13

External Environment
Opportunities, Challenges, and Risks

13.1. The strategy for Eleventh Plan must take into account the fact that our economy is now much more open to foreign trade and capital flows than it was fifteen years ago and is therefore more linked to the global economy. A globalized world is clearly one in which individual countries are more influenced by what happens elsewhere in terms of world prices, changes in world trade patterns and prices, changes in global capital market conditions and associated investor perceptions, changes in technology etc. The impact of globalization on developing countries has been much discussed and it is generally accepted that it presents both opportunities and also poses challenges and risks. These challenges are not identical for each country, because individual country circumstances differ. In this chapter we review the experience with managing trade and capital flows in the Tenth Plan and discuss some of the critical challenges arising from the external environment which we are likely to face.

MANAGING TRADE AND CAPITAL FLOWS

13.2. Managing the balance of payments is obviously one important challenge and an assessment of prospects in this dimension has been one of the basic functions of macroeconomic planning. This challenge is particularly large because of the changes that have taken place in our system of economic management since the liberalization of the economy in the Eighth Plan. It is important to note that transition to the new liberalized system has not posed problems on the external front. We have not had a balance of payments crisis since 1991, despite the global slow down after the East Asian crisis of 1997 and the sharp rise in oil prices in 2005. Contrary to the traditional fears that liberalization would exacerbate the scarcity of foreign exchange and make it difficult to manage the external of payments position, our actual experience has been a surfeit of riches.

13.3. Imports of goods and services have indeed increased as a percentage of GDP from about 10% in 1990–91 to 26% in 2006–07. However this increase has been paralleled by a corresponding increase in the exports of goods and services, particularly the latter, with the ratio as a percentage of GDP moving from 7.3% in 1990–91 to 22.8% in 2006–07. The current account deficit in recent years has varied from a small surplus, for example, 1.25% in 2002–03 and 2.31% in 2003–04 to a small deficit thereafter. The deficit is expected to be only –1.05 % of GDP in 2006–07. This compares with a deficit of –3.05% in 1990–91. Fortunately, managing deficit of this order will not present problems given the growing recognition of India's potential attractiveness as an investment destination. However, openness to capital flows can present problems for policy which need to be carefully calibrated. As far as trade is concerned, we need to exploit export opportunities opened by access to global markets by expanding our export of goods and services thus generating high quality employment. Countries such as China have exploited these opportunities very well and we need to learn from their experience. On the import front we need to be aware of the potentially disruptive effect of exposing domestic producers especially small producers to competitive pressure without giving them time for adjustment and assisting them where possible to improve their competitive capacity. Fortunately, the graduated pace of change followed thus far has avoided serious negative effect but

much more needs to be done in this area to ensure that the benefits of trade expansion and access to global opportunities are more broadly shared and that special attention is paid to its gender aspects.

REVIEW OF EXPORTS IN THE TENTH PLAN

13.4. The broad composition of exports during the Tenth Plan is shown in Table 13.1. Total exports grew at about 24% per year but this was largely because petroleum products grew at 54.32%. Manufactured goods recorded an impressive compound annual growth rate of 19.92% and exports of agricultural and allied products also rose at a healthy rate of 16.22%. The share of petroleum products in the export basket rose substantially at the expense of manufactured and agricultural goods. Supported by strong commodity prices, the share of ores and minerals was stable around 6% during the last three years as compared to about 3.7% during first two years.

TABLE 13.1
Composition of Exports during the Tenth Plan

Commodity Group	2002–03		2003–04		2004–05		2005–06		2006–07*		CAGR
	% share	% growth	% share	% growth	% share	% growth	% share	% growth	% share	% growth	
Agri. and Allied Products	12.73	13.71	11.8	12.27	10.14	12.5	9.91	20.52	9.91	22.53	16.22
Ores and Minerals	3.78	58.12	3.71	18.67	6.08	114.4	5.98	21.36	5.57	14.11	40.99
Manufactured Goods	76.33	20.62	75.95	20.5	72.7	25.24	70.38	19.48	65.51	14.05	19.92
Petroleum Products	4.89	21.58	5.59	38.5	8.37	95.87	11.29	66.53	14.69	59.39	54.32
Others	2.27	1.15	2.95	57.37	2.71	20.28	2.44	11.15	4.29	115.43	35.60
Total	**100**	**20.29**	**100**	**21.1**	**100**	**30.85**	**100**	**23.41**	**100**	**22.54**	**23.58**

Note: *Figures are provisional.
Source: DGCI&S.

13.5. The growth rate of exports of agriculture and allied products picked up during the last two years of the Tenth Plan supported by a sudden and substantial spurt in the exports of raw cotton and continued good performance by the 'agriculture and allied products' group. The share of manufactured products in the export basket was affected by the slowing down of exports in two major sectors, that is, textiles and clothing and gems and jewellery. The textiles and clothing sector grew at a healthy pace of 12.14 % during the four years of the Tenth Plan but the growth slowed down to 3.65% during the final year when the industry was adversely affected by the exchange rate movement. The gems and jewellery sector recorded only a negligible growth during the terminal year of the Tenth Plan. Gems and jewellery, which has been a leading item in India's export basket sustained a reverse because of the decision of the US Government to withdraw the GSP benefit, whereby Indian exports have lost the preferential tariff advantage over some of the competing supplying countries that were not receiving the benefits earlier. The deceleration of manufacturing sector exports during the last two years is also a reflection of the fact that petroleum products are not classified as a manufactured product. If these products are added to manufactured goods, as they should be, the share of manufactured goods has been retained at over 80% throughout the Tenth Plan period.

13.6. The direction of India's exports may be seen in the Table 13.2. America and Europe continued to be important destinations of Indian exports although their combined share declined from 48.62 to 42.12%. There was a marginal decline also in the already low share of Commonwealth of Independent States (CIS) countries. On the other hand, the share of Asia and ASEAN steadily increased during the Tenth Plan and the region accounted for nearly half of India's exports during the last three years of the Plan period. Exports to Africa also registered a steady increase.

REVIEW OF IMPORTS IN THE TENTH PLAN

13.7. Imports recorded a compound annual growth rate of 29.96% in dollar terms during the Tenth Plan period. The high growth of imports was mainly on account of increase in oil prices. The quantity of crude oil imported rose from about 90 MMT in 2002–03 to 130 MMT during the year 2006–07. However the dollar value of crude oil

TABLE 13.2
Direction of India's Exports

Region	2002–03	2003–04	2004–05	2005–06	2006–07*
	Percentage Share				
Europe	**24.17**	**24.54**	**23.55**	**24.16**	**22.89**
EU Countries (27)	22.55	22.74	21.85	22.53	21.26
Other WE Countries	1.58	1.73	1.65	1.58	1.57
East Europe	0.04	0.07	0.05	0.05	0.06
Africa	**4.65**	**4.82**	**5.05**	**5.27**	**6.63**
Southern Africa	1.21	1.24	1.51	1.88	2.23
West Africa	2.02	1.99	1.98	1.84	1.91
Central Africa	0.22	0.24	0.19	0.16	0.16
East Africa	1.20	1.35	1.37	1.39	2.33
America	**24.45**	**20.97**	**20.10**	**20.72**	**19.23**
North America	21.99	19.19	17.52	17.82	15.85
Latin America	2.46	1.78	2.58	2.90	3.38
Asia	**44.39**	**47.60**	**49.50**	**48.38**	**49.78**
East Asia	1.15	1.10	1.03	0.97	1.18
ASEAN	8.76	9.12	10.09	10.10	9.95
WANA	14.28	15.95	17.04	16.19	18.22
NE Asia	14.92	14.70	15.83	15.74	15.31
South Asia	5.28	6.73	5.51	5.38	5.12
CIS & Baltics	**1.75**	**1.63**	**1.31**	**1.21**	**1.17**
CARs Countries	0.16	0.24	0.21	0.16	0.15
Other CIS Countries	1.59	1.39	1.10	1.05	1.02
Unspecified Region	**0.59**	**0.44**	**0.49**	**0.24**	**0.27**
Total	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**

Note: Figures are provisional.
Source: DGCI&S.

imports in 2006–07 was more than US$ 57 billion, against about US$ 17.6 billion in 2002–03, that is, a more than three-fold increase over the period. The price of the Indian Basket of crude oil has increased from around US$ 26.6/bbl in 2002–03 to US$ 62.40 /bbl in 2006–07.

13.8. The broad composition of imports during the Tenth Plan may be seen in Table 13.3 given below. Bulk imports continued to account for a significant share of the total imports during the Tenth Plan mainly on account of crude oil. The crude oil and petroleum products taken together were the single most important category of imports during the Plan period. This group registered a compound annual growth rate of 32.45% during the Plan period accounting for about 26% to 30% of the total value of imports by India during the Tenth Plan. The share of 'other bulk items', which include important commodities like fertilizers, edible oils, non-ferrous metals, metal ores and products and iron and steel, witnessed a perceptible increase over the Plan period with a compound growth rate of 34.85%. The share of this group increased from 10.3% in 2002–03 to 13.6% in 2006–07. Iron and steel and metalliferrous ores and products are the two most important commodities of imports under the category of 'other bulk items'.

13.9. The share of machinery and project goods registered a significant increase during the Tenth Plan, increasing from 11.3% of total imports in 2002–03 to 18.1% in 2006–07. Imports of pearls, precious and semi-precious stones contracted sharply in the last two years of the Plan period after three years of very rapid growth reflecting the stagnation of exports of gems and jewellery.

13.10. The direction of the major imports may be seen in Table 13.4 The major change is that Asia and the ASEAN region recorded a significant increase during this

TABLE 13.3
Broad Composition of Imports

Commodity Group	2002–03		2003–04		2004–05		2005–06		2006–07*		CAGR
	% share	% growth	% share	% growth	% share	% growth	% share	% growth	% share	% growth	
A. Bulk Imports	**38.98**	**20.74**	**37.44**	**22.21**	**38**	**44.82**	**40.9**	**43.96**	**43.59**	**36.16**	**33.17**
(i) Petroleum Crude & Products	28.72	25.99	26.32	16.61	26.76	45.09	29.48	47.31	29.95	29.82	32.45
(ii) Other Bulk Items	10.26	8.13	11.12	37.9	11.24	44.19	11.42	35.98	13.64	52.51	34.85
B. Non-Bulk Imports	**61.01**	**18.64**	**62.56**	**30.48**	**62.01**	**41.43**	**59.1**	**27.51**	**56.42**	**21.94**	**27.76**
(i) Pearls, Precious & Semi-Precious Stones	9.87	31.16	9.12	17.58	8.45	32.18	6.12	–3.06	3.93	–18.03	10.13
(ii) Machinery & Project Goods	11.26	26.3	12.41	40.24	12.16	39.76	14.96	64.58	18.08	54.42	44.46
(iii) Others	39.88	13.99	41.03	30.91	41.4	43.98	38.02	22.86	34.41	15.6	25.00
Of which											
– Electronic Goods	9.12	48.05	9.60	34.05	8.96	33.13	8.88	32.51	8.37	20.42	33.35
– Gold & Silver	6.98	–6.42	8.77	59.89	10.00	62.62	7.59	1.50	7.69	29.40	26.16
Total	**100.00**	**19.45**	**100.00**	**27.25**	**100.00**	**42.70**	**100.00**	**33.76**	**100.00**	**27.75**	**29.96**

Note: Figures are provisional.
Source: DGCI&S.

TABLE 13.4
Direction of India's Imports

	Percentage Share				
Region	2002–03	2003–04	2004–05	2005–06	2006–07*
Europe	**24.98**	**24.04**	**22.98**	**21.18**	**23.64**
EU Countries (27)	20.90	19.29	17.31	17.44	18.25
Other WE Countries	4.07	4.73	5.66	4.72	5.36
East Europe	0.01	0.02	0.01	0.02	0.03
Africa	**4.71**	**3.50**	**3.02**	**2.71**	**5.97**
Southern Africa	3.52	2.51	2.06	1.77	1.53
West Africa	0.88	0.74	0.74	0.78	4.30
Central Africa	0.01	0.01	0.02	0.01	0.02
East Africa	0.30	0.24	0.20	0.15	0.12
America	**9.86**	**8.90**	**8.81**	**8.75**	**10.59**
North America	8.16	7.37	6.97	6.96	7.41
Latin America	1.70	1.53	1.84	1.79	3.18
Asia	**30.12**	**35.36**	**36.18**	**34.58**	**57.51**
East Asia	2.32	3.52	3.63	3.54	3.89
ASEAN	8.39	9.51	8.17	7.30	9.49
WANA	5.84	6.30	8.54	7.28	26.85
NE Asia	12.71	15.12	14.95	15.51	16.49
South Asia	0.86	0.91	0.89	0.95	0.79
CIS & Baltics	**1.37**	**1.61**	**1.76**	**1.98**	**1.86**
CARs Countries	0.06	0.06	0.06	0.05	0.08
Other CIS Countries	1.31	1.55	1.70	1.93	1.78
Unspecified Region	**28.96**	**25.59**	**27.25**	**29.82**	**0.43**
Total	**100.00**	**100.00**	**100.00**	**100.00**	**100.00**

Note: *Figures are provisional.
Source: DGCI&S.

period mainly on account of increase of import share of West Asia due to increase in all prices. The combined share of imports from America and Europe was steady during the Plan period.

TRADE BALANCE

13.11. The merchandise trade deficit widened sharply during the Tenth Plan as can be seen from Table 13.5, mainly on account of the growing oil import bill.

13.12. The extent to which the rising oil import values influenced the merchandise trade balance can be seen from Table 13.6 below. The substantial exports of petroleum products made a large contribution toward ameliorating the trade deficit.

TABLE 13.5
India's Trade Balance

(Value: US$ billion)

Year	Total Exports	Total Imports	Trade Balance
2002–03	52.7	61.4	–8.7
2003–04	63.8	78.1	–14.3
2004–05	83.5	111.5	–28.0
2005–06	103.1	149.2	–46.1
2006–07*	126.3	185.6	–59.3

Note: *Provisional.
Source: DGCI&S.

TABLE 13.6
Balance of Trade and Petroleum Products

(Value: US$ billion)

	2002–03	2003–04	2004–05	2005–06	2006–07*
BoT (Billion)	–8.7	–14.3	–28.0	–46.1	–59.3
BoT (without petroleum imports)	8.9	6.3	1.9	–2.1	–7.2
BoT (excluding petroleum from import and export)	6.4	2.7	–5.1	–13.8	–25.7

Note: P= Provisional.
Source: DGCI&S.

THE BALANCE OF PAYMENTS IN THE ELEVENTH PLAN

13.13. Projections of the balance of payments (BoP) for the Eleventh Plan have been discussed in Chapter 2. Exports are projected to grow at about 20% per year in US$ terms which is marginally lower than the rate at which they have been growing over the Tenth Plan. The current account deficit projected for the Eleventh Plan period could range between 1.2% and 2% of GDP. Financing a current account deficit of this order should not present a problem given the foreign capital inflows that are taking place and which can be expected to continue barring unexpectedly severe downside shock to the world economy. In fact, the capital flows we have been experiencing in recent years have proved difficult to manage leading to a sharp build up in foreign exchange reserves and upward pressure on the exchange rate which has adverse consequence.

STRATEGY FOR EXPORTS

13.14. A vigorous strategy for promoting exports must be an important part of our strategy for managing the balance of payment in the years ahead. An enhanced target of US$ 160 billion has been fixed for 2007–08 (the first year of the XI Plan) indicating a growth rate of 26.6%. On an average, the exports are projected to grow at the rate of about 20% or more during the Eleventh Five Year Plan period in current US$ terms.

13.15. To achieve this target, it is necessary to achieve the general conditions that would promote rapid growth of the economy, including especially the development of efficient infrastructure services. Of these, reliable power supply is perhaps the most important especially if we wish to strengthen the competitive capacity of our middle and small enterprises. In addition it is necessary to ensure the following:

- Promoting production and exports of commercial crops and agri-based processed products.
- Facilitating the provision of critical specialized infrastructure necessary for promoting exports of various commodities including agricultural and marine products in collaboration with State Governments where necessary.
- Expansion and modernization of infrastructure and quality control mechanisms through upgradation of technology and greater use of IT.
- Strengthening of various institutions involved in consultancy, design, human resource development and information services needed for export promotion. This is especially important for exploiting the export potential of medium and small exporters.
- Strengthening the institutions providing general support services to the exporters.

13.16. In line with government's policy of according a high priority to agriculture, the Eleventh Plan must place special emphasis on promoting production and exports of commercial crops and agro-based processed products. Ageing bushes/ plants are acting as a major constraint to the growth of the plantation sector leading to decline in productivity, high cost of production and deterioration in the quality of products. With a view to ensuring healthy growth and improved productivity in the plantation sector, a Special Purpose Tea Fund (SPTF) has been set up under the Tea Board for funding assistance for re-plantation and rejuvenation of old tea . The Scheme will be implemented during the Eleventh Plan period. Similar initiatives are envisaged to be put in place for other plantation crops viz. coffee, rubber, spices, cashew and coconut.

13.17. The following areas should receive special attention during the Eleventh Plan: (i) Simplification of procedures, (ii) streamlining of documentary requirements, (iii) accelerated implementation of EDI initiatives, (iv) fuller neutralization of taxes, (v) improving infrastructure facilities to international standards, and (vi) initiating necessary institutional and structural changes. Streamlining trade data infrastructure to remove anomalies and to enable providing a sound and timely basis for policy formulation along with improved trade infrastructure would be the focus of Eleventh Five Year Plan.

13.18. In order to reduce transaction costs, time limits must be fixed for various clearances/approvals/filing of documents.

OPPORTUNITIES IN EXPORTS OF GOODS AND SERVICES

13.19. Globalization provides us with a number of opportunities which we can exploit to our advantage provided we can take appropriate steps domestically.

Prospects for Manufacturing Exports

13.20. Manufacturing was the most heavily protected sector of the Indian economy with the most extensive Quantitative Restrictions (QRs) and the highest tariff rates till the end of the 1980s. Since the early 90s , one of the objectives of Trade Policy reforms has been to enable the manufacturers of exported products to functioned in an effectively free trade regime so that that they have access to inputs at international prices and customs duties and internal taxes borne by the exported product are fully rebated. As mentioned earlier competitive restrictions on imports were progressively abolished (except for reasons of safety and security) and import duties were broght down steeply. This trend of tariff reduction continued during the Tenth Plan period and the peak basic customs duties applying to a majority of non-agricultural products were reduced every year, from 30% at the beginning of 2002–03 to 10% at the end of 2006–07. As a result the simple average applied tariff rates on non agricultural products declined sharply during the Tenth Plan as shown in Table 13.7.

TABLE 13.7
Simple Average Applied Rate (Total)

	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Agricultural Products	44.2	41.3	41.3	36.8	36.9	36.9
Non-agricultural products	35.9	32.6	29.5	20.8	15.5	13.3
All commodities	37.1	33.7	31.3	22.9	18.3	16.5

Source: Calculations based on Data from Budget Document.

13.21. The Eleventh Plan will address the various issues involved so as to facilitate quicker and hassle-free movement of goods by road in order to reduce the time taken for transportation of goods from the production centres to the port of export, which is an important factor in determining the cost of transaction. To facilitate trade further, One Stop Documentation Centres (OSDCs) will be established in all major airports/ seaports/ ICDs. Full neutralization of indirect taxes including those imposed at the State level will be ensured in the Eleventh Five Year Plan so that Indian exports do not become uncompetitive by carrying the burden of internal and border taxes.

13.22. With the complete elimination of QRs and reduction of 'peak tariff' rates to 10% in non-agricultural products (with some exceptions), it is the manufacturing sector that has seen the most noteworthy trade liberalisation . After removal of most domestic controls on this sector, it has also been a significant beneficiary of the opening up of the capital account and the consequent flows of FDI, FII, and ECB. Though the initial surge in manufacturing GDP, following the domestic and import liberalization from 1991–92 to 1993–94, petered out around 1997–98, the manufacturing sector has again performed well after 2003–04. As competitive pressures on this sector were balanced by greater access to higher quality imported inputs, capital goods, finance and

technology, the global competitiveness of this sector has increased significantly. This is reflected in the restoration of high growth in manufacturing GDP and in the surge in outward FDI in the form of acquisition of foreign companies by Indian ones.

13.23. To ensure that this trend is strengthened and expanded it is necessary to reduce peak tariffs to 5%, for non-agricultural products eventually, make progress towards fuller capital account convertibility, accelerate the liberalization and development of the financial sector (e.g., long-term debt market) and complete the elimination of restrictions and controls (e.g., SSI reservation). Consideration of possible reduction of tariffs on agricultural products will have to await an international compact for reform of world trade in agriculture at the WTO negotiations.

13.24. The fact that manufacturing growth is high does not automatically mean that the sector does not suffer from some distortions. Inappropriate labour laws and cumbersome and pointless rules and procedures impose a cost that is separate from and over and above the wages that are paid to the worker. There are often high transactions cost of implementing the laws and the losses imposed by labour inflexibilities when demand falls. This may be one of the reasons why the historically natural shift of labour from agriculture to manufacturing has not taken place at the rate expected and the share of labour force in agriculture is so much higher than the share of GDP from agriculture.

13.25. The modern organized manufacturing sector has responded to the higher direct and indirect cost of labour (life time employment guarantee) by adopting more capital- and skill-intensive technology than it would have otherwise. It has also organized production processes so that labour-intensive stages of production and services are carried out in the unregistered sector. The more innovative entrepreneurs have focused on niche export markets by adopting technology to replace large numbers of unskilled labour with fewer semi-skilled workers. This has happened in conventional labour-intensive sectors like textiles as well as in labour intensive segments of sectors such as automobiles (components) and chemicals. Manufacturing has therefore developed some comparative advantage in what may be termed relatively skilled labour-intensive manufacturing. This is what will drive the growth of manufacturing GDP, outward FDI and manufactured exports. Though the private sector has geared up to exploit these opportunities, regulatory systems must be modernized (e.g. testing of drugs) and infrastructure support provided wherever necessary (e.g. specialized ports/berths for auto export) so as to support private efforts.

13.26. However the rate of growth of unskilled employment in the organized sector could continue to suffer as long as labour rigidities are not appropriately addressed.

Prospects for Services Exports

13.27. In the first 30 years of independence the emphasis on higher education coupled with slow GDP growth created an excess supply of highly educated manpower that could not be absorbed productively within the country. A small part of this stock of educated manpower migrated to the West and participated in the high tech wave linked to IT and internet. At a later stage, domestic entrepreneurship was able to couple the stock of highly educated manpower available domestically with network linkages with highly skilled NRI manpower abroad to generate the IT export boom in the 1990s.

13.28. India witnessed a steady growth in proportion of trade in services to total trade and this can be largely attributed to trade in IT and ITES. Services trade share has grown at the same rate as goods trade over the 1990s, that is, about 6.5% and the share of services in total trade is about 24%. Services exports grew by 71% in 2004–05 and reached US$46 billion. While India's share in world merchandise exports in 2004 was 0.8%, the corresponding share in world commercial services exports was 1.9%. India's share in world markets for IT software and services (including BPO) increased from 1.7% in 2003–04 to 2.3% in 2004–05 and an estimated 2.8% in 2005–06.[1]

13.29. An important reason for growth of the services sector, is the impact of trade liberalization and reforms on growth of services. According to one study[2] sectors that were open for FDI, external trade, or private ownership, etc. were the ones which experienced faster growth. Lower tariff (adjusted for changes in real effective exchange rate) and lower non-tariff barriers (in terms of import coverage ratio) were also

[1]See *Economic Survey 2005–06*.

[2]Gordon, J. and P. Gupta (September 2004), Understanding India's Services Revolution, IMF working Paper WP/04/171, found to have led to an increase in the usage of services in manufacturing sector. The process appears to have been aided by other reforms undertaken in this decade.

13.30. At the disaggregated level, exports of communications, computer & information services have more than doubled since the turn of the century (Table 13.7).

13.31. Studies confirm that India exhibits a strong revealed comparative advantage (RCA) in services as compared to goods. Between 1996 and 2000, the RCA index for services increased by 74% while that for goods declined by 15% [World Bank (2004)]. This increase in RCA of services was mainly on account of 'other business services' which include software exports, finance, communication, management, consultancy and telecommunication sectors.

13.32. At the disaggregated level, we find that India has a revealed comparative advantage vis-à-vis rest of the world in commercial services and other services (Table 13.8). In contrast India's RCA in transport and travel services has declined overtime.

TABLE 13.8
India's Exports and Imports of Disaggregated Services, 1990–2003

	Exports (US$ million)					
	1990	1995	2000	2001	2002	2003
Communications	....	....	598.8	1103.9	779.4	1065.9
Construction	....	....	501.9	65.1	231.4	284.1
Insurance	123.3	170.2	257.0	282.0	331.9	408.9
Financial	....	....	276.0	306.1	598.2	392.1
Computer & Information	....	....	4727.4	7407.4	8889.3	11365.7
Royalities & Licence Fees	1.3	1.4	82.6	37.2	20.2	25.2
Other Business Services	1967.1	2119.7	4147.8	2349.0	2699.1	2601.0
Personal, Cultural & Recreational	....	....	....	....	....	....
Government, N.I.E	15.4	11.5	653.7	537.9	352.9	305.1
	Imports (US$ million)					
	1990	1995	2000	2001	2002	2003
Communications	....	....	104.8	266.8	1002.6	610.5
Construction	....	....	127.1	470.3	601.0	1208.9
Insurance	343.9	558.8	813.2	810.9	892.6	1168.9
Financial	....	....	1277.2	1780.1	1434.3	488.0
Computer & Information	....	....	576.8	910.9	905.3	659.3
Royalities & Licence Fees	72.5	90.3	282.5	317.0	345.2	420.8
Other Business Services	1715.0	2713.8	4320.7	3732.5	4084.0	8088.1
Personal, Cultural & Recreational	....	....	....	....	....	....
Government, N.I.E	147.0	205.7	290.4	306.9	262.9	199.2

Source: Reserve Bank of India.

TABLE 13.9
Revealed Comparative Advantage (RCA)* of India in Services

	1980	1990	1998	1999	2000	Average (1998–2000)
Commercial Services	1.6	1.1	1.3	1.5	1.6	1.4
Transport Services	0.4	0.7	0.6	0.6	0.5	0.6
Travel Services	2.0	1.0	0.9	0.7	0.6	0.7
Other Services	0.9	1.2	1.3	1.5	1.6	1.4

Note: * RCA = (India's Export of ith Services to world /total export of Indian services)/(world export of ith services /total world export of services).
Sources: RBI 2005; World Bank, 2004.

13.33. Software services constitute around 50% of total exports while travel and transportation services constitute around 30%. Together these three services constitute around 80% of India's exports of services (Table 13.9). The high share of travel services in export earnings but a declining RCA and a falling share of travel in total exports of services highlight the urgency of formulating trade-boosting policies with respect to travel and tourism.

TABLE 13.10
Composition of India's Services Exports

	Service export (million US$)		Share in service exports (%)	
	2000–01	2003–04	2000–01	2003–04
Travel	3497	4122	22	17
Transportation	2046	3260	13	13
Insurance	270	420	2	2
Communication Services	1138	1047	7	4
Construction services	536	465	3	2
Financial services	347	315	2	1
Softwware services	6341	12200	41	49
News agency services	114	59	1	0

Source: RBI 2005.

IT AND ITES

13.34. Trade in IT and ITES has emerged as the main driver of India's growth of trade in services. Both domestic and international market for Indian IT-ITES has been increasing steadily. Exports have increased rapidly in the last six years (i.e., from US$4 billion in 2000 to around US$ 24 billion in 2006). Total market for Indian IT-ITES is around US$30 billion in 2006.

13.35. The competitiveness of India in IT and ITES trade has been examined by many analysts. For 2005, the Global Services Location Index[3] showed that India remained the best offshore location by a wide margin, although wage inflation and the emergence of lower-cost countries have decreased its overall lead.[4] Close competitors in this field were China and Thailand. Improved infrastructure and relevant people skills have increased the attractiveness of China as a low-cost option for servicing Asian markets. Thailand jumped from 13th to 6th in the 2005 Index and Southeast Asian countries had four of the top six locations on the Index.

[3]previously known as the Offshore Location Attractiveness Index
[4]A.T Kerney Global Services Location Index,2005

13.36. The rise and expansion of the Indian IT and ITES services industry is a much talked about subject the world over. Total export revenues earned by this sector have grown from US$ 7.7 billion 2001–02 to US$ 31.3 billon in 2006–07, thus showing a near 32 % compounded growth. India now accounts for 65% of the global market in offshore IT and 46% of the ITES market . A majority of the Fortune 500 and Global 2000 corporations are sourcing IT and ITES from India. Export forecast for the Eleventh Plan period is estimated at US$ 37.6 billion for 2007–08 which is expected to increase to US$ 86.6 billion in 2011–12 according to NASSCOM McKinsey Report 2005. The domestic software services market however is growing at a lower rate compared to software exports. From US$ 3 billion in 2002–03 the domestic market grew to nearly US$ 5 billion in 2004–05. Clearly Indian software services are a globalized and outward looking sector.

13.37. In the past three years, the reputation of the Indian IT and ITES industry has grown worldwide fuelled by greater commercial presence of the Indian IT companies in the US, UK, and other EU countries, more numbers of cross-border acquisitions by Indian companies, more business processing outsourcing by global companies from India and a movement by Indian companies towards a higher value added products and services.

13.38. The growth of IT/ITES industry has helped to create both direct and indirect employment. Indirectly the industry employs about three million people. Indirect employment arises out of expenditure on vendors including telecom, power, construction, facility management, IT, transportation, catering and other services. The industry has also created induced employment arising out of consumption expenditure of employees on food, clothing, utilities, recreation, health and other services.

13.39. Technological changes at a global level have led to the tremendous growth in the IT sector with the emergence of a number of new services (e.g. software development or internet access) and increasing tradability of existing services (e.g. cross-border medical diagnosis using online or video conferencing medium). The Indian software sector has been able to keep pace with changes at the global level, which is demonstrated by the double digit growth in the software and related services sector since the later half of 1990s and emergence of new services sector activities (e.g. BPO centres). Government policies including deregulation (such as tax exemption, reduction

of tariffs on software from 114% to zero, amendment of the copyright law etc) and incentives at the right time in right measures facilitated the growth of the Indian software industry since the 1990s. India's main advantage in its software sector story is that the sector has been able to tap into the pool of human resources that includes, engineering graduates, software professionals and English-speaking young graduates prepared to work in BPO centers.

13.40. India has a comparative advantage in Mode 1 as captured by outsourcing activities, Mode 3 as seen in increasing outward investment by Indian companies in US, UK and other developed and developing country markets and Mode 4 as captured by movement of Indian software professionals in the US, EU, etc. While a part of the movement by the software professionals is permanent and thus falls under migration, a significant part is temporary as demonstrated by a growing number of Indian software professionals returning to India from Silicon Valley of the US and other places.

13.41. Along with the rising opportunities in this sector, there are also many challenges faced by this sector in the recent years. These include:

- The prospect of protectionist legislations in developed countries and backlash against the BPO industry for the fear of loss of jobs in developed countries are some of the impediments to increasing exports of these services.
- A rise in the concerns over the security of data on customers which BPO professionals have access to and emerging shortages of skilled professionals.
- The Indian IT/ITES industry has been engaged more in developing low value and low technology products and services and less in innovation and back office processing work.
- An inadequate regime for preventing piracy in the IT/ITES industry is also viewed as a possible hindrance to foreign multinationals from moving their R&D outsourcing units to India.

13.42. Several initiatives have been taken to further enhance the availability of and access to suitable talent for IT-ITES in India. An image-enhancement programme is also in place to build greater awareness about the career opportunities in this segment. A comprehensive skill assessment and certification programs for entry-level talent and executives (low-middle level management) has been launched.

13.43. For India to fully capitalize on the opportunity and sustain its present lead in the global IT/ITES space, there is a need to focus on skill development to enhance the talent pool advantage, strengthening infrastructure to lower the transaction costs of business; and improve the domestic regulatory provisions.

HEALTH SERVICES

13.44. Rising income levels and the emergence of health insurance has facilitated the growth of high quality health care sector in India although the capacity to pay for health services remains limited to middle and high income brackets. With the opening of the insurance market in 2000 to private players, health and medical insurance has shown significant growth. Though at present, only 2.5 million people are covered under voluntary medical insurance. Cashless claim facilities offered by many players have led to a significant rise in health insurers.

13.45. The public health care system is not able to meet the growing demands for health care facilities. The gap between demand and supply has to be bridged by the private players, and this has facilitated the growth of the corporate health care industry in India. Emergence of strong corporate players in health care is not a substitute for expansion of public sector health facilities especially for the bulk of our population but it has led to professionalization of the industry, better hospital management and higher investments in infrastructure facilities.

13.46. An international dimension of the growth of the health care industry is the phenomenon of what is called medical tourism. Thailand has been able to attract more than one million medical tourists due to world-class infrastructure facilities in Thailand. India should be able to replicate the Thailand example by focusing on development of good-quality medical as well as tourism infrastructure. India certainly has the potential and the capacity to attract more than one million tourists per annum.

13.47. There are two clear advantages for India in the field of medical tourism. The first and the foremost is the cost advantage. The second unique advantage of India is that it offers holistic medicinal services. With yoga, meditation, ayurveda, allopathy and natural herbal treatments, India offers a unique basket of services to foreign patient-tourists that is difficult to match by other countries. Kerala has been the pioneering State in this area as evidenced by the

fact that Kerala and ayurveda have virtually become synonymous with each other. The preference for health tourism in Kerala is so strong that Kerala Ayurveda Centre (KAC) has been established at multiple locations in various major cities. Karnataka has also taken some very pioneering steps in promoting medical tourism. The Government of Karnataka has planned to setup Bangalore International Health City Corporation in order to cater to international patients for a wide variety of health care products and treatments. The recent operations of children from Pakistan in Bangalore have not only helped boost the medical economy in the State, but also helped in fostering goodwill, peace and harmony between India and Pakistan.

13.48. In Maharashtra, there is a wide array of speciality and super-speciality hospitals that can help promote medical tourism. Some of the major hospitals already in the business of medical tourism are Lilavati Hospital, Jaslok Hospital, Breach Candy, Hinduja Hospital, Wockhardt Hospital, and Apollo NUSI Wellness Retreat. The Asian Heart Institute at Mumbai's Bandra-Kurla Complex offers state-of-the-art facilities for all types of heart ailments. Hotels such as Hyatt, JW Marriott, Renaissance and Resort offer extensive spa facilities for both domestic and international tourists.

13.49. The Indian Health care Federation has prepared a roadmap for making India a world-class destination for medical tourism. Accreditation of Indian hospitals is paramount for medical tourism. This will help in ensuring quality standards across a spectrum of specialty and super-specialty hospitals. In order to encourage medical tourism, air connectivity needs to be strengthened for all the major cities in the country especially Delhi, Chennai, Bangalore, Pune, Hyderabad and Kolkata. Health-support infrastructure also needs to be created at the airports and other travel junctions. It is also essential to establish Indian health care brand synonymous with safety, trust and excellence. One-stop centres need to be established in key international markets to facilitate inflow of foreign patients, and immigration process needs to be streamlined for medical visitors.

13.50. A related area which can be exploited is provision of back end health care related services. Health care majors in the developed world, especially the US, are already outsourcing back-end health care services to Indian BPO firms. The major health care BPO operations in the country are Hinduja TMT (claims adjudication), Apollo Health Street (claims adjudication, billing and coding), Comat Technologies (transcription), Datamatics (transcription and forms processing) and Lapiz (medical billing).

MULTILATERAL TRADE NEGOTIATIONS

13.51. Since India is today much more integrated in the world economy than it was in the past, it needs a well-functioning rule based trading system more than in the past. Working constructively towards a fair and balanced agreements in the Doha Round is therefore an essential part of managing globalization. Since India had taken major strides toward liberalization of its trade and investment regime after the conclusion of the Uruguay Round on an autonomous basis, it entered into the Round with a strong bargaining position of being able to offer tariff bindings (which is what trade negotiations are about) without much threat of disruption. Although our bound tariffs on agricultural products are high, since domestic support is incomparably lower in India than in the industrialized countries, we have considerable leverage in agricultural negotiations as well.

13.52. Unfortunately the Doha Round currently appears to be in serious difficulty because of continued differences among the principal participants. India's priority in agriculture must remain seeking steep reduction in the levels of agricultural subsidies prevailing in the industrialized countries. The agreement to eliminate all forms of export subsidies was no doubt a very positive development. However, the fact remains that export subsidies have been and will be effectively substituted by domestic support. Obtaining cuts in this pillar therefore constitutes the key to success. It is important for access not only in the subsidizing country but in third country markets as well. Participants have so far focused on the level of cuts in Overall Trade Distorting Support and the Total Aggregate Measurement of Support.

13.53. The negotiations have not given adequate attention to one important point that has been made by G20 for putting some limitation on decoupled income payments. The architecture of the Agreement on Agriculture was based on the belief that fully decoupled income support caused no or minimal distortion to trade and production. Since then, two aspects have come to light. First, that in the real world there is no such thing as fully decoupled income support. Second, economists now agree that it was not quite right to characterize even fully decoupled income

payments as minimally distorting. As observed in a OECD study 'any policy that transfers income to producers could conceivably have some effect on production decisions by increasing farm incomes and farmers' wealth, by reducing income risks and by altering farmers' expectations. Unless deep reform is accomplished in domestic support by the developed countries developing countries cannot be expected to reduce tariffs on important agricultural products, which provide the means of livelihood to a large section of the population. In India the dependence on agriculture for employment and livelihood is very high and this is the central reason why India will need flexibility through special safeguards and in special products, both in coverage and treatment, unless radical reform in domestic support is adopted by the major industrialized countries encompassing not only steep reduction in what has been hitherto regarded as trade distorting but also strict disciplines on the Green Box payments which put money in the hands of the farmer from publicly funded government programmes.

13.54. In services, India's major interest is the liberalization of cross-border trade (Modes 1&2) and also in Mode 4 which relates to movement of person. In cross-border trade India has requested for broad-based commitments across a wide range of service sectors. In Mode 4 the main request by India is in respect of admission of independent professionals and contractual service suppliers for provision of services. It has been pressing for reduction of impediments such as visa and immigration procedures, economic needs test, work permit norms, etc. Its main trading partners have not been forthcoming in offering openings for professionals under Mode 4. Most members have not offered any commitment in the categories of contract service providers and independent professionals. Where a response has been forthcoming it is lacking in sectoral spread. Efforts to take up visa and immigration matters in the discussions on Domestic Regulations have also not gone very far.

13.55. India has autonomously liberalized Mode 3 in many sectors. Today FDI is allowed in all but a few service sectors such as retail trade, and establishment restrictions exist in accountancy and legal services. Among important service sectors, foreign equity caps of less than 50% apply only to insurance, print and electronic media covering news and current affairs, air transport and higher caps apply to telecommunications and private sector banking at 74%. India should be in a position to bind most of these, and perhaps go even further in exchange for comparable concessions in the areas of India's interest.

13.56. Since the Doha Round began, India has brought down its import tariffs on non-agricultural products successively every year and the peak tariffs for non-agricultural products at the beginning of the Eleventh Plan period are 10% (except for a handful of products). While the Swiss formula has been accepted for effecting cuts in tariffs, the negotiations are stalled by disagreement on the coefficients that should be applicable and particularly on the difference between the coefficients to be adopted by the developing and developed countries. The objection about accepting a lower co-efficient in the Swiss formula arises from the need to provide assurance that India is dealt with fairly. The World Trade Organizaton (WTO) rules and the Doha Ministerial Declaration speak of less than full reciprocity in reduction commitments being expected from the developing countries. Past practice suggests that reciprocity is a function of two factors viz., trade coverage and depth of reduction. When all the trade is being covered the extent of reduction becomes the sole measure of reciprocity. If the coefficients suggested by the developed countries (10 for the developed and 15 for the developing) were to be adopted India would be reducing its bound tariffs by 73%, the EC by 33% and the USA by 35%. This is clearly not consistent with the principle of reciprocity in trade negotiations and far removed from the agreed standard of less than full reciprocity from the developing countries.

13.57. Developed countries argue that the developing countries must lower their tariffs by a larger proportion because their bound tariffs were higher at the outset. However this ignores the fact that trade negotiation must start from the balance that was struck during the last Round. India has been autonomously reducing tariffs since the launching of the Round but it has a right to receive negotiating concessions for converting the applied levels into contractual commitments under the WTO Agreement. If the proportionate reduction by the developed countries is less, a reciprocal balance can be established in one of two ways. Either the developed countries deliver additional concessions in other areas (Mode 4 in services for instance) or India should be allowed to restore parity in reciprocity by adopting an appropriately high coefficient.

13.58. India has a strong interest in a successful conclusion of the Doha Round and should aim at the negotiations ending at a high level of ambition even if the impasse may need to be prolonged to accomplish such an outcome. We should not be deterred by the fear that the trend toward regional arrangements would strengthen and trade conflicts would intensify. The geopolitical dynamic which drives regional arrangements will remain unaltered as it did despite the successful conclusion of the Uruguay Round and such arrangement were broadened and strengthened and new ones were created with redoubled vigour at that time. There is no doubt a distinct possibility of increased trade disputes especially in agriculture after the demise of the Peace Clause, but India should not be daunted by the possibility of increased trade disputes as the major subsidizing countries are likely to face disputes and trade friction could eventually prove to be a tonic for the trading system if it helps to create a sense of urgency among the major players and a political will to effect deep reform in agriculture by the time they return to the negotiating table.

REGIONAL TRADE AGREEMENTS

13.59. Paradoxically, the successful conclusion of the Uruguay Round and the establishment of the WTO, was followed by a wave of regional trade agreements in the world. India too took similar steps. The India-Sri Lanka FTA was formed in 1998, and South Asian Preferential Trade Agreement was replaced by South Asian Free Trade Agreement (SAFTA) in January 2004. Several initiatives were taken for PTA or FTA with trading partners not only in the region but also outside the region. The new direction of trade policy toward regional trade agreements was given during the Ninth Plan period but the move intensified during the Tenth Plan. The position at the beginning of the Eleventh Plan is the following:

- Three FTAs are in existence viz., India-Sri Lanka FTA, SAFTA, and Indo-Singapore Comprehensive Economic Cooperation Agreement. Within SAFTA unilateral preferences have been extended to Bangladesh and Nepal.
- Apart from Asia-Pacific Trade Agreement (APTA) and Global System of Trade Preferences (GSTP) India has entered into four PTAs viz., Indo-Afghanistan PTA, India-Thailand Framework Agreement, Indo-Mercosur PTA and India-Chile PTA, the latter two not having been implemented until the beginning of the Eleventh Plan. Negotiations are ongoing for FTAs with the ASEAN, Thailand, Gulf Cooperation Council, Mauritius, South Korea, Japan, Israel, and the European Union. In the case of Mauritius it is envisaged that there would be PTA in goods and FTA in Services and investment. Another initiative is the Bay of Bengal Initiative Multi-Sector Technical and Economic Cooperation Framework Agreement, which envisages an FTA among Bangladesh, India, Sri Lanka, Myanmar, and Thailand. Negotiations are underway also for broadening the FTA in goods with Sri Lanka into a comprehensive economic cooperation agreement, embracing services and investment as well.
- Joint Study Groups have been set up for closer economic cooperation with China, Malaysia and Russia and a similar initiative has been taken in the context of India-Brazil-South Africa (IBSA)

13.60. India's engagement in a large number of regional trade initiatives raises some issues. There are strong geopolitical reasons for promoting close economic cooperation in South Asia and also with the countries of South East Asia and East Asia. India must aim to be a partof a future East Asian Free Trade Area, which could eventually evolve out of the ASEAN plus Six. But in order to avoid disruptions in domestic agriculture and industry a great deal of preparatory work needs to be done before we start implementing the FTAs. First, our infrastructure, both social and physical must be brought on par with the trading partner with whom we are entering into an agreement. It is particularly necessary to raise the level of education and skills and to improve power and transport infrastructure in the country, as otherwise an FTA would result in the flight of capital from the country. Efficiency in manufacturing in particular is a function of the quality of physical infrastructure and of skill development. Second, a level playing field must be created on the fiscal side. A great deal of progress has no doubt been made by the changeover from the cascade system of taxation and the introduction of Central Value Added Tax and State VAT. But in order to ensure that our industries do not suffer a disadvantage in an FTA the introduction of GST must be put firmly on course. There must be an understanding on the exchange rate policy as well, before we can have a soundly functioning FTA as a market driven exchange rate policy in one partner country cannot co-exist with a substantially controlled exchange rate policy in another. When the time is ripe

for negotiating FTAs both goods and services must be considered together so that balanced results are obtained. These fundamental aspects need to be attended to in parallel with operationalizing FTAs.

13.61. The easy way of going ahead with FTAs on the basis of exemptions of a long list of products needs to be avoided except in agriculture where there is a particular problem because of the dependence of majority of the population on the sector for their livelihood and the lack of alternatives for them for redeployment. Furthermore, in FTAs sufficient time should be given to manufacturing industries to adjust to new conditions of competition and the temptation to show quick results through 'early harvest' resisted. It has to be borne in mind also that in a rapidly globalizing world, manufacturers are keenly searching for cheaper inputs and it is very difficult to ensure that imports from a particular trading partner qualify as an 'originating' product. Strict rules of origin have been put in place, but the certificates of compliance with these rules are issued by authorities in the exporting country and the customs authorities in India do not have the wherewithal to verify the accuracy of the information on which the certificates are based.

13.62. If FTAs need preparation and time for adjustment, PTAs need to be shunned altogether. As demonstrated in the now defunct Tripartite Agreement and the Trade Negotiating Protocol among developing countries PTAs can have adverse effects through trade diversion. In addition PTAs can result in an inverted duty structure to the detriment of domestic industry, as has been the experience in the Indo-Thailand Agreement, which was in reality a PTA because of the operationalization of preference on selected products subject to 'early harvest'. The selective and partial preference in PTAs such as the GSTP and APTA and those envisaged in the Indo-Mercosur Agreement, while not resulting in any trade flows clutter up the tariff schedule of the country.

FOREIGN DIRECT INVESTMENT (FDI)

13.63. The liberalization of the FDI policy and the steady growth of the Indian economy contributed to a large increase in FDI inflows during the Tenth Plan period as can be seen from Table 13.11.

APPROVAL MECHANISM UNDER FDI POLICY

13.64. **Automatic route**—In most sectors FDI is permitted on the automatic route. FDI in such sectors/activities does not require any prior approval and only requires notification to the Reserve Bank of India within thirty days of such receipt of inward remittance; and filing of required documents within thirty days of issue of shares to foreign investors. FEMA Regulations prescribe specific formats for notifying foreign investments, transfer of shares to non-residents and payment for foreign technology/use of trademark/brand name made under the automatic route.

13.65. **Government approval route**—Limited activities require prior Government approval. Proposals for FDI are considered by the Foreign Investment Promotion Board (FIPB), now functioning under the Department of Economic Affairs, and decisions are conveyed in most cases within 6–8 weeks of receipt of complete application. Approval for foreign technology collaboration, where required, is considered by the Project Approval Board (PAB) under the Department of Industrial Policy and Promotion.

TABLE 13.11
Foreign Investment Flows during Tenth Plan Period

(Value: US$ million)

S. No.	Financial Year (April–March)	Equity		Reinvested earnings +	Other capital +	Total FDI Inflows	% age growth over previous
		FIPB route/ RBI's Automatic	Equity capital of unincorporated bodies#				
1.	2002–03	2574	190	1833	438	5035	() 18
2.	2003–04	2197	32	1460	633	4322	() 14
3.	2004–05	3250	528	1904	369	6051	(+) 40
4.	2005–06 (P)	5540	280	1676	226	7722	(+) 28
5.	2006–07 (P)*	15585	480	2936	530	19531*	(+) 153

Note: '#' Figures for equity capital of unincorporated bodies for 2005–06 and 2006–07 are estimates. '+' Data in respect of re-invested earnings and Other capital for the years 2005–06 and 2006–07 are estimated as average of previous two years; 'P' All figures are provisional; * Include swap of shares US$ 3.1 billion.

13.66. A comprehensive review of the FDI policy was undertaken in 2006 with a view to consolidate the liberalization already effected and further rationalize the FDI policy governing various activities. New sectors/ activities viz. Single Brand Product retailing, Power Trading, Coffee and Rubber processing and warehousing were opened for FDI.

13.67. As a result of the various rationalization measures, the FDI Policy has become progressively more liberal, transparent and investor-friendly. A liberal and transparent FDI policy has been put in place for the industry, services and infrastructure sectors under which FDI up to 100% is permitted in most sectors on the automatic route. Caps on foreign equity apply only in a few service sectors viz. 20% on FM radio broadcasting, 26% on insurance, defence production, print and electronic media covering news and current affairs, 49% on air transport services, asset reconstruction companies, cable network, DTH, hardware for up-linking, HUB etc., 51% for single brand retailing of products and 74% for atomic minerals, private sector banking, telecom services and the establishment and operation of satellites. A proposal for foreign investment/ technical collaboration requires prior government approval only if the foreign investor has an existing Joint Venture or technology transfer/trademark agreement in the 'same' field (determined on the basis of 4 digit NIC 1987 code) unless the investments are made by SEBI registered venture capital funds or where the existing investment by either of the parties is less than 3% or where the existing venture/collaboration is defunct or sick. This requirement does not apply for IT Sector, investments by multinational financial institutions and in the mining sector.

FDI Outlook

13.68. **A.T.Kearney FDI Confidence Index 2006** based on a seven-year survey of top 1000 firms, covering 68 countries receiving 90% of the FDI has rated India ahead of the US in terms of business confidence index. The top honours go to China. US is the fourth in the list. 45% of global investors are upbeat about India compared to last year. The report predicts India to be on the cusp of FDI take off, in view of the government focus on reforms, overcoming narrow business interests, de-bottlenecking infrastructure, logistics and regulatory barriers.

13.69. India has improved its position by two places in the **World Economic Forum's Global Competitive Index (GCI)** rankings for 2006–07, coming in 43rd, well ahead of Brazil (66), China (54), and Russia (62).

Strategy for FDI during the Eleventh Five Year Plan

13.70. Given the current scenario, FDI could increase significantly during the Eleventh Plan. During the Eleventh Plan steps would need to be taken to consolidate the gains from FDI by reducing the delays in State-level clearances required by investors to establish enterprises. Progress towards elimination of FDI limits in key sectors also needs to continue in order to increase FDI flows and stimulate transfer of technology, which is critical for improving competitiveness.

Foreign Technology Transfer Policy

13.71. FDI brings along with capital, modern technologies and best practices. The GoI has announced a liberal foreign technology transfer policy as well. The policy on foreign technology transfer is regulated on the basis of the quantum of payments allowed for technology transfers. Payments for technology transfer from a foreign collaborator are allowed to a joint venture with an Indian partner as also to wholly owned Indian subsidiaries of a foreign company. There is no time limit prescribed for the duration of payments to be made. The technology payments are governed by the Foreign Exchange Management (Current Account Transaction) Regulations, 2000. These do not cover the FDI Scheme which is governed by Foreign Exchange Management (Transfer or Issue of security by a Person Resident outside India) Regulations, 2000 except where specifically notified. In other words, there is no restriction on technology collaboration in areas, which are prohibited for foreign equity or which attract foreign equity caps under the FDI policy except where such a restriction has been notified.

13.72. At present, foreign technology collaboration involving payment of lump-sum amount of up to US $2 million and/or royalty at the rate of 5% on domestic sales and 8% on exports are allowed under the automatic route. In addition, the current policy also allows payment of royalty up to 2% on exports and 1% on domestic sales under the automatic route for use of trademark and brand names of the foreign collaborator without technology transfer. Cases involving payment of lump-sum amount or royalty beyond the limits prescribed under the automatic route are considered by the government on the recommendations of the PAB.

MANAGING CAPITAL FLOWS

13.73. A major issue that most emerging market countries need to address is how to cope with a world of greater capital mobility. There is general agreement that the emergence of large pools of international capital, highly mobile across borders, provides an important opportunity for developing countries to access additional capital to finance their development in both the private and the public sectors. However, it is also true that free capital mobility brings with it the risk of volatility. This risk is particularly great for developing countries because investor perceptions of the prospects of individual developing countries are more vulnerable to contagion effects which could lead to volatility that is not justified by underlying fundamentals. Developing countries also face problems because they typically lack financial system strong enough to deal with inward and outward capital mobility.

13.74. The difficult choices facing developing countries are usually described in terms of a 'trilemma' or the 'impossible trinity' which asserts that in a world of internationally integrated capital market flows, a country cannot simultaneously achieve all three objectives of free capital mobility, a stable exchange rate, and an independent monetary policy. It is possible to have an independent monetary policy (i.e., a target interest rate or money supply growth) and exchange rate stability, but in that case capital flows have to be controlled. Alternatively, if capital flows are completely free it is necessary to give up either exchange rate stability or the ability to set monetary policy independently. In practice, few governments make firm choices for all times, and a mixed strategy is often adopted. The exchange rate is flexible but not fully flexible, capital flows are moderated in various ways or monetary policy is forced to adjust in various ways. All these choices involve costs. However, there is general agreement that it is undesirable to allow too large an appreciation in the exchange rate in response to capital inflows that may be temporary. Efforts to avoid appreciation by unsterilized intervention run the risk of increasing liquidity and money supply with a possible increase in inflationary pressure. On the other hand, resort to sterilised intervention imposes interest cost on the Budget.

13.75. These problems illustrate the merit of the cautious approach adopted by the government in the matter of liberating capital inflows. The advantages of accessing pool of capital to finance development are recognized in the commitment to move gradually to fuller capital account convertibility. But the move is to be made gradually at a pace which enables the authorities to deal with unexpected volatility. In controlling capital flows it is important to recognize the relative attractiveness of different types of flows. In this regard direct foreign investment is the most preferred form of flow. Investments in Indian firms through the stock market and by venture capital funds in unlisted companies are also potentially beneficial. ECB and other short term flows are areas where one can introduce an element of control to moderate sudden surges. However, even with capital calibration it is not easy to manage a surge in capital inflows, if it occurs. In such situations, it is necessary to explore ways of limiting the fiscal cost of sterilizing large growth of reserves; either by making these flows less attractive or by means that do not require costly sterilization.