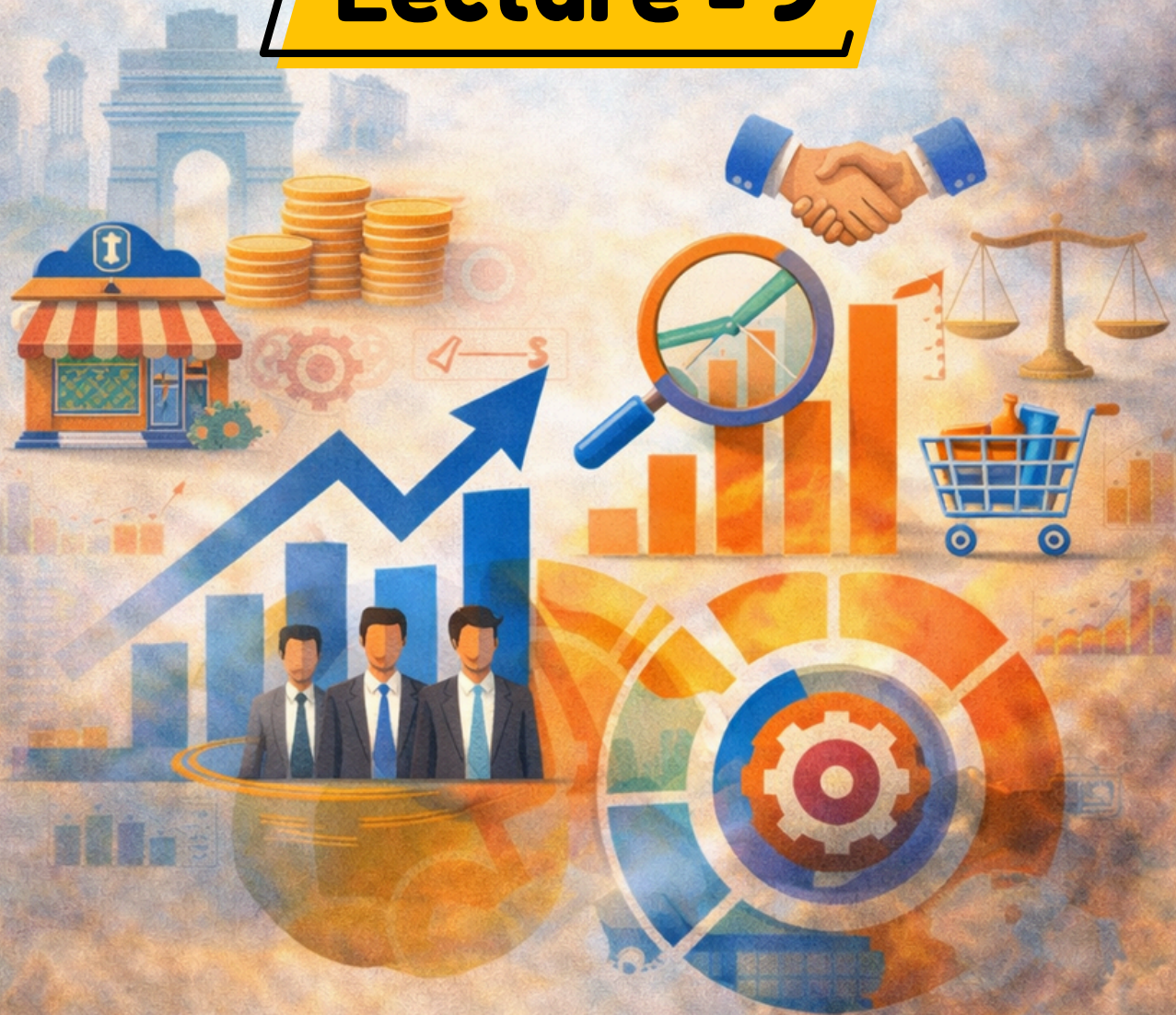
PARMAR SSC

BALANCE OF PAYMENT

Lecture - 9



BY PARMAR SIR

INTRODUCTION TO BALANCE OF PAYMENTS (BoP)

Definition & Concept

- **Balance of Payments (BoP):** It is a systematic record of all financial transactions (imports, exports, investments) between a country and the rest of the world over a specific period (usually a year).
- **Nature:** It acts like a balance sheet for a country's external trade.
- **Structure:** The BoP is primarily divided into two main accounts:

1. Current Account (Revenue Account equivalent).
2. Capital Account (Capital Account equivalent).

1. Current Account

- This account scans all the incoming and outgoing of goods and services between countries. It reflects the actual trade happening in the economy.
- **It is subdivided into three categories:**

1. Visible Items (Trade in Goods)
   - Refers to the export and import of physical goods (Tangibles) that can be touched and seen.
   - **Examples:** Tea, Coffee, Machinery, etc.
2. Invisible Items (Trade in Services)
   - Refers to the export and import of services (Intangibles).
   - **Examples:** Shipping, Banking, IT Services, Tele-calling.
3. Transfer Payments (Unilateral Transfers)
   - These are one-way transfers where no goods or services are exchanged in return.
   - **Components:** Remittances, Foreign Aid, and Grants.

Remittances: Money sent by foreign workers to their home country.

- **Global Ranking:** India is currently the top recipient of remittances in the world.
- **Runner-up:** Mexico ranks second.

2. Capital Account

- This account monitors capital transactions, specifically the purchase and sale of assets (both financial and non-financial) like land, properties, and stocks between a country and the rest of the world.

- **It is primarily divided into the following categories:**

1. Foreign Direct Investment (FDI)

- **Definition:** This refers to a long-term investment in a foreign country's physical assets.
- **Characteristics:** It involves acquiring ownership or management control of a company. It is considered a stable nature of investment because physical assets (like factories or land) cannot be sold off quickly to exit the country.
- **Example:** Walmart acquiring Flipkart is a classic example of FDI.

2. Foreign Portfolio Investment (FPI) / Foreign Institutional Investment (FII)

- **Definition:** This refers to a short-term investment in a foreign country's financial assets.
- **Characteristics:** It involves buying financial instruments like shares or debt without seeking management control.
- **Examples:** Investments in Stocks, Bonds, Mutual Funds, and NRI Deposits.

> "**Hot Money**": FPI is often referred to as "Hot Money". This is because it is highly volatile; investors can easily sell their stocks or bonds and exit the economy rapidly if the market becomes unstable.

3. FDI Routes and Sectoral Limits

- Investments enter India through two main routes: the Automatic Route (where no government approval is required) and the Government Route (where mandatory approval is needed).
- **Defence Sector:** Investments up to 74% are allowed via the Automatic Route. Any investment beyond 74% (up to 100%) requires approval through the Government Route.
- **Insurance Sector:** Foreign investment is now allowed up to 100% via the Automatic Route.

DEFICITS & THE 1991 ECONOMIC REFORM

Current Account Deficit (CAD)

- **Definition:** A Current Account Deficit occurs when a country imports more goods, services, and capital than it exports.
- **Components:** It includes the balance of trade, net income from abroad, foreign aid, and net current transfers.

- **Key Insight:**
  - A deficit implies the country is a net borrower from the rest of the world to finance its imports.
  - **Current Status:** India generally runs a CAD, currently around 1.2% of GDP (RBI comfort level is 2–2.5%).
- **Historical Exception (Surplus Era):**
  - From 2000 to 2003, India witnessed a Current Account Surplus.
  - **Reason:** A boom in services exports (IT/BPO sector) and reduced imports significantly boosted the balance.

Twin Deficit

- **Definition:** This economic condition occurs when a country suffers from both a Current Account Deficit and a Fiscal Deficit simultaneously.
- **Fiscal Deficit:** Total Expenditure – Total Receipts (excluding borrowings)
- **Current Account Deficit:** Import Bill > Export Earnings.

Balance of Payments Crisis (1991)

- **Also Known As:** Currency Crisis.
- **The Situation:**
  - By 1990-91, India's foreign exchange reserves had depleted significantly.
  - **Import Cover:** India had foreign currency left for only two weeks (a fortnight) of essential imports.
  - The country was unable to pay for essential imports or service its foreign debts.
- **The Solution:**
  - India approached the IMF (International Monetary Fund) for a bailout loan.
  - The IMF agreed but imposed strict conditions requiring structural reforms in the Indian economy.
- **Key Architects of Reform:**
  - **Prime Minister:** P.V. Narasimha Rao.
  - **Finance Minister:** Dr. Manmohan Singh.

LPG Reforms (1991)

- To overcome the crisis, the government introduced the LPG Model as part of the New Economic Policy.

L - Liberalisation (Udarikaran)

- **Definition:** Removing unnecessary government restrictions and controls on the economy.
- **Key Measures:**
  - **Abolition of License Raj:** Industrial licensing was scrapped for most sectors.
  - **Tariff Reduction:** Import duties (tariffs) were lowered to make trade easier.
  - Deregulation of markets to encourage competition.

P - Privatisation (Nijikaran)

- **Definition:** Transfer of ownership, management, or control of public sector (government) enterprises to the private sector.
- **Objective:** To improve efficiency and reduce the financial burden on the government.

G - Globalisation (Vaishvikaran)

- **Definition:** Integrating the national economy with the global economy.
- **Process:** Increasing the free flow of goods, services, capital, technology, and labor across international borders.
- **Outcome:** Opening up the economy to Foreign Direct Investment (FDI) and foreign technology.

FOREIGN RESERVES

- **Definition:** Forex reserves are assets held by a nation's central bank (RBI in India) or monetary authority.
- **Purpose:** They are held to provide import cover (ensuring the country can pay for essential imports) and to protect the economy against external shocks (like recessions, wars, or currency volatility).
- **Current Context:** During the 1991 crisis, India had import cover for only two weeks. Today, India holds enough reserves to cover nearly a year of imports.

The Four Main Components of Forex Reserves:

	Component	Description	Key Details
1	Foreign Currency Assets (FCA)	The largest component. It consists of currencies (assets) of other countries hold by the central bank.	Accumulated through trade (exports) and foreign investments.
2	Gold Reserves	Physical gold hold by the central bank	Gold has universal acceptability and provides security. Recently, India shifted a significant portion of its gold from the UK back to domestic vaults for security.

	Component	Description	Key Details
3	Special Drawing Rights (SDRs)	Also known as "Paper Gold". It is an international reserve asset created by the IMF.	It is not a real currency but a claim on the freely usable currencies of IMF members.
4	Reserve Tranche Position (RTP)	The quota of currency each member country must maintain with the IMF.	This is the portion of the quota that can be withdrawn without any conditions. A higher quota results in higher voting power at the IMF.

- India currently holds the 8th rank in terms of voting power at the IMF.
- **Top Ranks:** 1. USA, 2. Japan, 3. China.

The Global Five Currency Basket (SDR Basket)

- The value of the SDR is determined by a weighted average of a basket of five major currencies.

1. US Dollar ($) - USA
2. Euro (€) - Eurozone
3. Yen (¥) - Japan
4. Pound Sterling (£) - United Kingdom
5. Yuan (Remnimbi) (¥) - China

International Monetary Fund (IMF) and World Bank

- **Headquarter:** Washington D.C.
- The Bretton Woods Conference in 1944 (officially known as United Nations Monetary and Financial Conference) was a gathering of 44 nations with 730 delegates which resulted in the formation of IMF and World Bank (Twin Organisations).
- **1929-30:** Great Depression in USA
- It also resulted in creation of International Bank for Reconstruction and Development (IBRD) which is now a part of World Bank.

Major Reports Published by IMF

- The IMF releases these key reports twice a year to analyze the global economy.

Key Reports:

1. World Economic Outlook (WEO)
2. Global Financial Stability Report (GFSR)
3. Fiscal Monitor (FM)

Top Borrowers of IMF



NOSTRO AND VOSTRO

NOSTRO

- A Nostro ("our") account refers to a bank account that a domestic bank holds in a foreign bank in foreign currency → "Our account/money in your bank".
- It is used for international transactions and trade.
- E.g. Bank X has an account with Bank Y in Bank Y's home currency.

VOSTRO

- A VOSTRO ("your") account refers to a bank account that a foreign bank holds in a domestic bank in the domestic currency → "Your account/money in our bank".
- It allows foreign banks to conduct transactions in the domestic market.
- E.g. City Banks partners with HDFC Bank based in India and opens an account with the denoted currency INR.

CURRENCY VALUATION CONCEPTS

- The value of a currency can change due to two main factors: Market Forces (Supply & Demand) or Government Intervention.

Market-Driven Valuation (Floating Exchange Rate)

- These changes occur automatically based on the demand and supply of currency in the forex market.

Depreciation:

- **Definition**: A decrease in the value of the domestic currency due to market forces.
- **Logic**: When the supply of domestic currency is high but demand is low (it is "too available"), its value falls.
- **Example**: Exchange rate moves from $1 = ₹80 to $1 = ₹90. You now need more rupees to buy the same dollar.
- **Impact**: Exporters benefit because they earn more rupees for every dollar sold. Exports become more competitive.

Appreciation:

- **Definition**: An increase in the value of the domestic currency due to market forces.
- **Logic**: When the demand for domestic currency rises significantly.
- **Example**: Exchange rate moves from $1 = ₹90 to $1 = ₹80. You need fewer rupees to buy a dollar.
- **Impact**: Importers benefit because foreign goods become cheaper to buy.

Government-Driven Valuation (Fixed Exchange Rate)

- These changes are deliberately made by the Central Bank or Government.

Devaluation:

- **Definition**: A deliberate downward adjustment (reduction) of the value of domestic currency against a foreign currency.
- **Purpose**: Often done to boost exports by making them cheaper for foreign buyers.
- **Condition**: Devaluation is most beneficial if the volume of exports rises proportionately to the drop in price.

Revaluation:

- **Definition**: A government-induced appreciation of the domestic currency under a fixed exchange rate system.

Concept	Cause	Impact on Exports
Depreciation	Market (Supply > Demand)	Positive (Competitiveness Increases)
Appreciation	Market (Demand > Supply)	Negative (Competitiveness Decreases)
Devaluation	Government / Central Bank	Positive (Done to boost exports)
Revaluation	Government / Central Bank	Negative

DIFFERENT TYPES OF CURRENCIES

1. Hard Currency

- **Definition:** A currency that has a high level of liquidity and universal acceptability.
- **Liquidity:** It can be easily and quickly converted into cash or other currencies.
- **Confidence:** It is widely trusted in international markets.
- **Example:** US Dollar (USD).

2. Soft Currency

- **Definition:** A currency that is easily available in the forex market.
- **Characteristics:** It has lower liquidity and acceptability compared to hard currency. Because it is easily available, its demand is relatively lower.
- **Example:** Indian Rupee (INR) or currencies of developing nations.

3. Hot Currency

- **Definition:** A hot currency is one that enters and exits an economy at a rapid pace.
- **Explanation:** As countries reduce their dependency on the dollar, it exits those economies rapidly, making it a "hot" currency in that specific context.

4. Heated Currency

- **Definition:** A domestic currency that is under high pressure of depreciation.
- **Scenario:** This occurs when a currency's value is dropping rapidly against a hard currency due to market forces or economic instability.

5. Cheap Currency

- **Definition:** A currency becomes "cheap" when the government follows an expansionary policy.
- **Mechanism**: The government starts repurchasing its bonds before maturity.
- **Impact**: By buying back bonds, the government injects money (liquidity) into the economy.
- **Result**: High supply of currency leads to depreciation, making the currency "cheap".

6. Dear Currency

- **Definition**: A currency becomes "dear" (expensive/scarce) when the government follows a contractionary policy.
- **Mechanism**: The government starts selling its bonds.
- **Impact**: By selling bonds, the government soaks up liquidity from the economy.
- **Result**: Low supply of currency leads to appreciation, making the currency "dear".

EXCHANGE RATE SYSTEMS & INDICES

Evolution of Exchange Rate Regime in India

- India's exchange rate system has evolved significantly over the decades, moving from a rigid, fixed system to a market-determined one.
  - **1928 – 1948:** The Indian Rupee was pegged to the British Pound Sterling.
  - **Post-1948 (IMF Era):** After the establishment of the IMF, many countries, including India, pegged their currencies to the US Dollar.
    - **System:** Fixed Exchange Rate System (or Pegged System).
    - **Concept:** The value was fixed by the government (e.g., $1 = ₹20) and did not fluctuate with market demand.
  - **1975:** India fully delinked its currency from the Pound Sterling.
  - **1992 – 1993:** India shifted to a Floating Exchange Rate System following the Balance of Payments crisis.

LERMS (Liberalised Exchange Rate Management System)

- **Introduction:** Introduced in March 1992.
- **Mechanism:** It was a Dual Exchange Rate System.
  - It allowed a partial float where some rates were determined by the market and others by the government.
- **Significance:** It marked the transition from a fixed regime to a market-determined exchange rate system where market forces (supply and demand) determine the currency's value.

NEER vs. REER (Exchange Rate Indices)

- To understand the external value of the Rupee against multiple trading partners, economists use "effective" exchange rates rather than just the USD-INR rate.

Nominal Effective Exchange Rate (NEER)

- **Definition:** It is the weighted average of bilateral exchange rates of the domestic currency against a basket of foreign currencies.
- **Weights:** Weights are assigned based on the trade importance of each currency (e.g., USD gets a higher weight if trade with the US is high).
- **Interpretation:**
  - An increase in NEER indicates appreciation of the Rupee.

  Note: It does not adjust for inflation.

Real Effective Exchange Rate (REER)

- **Definition:** It is the NEER adjusted for inflation (relative prices).
- **Formula:** REER = NEER - Inflation Differential.

EXCHANGE RATE MECHANISMS

FERA (Foreign Exchange Regulation Act, 1973)

- **Intent:** Introduced to conserve foreign exchange resources and prevent their misuse.
- **Nature:** It was a draconian and rigid law.
- **Key Provision:** Under FERA, any violation (e.g., unauthorized currency conversion) was treated as a criminal offense.
- **Reason for Repeal:** Its rigid regulations were hindering India's economic growth and globalization efforts.

FEMA (Foreign Exchange Management Act, 1999)

- **Transition:** Enacted post-1991 reforms to replace FERA.
- **Focus:** It focuses on enhancing India's foreign exchange reserves and promoting foreign trade and payments.
- **Key Change:** It decriminalized offenses. Violations under FEMA are treated as civil offenses, making it much more business-friendly.

Convertibility of the Rupee

- Convertibility refers to the ease with which a country's currency can be converted into gold or another currency.

1. Current Account Convertibility

- **Definition:** Freedom to convert domestic currency into foreign currency (and vice versa) for trade in goods and services (Current Account transactions).
- **Status:** India has Full Current Account Convertibility.
- **Date:** This was achieved in August 1994.
- **IMF Connection:** This complies with Article VIII of the IMF Articles of Agreement.

2. Capital Account Convertibility

- **Definition:** Freedom to convert currency for capital transactions like buying foreign assets, real estate, or equity investment.
- **Status:** India has Partial Capital Account Convertibility (approx. 40:60 ratio). It is not yet fully convertible.

The Tarapore Committees (1997 & 2006)

- **Purpose:** The RBI constituted committees under the chairmanship of S.S. Tarapore to create a roadmap for Full Capital Account Convertibility.
- **Recommendations:**
  - The committee recommended moving towards full convertibility gradually.
  - It laid down strict pre-conditions (like low fiscal deficit, low inflation, and low NPAs) before full convertibility could be attempted.



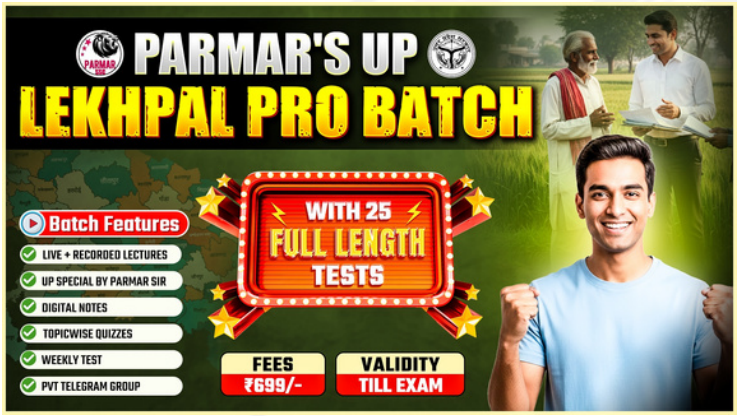


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