UNIT 21 EMPIRICAL ASPECTS OF TRADE AND BALANCE OF PAYMENTS

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21.0 OBJECTIVES

After reading this unit you will be able to:

- outline the empirical dimensions of India's foreign trade;
- explain the changes in the different aspects of the structure of India's foreign trade in terms of volume, composition and direction;
- describe the concept and significance of balance of payments;
- discuss the role of balance of payment deficits in the growth process;
- explain the trends in India's balance of payments since the early 1950s;
- outline the importance of different exchange rate regimes and the broad changes in the exchange rate management system; and
- describe the meaning and implications of the full convertibility of rupee.

21.1 INTRODUCTION

As stated in Unit 20, foreign trade worked as an engine of growth in UK (18th & 19th centuries), Japan, South Korea, Taiwan and other East Asian Countries (20th century), and more recently, in China, by generating impulses that had strong forward and backward linkages with many sectors of the economy. These countries also gained by opening up their economies to foreign capital and enterprise. Since the 1990s, India too has adopted similar policies. Liberalisation of trade and opening up of the economy has dramatically transformed the profile of India's foreign trade and balance of payments scenario. The present unit discusses the principal features of India's foreign trade and balance of payment profiles.

21.2 EMPIRICAL DIMENSIONS OF FOREIGN TRADE

An analysis of a country's foreign trade can be made in terms of its

three main profiles: (i) volume, (ii) composition, and (iii) direction.

21.2.1 Volume of Trade

It relates to the size of international transactions. Since a large number of commodities enter in international transactions, the volume of trade can be measured only in terms of money value. The trends in the value of trade over time help us to identify the basic forces that may be operating at different periods in the economy.

However, mere absolute changes in the value of trade is not a satisfactory guide. Hence, it is necessary to find the changes in the value of trade by relating them to two variables, viz.

- Share of exports/imports in GDP, and
- Share of exports/imports in world trade.

The share of exports/imports in GDP indicates the degree of outward-orientation or openness of an economy in regard to its trade. This, in a broad way also reflects the nature of trade strategies adopted in the country. The ratio of exports to GDP could also be interpreted to reflect the average supply capability of the economy in terms of its exports. It can therefore be called as ***average propensity to export***. A similar ratio between imports and GDP gives the ***average propensity to import***. However, the relative share of exports in output under an efficient allocation of resources will be less in bigger economies than in smaller economies. This is in the sense of developed economies being more self-contained as compared to the situation of the developing economies. Such economies have to also import, sometimes in large numbers, all types of goods and services required in the process of development e.g. capital goods, intermediate goods, consumer goods, etc. To finance such imports, these economies have to focus on exports to establish balance of trade.

The share of exports in the world trade indicates the importance of the country as a nation in the world economy. It reflects the market thrust that the country is able to realise in the presence of the various competitors in the world market. Changes in this ratio, thus, indicate the shift in the position of the comparative advantage of the country.

Further, changes in the value of exports may be compared to the changes in the value of imports. It is the relationship between these two variables which is known as the *terms of trade (TT),* i.e. the terms at which exports exchange for imports. Terms of trade can be defined in respect of (i) net barter terms of trade, (ii) gross barter terms of trade, and (iii) income terms of trade.

i) **Net Barter Terms of Trade**: Also called as the commodity terms of trade, this measures the relative changes in the import and export prices. This is expressed as:

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$$N = P_x / P_m$$

Where P_x and P_m are price index numbers of exports and imports respectively. A rise in N indicates that a larger volume of imports could be received in exchange for a given volume of exports. However, the net barter terms are relevant only when nothing enters into the trade between countries except sales and purchases of merchandise.

ii) **Gross Barter Terms of Trade**: This is the ratio of the physical quantity of imports to physical quantity of exports. This is expressed as:

$$G_t = Q_m / Q_x$$

where Q_m and Q_x are the quantity or volume index numbers of imports and exports respectively. A rise in G_t is regarded as a favourable change in the sense that more imports are received for a given volume of exports (in the ith year than in the base year).

iii) **Income Terms of Trade**: This is expressed as:

$$I = P_x \cdot Q_x / P_m$$

A rise in I indicates that the nation's capacity to import, based on exports, has increased i.e. it can obtain a larger volume of imports from the sale of its exports.

21.2.2 Composition of Trade

It is indicative of the structure and level of development of an economy. For instance, most of the underdeveloped countries (UDCs) [a term not used any longer having since been replaced by the term developing countries for long] depend for their export earnings on a few primary commodities (PCs). These countries export raw materials of agricultural origin and import manufactured industrial products, thus, denying themselves the benefits of value added. As an economy develops, its trade gets diversified. It no more remains dependant on a few primary commodities for its exports as it begins to export more of manufactured industrial goods importing industrial raw materials, capital equipment and technical know-how.

Manufactured exports create greater value addition than the PCs as they go through more stages of processing. The manufacturing sector has greater linkages with the rest of the economy and, hence, the downstream effect on exports from these sectors are likely to be greater than primary exports.

The commodities entering trade could also be classified by various other criteria such as value added per unit of output, productivity of labour, capital intensity in production, the strength of backward and forward linkages, etc. The shifts in the commodity composition of trade in

these categories would bring out the nature of structural changes in regard to income generation, employment effect and overall industrialisation through linkage effects, etc. The following questions need to be analysed in this regard:

- What is the degree of concentration in the composition of exports/ imports? Has there been any change in the degree of concentration over time?
- Is there any shift in the shares of the primary products and manufactured products in the total export or import traded?

21.2.3 Direction of Trade

The direction of trade is indicative of the structure and level of economic development. As a country develops and its trade gets diversified, it has to seek new outlets for its exports. Its horizon of choice in terms of imports also gets widened. The country begins to trade with an increasingly large number of countries. One could therefore ask whether there has been a concentration or a dispersion of the markets for exports and sources of supply for imports.

It is in terms of these components that we have to study the trends in India's foreign trade during the course of economic planning.

21.3 VOLUME OF INDIA'S FOREIGN TRADE

As envisaged in our development strategy, the volume of merchandise trade has been on the rise; the trade to GDP ratio has gone up from 13 percent in the 1980 to about 25 percent presently. The increase has been shared both by exports and imports.

21.3.1 Exports

India's total exports have increased manifold, from Rs. 606 crores in 1950-51 to over Rs. 6,25,064 crores in 2007-08. However, the increase has not been uniform over the years. Whereas the exports hardly showed any variation during the first decade and a half of our getting independence, i.e. between 1950-51 and 1965-66, it multiplied manifold during the next four decades, i.e. between 1966-67 and 2007-08. We can, therefore, conveniently divide the whole period into two sub-periods, with 1965-66 serving as the year of divide. We shall now identify the trends and the forces that have been at work during each of these sub-periods.

Before 1965-66

India's exports were slow to grow during the first fifteen years of economic planning, notwithstanding the fact that this period has been described as the *Golden Era* for world exports.

This fact can be established with the help of two comparisons, viz.

- A comparison with the growth in total world exports.
- A comparison with the growth of net national product (NNP).

The total exports formed as much as 6.8 percent of the NNP in 1950-51 and 8.0 percent in 1951-52. This share fell to 3.9 percent in 1965-66 indicating that the growth in the *exports sector lagged behind the growth in other sectors of the economy.*

India's share in the total world exports was 2.2 percent in 1951. It came down steeply to 1.3 percent in 1958, and further to 1.1 percent in 1965.

After 1965-66

In 1966, the Indian rupee was devalued to bring domestic prices in alignment with external prices. After this devaluation, initially, exports were slow to pick up. But in 1972-73, a real breakthrough in exports occurred. This was mainly due to a substantial growth in the exports of sugar, iron and steel, fruits and vegetables and food products. A considerable growth was also recorded by engineering goods, leather goods, apparel, handloom cloth, chemicals and allied products, and various handicrafts, especially gems and jewellery.

A second major change in the trend in exports occurred in 1986-87, and has continued since, with evidence of a new dynamism of India's export performance brought about by a more supportive domestic industrial policy. This policy emphasised on competition, efficiency, scale economies and technological up-gradation. Further, a more liberal import policy ensured greater and easier access to imported inputs of raw materials and components as also technology. The pursuit of a realistic exchange rate also helped in preserving a competitive edge in exports. As a result, exports increased at an annual average rate of more than 25 percent in rupee terms.

In view of these factors, over the last twenty years i.e. 1987-2007, the upward trend in exports has been consistently maintained, except for some occasional dips. Currently, the export sector is poised for a major break-through, notwithstanding the serious uncertainties and instabilities caused by financial turmoil in the developed world. This shows that Indian exporters are successfully exploiting the scope of productivity gains that exist today. For instance, major emphasis is laid on improving the infrastructure in the country. Falling interest rates have also helped considerably to maintain competitiveness. This trend should strengthen India as it progressively gets greater market access, especially in services within the framework of WTO.

Relative Position

As already stated, changes in the value of trade may not be much useful

in assessing the export performance. *We must study the relative position*. We can employ, presently, three types of comparisons for this purpose.

i) **Comparison with the First Decade and a-half of Planning:** As to this, the conclusion is obvious i.e. India's exports have picked up and continued to maintain an upward trend.

ii) **Comparison with the Growth of GDP:** The share of exports in GDP too has increased over the years. Whereas it was a mere 3.1 percent in 1965-66, it was 13.0 percent in 2007-08. The aggregate exports of all high-income countries combined are 15 percent of their aggregate GDP whereas the average for all low-income economies (including China) is 18 percent.

iii) **Comparison with the Growth of World Exports:** India's exports, as compared to the world exports, have been slow to grow. Consequently, India's share in the world exports fell to a low of 0.42 percent in 1980-81. This is in spite of the country's comparative advantages like: low wages, educated workforce, etc. During the 1980s and the 1990s, there has been some improvement in this ratio, varying between 0.50 and 1.00 percent, indicating improvement in the export sector.

In short, India's exports shows a mixed trend. Whereas the rate of growth as measured in terms of past performance (or in terms of its share of national income) shows a rise, its performance when measured in terms of the share in world exports is very low.

21.3.2 Imports

India's total imports have increased from Rs. 608 crores in 1950-51 to an estimated Rs. 9,49,134 crores in 2007-08. It is estimated that 1 percent increase in national income requires imports to grow by 1.2 percent. This would mean that to achieve the targeted 9.0 percent per annum rate of growth, the import bill would rise by about 10.8 percent per annum. The overall trend of imports has been that of an increase right since 1954-55, with some dips now and then. While exports have been mainly dependent on world demand and availability of exportable surpluses, imports have been largely a matter of government policy.

Till 1980s, the government had adopted an import control policy. This included measures like licensing, quotas, bans, etc. of imports and tariff measures for providing protection to domestic units. The degree of control varied depending on the circumstances obtaining in the economy. Initially, the objective of the import trade control was to save foreign exchange. Over the years, the import trade control acquired a more positive and wider role in the economic development and industrial growth of the economy. It sought to facilitate the availability of such imported inputs crucially needed to broaden the base of industrial production and growth, especially for promoting exports.

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21.4 COMPOSITION OF INDIA'S FOREIGN TRADE

21.4.1 Exports

The picture that emerges from the aggregate behaviour of export values, volumes and prices gets reflected in the performance of individual commodities. There are two marked features of the composition of exports as they have emerged during the last five and a-half decades.

Till 1965-66

During the first decade and a-half, i.e. till 1965-66, India's export efforts leaned heavily on three principal commodities, viz. tea, jute and cotton goods. These three commodities among themselves commanded between 45 and 50 percent of the total export earnings. Other principal items of export during this period were manufactured tobacco, cashew kernels, leather and iron ore.

Since 1965-66

Since 1965-66, the commodity composition of India's exports has undergone a total transformation, which, in turn, has also contributed to a rapid expansion of India's exports during this period. The diversification in exports largely reflects the growth and industrialisation of the economy. It is also indicative of India's resolve to realise the goal of self-reliance. Important new commodities that have been added to the export basket and have acquired considerable significance in terms of their export value realisations are engineering goods, leather manufactures, cotton apparels, pearls and precious stones, chemicals and allied products, woollen carpets, iron and steel, etc.

Economic Reforms and Stimulus to Exports

The on-going economic reforms characterised by trade liberalisation (brought about by the reduction of tariff and non-tariff barriers) is expected to bring about following effects:

- It will stimulate production of labour intensive items and bring about more efficient use of resources as country specialises in production of goods where it has a comparative cost advantage.

- The growth in output will allow the buoyant sectors to reap the advantages of large-scale production.

- Competitive pressures will induce firms to raise production achieving more efficient plant sizes and lower per unit costs. Firms will also become quality-conscious.

- The termination of multi-fibre agreement (MFA) is expected to offer

opportunities for larger exports of textiles, although the competitive pressures from other competing developing countries' low-cost producers may rise.

21.4.2 Imports

Imports, as already mentioned, have been largely governed by the import trade control policy of the government although the composition of imports has been changing in response to the needs of the economy.

India's imports can be classified into three parts viz. (i) consumer goods, (ii) raw materials and intermediates, and (iii) capital goods. While the import of consumer goods have been totally restricted, permitted only when required to meet domestic shortages, imports of raw materials, intermediate goods and capital goods have increased.

Consumer Goods

The import of consumer goods, as already stated, have been allowed only when they are required to meet domestic shortages. Among these, the more important have been cereals, especially wheat and pulses. Hence, these imports do not show any systematic pattern. They have been usually high in the year succeeding the bad crop year. Since 1976-77, these imports have been negligible primarily because of large food-grains production during the period 1976-2008.

Capital Goods

The import of capital goods (e.g. machinery and other industrial equipment) shot up rapidly between 1955-56 and 1965-66, which correspond to the period covered by the Second and Third Plans.

Subsequently, there was a significant slow-down in imports of capital goods whereby domestic investment activity had slowed down. Imports of capital goods which formed as much as 29.5% of total imports during 1960-61 came down to only 15.0% in 1990-91.

With the on-set of the economic reforms programme, technological improvement and efficiency became the keywords for industrial survival in the emerging competitive environment.

Import of capital goods increased during the decade of 1990s and after. This increase could be attributed to the following three reasons:

- Indian manufactures introduced advanced technology to meet international competition.
- Import duties were reduced and regulations on import of capital goods were relaxed.
- Inflow of FDI rose. When joint venture companies are set up, they are likely to result in the import of capital goods from the partner countries.

Intermediate Goods

The group of commodities which has been growing in importance over the years consists of raw materials and intermediate goods most of which are in the nature of 'maintenance imports'. As the growth process moved, shortages and scarcities of different types of raw materials and intermediate goods began to be felt. These shortages would adversely affect the utilisation of capital goods, but for the import of required intermediate goods. Hence, the large imports of these commodities have been allowed. Among these imports, the most significant have been crude oil and petroleum products, fibres, fertilisers, chemical products, iron and steel, and non-ferrous metals. In short, the product profile of India's imports shows a strong push towards modernisation of Indian industry.

The composition of India's foreign trade reflects the structural changes that the Indian economy has undergone over the period of last five decades. It is no longer an exporter of primary commodities and an importer of manufactured goods. It exports manufactured goods and imports raw materials, intermediate goods and capital goods.

21.5 DIRECTION OF INDIA'S FOREIGN TRADE

21.5.1 Exports

The relative importance of the U.K. and the U.S.A. as outlets for our exports has declined over the years. Whereas in 1950-51, these countries together accounted for more than 40 percent of India's exports, this share came down in 2007-08 to less than 23 percent. The U.S.A., all the same, continues to be our principal buyer. It has, however, to contend with EU member-nations who as a group offer us a very rich market. The economic conditions in industrial countries significantly determine the demand for India's exports.

More Recent Development

Over the last decades, in wake of Look East Policy, India's exports to Asia and Oceania markets, with which ethnically, culturally and economically India is closer, have shown a sharp jump. In fact, the current boom in exports is sustained largely by what officials see as an unexpected and healthy rise in exports to the Asia and Oceania countries, which include the ESCAP countries like Australia, Iran, Japan, Korea, Malaysia, Singapore, Thailand, Hong-Kong, Bangladesh and Nepal. The shift in favour of these countries implies that Indian exporters have begun concentrating in markets closer home to capitalise on the advantages from lower freight cost. It is also an evidence of the outward orientation being imparted to the economy by reforms.

However, the expansion of trade within Asia is inevitably going to be constrained by the fact that many countries, particularly the fastest growing ones, have similar resource endowments. For instance, they are commonly competitive in labour-intensive products. And as they will find it difficult to sell these goods in each others' markets, their aim is to compete for a share in the American and European markets.

21.5.2 Imports

The direction of imports has been largely influenced by the development of the economy. In the initial stages of growth, a large part of the development process was financed through foreign aid, which was primarily in the form of tied aid. As a result, a large part of imports originated from the aid-giving counties.

- In 1965-66, more than 35 percent of India's total imports came from the U.S.A. Since then the share of the U.S.A. has declined although it continues to be our largest supplier, accounting for about 8 percent of our total imports.
- The share of the U.K. in India's imports has also sharply declined although it continues to be a principal supplier. Among the other major countries that have made inroads into our import trade are Belgium, Canada, France, Germany and Japan. The EU as a group accounts for about 24 percent of our imports.
- A more significant development has been the emergence of oil-producing countries as a significant purchasing centre for us. Sharp increase in the unit value of petroleum and its products have led to higher oil import bill. The OPEC accounts for about 22 percent of our total imports.
- Since the liberalisation in more recent years a glut of imports has been taking place from China and East Asian countries. These imports, presently, are limited to low-price consumer goods.

Diversification or Concentration?

Nine countries, viz. the U.S., the U.K., Germany, the erstwhile USSR, Japan, Iran, Iraq, Australia and Canada had a lion's share ranging between 51 to 62 percent of our exports and 56 to 75 percent of imports during the three decades from 1951-52 to 1979-80. In 1990-91, their share of exports was as high as 56.7 percent while their share in imports had declined to 47.6 percent. More recently, in 2004-05, 51.7 percent of our total exports had their destination in the EU, the USA and the UAE. Likewise, about 40.5 percent of our total imports originated from the EU, the USA and Japan. It is therefore clear that India's foreign trade is not diversified. By implication this means that India would have to explore new sources of imports and new markets for its products in a fast globalising world.

To sum up, during the last five decades, significant changes have been observed in the volume, composition and direction of India's foreign trade. Although most of these changes have been in consonance with the development needs of the economy, following problems need immediate attention.

- Problems of deficits in the balance of trade. Growing trade deficits had posed problems of resource mobilisation for the Indian planners till the recent past. This, therefore, needs to be monitored continuously.

- Our share in world trade (which is presently less than 1 percent) needs to be increased if India is to play its rightful role in the international division of labour.

- The expansion of trade within Asia is inevitably going to be constrained by the fact that many countries, particularly the fastest ones, have similar resource endowments. To go beyond mere diversification and act as a genuine engine of growth, Asian trade will have to be driven by forces similar to those in Europe. Gains can come from increasing efficiencies as production relocates across borders to take advantage of scale economies and other factors.

Check Your Progress 1

1. What major changes have taken place in the volume of India's foreign trade during the last three decades?

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2. How has the composition of India's exports been affected by economic reforms?

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3. Highlight the important changes in the direction of India's foreign trade in recent times

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21.6 BALANCE OF PAYMENTS AND PROBLEM OF DEFICITS

The principal tool for the analysis of the monetary aspects of international trade is the balance of international payments settlement. This statement, also simply known as the 'balance of payments' (BOP), is a systematic record of all international economic transactions, visible and invisible, of a country during a given period, usually a year. In other words, the statement is a device for recording all the economic transactions within a given period between the residents of a country and the residents of other countries. The BOP of each of the individual countries, technically speaking, always *'balances'*. Such equality in the debit and credit sides of the BOP, known as equilibrium, has no economic significance. It simply results from the double entry bookkeeping procedure, which is used to record the transactions.

The analysis of the BOP can be done in terms of its two major sub-divisions: (a) Current Account, and (b) Capital Account.

21.6.1 Current Account

The *Current Account* can be broken down into two parts, viz. (i) balance of trade and (ii) balance on invisibles. The *Balance of Trade* (BOT) deals only with exports and imports of merchandise (i.e. visible items). The *Balance on Invisibles* (BOI) shows net receipts on account of invisibles. These include the remittances, net service payments, etc. It is not necessary that the BOT should always balance; more often than not, it will show either a surplus or a deficit. Similarly, the BOI will always show either a surplus or a deficit. A surplus on BOT may be matched with a surplus or deficit on BOI. If the surplus on BOI equals the deficit on BOT, the current account will show a net balance. However, there is no reason why these two balances should always be equal; as a matter of fact, the balance on current account always shows a deficit or a surplus. A surplus on current account leads to an acquisition of assets or repayment of debts previously contracted, and a deficit involves withdrawal of previously accumulated assets or is met by borrowings.

21.6.2 Capital Account

The *Capital Account* presents transfers of money and other capital items and changes in the country's foreign assets and liabilities resulting from the transactions recorded in the current account. The deficit on the current account and on account of capital transactions can be financed by external assistance (e.g. loans and grants drawn from the International Monetary Fund) and allocation of the Special Drawing Rights.

The BOP accounts provide a link between the increase in gross external debt and the portfolio and spending decisions of the economy.

Thus, increase in gross external debt = Current account deficit (CAD)

– direct and long-term portfolio capital inflows

+ official reserve increase

+ other private capital outflows

21.6.3 Balance of Payments and Developing Economies

It is well known in development economics that UDCs invariably start of as debtor economies. In the process of development itself, these economies have to import a great deal of capital goods, food and raw materials and spares and components. They also have to import new technologies. Hence, the total exchange outgo cannot be matched by export earning. It is, however, expected that in a decade or two, as the new capital goods and technologies become effective with their products directed towards exports, the volume of exports expand and, in due course, overtake imports. A developing economy at that stage moves on from being a debtor economy to a more balanced one in terms of BOP and, finally, becomes a creditor economy, when its exports are more than its imports. Thus, from being a net debtor in the beginning, it becomes a net creditor in the end and, in fact, begins to invest abroad rather than have others lending to and investing in it.

21.6.4 Current Account Deficit (CAD)

A current account deficit, as seen from the above, is nothing but a measure of a country's savings gap, i.e. the excess of investment over savings. It represents the net transfer of resources from the rest of the world to the country running the deficit. Therefore, in a developing country, with huge needs for funds for investment, a CAD is unavoidable as it represents investment which would otherwise be beyond its potential to finance from its own savings. In view of this, CADs are best when financed by foreign capital inflows.

The right CAD for any country, therefore, depends on its ability to absorb and service the capital inflows. If these resources can be deployed productively and in ways that enhance its ability to repay, a high CAD to GDP ratio is nothing to worry about. But if they cannot, then it is inviting trouble. Too high a ratio can prove unsustainable in the long run as it did in East Asian economies in 1998 and in Mexico earlier. To that extent low CAD to GDP ratio has its advantages. However, a very low ratio carries with it an opportunity cost - of not being able to benefit from resources that could be drawn from outside.

21.7 TRENDS IN INDIA'S BALANCE OF PAYMENTS

India has faced pressures on BOP from time to time either due to certain domestic compulsions or due to external factors. In this context, the whole period, covering nearly five decades, can be divided into five sub-periods, depending on: (i) the nature of the BOP problem, (ii) the overall macro-economic environment, and (iii) the external situation.

Period I (up to 1975-76): A Period of Deterioration

The period was very difficult for India's BOP, partly because of slow growth of exports in relation to import requirements and partly because of adverse external factors. Despite tight import controls (through quantitative restrictions) and foreign exchange regulations, the CAD was 1.8 percent of the GDP. Foreign exchange reserves were at a low level, generally less than necessary to cover three months' imports. Almost the entire CAD (92 percent) was financed by inflows of external assistance on highly concessional terms.

Period II (1976-77 to 1979-80): A Period of Transition and Improvement

These few years stand out as the golden years for India's BOP. India had a small current account surplus (0.6 percent of the GDP on an average) and foreign exchange reserves equivalent to about seven months' imports. Export growth was good but the primary reason for the improvement in BOP was the dramatic improvement in net invisibles (by way of large remittances from the middle east from Indian emigrants). Net invisibles increased from Rs. 193 crores in 1974-75 to Rs. 2,486 crores in 1979-80.

Period III (1980-81 to 1989-90): Emergence and Persistence of Structural Imbalances

This period corresponds to the Sixth and the Seventh Plan periods. The Sixth Plan was launched when the economy was faced with severe BOP difficulties. In 1981, India entered into an arrangement with the IMF for a loan of *SDR 5 billion* under the Extended Fund Facility. The amount was to be disbursed over a three-year period. India, however, drew only SDR 3.9 billion and the arrangement was terminated in early 1984 at India's request because of the improvement in the BOP position in 1983-84.

The deficit on external trade and payments suddenly jumped from the first year of the Seventh Plan and was particularly acute during the last two years of the plan. The CAD more than trebled over the plan period as a whole. The deficit was as high as 2.2 percent of the GDP, as compared to 1.3 percent during the Sixth Plan.

Period IV (1990-91 to 1995-96): Stabilisation and Strengthening

The BOP crisis reached its climax during 1990-91 - CAD reached a high of 3.3 percent of the GDP during this year.

A comprehensive strategy to deal with the BOP situation was put in practice. The principal elements of the BOP strategy were as follows:

- **Preference to Non-Debt Creating Capital Flows:** The most important element of strategy has been the paradigm shift in the attitude towards inflow of capital from abroad. Capital inflow from abroad was earlier treated more generally as a device to finance CAD. Now non-debt creating capital inflows, especially FDI, is being encouraged on account of their positive impact both in terms of technology and the stabilising role in external sustainability. The policy has, therefore, been to gradually liberalise capital account.

- Recognising that liberalisation of capital account needs to be treated as a continuous process, the approach is being based on a careful and continuous monitoring of certain preconditions/signposts such as monetary and fiscal discipline, exchange rates, structural reforms, etc.

- Stabilisation and strengthening of strict fiscal and monetary discipline to control aggregate demand in place of monetary policy aimed at slowing down the growth of money supply.

- **Exchange Rate Policy:** The exchange rate policy was progressively liberalised in the successive union budgets of early 1990s. For instance:

  - A dual exchange rate system, called liberalised exchange rate management system (LERMS), was introduced in the union budget of 1992-93. Under this system, 40 percent of foreign exchange earnings were to be surrendered at the official exchange rate. Remaining 60 percent could be converted at a market-determined rate.

  - The budget for 1993-94 introduced another scheme viz. the unified exchange rate system (UERS) in which rupee was convertible at a unified market determined rate of exchange. Under this, all payments and receipts of foreign exchange were to be converted in rupees at market-determined rate of exchange.

  - The budget for 1994-95 introduced full convertibility on current account making many trade transactions relatively more free of controls.

Further, import restrictions on capital goods, raw materials and components were virtually removed. With this, excess import-demand

would be reflected in a higher market exchange rate with which a self-correcting mechanism was expected to operate keeping the trade deficit in check.

Period V (1996 to 2008)

Over the last decade or so, two prominent features on the BOP front can be indicated as follows:

1. On the current account front:

   i) **Firstly**, trade deficits have been widening. Both exports and imports have multiplied fast, but imports have risen at a faster rate than exports. Expanding exports, in turn, reflect (a) the impact of liberalisation measures, and (b) increasing manufacturing activity in the domestic economy.

   ii) **Second,** there has been a phenomenal increase in the net surplus on account of invisibles. This, in turn, is principally due to (a) buoyancy in private transfers (i.e. inward remittances), and (b) fast expansion in exports of services, especially software. India is unique among emerging economies to have a sizeable invisible surplus that substantially offsets the merchandise trade deficit. As a result, although India has been running a current account deficit (except during 2002-04 when India experienced a current account surplus), the deficit has been conveniently managed, largely because of huge surplus on capital account as the following point clarifies.

2. On the capital account front, India has been running a big surplus. The size of the surplus has been much more than what is required to finance the current account deficit. As a result, India has been rapidly building up its foreign exchange surplus. The capital account demonstrates features like:

   i) Increased inflows and outflows of capital especially since 2003.

   ii) The composition of capital flows has undergone change by way of:

      a) Official external assistance gradually losing out its significance;

      b) FDI and portfolio investment have surged, with the FDI inflows being much more than portfolio investment; and

      c) Easing of controls resulting in external commercial borrowings in a prominent manner.

Overall, therefore, India's balance of payments (both current account and capital account) has been in surplus, resulting in rapid build-up of foreign exchange reserves. However, it should also be noted that the acceleration in India's growth momentum since 2003 owes partly to the

exceptionally easy global liquidity conditions. This has increased the scope for risk-taking contributing to an increase in the volume of capital inflows into India.

21.7.1 Long-run Perspective

Our long term strategy should aim at enhancing the economy's absorptive capacity to achieve higher levels of real investment. At the same time, we must ensure that we do not become dependent on external capital, for if it dries up, our currency loses its value. Speculators anticipate this by betting against the currency, which puts pressure on it. When this happens, the value of investments drop. The flight of capital increases the pressure on the currency, and such a situation might warrant the assistance of the central bank. Therefore, no country must let its CAD go beyond 3 to 4 percent of GDP which in India's case works out to about $ 45 billion. Also, the composition of its reserves and the vulnerability of its capital inflows to short-term uncertainties must be minimised. This implies that as the economy grows up, outside influences will increasingly impact and constrain policy-making along with domestic imperatives. This requires that imports must be constantly monitored for its composition, and capital goods imports must be encouraged as compared to consumer goods. Exports should always be a priority and to the maximum extent possible, the trade deficit should be narrowed. With a large service sector and huge stock of service professionals, a big push in multiple directions is required for exploiting the market potential in this area. Short-term debts should not be allowed to reach a level where its refinancing could create a crunch. Direct investments are more important than portfolio investments in that they represent more stable and committed flows.

Check Your Progress 2

1. What is meant by balance of payments? Distinguish between current account and capital account.

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2. Outline the significance of balance of payments in a developing economy in about 50 words.

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3. Do current account deficits need to be avoided in all situations?

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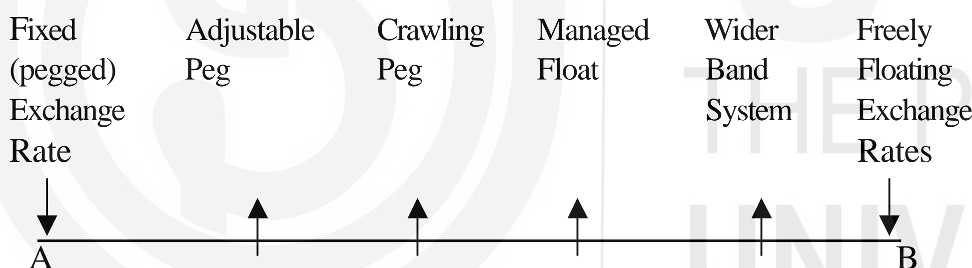
21.8 EXCHANGE RATE REGIME

Exchange rate regime refers to the way in which a country manages its currency is respect of other foreign currencies and the foregin exchange market. Between the two limits of fixed and freely floating exchange regimes, there can be several other types of regimes as shown in Fig. 21.1. In their operational objective, it is closely related to monetary policy of the country with both depending on common factors of influence and impact. Exchange rate regime has a big impact on world trade and financial flows. The volume of such transactions and the speed at which they are growing make the exchange rate regime a central piece of any national economic policy framework.

Figure 21.1: Types of Exchange Rate Regime



In Fig. 21.1, as one moves from point A on the left to point B on the right, both the frequency of intervention by domestic monetary authorities and required level of international reserves tend to be lower. Under a pure fixed-exchange-rate regime (point A), authorities intervene so that the value of the domestic currency vis-à-vis the currency of another country, say the US dollar, is maintained at a constant rate. Under a freely floating exchange-rate regime, authorities do not intervene in the market for foreign exchange and there is minimal need for international reserves.

21.8.1 Exchange Rate System in India

India was among the original members of the IMF when it started functioning in 1946. As such, India was obliged to adopt the Bretton Woods system of exchange rate determination. This system is known as the par value system or pegged exchange rate system. Under this system, each member country of the IMF was required to define the value of its

currency in terms of gold or the US dollar and maintain (or peg) the market value of its currency within ± percent of the defined (par) value.

The Bretton Woods system collapsed in 1971. Consequently, the rupee was pegged to pound sterling for four years after which (since September 1975) it was initially linked to the basket of 14 currencies but later reduced to 5 currencies of India's major trading partners. This system continued through the 1980s; though the exchange rate was allowed to fluctuate in a wider margin and to depreciate modestly with a view to maintaining competitiveness. However, the need for adjusting exchange rate became precipitous in the face of the external payments crisis of 1991. As a part of the overall macro-economic stabilisation programme, the exchange rate of the rupee was devalued in two stages by 18 percent in terms of the US dollar in July 1991. With that, India entered into a new phase of exchange rate management.

21.8.2 Objectives of Exchange Rate Management

The main objectives of India's exchange rate policy is to ensure that the economic fundamentals are truly reflected in the external value of the rupee. Subject to this predominant objective, the conduct of exchange policy is guided by the following:

1. Reduce volatility in exchange rates, ensuring that the market correction of exchange rates is effected in an orderly and calibrated manner;

2. Help maintain an adequate level of foreign exchange reserves;

3. Prevent the emergence of destabilisation by speculative activities; and

4. Help eliminate market constraints so as to assist the development of a healthy foreign exchange market.

Exchange Rate Reforms

Exchange rate reforms have proceeded gradually beginning with a two-stage cumulative devaluation of rupee by about 20 percent effected in July 1991. Subsequently, as mentioned earlier, the Liberalised Exchange Rate Management System (LERMS) was introduced in 1992 which was later replaced by the Unified Exchange Rate System (UERS) in 1993. The net result was an effective devaluation of the rupee by around 35 percent in nominal terms and 25 percent in real terms between July 1991 and March 1993.

21.8.3 Features of the Current Regime

The principal features of the current exchange rate regime in India can be briefly stated as follows:

1. The rates of exchange are determined in the market.

2. The freely floating exchange rate regime continues to operate within the framework of exchange control.

3. Current receipts are surrendered (or deposited) to the banking system, which in turn, meets the demand for foreign exchange.

4. RBI can intervene in the market to modulate the volatility and sharp depreciation of the rupee. It effects transactions at a rate of exchange which could change within a margin of 5 percent of the prevailing market rate.

5. The US dollar is the principal currency for the RBI transactions.

6. The RBI also announces a Reference Rate based on the quotations of select banks in Bombay at twelve noon every day. The Reference Rate is applicable to SDR transactions and transactions routed through the Asian Clearing Union.

In short, the Indian rupee has matured to a regime of the floating exchange rate from the earlier versions of a 'managed float'.

21.8.4 Convertibility on Current Account

The current regime of exchange rate has been accompanied by full convertibility on current account with effect from August 20, 1994. Accordingly, several provisions like remittances for services, education, basic travel, gift remittances, donation, and provisions of the Exchange Earners' Foreign Currency Account (EEFCA) were relaxed. In a further move, announced in 1997, the RBI liberalised the existing regulations in regard to payments for various kinds of feasibility studies, legal services, postal imports and purchases of designs and drawings. With this, India acquired a status called as the IMF Article VIII Status. By attaining the Article VIII status, India has reached a position by which it can instil confidence among the international investor community, paving the way for further inflow of foreign capital. Further, India is also committed to allowing free outflow of current account payments (like interest) even if there is a serious foreign exchange crisis.

Notwithstanding the above, the government still retains many controls on current account. Among these, the following may be specifically mentioned:

i) Repatriation of export proceeds within six months;

ii) Caps on the amounts spent on the purchase of services abroad;

iii) Restrictions on the repatriation of interest on rupee debt;

iv) Dividend-balancing for FDI in some consumer goods industries;

v) Restrictions on the repatriation of interest on NRI deposits;

vi) Rupee is not allowed to be officially used as international means of payment. Indian banks are not permitted to offer two-way quotes to NRIs or non-resident banks.

With the help of these controls the governments can significantly alter the flow of foreign exchange and the exchange rate of rupee. Additionally, the RBI can influence the exchange rate through direct purchase and sale of foreign exchange in the market.

21.8.5 Convertibility on Capital Account

Drawing on the experience of the past decade and a half, the extent and timing of capital account liberalisation is sequenced with other reforms like strengthening of banking systems, fiscal consolidation, market development and integration, trade liberalisation, etc. all of which are in tune with the changing domestic and external economic environment. A hierarchy is thus established in the sources and types of capital flows. The priority has been to liberalise inflows relative to outflows, but all outflows associated with inflows have been totally freed. Among the types of inflows, FDI is preferred for its stability, while short-term external debt is avoided. A differentiation is made between corporates, individuals and banks.

For outflows, the hierarchy for liberalisation has corporates at the top, followed by financial intermediaries and individuals. Restrictions have been eased for corporates seeking investments and acquisitions abroad which strengthen their global presence. Banks and financial intermediaries are considered a source of greater volatility as their assets are relatively illiquid and their liabilities are demandable. They are thus susceptible to self-fulfilling crisis of confidence leading to a contagion effect. In view of this, liberalisation for outflows in this sector has been tied to financial sector reforms. For individuals, residents are treated differently from non-residents, and non-resident Indians are accorded a well-defined intermediate status between residents and non-residents.

21.8.6 Intervention By RBI

In the current exchange rate regime, introduced in 1993, the RBI has been actively intervening in the foreign exchange market with the objective of maintaining the real effective exchange rate (REER) stable. The RBI uses two types of intervention in this regard:

1. **Direct Intervention**: It refers to purchases and sales in international currency (i.e. US dollars and euro) both on-spot and also in forward markets.

2. **Indirect Intervention**: It refers to the use of reserve requirements and interest rate flexibility to smoothen temporary mismatches between demand and supply of foreign currency.

Intervention by the RBI has raised a question as to whether or not there should be an exchange rate band within which the central bank should allow the currency to fluctuate. The Tarapore Committee in its report on Capital Account Convertibility had, while suggesting transparency in the exchange rate policy of the central bank, recommended a band within which it would allow the currency to move. The RBI has been, in contrast, saying that there cannot be such rigidities in exchange rate policy, and, therefore, the bank should have the right to intervene at its discretion. Such interventions are considered necessary till the rupee is made fully convertible.

21.9 FULL CONVERTIBILITY OF RUPEE

Meaning of a Convertible Currency

A convertible currency is one, which can be converted into foreign currencies and can be used freely for payment of goods and services, including travel, without any constraints or limitations imposed on it. This is to be contrasted with a controlled currency, which cannot be converted into foreign currencies without prior authorisation because of exchange controls imposed in that country.

The convertibility can be for current account transactions (with restrictions on capital flows) or capital account transactions or for both the current and the capital accounts. Each has its benefits while posing certain risks and challenges to the economy.

Convertibility requires an appropriate and credible economic environment. In the absence of such environment providing the much required confidence in macro-economic stability and the competitiveness of domestic enterprises, establishment of capital account convertibility entails the risks of capital flight and greater volatility in exchange rates. It is because of this that many countries have maintained various restrictions on different types of capital flows until their economies are well advanced.

21.9.1 Changeover to Full Convertibility

Indian rupee was made fully convertible on current account in 1994. Following this, several provisions relating to flows of foreign exchange were relaxed. Further, as stated before, in 1997, the RBI liberalised the existing regulations in regard to payments in foreign exchange thereby according India the status of IMF Article VIII.

On the capital account, liberalisation measures has kept in tune with other reforms. The extent and timing of capital account liberalisation is sequenced with other reforms and the changing domestic and external economic environments. As such, rupee is not fully convertible on capital account.

Having made rupee convertible on current account and partially convertible on capital account, full convertibility of rupee should be the next logical step. There are, however, reasons to weigh both the pros and cons before this step is undertaken.

21.9.2 Gains From Full Convertibility

Capital account convertibility can yield many efficiency gains. These are:

i) By setting the prices right, it enables the aggregate savings and investment to be optimised, giving both allocative efficiency and competitive discipline to the economy.

ii) By providing the opportunity of using the world markets for achieving diversification, it permits both savers and investors to protect the real value of their assets.

iii) By exposing the financial sector to global competition, capital account convertibility stimulates efficiency, stabilisation and innovation.

iv) By symbolising the economy's openness and freedom, it will not only attract foreign capital but also encourage foreigners to take large and more permanent ownership positions in domestic enterprises, and persuade them to be less inhibited about sharing technologies, management practices and markets. A free forex regime thus acts as a strong magnet to the riches of the world.

v) Once the capital account is freed, the Indian stock market, foreign exchange, bond and commodity markets will become more linked to the global markets and the Indian markets will be truly part of an international economy. Interest rates in India will then be more closely aligned with global rates assuring our industry and agriculture adequate credit at reasonable rates.

vi) Under a free forex and full convertibility atmosphere, asset switching possibilities will bring about a greater degree of efficiency; just like 'arbitrage' possibilities of an insular market will disappear.

vii) Capital account convertibility provides resident Indians with investment opportunities overseas.

viii) A non-convertible rupee insulates the Indian economy from global crises, but keeps its poor.

21.9.3 Costs of Full Convertibility

There are no free lunches in real life for macroeconomic management. Among the important costs associated with capital account convertibility the following are important:

i) Convertible rupee would encourage capital flight.

ii) The capital outflows would have to be neutralised, at least by an equal volume of inflows in the form of investments by foreigners or a matching increase in export earnings. The former would require their confidence, not just in economy's potential but also in the government that it would not panic and reintroduce capital controls. The latter is an uphill task. In other words, both will take time.

iii) Total capital decontrol in the present situation is premature, as trade sector reforms are not yet complete. A trade sector that is still in the process of adjustment emits faulty signals about the relative profitability of various sectors. Capital will more likely flow into sectors that will not eventually survive international competition. The differing speeds with which asset and goods markets adjust can make a crucial difference in this regard.

iv) Fiscal consolidation, which is basic to our reform strategy, can be eroded by premature capital decontrol. In the event of net inflows, the fiscal costs of monetising them can be heavy. Further, because of volatile exchange rate movements, it could be uncertain too. Likewise, in the event of outflows, the domestic tax base will shrink, with its obvious fiscal repercussions. In either case, RBI will lose control over the money base and the monetary policy will become largely ineffective in inflation management.

v) If immediate full convertibility also means full-scale trade convertibility, it would play havoc with the Indian industry and stock markets. The slowdown in domestic industrial growth under the impact of greater foreign competition would bring adverse influence on the corporate profitability sending the stock market into a tailspin. Under these circumstances, it would be impossible to have a vibrant, attractive and lucrative capital market.

vi) From the point of view of attracting foreign capital, we would be sending less positive signals by premature capital account convertibility than by robust macroeconomic adjustment . In other words, the advantages of capital account convertibility cannot be derived until fiscal consolidation is complete.

One may not fully agree with Prof. Jagdish Bhagwati, the internationally acknowledged champion of free trade, when he says that 'he will avoid full convertibility like plague'. This may appear a harsh judgement, but not wrong. It finds support from Paul Krugmen when he remarks that 'it is an extremely dangerous world out there. The risks of getting caught in the pinball game are too high'.

21.9.4 Adjustment Measures

Before the decision on full convertibility is finally taken, it must be

preceded by a number of adjustment measures. To recapitulate, these measure are:

- Fiscal consolidation of a stable and robust order;
- Achieving a strong and sustainable BOP adjusted position;
- Achievement of low and stable level of inflation;
- Completion of the trade and financial sector reforms;
- Establishment of globally competitive interest rates; and
- Establishment of efficient infrastructure and streamlined production procedures for achieving high productivity and quality consciousness.

In short, controls over outward capital movements and foreign borrowing should ge retained until at least the domestic financial system has been strengthened and economic conditions are so stable that the movement of money from India to the United States matters as little as its movement from Mumbai to Delhi. We should not show any haste. There are lessons in patience we can emulate. The first country to industrialise, the United Kingdom, lifted controls as recently as in 1979. Most developed countries have removed capital controls only in the last two decades. South Korea, the success story of the twentieth century, still maintains extensive capital controls. So are the vast majority of developing countries who continue to impose capital controls. No country that has gone in haste for total convertibility has managed to sustain itself when faced with continued fiscal deficits and structural disequilibrium. The issue of full convertibility therefore relates more to the right sequencing of reforms than to their speed.

21.10 LET US SUM UP

The unit presents a profile of India's foreign trade and balance of payments. During the early phase of economic planning, the foreign trade sector was relegated to the background with import substitution, rather than export promotion, forming the core of development strategy pursued in India. The balance of payments difficulties made it imperative to bring about changes in this strategy and adopt export promotion as an independent goal of growth strategy. The ensuing opening up of the economy and liberalisation resulted in dramatic changes in the structure of India's foreign trade. Balance of payments situation improved with large inflows of foreign capital. In this fast changing situation, rate of exchange has come to play an important role. There is a need to pursue a growth-friendly exchange rate regime. A diligent sequencing and focused pursuit of reform measures is called for.

21.11 KEY WORDS

Terms of Trade : Refers to the relationship between exports and imports. It is the relative price of country's exports to imports.

Multi-Fibre Agreement : Also known as Agreement on Textile and Clothing (ATC), MFA governed the world trade in textiles and garments from 1974 to 2004 i.e. till it expired in 2005. It imposed quotas on the amount 'developing countries' could export to 'developed countries'.

Balance of Payment (BoP) : It is a systematic record of all international economic transactions (both visible and invisible) of a country during a given period like a year.

Special Drawing Rights (SDRs) : Created to replace gold, SDRs are used as a unit of account by the IMF. They are potential claims on the freely usable currencies of IMF members.

Arbitrage : Refers to the simultaneous buying and selling of assets in different markets or in derivative forms taking advantage of the differing prices.

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21.12 SOME USEFUL BOOKS

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21.13 ANSWERS OR HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1. See Section 21.3
2. See Section 21.4
3. See Section 21.5

Check Your Progress 2

1. See Section 21.6
2. See Sub-section 21.6.3
3. See Sub-section 21.6.4

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