UNIT 3 INDIA'S BALANCE OF PAYMENTS

3.0 Objectives

3.1 Introduction

3.2 Concept of Balance of Payments

3.2.1. Balance of Trade and Balance of Payments
3.2.2. Balance of Payments Accounting
3.2.3 Balance of Payments Deficits
3.2.4 Balance of Payments and Emerging Economics

3.3. Current Account Deficit

3.4. Trends in India's Balance of Payments

3.5. Problems of Deficit and Trade Policy

3.6. Deficit and Surplus in Balance of Payments

3.7. Balance of Payments Disequilibrium

3.8 Factors Affecting Balance of Payments

3.9 Methods of Correcting Disequilibrium

3.10. Let Us Sum Up

3.11. Key Words

3.12. Terminal Questions

Select References

ignou THE PEOPLE'S UNIVERSITY

3.0 OBJECTIVES

After you have studied well this unit, you will be able to:

1. Discuss the concept of balance of payments
2. Identify the current account and capital account components of balance of payments
3. Analyse long term trends in India's balance of payments
4. Explain how the balance of payments always appears in balance
5. Explain the concept of disequilibrium in balance of payments
6. Discuss the measures that can be taken to correct the balance of payments

3.1. INTRODUCTION

Balance of payments refers to all economic transactions between domestic and foreign residents over a stipulated period. The balance of payments of a country provides an overall view of its international economic position. It is very much helpful for the policy makers and the business communities. In this unit, you will learn the concept of balance of payments, the balance of payments accounting procedure, trends in India's balance of payments. You will be further familiarized with the concept of disequilibrium in the balance of payments, factors affecting balance of payments and the methods of correcting disequilibrium.

3.2. CONCEPT OF BALANCE OF PAYMENTS

Balance of payments refers to all economic transactions between domestic and foreign residents over a stipulated period, generally one year. The analysis of balance of payments is immensely useful for the policy makers and business communities. Moreover, it is an important instrument for maintaining external economic stability. A close understanding of dependence of international business upon balance of payments is necessary for successful strategy of international business.

Balance of Payments is an annual statement of accounts. This statement pertains to the transactions that take place between an economy and rest of the world. This statement looks at the monetary aspect of these transactions. All the goods and services that are sold by a country to all other nations constitute exports. A country gains foreign exchange of equivalent value. Similarly all imports from rest of the world carry an obligation of making payments in foreign exchange. Likewise capital inflows and outflows take place between different countries.

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 book-keeping procedure which is used to record the transactions.

3.2.1 Balance of Trade and Balance of Payments

Before proceeding further we should make clear the balance of trade and balance of payments, and balance of payments accounting. Let us learn these aspects of balance of payments in detail.

Export and import of goods and services between two countries are classified respectively as 'visible' and 'invisible' exports and imports. Visible items are those which are physically exported and imported, like merchandise, gold, silver and other commodities. Balance of trade refers to the difference between physical imports and exports, i.e. visible items only for a period

say, a year. During a given period of time, exports and imports may be exactly equal in which case, the balance of trade is said to be balanced. If the value of exports of a country exceeds the value of imports, the country is said to have an export surplus or a favourable balance of trade. When the value of imports coming to a country is greater than the value of exports, the balance of trade is said to be unfavorable.

International trade includes not only import and export of goods but also services. The exchange of services between countries is called invisible exports and imports such as air and ocean shipping, financial and other services like banking, insurance, travel, investment income, etc. Export and import of goods are treated as visible trade as they are physically recorded at the customs barriers of the country. Receipts and payments for services are items of invisible trade.

The balance of payments is broader than the balance of trade for it includes not only visible items but also invisible items. Hence, the balance of payments presents a better picture of a country's economic and financial transactions with the rest of world than the balance of trade. Balance of payments is a comprehensive and systematic record of all economic transactions between the residents of a country and the rest of the world. It presents an account of all receipts and payments on account of goods exported, services rendered and capital received by residents/Government of a country (inflows from abroad) and goods imported, services received and capital transferred by the residents/ Government of a country (outflows abroad).

3.2.2 Balance of Payments Accounting

In balance of payments accounting the balance of payments should be zero because every transaction is two-sided with debits balancing credits. But in practice, the balance of payments will not always be equal to zero. This can be due to, among other things, a country's central bank engaging in transactions that are not counted towards the country's balance of payments, or the lack of available statistical data to record all transactions. Balance of payments is classified as: (i) balance of payment on current account, and (ii) balance of payment on capital account.

Current Account: The balance of payments on current account records the current position of the country in the transfer of goods, services, and merchandise as well as invisible items, donations, unilateral transfers, etc. Current account is like an income and expenditure account. Surplus or deficit in current account is transferred to capital account which is like a balance sheet and thus balances itself in historic sense.

Capital Account: Balance of payments on capital account shows the country's financial position in the international scenario, the extent of accumulated foreign exchange reserves, foreign assets and liabilities and the impact of current transactions on international financial positions.

The changes in foreign exchange reserves arising out of current account transactions are included in the capital account in order to find out the exact foreign exchange reserve. The capital account provides relief to deteriorating balance of payments positions. Its favourable effect depends upon the availability of net capital transfers, i.e., gross inflow, of capital minus payment by way of amortization. In short, capital account reflect, changes in foreign assets and liabilities of the country and affects its creditor/debtor, position. Net changes in current account are reflected by a

corresponding opposite change in the capital account, changing the foreign assets and liabilities position of the country, Look at Table 2.1 which shows various items of balance of payments.

Table 3.1: Main Items in the Balance of Payments.

Items	**Definition**
A. Current Account (1+2) (a) Merchandise exports (b) Merchandise imports	 Sales of goods abroad Purchase of foreign goods
1. Trade balance (a-b)	Goods trade balance
2. Invisibles (a+b+c+d) (a) Non Factor Services (b) Investment Income (c) Private Transfers (d) Official Transfers - Grants	(i) Sales of services, e.g. insurance, software plus spending of foreign visitors (tourists) (ii) Purchase of foreign services (i) Dividends, interest, etc. received from abroad. (ii) Payment of dividends, interest, etc. Net private payments, e.g. remittance from workers abroad. Net official payments, e.g. overseas aid.
B. Capital Account (1+2+3+4) 1. Foreign Investment (a) Direct Investment (b) Portfolio Investment 2. Others flows 3. Comm. & other borrowings 4. Non-resident deposits (net) **C. Reserves and Monetary Gold**	 Net direct investment in plant and machinery, etc. Net purchases/sales of shares, bonds, etc. Sum of other items, including delayed export receipts and E & O Official borrowing and lending.

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

Current Account

The *Current Account* can be broken down into two parts, *viz.,* one, balance on trade, and, two, balance on invisibles. The *Balance of Trade* (BOT) deals only with exports and imports of merchandise (or visible items). The Balance on Invisibles (BOI) shows net receipts on account of invisibles. These include the remittances, net service payments, etc. Conceptually, invisible earnings can be classified in two components—factor income and non-factor income. The former includes remittances of interest, dividends and work compensation. In the case of India, interest and dividends constitute a net outflow, while work compensation (termed 'private remittances') form an important net inflow. Trade in non-factor services includes tourism and travel, air and

marine transportation, insurance, consultancy and software. The RBI classifies non-factor services into travel, transportation, insurance, government and miscellaneous services. Software, global back-offices, media, consultancy and other technology- related services would fall under 'miscellaneous services' and to the extent that the activity is of a 'body-shopping' character, it would also fall under 'private remittances'.

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. But then there is no reason why these two balances should always be equal, again, always in opposite directions. As a matter of fact, the balance on current account can always show 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.

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 (loans and grants), drawings from the International Monetary Fund and allocation of the Special Drawing Rights.

The BOP equation is:

current account + capital account + official reserve account = 0

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 increases + Other private capital outflows

The above equation shows that an increase in external debt can have three broad sources: current account deficits not financed by long-term capital inflows, borrowing to finance a reserve build-up or private outflows of capital.

3.3.3 Balance of Payments Deficits

In India, balance of payments deficits have been largely caused by excess of imports over exports in merchandise. At times and to a small extent the deficits have been in invisible trade also. The major source of deficits has been the rising obligations to meet amortization payments. This has involved large sums on the return of loans which became due and the large interest payments thereon. Large withdrawals from non-resident accounts also contributed to deficits.

On June 21, 1991 when the new Government took the office, it inherited the economy in deep crisis. The balance of payments situation was precarious, with reserves at a low level and the weakening of international confidence having resulted in a sharp decline in capital inflows

through commercial borrowing and non-resident deposits. The crisis in the Middle East had exacerbated the situation by contributing to higher oil import bill in 1990-91 and the temporary loss of exports markets and remittance earnings.

Structural reforms encompassing the industrial sector, the foreign trade and foreign investment were taken. From 1991 the country embarked on a liberalised trade regime with a short negative list of imports, removal of quantitative restrictions for all goods except consumer goods, a phased reduction in customs duties, an adjustment in the exchange rate through a two-step devaluation of the rupee in July 1991 and the movement to a market determined exchange rate. The policy towards foreign portfolio investment has also been substantially liberalised. Foreign investment policy was modified to eliminate barriers, alignment of taxes with international levels and transparency with full repatriation benefits and investor protection.

The structural reforms were aimed at integrating industrial, trade and exchange rate policies to enhance the efficiency in the economy. The beneficial effects of these measures are reflected in a robust export and invisible growth. The post 1991 period has seen a Surge in capital inflows resulting in growth of foreign exchange reserves.

3.3.4 Balance of Payments and Emerging Economies

It is well known in development economics that EEs invariably start as debtor economies. In the process of development itself, these economies have to import a great deal of capital goods, consumer goods, food and raw materials and spares and components. They also have to import some new technologies and, hence, the total exchange outgo cannot be matched by export earnings. But as the new capital goods and technologies begin to become effective and their products are directed towards exports, export goods and services become competitive in cost and quality. In that case, the volume of exports expands and, in due course, begins to overtake imports. A developing economy then moves on from being a debtor economy to a balanced one in terms of BOP and, finally, becomes a creditor economy, exporting more than it imports and giving credit to buyers. 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.

3.3 CURRENT ACCOUNT DEFICIT

The general belief is that high CADs are dangerous. In general, this is correct. But the converse—that low CADs are good —is not.

The role of CADs can be rightly, in brief, put in the following perspective:

One, running current account deficits is a good thing as long as foreign savings are invested, since this can, *ceteris paribus,* raise rates of economic growth. Such deficits should be sustainable over the medium to long-term. *Two,* since FDI goes directly into investment, these should be encouraged without limits and restrictions, some strategic, brown-field areas excepted. *Three,* external debt, especially the more volatile short-term component, needs to be limited to

productive investment or variable capital to finance production. If external debt tends to imprudent levels, it should be further restricted to financing the foreign exchange compo-nent of investment and variable capital. *Four,* portfolio flows need not be actively encouraged beyond what is necessary to fund the current account deficit. Such flows can be volatile, can inflate asset prices, lead to sudden, sharp appreciation of the currency, and queer the pitch for monetary policy.

The right CAD for any country, therefore, depends on its ability to absorb and service 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 ratio has its advantages.

But, too low a ratio carries with it an opportunity cost—of not being able to benefit from resources that could be drawn from outside.

3.4 TRENDS IN INDIA'S BALANCE OF PAYMENTS

India had faced pressures on BOP from time to time either due to certain domestic compulsions or due to external factors. The whole period, covering nearly six decades, can be divided into two sub-periods, *viz.* (i) Before 1991, and (n) since 1991.

Period I (Before 1991)

The entire 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. Foreign exchange reserves were at a low level, generally less than necessary to cover three months' imports. Almost the entire CAD (92 per cent) was financed by inflows of external assistance.

Factors Responsible for BOP Deficits

1. *Widening trade deficits* that were caused mainly by the fact that the import requirements of the economy increased at a much faster rate than the rate of growth of exports.
2. *Gradual decline in net receipts from invisibles* with the result that the contribution of net invisibles in financing the deficit declined, leading to a greater dependence on inflows of external capital. Thus, net invisibles, which financed nearly half of the trade deficit during 1981-82 to 1984-85, contributed only 8 per cent to meeting the financial requirements in 1990-91.
3. *Reduction in inflows of concessional assistance to India,* principally from the World Bank Group; as a result, India had to take recourse to large commercial borrowings on relatively hard terms. The hardening of terms had an important impact on India's debt service obligations on multilateral loans.

   The BOP crisis reached its climax during 1990-91 —CAD reached the high of 3.3 per cent of the GDP during this year.

Period II (Since 1991)

In 1991, a comprehensive strategy to deal with the BOP situation was put in practice. The principal elements of the BOP strategy can be summarised as follows:

1. **Preference to Non-debt Creating Capital Flows***:* Non-debt creating capital inflows, specially FDI, are 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.
2. **Exchange Rate Policy***:* All payments and receipts of foreign exchange to be converted in rupees at market-determined rate of exchange.
3. **Liberalised Import Policy***:* In a burst of liberalisation in 1991-92, some 3,000 tariff lines that covered raw materials, intermediates and capital goods were freed from licensing restrictions.

   Other measures taken during the period included considerable reductions in peak tariffs. Cash margins and interest surcharge on import credit abolished, harmonised system of customs classification introduced.
4. **Structural Reforms***:* Substantial deregulation of industry and trade.

As a result of the pursuance of this strategy, the BOP situation underwent a dramatic change during the decade of 1990s. BOP was no more being perceived as a constraint on macro-economic policy; both the current account and the capital account have contributed to this change in perception.

The prominent features of the BOP situation as it has emerged over the last three decades can be briefly summarised as follows:

1. On the current account, two important features have been as follows:
   (i) Trade deficits have been widening. Both exports and imports have multiplied fast, but imports have risen at a faster rate than exports. Expanding imports in turn reflect *(a)* the impact of liberalisation measures, and *(b)* increasing manufacturing activity in the domestic economy,
   (ii) There has been a phenomenal increase in net surplus on account of invisibles. This, in turn, is principally due to (a) buoyancy in private transfers (i.e., inward remittances), and fast expansion in exports of services, especially software. India is unique among emerging economies to have a sizable invisible surplus that substantially offsets the merchandise trade deficit. As a result, although India has been running a current account deficit, the deficit has been conveniently manageable, largely because of huge surplus on capital account.

2. On the capital account, India has been running a big surplus. The size of 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 reserves. The capital account demonstrates following features:
   (i) Both inflows and outflows of capital have increased,
   (ii) The composition of capital flows is undergoing a change:
   (a) Official external assistance has been gradually losing out its significance;
   (b) FDI and portfolio investment have surged, and among the two the inflows on account of FDI have been more than on account of portfolio investment;
   s(c) With easing of controls external commercial borrowings have been coming back into prominence. Gold imports are classified as current account transactions, though for all practical purposes it is a capital account transaction. It is equivalent to Indians buying an overseas asset. Its

impact might be the same in terms of cash flow or liquidity, but in terms of the trade deficit it has a crucial role of play. If gold imports are classified as capital account transactions India's trade deficit will not exceed 1% of GDP.

After a sharp increase to 4.8% of GDP in 2012-13 from 2.8% in 2009-10, the current account deficit declined dramatically to 2% in 2015-16. With the resumption of capital flows, both as a result of the special measures taken by the RBI and the general improvement in the global climate, capital flows were adequate and the pressure on the rupee eased.

TABLE 3.2 : INDIA'S OVERALL BALANCE OF PAYMENTS

(US$ million)

	2017-18	2018-19	2019-20	2020-21	2021-22 (P)
1	2	3	4	5	6
A. **CURRENT ACCOUNT**					
1 Exports, f.o.b.	3,08,970	3,37,237	3,20,431	2,96,300	3,11,191
2 Imports, c.i.f.	4,69,006	5,17,519	4,77,937	3,98,452	4,46,835
3 Trade Balance	-1,60,036	-1,80,283	-1,57,506	-1,02,152	-1,35,644
4 Invisibles, Net	1,11,319	1,23,026	1,32,850	1,26,065	1,09,077
a) 'Non-Factor' Services of which :	77,562	81,941	84,922	88,565	79,203
Software Services	72,186	77,654	84,643	89,741	80,274
b) Income	-28,681	-28,861	-27,281	-35,960	-29,441
c) Private Transfers	62,949	70,601	76,217	74,439	59,880
5 **Current Account Balance**	-48,717	-57,256	-24,656	23,912	-26,567
B. **CAPITAL ACCOUNT**					
1 Foreign Investment, Net (a+b)	52,401	30,094	44,417	80,092	24,947
a) Direct Investment	30,286	30,712	43,013	43,955	26,509
b) Portfolio Investment	22,115	-618	1,403	36,137	-1,562
2 External Assistance, Net	2,944	3,413	3,751	11,167	2,709
3 Commercial Borrowings, Net	-183	10,416	22,960	-134	4,863
4 Short Term Credit, Net	13,900	2,021	-1,026	-4,130	13,284
5 Banking Capital of which :	16,190	7,433	-5,315	-21,067	12,631
NRI Deposits, Net	9,676	10,387	8,627	7,364	3,075
6 Rupee Debt Service	-75	-31	-69	-64	-59
7 Other Capital, Net[&]	6,213	1,057	18,462	-2,143	30,935
8 Total Capital Account	91,390	54,403	83,180	63,721	89,309
C. Errors & Omissions	902	-486	974	-347	782
D. **Overall Balance [A(5)+B(8)+C]**	43,574	-3,339	59,498	87,286	63,524
E. Monetary Movements (F+G)	-43,574	3,339	-59,498	-87,286	-63,524
F. IMF, Net	0	0	0	0	0
G. Reserves and Monetary Gold (Increase -, Decrease +)	-43,574	3,339	-59,498	-87,286	-63,524
of which: SDR allocation	0	0	0	0	-17,862
Memo: As a ratio to GDP					
1 Trade Balance	-6.0	-6.7	-5.6	-3.8	-5.9
2 Net Services	2.9	3.0	3.0	3.3	3.4
3 Net Income	-1.1	-1.1	-1.0	-1.3	-1.3
4 Current Account Balance	-1.8	-2.1	-0.9	0.9	-1.2
5 Capital Account, Net	3.4	2.0	2.9	2.4	3.9

6 Foreign Investment, Net	2.0	1.1	1.6	3.0	1.1
P: Data are provisional and pertain to April-December 2021.					
& : Includes delayed export receipts, advance payments against imports, net funds held abroad and advances received pending issue of shares under FDI.					
Note: 1. Gold and silver brought by returning Indians have been included under imports, with a contra entry in private transfer receipts.					
2. Data on exports and imports differ from those given by DGCI&S on account of differences in coverage, valuation and timing.					
Source: RBI.					

Look at Table 8, it shows the details of the various items of Balance of payments. In the year 2020-21, the trade balance has a negative balance of (-1, 02,152 US $ millions), while invisibles stood at 1, 26,065 US $ millions. The current account has a balance of 23,912 US $ millions and capital account has a balance of 63,721 US $ millions. Errors and omissions constitute -347 US $ millions. The overall balance stood at 87,286 US $ millions. In the year 2021-22, the trade balance has a negative balance of (-1, 35,644 US $ millions), while invisibles stood at 1, 09,077 US $ millions, current account has a balance of (-26,567 US $ millions) and capital account has a balance of 89,309 US $ millions. Errors and omissions constitute 782. The overall balance stood at 63,524 US $ millions.

As the Table 8 shows, Invisible exports i.e. services have been increasing from the year 2017-18 to 2019-20. The exports have decreased during the year 2020-21 to 2021-22. The increasing services trade has been able to offset the negative trade balance. Therefore, efforts should be made to promote exports of goods and services to bridge the deficits of the current account balance of BOP. Similarly capital account balance of BOP may be improved by increasing the foreign capital inflows as well as productive use of foreign investment.

According to Economic Times February 09, 2023 the current account deficit in the world's fifth largest economy (India) was at3.3% of GDP for the first half of Financial Year 2023. Services exports rose about a fifth year on year in the third quarter, largely driven by software, businesses and travel. The net balance under services and remittances are expected to remain in large surplus partly offsetting the trade deficit.

The overall balance stood at 87,286 US $ millions for the year 2020-21 and 63,524 US $ millions for the year 2021-22. In the year 2020-21, trade balance constitutes -3.8% of the total GDP while net services hold 3.3%, net income has -1.3%, current account balance has 0.9%, capital account has 2.4 % and foreign investment constitutes 3.0%. In the year 2021-22, trade balance constitutes -5.9% of total GDP, while net services hold 3.4%, net income has -1.3%, current account balance has -1.2%, capital account has 3.9% and foreign investment constitutes 1.1%.

3.4.1 Reversal of Trend 2020-21

In a reversal of the trend, Indian Balance of Payments has become critical. If the Great Recession of the West slowed globalization, the covid pandemic snapped supply chains and showed the perils of import over-reliance. Meanwhile, the Ukraine war has joined US-China trade tensions to reveal the frailty of economic ties that girdle the globe. Long-uphold norms of cross-border commerce have failed to survive contact with this year's hostilities. Supply embargoes have

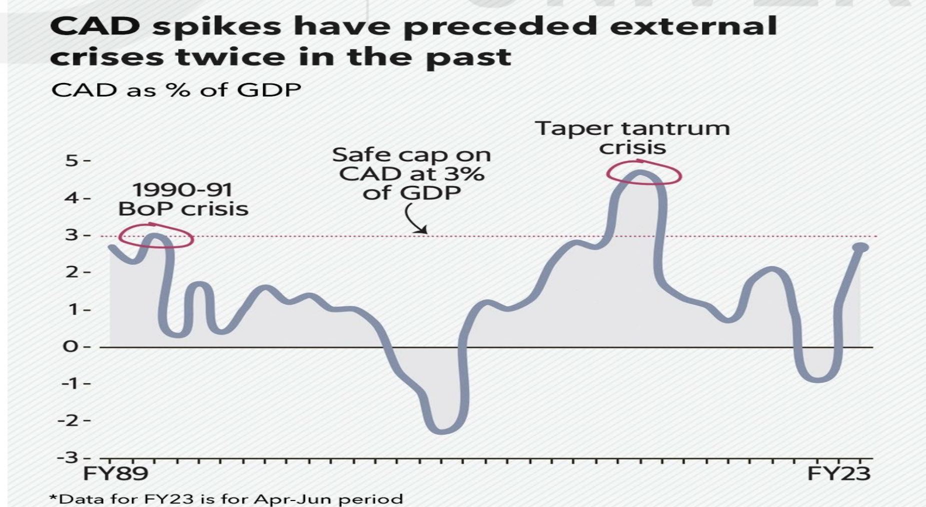
arisen amid a scenario of rising import tariffs and mercantilist attitudes. Main features of this situation are as follows:

1. FPI Unreliability

On the capital account, the most volatile component, foreign portfolio investments (FPIs), showed net outflows until the June-ended quarter in response to rising US interest rates, higher geopolitical risk, and central bank tightening around the world FP1 flows are notoriously volatile and shift nimbly from one country to another in search of returns. India has suffered portly because FPIs tend to lump all emerging market assets together and sell them off in a risk-averse scenario. However, Indian assets, both debt and equity, face another disadvantage. Not only has the rate gap between India and the US narrowed, the weaker rupee has also reduced dollar returns for investors. If the current fiscal ends up with a net pullout of FPI flows, it would reduce dollar inflows available to finance the CAD. India then has to look to other sources of funding, such as the special foreign currency non-resident account (FCNR) deposits launched in 2013, or run down its forex reserves.

2. CAD Breaches

CAD has breached the 3% mark only twice since 1990. In 1991, it was because of an oil price rise triggered by Iraq's invasion of Kuwait, which increased India's crude bill so much that its forex reserves were not enough to cover even one month of imports. 'Die country was forced to seek funding from the International Monetary Fund, devalue the rupee, and implement economic reforms. During 2011-13, supply disruption in West Asia pushed oil over $100 per barrel, resulting in 4%-plus levels of CAD. By the time of the famous "taper tantrum" speech in May 2013, India's external position was so fragile that the rupee lost 20% within four months. These events reinforce the role of CAD as a red flag. Investors tend to associate a CAD spike wit h exchange rate weakening and market volatility. Hence, any development that could push CAD beyond the 3% threshold would weaken investor sentiments, leading to dollar outflow s and a weaker rupee.



Source: RBI

Fig. 3.3

3. External Risk

However, this time, India is unlikely to see a repeat of past crises. India is one of the few economies expected to grow at 7% this fiscal and is thus an attractive investment destination. Despite recent depletion, its forex reserves are still healthy and the national debt is largely in rupees, which makes a panicky scramble for dollars to honour debts less likely.

The rising CAD need not be seen as a predictor of an external crisis, but rather an indicator of increased external risk, which can be mitigated by reducing the deficit or improving inflows. The former is tough in the current global scenario, but the latter is achievable. If India can keep its fundamentals strong, it may attract enough investments on a sustained basis to not just finance an occasionally higher CAD but to be able to raise the red mark itself above 3%.

Check Your Progress 1

1. What do you mean by Balance of payments on current account ?

……………………………………………………………………………………………

……………………………………………………………………………………………

……………………………………………………………………………………………

2. What do you mean by Balance of capital account?

……………………………………………………………………………………………

……………………………………………………………………………………………

……………………………………………………………………………………………

3. Distinguish between balance of trade and balance of payments.

……………………………………………………………………………………………

……………………………………………………………………………………………

……………………………………………………………………………………………

3.5. PROBLEMS OF DEFICIT AND TRADE POLICY

The measures embodied in our Plans to meet payment deficits can be conveniently classified in two parts, *viz.,* import substitution and export promotion.

Import Substitution

Import substitution implies indigenous production of raw materials, intermediate goods and final consumer and capital goods that had hitherto been imported. Import substitution was the major plank of India's foreign trade policy during first fifteen years of economic planning. It was visualised that large imports of capital goods and equipment would help the country build up sufficient domestic production capacity to meet the internal requirements. This presumption was in-built in the Mahalanobis strategy of heavy-industry-led growth. A further assumption of the strategy was that once the production capacity within the country had been built up it would be

possible to give up imports to a large extent. Working on this hypothesis, our Plans provided for the required large imports, financed largely by external assistance.

The progress of import substitution in the country has been quite satisfactory. In the sphere of consumer goods, we have the capacity to produce exportable surplus and are competing effectively in the international markets. Likewise, indigenous production of capital goods has also expanded very fast and the country is gradually becoming self- sufficient in their production too, as would be seen from the fact that the share of imports in the total estimated supplies has been gradually falling over the years.

But all this does not mean that country's import requirements have decreased or show signs of falling. India's imports have been mounting. As a percentage of national income they are about 25 per cent presently thus falsifying the Mahalanobis assumption that these would fall.

So far as containing the growth rate of imports is concerned prospects do not seem to be bright on several grounds.

(a) A sizable chunk of imports is accounted for by items whose imports cannot be reduced as it could disturb the current price stability, unless their domestic output is increased.

(b) Any attempt to curb imports of petroleum, fertilisers, capital goods and other essential goods could only hamstrung the pace of economic growth of the country. Such attempts could also frustrate the current phase of liberalisation aimed at pushing up the growth rate of industrial economy. In this context it may be noted that with the growth of economy the country's imports are likely to escalate.

More importantly, imports keep our industry on its toes—price-wise, quality-wise and technologywise. Hence, our policies and efforts should be geared to earn means with which to finance the rising needs of imports in the economy. That takes us to the sphere of export promotion.

Export Promotion

The terms 'outer-oriented', 'export promotion', 'export substitution' and 'export-led growth' have all been used interchangeably to describe the policies adopted in the successful exporting countries

Exports are to growth what oxygen is to human organism, and, therefore, the export sector is being regarded 'second only to defence'. This expresses the need for a vigorous export drive.

A look at the overall exports data shows that there are many sectors where growth is flagging: from vehicles to machinery and commodity exports. It also shows that even after a dozen years of reform, India is still largely a commodities exporter, with its information technology services classified as invisibles. Even though we manage to sell some manufactured goods overseas, their share is still lower than what could have been expected in a large country like India. Even for relatively unsophisticated products such as refrigerators and flat panel television screens, India relies on imports, not domestic production.

India must increase the share of manufacturing in its economy. Eventually, this will lead to India becoming an exporter of manufactured goods. That will help us narrow the current account

deficit in two ways: by substituting imported manufactures with domestic ones and by exporting some of the locally-made goods overseas. In order for this to happen, India must clear the decks for large investments by global manufacturing companies that now prefer to operate in south-east Asia or China. The government must cut through the maze of red tape of clearances, licences and permissions that entangle projects and rationalise labour laws.

3.6 DEFICIT AND SURPLUS IN BALANCE OF PAYMENTS

You have learnt that BOP accounting is based on the principles of double entry book keeping, meaning thereby that for every credit entry, there is a debit entry. Thus, a BOP account always balances. The difference between aggregate debit and credit is called balance. In case debit exceeds credit, the balance is negative or deficit, when the credit exceeds debit, the balance is positive or surplus. Obviously, the term, deficit or surplus cannot refer to the entire BOP but sub set of accounts included in BOP.

Where the value of exports exceeds that of imports, the situation is referred to as trade surplus or surplus on trade account. Excess of imports over exports results in trade deficit or deficit on trade account.

The transactions appearing in a balance of payments can be classified in two categories, viz autonomous transactions and accommodating or financing transactions. Autonomous transactions take place on their own, in response to their felt needs and are independent of situation in the balance of payments. Accommodating or financing transactions refer to the flows which take place in response to surplus or deficit in the balance of payments. For example, a country may incur or raise its liabilities or reduce its assets in order to pay for the deficit. A deficit in balance of payments arises when payments for autonomous or self motivated transactions exceed receipts. In case, there is a deficit or surplus, there have to be some compensatory transactions to balance the imbalance. Autonomous and financing transactions are also referred to as above the line and below the line respectively.

While changes in reserve assets can be measured accurately, recording of other items is subject to errors arising out of data inadequacies, discrepancies of valuation and timing, erroneous reporting etc. These are reconciled through a fictitious head of account called ‘Errors and Omissions’.

3.7 BALANCE OF PAYMENTS DISEQUILIBRIUM

A nation’s balance of payments is said to be in equilibrium when it is neither drawing upon its international reserves to make excess payments nor accumulating such reserves as a result of its receipts. In other words, when a country is not able to pay for its import of goods and services from its export earnings, or accumulating reserves year after year, a disequilibrium in balance of payments sets in. Policy initiatives are needed to restore equilibrium.

A disequilibrium in balance of payments may be short term or long term in nature. Short term disequilibrium arises largely on account of cyclical factors or unexpected developments. A crop

failure or earthquake may lead to a sudden decline in export earnings and consequently a disequilibrium.

Long term or structural disequilibrium arises on account of long term structural changes in the economy. Decline in demand for export products due to technological changes may bring about a decline in export proceeds. Decline in demand and prices for natural rubber or jute on account of development of synthetics may be cited as an example. Such a situation can be remedied only by diversification of economy,

3.8 FACTORS-AFFECTING BALANCE OF PAYMENTS

3.8.1 Current Account

A country's current account balance can significantly affect its economy, therefore, it is important to identify the factors that influence it. The most important factors are:

i) Inflation
ii) National Income
ii) Government Restructures
iv) Exchange Rate.

Let us discuss them one by one.

Inflation: If a country's inflation rate increases relative to the countries with which it trades, its current account balance would be expected to turn adverse. Due to higher prices at home, consumers and corporations within the country are likely to purchase more goods overseas leading to rise in imports, while the country's exports may decline.

National Income: If a country's national income rises at a higher rate than those of other countries, its current account is expected to decrease, other things being equal. As real income (adjusted for inflation) rises, so does consumption of goods. Part of the increase in consumption may be met by imported goods.

Government Restrictions: If a country's government imposes a tax (often referred to as a tariff) on imported goods, the prices of foreign goods will increase. An increase in prices of imported goods relative to goods produced at home may discourage imports and improve the current account balance. In addition to tariffs, a government may restrict imports by other measures such as total ban or quota restrictions.

Exchange Rate: The value of a country's currency in terms of other currencies is called the exchange rate. Changes in a currency's exchange rate brought about by market forces or actions by national government or governments of other countries will influence a country's current account balance. An appreciation in a country's exchange rate vis-a-vis another country's currency, other things being equal, is likely to lead to decline in the country's exports and increase in imports Thus, if Rupee appreciates in value vis-a-vis US Dollar, exports are likely to be hit and imports are likely to grow. The opposite will be the impact of depreciation in

exchange rate of a country's currency, i.e. it is likely to lead to growth in exports and decline in imports.

However, according to J-curve theory, a country's trade deficit worsens just after its currency depreciates because price effects will dominate the effect on volume of imports in the short run. That is the higher costs of imports will more than offset the reduced volume of imports. Thus, the J-curve theory, states that a decline in the value of home currency should be followed by a temporary worsening in the trade deficit before its longer term improvement,

3.8.2 Capital Account

As with current flows, government policies affect the capital account as well. A country's government could, for example, impose a special tax on income derived by local investors from foreign investments. A tax would discourage people from investing abroad and could therefore, increase the country's capital account. Capital flows are also influenced by capital controls of various types. Interest rates also affect the capital flows. A hike in interest rates relative to other countries may attract capital flows from abroad. Conversely, a reduction in domestic rates may induce people to invest abroad.

The anticipated exchange rate movements by investors in securities can affect the capital account. If a home currency is expected to strengthen, foreign investors may be willing to invest in the country's securities to benefit from the currency movement. Conversely, a country's capital account balance is expected to decrease, if its home currency is expected to weaken, other things being equal.

When attempting to assess why a country's capital account changed and how it will change in future, all factors must be considered simultaneously. A particular country may experience a reduction in capital account even when its interest rates are attractive, if the home currency is expected to depreciate.

3.9 METHODS OF CORRECTING DISEQUILIBRIUM

When disequilibrium arises, the following measures are usually adopted.

i) Use of past reserves
ii) Borrowings from IMF
iii) Monetary and fiscal policy measures
iv) Exchange rate adjustments.

Let us learn them in detail.

Use of Past Reserves: A country may make use of past reserves to finance the BOP deficit provided such reserves are available. Such reserves consist of gold, foreign currencies and fund related assets i.e. reserve position with the IMF and holdings of special drawing rights. In recent

years, increase in quotas and additional allocations of SDRs and expanded private capital flows have contributed to an overall increase in national reserves of several countries.

Borrowing from IMF: Countries with disequilibrium in B.O.P. can make use of IMF facilities. These are:

i) Stand by loans
ii) Extended Fund Facilities (EFF)
iii) Structure Adjustment Facilities (SAF)
iv) Enlarged Structural Adjustment Facilities (ESAF).
v) Compensatory and Contingency Financing Facilities (CCFF)
vi) Systemic Transformation Facilities (STF).

Monetary and Fiscal Policy Measures: Monetary and fiscal policies are also important tools for influencing BOP conditions. A change in money supply brought about either through fiscal or monetary policies can bring about the required change in the level of total demand, including demand for imported goods and services.

Exchange Rate Adjustments: Adjustments in exchange rate is an effective tool. A downward adjustment in exchange rate will make exports cheaper and imports dearer. In other words, as a result of such a policy, exports will be encouraged and imports will be discouraged and equilibrium will be restored.

All these measures, however; suffer from certain limitations. Hence, managing disequilibrium in BOP continues to be a major problem with any country. A policy initiative taken for the sake of achieving equilibrium in BOP may come into conflict with other, rather more endearing objectives, such as, economic growth, employment and price stability. Reconciling such conflicts is the challenge to policy makers.

Check your progress. 2

1. What is Official Reserve Account?

………………………………………………………………………………………………
………………………………………………………………………………………………
………………………………………………………………………………………………

2. What do you mean by current account deficit?

………………………………………………………………………………………………
………………………………………………………………………………………………
………………………………………………………………………………………………

3. What are capital flows?

…………………………………………………………………………………………

…………………………………………………………………………………………

…………………………………………………………………………………………

Check Your Progress C

1. Distinguish between import substitution and export promotion.

   …………………………………………………………………………………………

   …………………………………………………………………………………………

   …………………………………………………………………………………………

2. What do you mean by disequilibrium in balance of payments?

   …………………………………………………………………………………………

   …………………………………………………………………………………………

   …………………………………………………………………………………………

3. Write four factors affecting balance of payments.

   …………………………………………………………………………………………

   …………………………………………………………………………………………

   …………………………………………………………………………………………

ignou THE PEOPLE'S UNIVERSITY

3.10 LET US SUM UP

Balance of payments is an annual statement of accounts of monetary transactions of a country with rest of the world. These monetary transactions arise out of the flows of goods, services and capital.

Our goods and services are paid by overseas buyers, and we pay when we demand their goods and services. Balance of Payments thus is an indicator of the state and structure of an economy in relation to the rest of the world. Current account deficits are made use of to finance the developmental needs of an economy. To that extent deficits play a positive role in the process of economic development. But too much of a dependence on deficits may cause instability and prove disruptive. Thus there is a need to adapt a balanced view over these deficits. India has been by and large successful in coining and following such a balanced approach.

3.11 TERM - END EXERCISES

1. Explain the term Balance of Payments. Also distinguish between balance of payments and balance of trade.

2. Explain the relationship between balance of payments deficit and fiscal deficit.
3. Discuss the importance of balance of payments in an emerging economy.
4. Why should balance of payments of a country should always balance? Discuss the significance of this equality.
5. Outline policy measures to meet balance of payments deficits in an emerging economy like India.
6. Discuss the trade challenges being faced by India in its strategy to meet balance of payments deficits.

3. 12 .KEY TERMS

1. Balance of Trade: Statement of monetary transactions of a country on account of exports and imports of merchandise.
2. Balance on Invisibles: Statement of monetary transactions of a country on account of trade in services.
3. Balance of Payments: Statement of accounts of all types of monetary transactions of a country with rest of the world.
4. Balance of Payments on Current Account: Statement of Accounts of monetary transactions of a country on account of exchange of merchandise and invisibles.
5. Balance of Payments on Capital Account: Statement of Accounts of monetary transactions on account of inflow and outflow of capital from a country.
6. Disequilibrium in Balance of Payments: it arises when aggregate inflows of foreign exchange do not match aggregate outflows of foreign exchange.
7. Depreciation of a currency. It takes place when the exchange value of domestic currency falls in terms of a foreign currency.
8. Appreciation of a Currency. It is a situation in which the exchange value of domestic currency rises in terms of a foreign currency.

SELECT REFERENCES

1. Govt. of India, Economic Survey Annual
2. Reserve Bank of India Annual Report
3. Reserve Bank of India, Balance of Payments Manual
4. World Bank, World Development Report Annual

ignou THE PEOPLE'S UNIVERSITY