UNIT 14 INDIA'S BALANCE OF PAYMENTS

Objectives

This unit familiarises you with the

- definition of Balance of Payments (BOP);
- components of BOP;
- significance of BOP;
- developments in India's BOP since 1950-51;
- BOP crisis in the 90s and subsequent developments; and the
- issues of Rupee convertibility.

Structure

14.1 INTRODUCTION

The balance of payments of a country is a systematic record of all economic transactions between the residents of a country and the rest of the world. It is composed of all receipts on account of goods exported, services rendered and capital received by residents and payments made by them on account of goods imported, services received and capital transferred to non-residents or foreigners.

A balance of payments table is designed to summarise a nation's transactions with the outside world. The balance of payments of a country consists of (i) current account, (ii) capital account and (iii) cash account/official reserve assets account. The current account component portrays the flow of goods and services in the form of exports and imports for a country during a given year. The capital account shows the volume of private foreign investment and public grants and loans from individual nations and multilateral donor agencies such as the IMF, World Bank, etc.

The official reserve assets accounts comprise its gold stock, holdings of its convertible foreign currencies, and Special Drawings Rights (SDRs). This account is the balancing item in response to current and capital accounts transactions. The account will see a decline in terms of foreign exchange reserves i.e., a net outlflow of foreign exchange, whenever total disbursements on the current and capital accounts exceed total receipts. Thus, the balance on current account plus the balance on capital account must always be offset by the balance on official reserves asset account.

If the balance on current and capital accounts is negative, it would represent balance of payments "deficit". But if the balance on current and capital accounts is positive, it would be called a balance of payments "surplus".

14.2 FINANCING PAYMENTS DEFICITS : THE INTERNATIONAL MONETARY SYSTEM AND SPECIAL DRAWING RIGHTS

A blance of payments table for a hypothetical country is presented in Table 14.1. The country has a net negative balance of Rs. 1500 crore on current account. Commodity imports plus payments to foreign shipping firms exceed commodity exports plus payments to Indian Shipping firms by Rs. 1500 crore. On the capital account front, the country experiences a net inflow of Rs. 1300 crore. This comprises a net private foreign investment of Rs. 800 crore and a net government and multilateral flows of Rs. 700 crore. Though the gross inflow of government and multilateral assistance was Rs. 1000 crore, this is partly offset by the capital outflow of Rs. 300 crore representing debt repayments, consisting of amortisation and interest payment on former loans.

Table 14.1: Balance of Payments : A Hypothetical Case

(Rs. in crores)

Item		Amount
A. Current Account:		
Commodity Exports		2500
i) Primary Products	1500	
ii) Manufactured goods	1000	
Services (e.g.: Shipping costs)		1000
Commodity Imports		3500
i) Primary Products	500	
ii) Manufactured goods	3000	
Services		1500
Balance on Current Account		– 1500
B. Capital Account:		
Private foreign investment (net)		+ 800
Government and multilateral flows (net)		+ 700
i) Loans	+800	
ii) Grants	+200	
iii) Debt repayments	–300	
Private transfer payments (net)		–200
Balance on Capital Account		+1300
Balance on Current and Capital Account		–200
C. Official Reserves Asset Account:		
Net decrease in official monetary reserves		+200
Balance on Official Reserves Asset Account		+200

But the net private transfer payments of Rs. 200 crore — monetary outflows of private individuals such as friends and relatives living overseas — bring the balance on capital account to Rs. 1300 crore.

The combined net balance on current and capital accounts is a negative Rs. 200 crore. This amount represents the balance of payments deficit of our hypothetical economy. How to finance this negative balance on combined current and capital accounts?

To offset the negative balance, our hypothetical economy can rely on its Central Bank holdings of official monetary reserves. Such reserves consist of gold, convertible foreign currencies (such as US dollar and British pounds) and Special Drawing Rights. International reserves serve for countries the same purpose that bank accounts serve for individuals. They can be drawn on to pay bills and debts; they may increase due to current account or capital account surplus or both.

The balance on current account plus the balance on capital account must always be offset by the balance on official reserves asset account. In the present case of our hypothetical economy, there is a net outflow of Rs. 200 crore and accordingly the official monetary reserves declined by the same amount.

A country which is faced with exiting or projected balance of payments deficits on combined current and capital accounts has a variety of policy options. It can seek to improve the balance on current account by promoting export expansion/ or limiting imports. A second alternative, though often not exclusive of the frist, is to improve the balance on their capital account by encouraging more private foreign investment and seeking more public foreign assistance. Finally, a country can also seek to modify the detrimental impact of chronic balance of payments deficits by expanding their stocks of official monetary reserves. Generally, under the workings of the international monetory system, countries with deficits in their balance of payments are required to pay for these deficits by drawing down on their official reserves comprising gold, U.S. Dollars and SDRs.

The SDR owe its origin to the phenomenal growth in the volume and value of world trade. The remarkable expansion of international trade necessitated a new international asset to supplement the limited stock of gold and dollars. Consequently, in 1970 the International Monetary Fund (IMF) was given the authority to create $10 billion of these SDRs. These new international assets perform many of the functions of gold and dollars in setting balance of payments accounts.

14.3 IMPORTANCE OF BALANCE OF PAYMENTS

A country's balance of payments reveals various aspects of a country's international economic position. It presents the international financial position of the country. It helps the Government in taking decisions on monetary and fiscal policies on the one hand, and on external trade and payments issues on the other.

In the case of a developing country, the balance of payments shows the extent of dependence of the country's economic development on the financial assistance by the developed countries.

The greatest importance of balance of payments lies in its serving as an indicator of changing international economic position of a country. The balance of payments is the economic barometer which can be used to appraise a nation's short-term international economic prospects, to evaluate the degree of its international solvency, and to determine the appropriateness of the exchange rate of country's currency.

However, a country's favourable balance of payments cannot be taken as an indicator of economic prosperity nor its adverse or unfavourable balance of payments is a reflection of bankruptcy. A balance of payments deficit *per se* is not the proof of competitive weakness of a nation in foreign markets. However, the longer the balance of payments deficit continues, the more it would imply some fundamental problems in that economy. Similarly, a favourable balance of payments should not always make a country complacent. A poor country may have a favourable balance of payments due to large inflow of foreign loans and equity capital. A developed country may have adverse balance of payments due to massive assistance given to developing countries.

Thus, a deficit or surplus of balance of payments of a country *per se* should not be taken as an index of economic bankruptcy or prosperity of the country. The balance of payments deals only with the transactions of the period under review. It does not provide data about assets and liabilities that relate one country to others. However, despite all these short comings, the significance of balance of payments lies in the fact that it provides vital information to understand a country's economic dealings with other countries.

Activity 1

Develop a table of statistics for a hypothetical economy for three consecutive years showing:

(i) Trade surplus, current account deficit, capital account surplus and a decline in forex reserves — in the first year.

(ii) Trade deficit, current account surplus, capital account deficit and a decline in forex reserves — in the second year; and

(iii) Trade surplus, current account surplus, capital account deficit, and an increase in forex reserves — in the third year.

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14.4 INDIA'S BALANCE OF PAYMENTS: 1950-51 TO 2000-01

The BOP in the 50s: In the early 1950s when India launched its economic planning, the balance of payments position was more or less comfortable. But in 1951-52, there was a large trade deficit and as a result, despite net surplus invisible transfers and capital account surplus (which was due to long term loans), there was overall deficit on the current and capital accounts, which was met by the official reserves account. In 1952-53 and 1953-54, the net surplus invisible transfers more than offset the trade deficit and capital account deficit. As a result, India experienced current account surplus and net surplus on combined current and capital accounts resulting in an increase in the official reserves position.

In 1954-55, though there was surplus on both current and capital accounts, due to repayments to the IMF, there was outflow from the official reserves account. In 1955-56, there was an inflow into the official reserves account due to surplus current and capital accounts, despite repayments in the I.M.F. (For year by year statistics on India's Balance of Payments see. *Reserve Bank of India; India's Balance of Payments, 1948-49 to 1988-89,* Bombay, July 1993).

But the scenario changed substantially since then. In the second five year plan, India laid emphasis on the development of heavy and basic industries which necessitated large scale imports of machinery and capital equipments. The consequent trade deficit was much more than the net surplus invisible transfers and surplus capital account. As a result, India resorted to borrowing from the I.M.F. to some extent and the remaining deficit was met from the official reserves account. Throughout the late 50s, India experienced an outflow from the official reserves account towards meeting the balance of payments requirements. As a result, the foreign exchange reserves of the country declined sharply.

The BOP in the 60s: In the early 60s, the situation did not improve. The trade and current account deficits increased sharply due to large scale imports of food grains, machinery and equipments. India sought external assistance in a big way under capital account. I.M.F. borrowings supplemented the loans to meet the current account deficit. On the whole, there was a net outflow from the official reserves account during the first-half of 60s.

Heavy trade deficits, debt obligations and a sharp fall in foreign exchange reserves led to the devaluation of the rupee in 1966. The rupee was devalued against the US dollar by 57.5 percent. This exchange rate adjustment enabled India to curtail imports and encouraged the growth of exports. However, India continued to have deficits both on trade account and current account. As a result, there was a substantial increase in external assistance. This enabled, among others, an increase in the foreign exchange reserves of the country in the latter half of 1960s. Throughout the 60s, India and current account deficits and thanks to long term loans, among others, surpluses on capital account front. The foreign exchange reserves could increase at the end of the decade due to these long term loans.

The BOP in the 70s: In the early 70s, though exports grew more significantly, the larger increase in imports led to continued trade deficits and India had deficits even in terms of invisible transfers (Table 14.2). The combined deficit on the current account forced the country to continue to seek external assistance. In 1973-74, however, the country had a substantial current account surplus (about Rs. 1135 crore), despite a trade deficit of Rs. 510 crore. This was due to large surplus in terms of invisible transfers. However, amortisation (Rs. 2000 crore) caused the country to have large capital account deficit and as a result, there was an outflow from the foreign exchange reserves account to the extent of Rs. 84 crore.

In 1973-74, the International economy, particularly oil importing countries, experienced the first oil-price hike-shock. This put a severe pressure on the balance of payments of these countries by raising the import bill dramatically. India's trade deficit more than doubled in 1974-75 (Rs. 1284 crore) as compared to 1973-74 (Rs. 510 crore). The surplus invisible transfers (Rs. 331 crore) could reduce the current account deficit only to Rs. 956 crore. As a result, India went for huge external assistance (Rs. 1214 crore) to tide over the balance of payment problems. Substantial external assistance became a regular feature thereafter.

On the whole, the adjustment to the first oil shock of 1973-74 was rendered smooth by a combination of buoyant exports, spurt in private transfer receipts and increased inflow of external aid. Exports, benefited by the expansion in global trade, rose at an annual rate of 6.8 percent in volume terms and by 15.6 percent in US dollar terms during the decade. Private transfers rose substantially and in fact, in the post first oil shock period, financed roughly 80 percent of the trade deficit. The utilisation of external assistance was significant and was substantially higher than the financing requirement for the decade, allowing for a build up of foreign exchange reserves.

Table 14.2: Balance of Payments : 1960-61 to 1980-81

(Rs. in Crores)

		1960-61	1970-71	1980-81
1.	Imports (c.i.f.)	1105.7	1826.1	12543.6
	a) PL 480 Title I	185.1	49.9	—
	b) Others	920.6	1776.2	12543.6
2.	Exports (f.o.b.)	630.5	1404.5	6576.4
3.	Trade balance (2-1)	–475.2	–421.6	–5967.2
4.	Non-monetory gold movement (net)	—	13.1	—
5.	Invisibles			
	a) Receipts	259.9	496.1	5980.2
	b) Payments (of which;	177.1	533.0	1579.6
	Interest and service payments on loans & credits)	(33.8)	(203.8)	(282.4)
	c) Net	82.8	–36.9	4310.6
6.	Current account (net)	–392.4	–445.4	–1656.6
7.	Capital transactions			
	a) Private			
	i) Receipt	51.5	79.9	162.9
	ii) Payments	35.0	59.6	65.5
	iii) Net	16.5	20.3	97.1
	b) Government miscellaneous			
	i) Receipt	147.0	323.7	1010.9
	ii) Payments	42.0	353.3	1246.8
	iii) Net	105.0	–29.6	–235.9
	c) Amortisation Payments (gross)	–37.6	–231.8	–691.3
	d) Repurchases from IMF	–10.7	–154.0	–7.5
	e) Banking capital (net)	9.7	0.1	12.7
8.	Errors & omissions	–6.3	–66.9	–158.0
9.	Total surplus (+)/Deficit(–) (6 to 8)	–315.8	–907.3	–2639.5
	FINANCED By:			
10.	External assistance loans	256.6	743.3	1728.7
11.	Drawings from IMF (gross)	—	—	274.3
12.	Allocation of SDRs	—	75.4	120.5
13.	Decline (+)/increase (–) in reserves	59.2	88.6	516.0
	Total (10 to 13)	**315.8**	**907.3**	**2639.5**

Source: *Economic Survey,* Part II, 1991-92.

The BOP in the early 80s: During the 80s, issues relating to the balance of payments came to occupy the centre stage in terms of India's macro economic management. The second oil-price hike-shock in 1979 had a far more severe impact on the economy's balance of payments than that of the first shock in 1973-74. The full effects of the second oil shock spilled over into the 80s. Between 1978-79 and 1981-82, imports almost doubled. The increase in petroleum, oil, lubricants (POL) imports accounted for a little over half the increase in the overall imports. This was followed by the second-round effects on non-POL imports.

Export performance was depressed by the severe international recession of 1980-83. Exports grew by about 3 percent, in terms of volume. Net invisible receipts were substantially higher and continued to provide support to the balance of payments. However, the sharply widening trade deficit resulted in an increased current account deficit which reached almost Rs. 3000 crore in 1981-82. External assistance and I.M.F. borrowings together enabled the country to control the balance of payments position.

However, in the subsequent three years, the balance of payments pressure eased to some extent, due to a number of factors. There was a decline in the volume growth of imports from an average rate of 11 percent during 1978-82 to a little over 2 percent during 1982-85. This was largely due to a decline in net oil imports which in turn, was due to the discovery of crude oil in Bombay High and the subsequent domestic crude oil production.

However, exports did not grow substantially due to adverse internal and external conditions. The invisibles account deteriorated as the interest payments to service external borrowing acquired a steady rising trend. Private transfers stagnated with the arrest in labour migration boom. Due to all these factors, current account deficit hovered around Rs. 3000 crore during 1982-85. External assistance, I.M.F. borrowings and commercial borrowings together enabled the country to manage the balance of payments position.

The BOP during 1985-90: The latter half of the 80s saw the building up of strains on the balance of payments. Trade deficits and consequently current account deficits increased substantially and remained at high levels throughout (Table 14.3).

Recovering from the stagnation in 1985-86, the volume growth of exports in the subsequent four years ranged between 10 to 12 percent per annum. But imports rose more sharply. The volume of net POL imports increased from 12.4 million tonnes in 1984-85 to 23.5 million tonnes in 1989-90. The fall in international crue oil prices during the period helped to some extent, to contain the oil import bill. On the other hand, non-oil imports increased significantly due to large imports of food grains in 1988-89. Imports of capital goods, defence imports, imports of ships and air crafts, etc. and export-related imports also went up.

At the same time, support from invisible receipts fell due to steadily growing interest payments and outgo on account of profits, dividends, royalty, technical fees and professional fees. The current account deficit averaged around Rs. 7800 crore during 1985-90. The repayments to the I.M.F during the period put added pressure on the balance of payments. External assistance, commercial borrowings and non-risdent deposits together made up the balance. However, as a result, India's external debt doubled and the debt service ratio rose from 13.6 percent in 1984-85 to almost 31 percent in 1989-90.

Table 14.3: Balance of Payments : 1985-86 to 1989-90

(Rs. in Crores)

	1985-86	**1986-87**	**1987-88**	**1988-89**	**1989-90**
1. Imports (c.i.f.)	21163.6	22668.9	25692.5	34202.3	40642.4
a) PL 480 Title I	—	—	—	—	—
b) Others	21163.6	22668.9	25692.5	34202.3	40642.4
2. Exports (f.o.b)	11577.6	13315.0	16396.4	20646.7	28229.0
3. Trade balance (2-1)	–9586.0	–9353.9	–9296.1	–13555.6	–12413.4
4. Non-monetary gold movement (net)	28.5	—	—	—	6.4
5. Invisibles					
a) Receipts	7872.5	8274.4	9278.5	10926.3	12483.9
b) Payments (of which Interest & service payments on loans & credits)	4245.0	4750.5	6275.0	7780.7	9900.7
c) Net	3630.2	3523.9	3003.5	3145.6	2583.2
6. Current account (net)	–5927.3	–5830.0	–6292.6	–10410.0	–9823.8
7. Capital transactions					
a) Private					
i) Receipts	2566.9	3141.4	3880.5	6261.4	9816.2
ii) Payments	212.6	514.2	966.3	2520.7	6191.4
iii) Net	2354.3	2627.2	2914.2	3740.7	3624.8
b) Government miscellaneous					
i) Receipts	2233.2	5386.9	8499.1	9465.5	12015.3
ii) Payments	895.8	2060.9	4837.9	3571.7	6153.3
iii) Net	1337.4	3326.0	3661.2	5893.8	5862.0
c) Ammortisation payments (Gross)	–1465.3	–3039.9	–3611.0	–3924.3	–3773.4
d) Repurchases from IMF	–253.0	–672.3	–1209.0	–1547.3	–1459.6
e) Banking capital (net)	186.1	–70.1	74.8	–265.2	59.2
8. Errors and Omissions	580.1	–129.3	–947.7	203.4	–720.0
9. Total Surplus (+)/Deficit (–) (6 to 8)	–3187.1	–3788.4	–5410.1	–6308.9	–6230.8
FINANCED BY:					
10. External Assistance Loans	2481.2	3056.2	4453.9	4859.6	4998.4
11. Drawing from IMF (Gross)	—	—	—	—	—
12. Allocations of SDRs	—	—	—	—	—
13. Decline (+)/ increase (–) in Reserves	706.5	732.2	956.2	1449.3	1232.4
Total (10 to 13)	**3187.7**	**3788.4**	**5410.1**	**6308.9**	**6230.8**

Source: *Economic Survey,* 1995-96.

The BOP crisis — 1990-92: In 1990, the Gulf crisis led to a sharp increase in oil prices. This led to an increase in the import bill of POL. From an average of Rs. 499 crore per month in June-August, 1990, POL imports rose sharply to Rs. 1221 crore per month in the subsequent six months. There was a steep rise in world oil prices on the annexation of Kuwait and spot purchases were very costly, which were made to prevent shortages in the domestic market. The rise in the cost of POL imports more than accounted for the rise in trade deficit from an average of Rs. 619 crore per month in June-August 1990 to Rs. 1229 crore per month in the subsequent six months.

The situation was aggravated when Indian workers employed in Kuwait had to be airlifted back to India, and their remittances stopped flowing in. The UN trade embargo on Iraq led to the cessation of exports to Iraq and Kuwait.

The problems on the trade account were compounded further by the developments on the capital account. There was a loss of confidence in the Government's ability to manage the situation. Commercial loans began to dry up. This was accompanied by a net outflow of NRI deposits, which began in October 1990, continued in 1991. The situation got reversed only in January 1992.

All these led to a dwindling of India's foreign exchange reserves. They declined from a level of Rs. 5480 crore at the end of August 1990 to Rs. 1666 crore on 16th January 1991. Though emergency borrowings from the I.M.F. provided some temporary relief, the decline in reserves continued unabated. By June 1991, the level of foreign exchange reserves dropped so precipitously that they were barely sufficient to finance imports for a fortnight. A default on payments for the first time in Indian history had become a serious possibility in June 1991.

It was at this juncture that the Government of India introduced measures of fiscal correction and structural reform through radical changes in trade and industrial policies. To finance the balance of payments requirements, Government resorted to borrowings from the I.M.F., the World Bank, the Asian Development Bank as well as from bilateral donors. In July-September 1990, it withdraw the reserver tranche (RT) of SDR 490 million. In December 1990, it applied for the first credit tranche (FCT) of SDR 552 million and negotiated drawals under the contingency compensatory finance facility (CCFF) which totalled SDR 1.352 billion between January and September 1991.

In addition, the Government drew a total of SDR 270 million under the upper credit tranche standby arragement and a further SDR 461 million by April 1992. A structural adjustment loan of $ 500 million was drawn from the World Bank. Additional fast disbursing assistance was tied up with the Asian Development Bank and with some bilateral donors. The loss of reserves was thus stopped and from October 1991 onwards there was a steady build up.

With the sharp decline in imports (not in rupee terms but in dollar terms because of rupee currency devaluation) and increase in exports (in rupee terms and not in dollar terms, due to devaluation), trade deficit declined from Rs. 16934 crore/US $ 9438 million in 1990-91 to Rs. 6495 crore/US $ 2798 million in 1991-92 (Table 14.4). Due to external assistance and drawals from the IMF, the foreign exchange reserves position improved from 1991-92 onwards. In fact, the dip in foreign exchange reserves was the worst ever experienced by India since independence, particularly in terms of its ability to meet the country's imports and current payments. By 2000-01, India's foreign exchange reserves position has strengthened substantially (Table 14.5).

Table 14.4: Balance of Payments : 1990-91 to 1992-93

(Rs. in Crores)

		1990-91	1991-92	1992-93
1.	Imports (c.i.f.)	–50086	51418	68863
	a) PL 480 Title I	—	—	—
	b) Others	50086	51418	68863
2.	Exports (f.o.b)	33153	44923	54762
3.	Trade balance (2-1)	–16934	–6495	–14101
4.	Invisibles			
	a) Receipts	13394	23449	23901
	b) Payments (of which;	13829	19191	22564
	Interest and service payments on loans & credits)	(4958)	(6346)	(7395)
	c) Net	–435	4258	1337
5.	Current account (net)	–17369	–2237	–12764
6.	Capital transactions			
	a) Private			
	i) Receipt	15064	30512	32087
	ii) Payments	10710	18490	24599
	iii) Net	4354	12022	7488
	b) Government miscellaneous			
	i) Receipt	18594	13087	19374
	ii) Payments	7383	14963	16250
	iii) Net	11211	–1876	3124
	c) Amortisation miscellaneous (gross)	–5725	–7365	–9100
	d) Rupee Debt Service	–2140	–2785	–2335
	e) Repurchases from IMF	–1156	–1127	–868
	f) Banking capital (net)	–1134	–405	2859
7.	Errors & omissions	237	–301	–246
8.	Total surplus (+)/deficit (–) (5 to 7)	–11721	–4073	–11842
FINANCED BY :				
9.	External assistance loans	6095	10715	10173
10.	Drawings from IMF (gross)	3334	3205	4231
11.	Allocation of SDRs	—	—	—
12.	Decline (+)/ increase (–) in reserves	2293	–9845	–2563
	Total (9 to 12)	**11721**	**4075**	**11841**

Source: *Economic Survey,* 1995-96.

The BOP: 1992-95 : During 1992-93, with the lift of import curbs, import growth picked up. Since the growth in exports was not that significant, trade deficit, once again, increased both in rupee and dollar terms. The invisibles account recorded a deterioration as travel receipts suffered due to decline in travel arrivals. Private transfers remained more or less stable. On the other hand, there was a rise in the outgo on interest payments, royalties, technical fees and miscellaneous payments. As a result, current account deficit increased from Rs. 2237 crore/US $ 1178 million in 1991-92 to Rs. 12764 crore/US $ 3526 million in 1992-93.

Table 14.5: India's Foreign Exchange Reserves : Historical Perspective

(US $ million)

Year	Forex Reserves[1]	Import cover (No. of months)[2]	Current Payments Cover (No. of months)[3]
1950-51	1914	16.8	14.6
1955-56	1648	12.2	10.6
1960-61	390	2.0	1.7
1965-66	383	1.6	1.3
1970-71	584	2.9	2.2
1975-76	1657	3.3	2.9
1980-81	5850	4.5	4.0
1985-86	5972	4.2	3.5
1990-91	2236	1.0	0.8
1991-92	5631	3.2	2.3
1992-93	6484	3.3	2.5
1993-94	15068	7.5	5.4
1994-95	20809	8.0	5.7
1995-96	17044	5.0[4]	3.8[4]
1996-97	22367	—	—
1997-98	25975	—	—
1998-99	29522	—	—
1999-00	35058	—	—
2000-01	39554	—	—

Source: *Economic Survey,* 1995-96 & 2002-03.

1. *a) Excluding Gold and SDRs*
   b) Year end level
2. *Based on foreign exchange reserves of respective year end levels*
3. *End January 1996*
4. *Estimates*

During 1993-94, there was a distinct improvement in the balance of payments position. A significant growth in exports the fall in international prices of crude oil and the slack in the growth of non-POL imports resulted in a sharp contraction in trade deficit. The decline in international interest rates also provided a measure of saving in the invisibles account. The market determined exchange rate led to strong growth in remittances. As a result of all these, the current account deficit declined significantly.

By this time, thanks to liberalised foreign investment policy, the flow of foreign investment has started increasing. The total foreign investment (which includes direct foreign investment, Foreign institutional investment and Euro equities) went up to US $ 4110 million in 1993-94 from US $ 68 million in 1990-91, US $ 154 million in 1991-92 and US $ 585 million in 1992-93. These, among others, led to a substantial increase in the foreign exchange reserves of the country.

Table 14.6: Balance of Payments : 1990-91 to 1994-95

		1990-91	1991-92	1992-93	1993-94	1994-95
1.	Exports	18477	18266	18869	22700	26763
2.	Imports	27914	21064	23237	23985	31269
	of which : POL	6028	5364	6100	5650	5882
3.	Trade Balance	–9437	–2798	–4368	–1285	–4506
4.	Invisibles (Net)	–243	1620	842	970	2191
	Non Factor Services	979	1207	1128	777	–494
	Investment Income	–3752	–3830	–3422	–4002	–3905
	Pvt. Transfers	2069	3783	2773	3825	6200
	Official Grants	461	460	363	370	390
5.	Current Account Balance	–9680	–1178	–3526	–315	–2315
6.	External Assistance (Net)	2210	3037	1859	1700	1250
7.	Commercial Borrowings (Net)	2249	1456	–358	1252	1029
8.	IMF (Net)	1214	786	1288	191	–1146
9.	NRI Deposits (Net)	1536	290	2001	940	847
10.	Rupee Debt Service	–1193	–1240	–878	–745	–1050
11.	Foreign Investment	68	154	585	4110	4895
	of which:					
	i) DFI	68	154	344	620	1314
	ii) FII	0	0	1	1665	1503
	iii) Euro equities	0	0	240	1460	1839
12.	Other flows	2318	271	–243	1735	1247
13.	Capital account total (Net)	8402	754	4254	9183	7072
14.	Reserve Use	1278	–3576	–728	–8868	–4757
	As percent of GDP					
	Exports	6.2	7.3	7.8	8.9	8.9
	Imports	9.4	8.3	9.8	9.4	10.4
	Trade Balance	–3.2	–1.1	–2.0	–0.5	–1.5
	Invisible Balance	–0.1	0.7	0.2	0.4	0.7
	Current Account Balance	–3.2	–0.4	–1.8	–0.1	–0.8

Source: *Economic Survey:* 1995-96.

During 1994-95, both exports and imports grew significantly: exports grew by 18.4 percent, in US dollar terms and imports by 22.9 percent. The growth in imports was in line with the expansion in industrial growth and investment activities. The higher growth in imports led to an increase in total deficit from US $ 1285 million in 1993-94 to US $ 4506 million in 1994-95. Invisible payments also rose considerably. As a result, the current account deficit widened from the abnormally low level of US $ 315 million in 1993-94 to US $ 2315 million in 1994-95 (Table 14.6).

The rise in the current account deficit was expected due to the recovery of the Indian economy from recession and there were no financing problems of this deficit either. Total capital flows in 1994-95 were much in excess of financing needs and thus contributed to the foreign exchange reserves buildup. Foreign currency assets of the Reserve Bank of India (R.B.I) increased from US $ 15.07 billion at the end of March 1994 to a historical peak of US $ 20.81

billion at the end of March 1995. Total foreign exchange reserves, including gold and special Drawing Rights (SDRs), amounted to US $ 25.19 billion at the end of March 1995 equivalent to about ten months of imports in 1994-95.

The balance of payments (BOP) has been in an overall surplus since 1996-97, with reserves rising, on an average, by US $ 6.21 billion per annum during 1996-97 to 2001-02. The current account deficit, which signifies country's overall current liabilities, has come down from a level of 3.1 percent of GDP in 1990-91 to a current account surplus of 0.3 percent of GDP in 2001-02, implying a situation where the current receipts exceed current liabilities. On the capital account, inflows have remained buoyant (except in 1995-96) bolstering the reserves during this period. Overall balance of payments position has, thus, transformed over the past decade from a difficult one at the beginning of 1990s to a comfortable situation in 2001-02.

Table 14.7: Balance of Payments : 1995-96 to 2001-02

(in US $ million)

	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02
1. Exports	32311	34133	35680	34298	37542	44894	44915
2. Imports	43670	48948	51187	47544	55383	59264	57618
of which: POL	7526	10036	8164	6399	12611	15650	14000
3. Trade balance	–11359	–14815	–15507	–13246	–17841	–14370	–12703
4. Invisibles (net)	5449	10196	10007	9208	13143	11791	14054
Non-factor services	–197	726	1319	2165	4064	2478	4199
Investment income	–3205	–3307	–3521	–3544	–3559	–3821	–2654
Pvt. transfers	8506	12367	11830	10280	12256	12798	12125
Official transfers	345	410	379	307	382	336	384
5. Current account balance	–5910	–4619	–5500	–4038	–4698	–2579	1351
6. External assistance (net)	883	1109	907	820	901	427	1204
7. Commercial borrowing (net) @	1275	2848	3999	4362	313	4011	–1147
8. IMF (net)	–1715	–975	–618	–393	–260	–26	0
9. NR deposits (net)	1103	3350	1125	960	1540	2317	2754
10. Rupee debt service	–952	–727	–767	–802	–711	–617	–519
11. Foreign investment (net)	4615	5963	5353	2312	5117	4588	5286
of which:							
(i) FDI (net)	1954	2651	3525	2380	2093	1828	3266
(ii) FIIs	2009	1926	979	–390	2135	1847	1505
(iii) Euro equities & others	652	1386	849	322	889	913	515
12. Other flows (net) +	–2235	–1131	–606	608	3940	–2291	2828
13. Capital account total (net)	2974	10437	9393	7867	10840	8409	10406
14. Reserve use (–increase)	2936	–5818	–3893	–3829	–6142	–5830	–11757
As percent of GDP mp							
Exports	9.1	8.9	8.7	8.3	8.4	9.8	9.4
Imports	12.3	12.7	12.5	11.5	12.4	13.0	12.0
Trade balance	–3.2	–3.8	–3.8	–3.2	–4.0	–3.1	–2.6
Invisibles balance	1.6	2.7	2.4	2.2	3.0	2.6	2.9
Current account balance	–1.7	–1.2	–1.4	–1.0	–1.1	–0.5	0.3

Source: *Economic Survey,* 2002-03.

India's balance of payments in 2001-02 exhibited mixed developments. While exports, on BOP basis, remained stagnant at previous year's level, imports declined by 2.8 percent, thus resulting in a decline in merchandise trade deficit, as percent of GDP, from 3.1 percent in 2000-01 to 2.6 percent in 2001-02. Given the buoyancy in invisible flows, which reached a level of 2.9 percent of GDP, the current account turned into a surplus in 2001-02, after a gap of 24 years (current account surplus was last recorded in 1977-78). The net capital flows also improved during the year (Table 14.7), thus resulting in largest reserves build-up in a single year. With the current account in surplus and fairly improved capital inflows, the net accretion to foreign exchange reserves in 2001-02 was all-time high in the past decade.

Stagnation in export growth in 2001-02 as compared with an increase of 19.6 percent in 2000-01 was partly due to weak external demand, which seems to have affected India's export performance. The decline in imports, on BOP basis, was mainly due to lower POL imports. However, the non-oil and non-gold imports. However, the non-oil and non-gold imports, on customs basis, grew at moderate rate of 8.9 percent in 2001-02. The consequential trade deficit came down from US $14.37 billion in 2000-01 to US $12.70 billion in 2001-02, representing 2.6 percent of GDP. The net inflows of invisibles at US $ 14.05 billion, not only covered the entire trade deficit, but also resulted in a surplus in current account by US $ 1.35 billion, representing 0.3 percent of GDP. However, the current account surplus achieved with stagnant exports and a negative growth in imports may be a temporary feature for the economy as a sustainable current account surplus must be based on reasonable export and import growth, consistent with the rising development needs and export competitiveness of Indian products abroad.

The capital flows continued to remain strong despite uncertainities in international financial markets. Net capital flows increased from US $ 8.41 billion in 2000-01 to US $10.41 billion in 2001-02, increase being mainly due to higher inflows of external assistance, FDI and NRI deposits. The net external assistance in 2001-02 improved to US $1.20 billion from a level of US $ 0.43 billion in 2000-01. Net commercial borrowings, however, remained negative at US $ 1.15 billion in 2001-02 with lower gross disbursement due to weak domestic demand. The net foreign investment inflows in 2001-02 at US $ 5.29 billion were the highest inflows during the past four years, indicating the rising confidence of international investors in Indian economy. Total portfolio investments at US $ 2.02 billion, with investment by FII at US $ 1.50 billion and GDRs/ADRs etc. at US $0.52 billion, were lower by US $740 million compared to 2000-01. NRI deposits in 2001-02 at US $2.75 billion were higher than the level of US $2.32 billion in 2000-01. These capital flows, along with the surplus in the current account, resulted in an increase of US $11.76 billion to the foreign exchange reserves in 2001-02.

The latest information on BOP, released by RBI, is available for the first half of the current financial year. The BOP statistics for April-September 2002 show that the current account during the first half of the year continued to remain in surplus at US $1.67 billion mainly due to buoyancy in private transfers (remittances) and software exports. Quarterly data reveal that the current account balance has continued to exhibit surplus consecutively for the previous four quarters. Given the latest trends in various components of the BOP, the current account balance in 2002-03 is likely to remain in surplus as in the previous year.

Activity 2

Construct a bar diagram showing India's current account balance, capital account balance and forex reserves for the period 1995 to 2000. List the major features.

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14.5 EXCHANGE RATE AND BALANCE OF PAYMENTS : RUPEE CONVERTIBILITY

An important factor which influences the Balance of Payments of an economy is the exchange rate of its currency vis-à-vis other major currencies. Therefore, influencing the exchange rate movement is one of the instruments available for correcting the imbalances in the current account. Obviously, besides exchange rates, there are a host of other factors such as world demand, quality of products, marketing skills and supply availabilities which have a bearing on export growth particularly of developing countries. Nevertheless, real effective exchange rate is an important explanatory factor of export growth.

In the 90s, India introduced several measures which have a significant bearing on the exchange rate regime. In July 1991, a correction for over-valuation of rupee through two steps downward adjustment of the rupee was undertaken. Simultaneously, the EXIM Scrip scheme was introduced under which certain imports were permitted only against export entitlement. The Scheme aimed at providing additional incentives to exporters through premium on the scrips as well as establishing a quantitative link between imports and exports.

This was followed by a dual exchange rate management, which entailed the surrender of 40 percent of the exchange earnings at the official rate hereby facilitating the import of certain commodities at the official exchange rate. During the period of the Liberalised Exchange Rate Management System (LERMS), the market performed well equilibrating 60 percent of current receipts which were realised at the market rate of exchange with a large section of imports, which had to be financed by foreign exchange obtained from the market. The market exchange rate remained stable, the gap between official and market rates remained, more or less, around 17 percent. The overall stability in market conditions witnessed during this period enabled the unification of exchange rates later.

Current Account Convertibility

In March 1993 India moved from the earlier dual exchange rate regime to a single, market determined exchange rate system. Under this system, there is no officially fixed exchange rate of the rupee. Instead, the rate is determined by the demand and supply conditions in the foreign exchange market. The role of R.B.I. is confined to intervening to maintain orderly market conditions and to curb excessive speculation.

Despite the shift to market determined system, the rupee dollar rate remained stable at about Rs. 31.4 for over two years since March 1993. This was mainly due to the large inflow of foreign investments. In fact, if the rupee had been left to be determined solely by market supply and demand for foreign exchange, rupee would have appreciated sharply against dollar in this period. This would have hurt exports and pushed up imports. Therefore, to prevent rupee appreciation, R.B.I. intervened by buying dollars (to the extent of US $ .13 billion during March 1993 – December 1994) in the market.

The reduction in net capital inflows and the widening of the current account deficit in 1995-96 ended the earlier period of surplus dollar availability. In fact, during the prolonged period of stability of the rupee-dollar rate from March 1993 to July 1995. India's competitiveness in international markets eroded due to higher rate of inflation in India as compared to the major trading partner nations. As a result, Real Effective Exchange Rate (REER) of the rupee appreciated by about 8 percent between 1993-94 and August 1995. Had this erosion of India's competitiveness continued, it would have adversely effected exports, the trade balance and overall balance of payments.

The market-triggered adjustment in the exchange rate which occurred after August 1995 resulted in an exchange rate of Rs. 36.63 in February 1996. This brought REER of rupee back to approximately the level prevailing in March 1993. Thus, the change which occurred in the exchange rate in 1995-96 corrected the erosion in India's competitiveness and thereby stabilised export growth and contained import growth.

But since then, the exchange rate of the rupee against the US dollar recovered to Rs. 34.24 in April 1996. In the subsequent months of 1996 and early months of 1997, the rate moved in the narrow range of Rs. 35.01 to Rs. 35.93. The rupee-dollar rate remained steady although inflation in India was higher than in the major trading partner nations. This, again, resulted in some appreciation of the rupee in REER terms. A depreciation in rupee-dollar exchange rate will therefore, be helpful once again to improve the trade balance and current account balance.

Capital Account Convertibility

The measures taken towards current account convertibility of Indian rupee and the stability shown by the rupee for a fairly long period of months, with certain exceptions, since 1993 have brought to the fore the issue of capital account convertibility. Convertibility essentially means the ability of residents and non-residents to exchange domestic currency for foreign currency without limit, whatever may be the purpose of transactions.

Capital account convertibility is differentiated from current account convertibility. According to Article VIII of the I.M.F. Articles of Agreement, which defines current account convertibility, "no member shall without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions". This implies that, domestic importers as well as foreign exporters should be able to exchange domestic money for foreign currency to settle any transactions involing the purchase of goods and services from abroad.

With the significant changes that have been introduced since March 1993 in India's exchange rate system, India has almost achieved convertibility on current account transactions. However, there are still some restrictions relating to some of the invisible transactions, such as travel. To conform to Article VIII of I.M.F., India has to remove controls on these items.

Capital account convertibility implies movement of funds in and out of the country without restrictions. This kind of regime involves certain risks. The major risk is the possibility of capital flight. Another risk is the possibility of macro economic instability arising from the movement of short term capital movements described as 'hot-money'. A free movement of funds will lead to integration of financial markets. Therefore, an efficient domestic financial system free from administrative restrictions is a pre-requisite for the introduction of capital account convertibility.

However, indications towards capital account convertibility have already come. In the Union Budget, 1997-98, the Finance Minister has proposed to constitute a Committee of experts to recommend a fixed time period to introduce capital account convertibility. The achievement of:

- sound economic growth (in the range of 8 to 10 percent per annum)
- efficient macro-economic management, (with negligible fiscal deficit)
- controlled current account deficits, if not surplus; and
- steady and consistent increase in foreign exchange reserves (in the range of US $ 40 to 50 billion)

will enable India to go for capital account convertibility.

14.6 INDIA'S BALANCE OF PAYMENTS: VIABLE OR VULNERABLE?

Independent India has twice experienced BOP crisis: in the mid sixties and early nineties. The second BOP crisis was more severe in magnitude and impact. Since the crisis years of 1990-91 and 1991-92, India has come a long way. Though the crisis has been overcome, steps need to be taken to ensure that such a crisis does not recur.

With the exception of certain years, India has been continuously experiencing huge deficits both on trade and current accounts. The ease with which financing requirements can be met from different sources should not become the basis for incurring current account deficits. In fact, international capital flows are fair weather friends. They begin to reverse and flow back, the moment the economy faces trouble. Therefore, the objective should be to contain current account deficit at that level which can be financed by normal capital flows.

To make the balance of payments viable, the key lies in consistently stepping up exports. On the import front, POL will require special attention if the country has to be protected from external-price hike-shocks. Petro products being the dominant import item, measures be taken to augment domestic production. There is ample scope for locating new petro reserves as only 6 out of 26 basins that have potential for oil and gas in India have been explored and that too only partially. Significant and consistent export growth so as to cover the growing import bill will bring a turn-around by removing vulnerability of India's balance of payments.

14.7 SUMMARY

India's balance of payments position was more or less comfortable in the early 50s. The import of machinery and capital equipments due to the large scale promotion of heavy and basic industries caused a steep rise in trade and current account deficits. The increase in food grain imports, machinery and equipments further increased the import bill and thereby the deficits on trade account as well as current accounts in the early 60s. This severely strained the balance of payments necessitating currency devaluation in 1966. This did not alter the situation significantly in the immediate future. In the mid 70s, due to the oil shock, India's trade deficit doubled but the situation could be managed by higher export growth, more invisible receipts and external aid.

However, it was only in the later 80s that pressure started building up on the BOP. The gulf crisis in 1990 and subsequent developments caused the worst ever BOP crisis in 1991-92. Though the country has successfully overcome this crisis, a long term strategy is imperative to achieve consistent high export growth, control POL imports, reduce country's dependence on external borrowings to the minimum and thereby achieve a sound BOP position.

14.8 KEY WORDS

Current Payments Current payments represent sum of merchandise imports and invisible payments.

Real Effective Exchange Rate (REER) India's index of REER is obtained by adjusting the index of nominal effective exchange rate (using a basket of major currencies) by the differential rate of inflation in India as compared to the major currencies.

14.9 SELF ASSESSMENT QUESTIONS

1. What is balance of payments? What is its significance? Discuss its composition.
2. Describe the trends of India's balance of payments during the 50s, 60s and 70s. Analyse the major features and its implications.
3. Evaluate the circumstances which led to the BOP crisis in 1991-92. What lessons can be learnt from this crisis? How did India overcome this crisis?
4. What is currency convertibility? What should be the pre-requisites for a country to go for capital account convertibility? Do you subscribe to the view that India should go for capital account convertibility in the near future?
5. Discuss the trends of India's balance of payments since 1991-92. What measures need to be taken as part of a long term strategy to prevent the occurrence of another BOP crisis?
6. Define the terms: balance of trade, balance of invisible transfers, current account balance, capital account balance and balance of payments.
7. Prepare a write up on the merits and demerits of currency convertibility for a developing economy.

14.10 FURTHER READINGS

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