opportunities and market access. As per the WTO's Trade Monitoring Report, November 2023[117], the pace of WTO members' implementation of new export restrictions has increased significantly since 2020. 75 export restrictions on food, feed and fertilisers are still in place globally, in addition to 20 COVID-19-related export restrictions. For 2023, the trade covered by import restrictions in force was estimated at USD 2,480 billion, representing almost one-tenth of total world imports.

4.86 It is critical to explore what these changing paradigms mean for India. Policies need to be a mix that straddles security concerns with economic considerations. India's push towards manufacturing in complex and niche sectors through schemes such as PLI and Make in India aims to balance these goals. On the other hand, India's edge in services will catalyse our globalisation over the coming years. A recent paper by the Peterson Institute for International Economics[118], asserts that globalisation in services is ongoing, even as we are past the era of hyperglobalised trade in goods. This implies that the global demand for India's services sector exports is here to stay.

4.87 India is simultaneously working towards unlocking the potential gains from growing integration by augmenting the logistics front. This is evident from the large infrastructure deals which have been signed to ramp up trade. For instance, the International North-South Transport Corridor (INSTC) is expected to shorten trade time for shipments to Russia and Europe. Another major joint infrastructure deal, the India-Middle East Europe corridor (IMEC), will connect Asia with Europe via ports and railroads. Similarly, there is a concerted effort towards striking trade agreements with countries spanning geographies.

115 OECD Economic Outlook, May 2024, https://www.oecd.org/economic-outlook/may-2024/
116 https://tinyurl.com/2xf5cb6x
117 WTO end year Trade Monitoring Report November 2023, https://www.wto.org/english/news_e/spno_e/spno42_e.htm
118 Ibid, Note 37.

4.88 Ultimately, India needs to focus on improving its competitiveness in many product areas. For example, India has tremendous potential in becoming a large global exporter in agricultural commodities. Fostering stronger regional trade ties and adding more markets for Indian goods will help mitigate global demand fluctuations. In an era when global economic growth is likely to be buffeted by geopolitical tensions and protectionism, growing India's exports of goods and services will be a stiffer challenge than before. Product safety and quality consciousness in the private sector and policy stability in the public sector are obvious starting points to turn the challenge into an opportunity.

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