



## Issues facing India's Balance of Payment

**Thomas Mathew**

St. Francis Institute of Management & Research  
saintl@vsnl.com

*This paper takes a look at the genesis of the economic crisis in the Balance of Payment situation of India leading to the current situation taking into consideration the high trade deficit. This paper would be analysing the various issues and views for the prospects of growth in India based on the the latest global financial system. The findings would be vital to help formulate the policies to make the Balance of Payment more sustainable for the Indian economy to grow at a robust rate. An attempt is also made to assess the vulnerabilities to finance the debt in order to help prevent this crisis and foster growth.*

The **Balance of Payments** (or **BOP**) measures the payments that flow between any individual country and all other countries. It is used to summarize all international economic transactions for that country during a specific time period, usually a year. The BOP is determined by the country's exports and imports of goods, services, and financial capital, as well as financial transfers. It reflects all payments and liabilities to foreigners (debits) and all payments and obligations received from foreigners (credits). Balance of payments is one of the major indicators of a country's status in international trade, with net capital outflow.

### Components of BOP

- Current Account
- Capital Account
- Change in official reserve
- Financial Account

### Current Account

This covers the flow of goods, services and income in and out of a given country and also financial aid from governments abroad:

- Trade in goods is also known as trade in visibles or tangibles,
- Trade in services is also known as trade in invisibles or intangibles.
- Income refers not only to the money given back from investments made abroad (investments are recorded in the financial account but income from investments is recorded in the current account) but also to the money sent by individuals working abroad that send money to their families back home (this is usual only in diasporas and developing countries).

*Current account* =

- Trade Balance
  - Net Exports (Exports - Imports) of Merchandise (tangible goods)
  - Net Exports (Exports - Imports) Services (such as legal and consulting services)
- + Net Factor Income From Abroad (such as interest and dividends)
- + Net Unilateral Transfers from Abroad (such as foreign aid, grants, gifts, etc.)

### **Capital Account**

The capital account "records the international flows of transfer payments relating to capital items". It therefore records a country's inflows and outflows of payments and transfer of ownership of fixed assets (capital goods). Examples of such goods could be factories and so on.

Summing up, The Capital Account accounts for the transfer of capital goods.

### **Official Reserves**

- The official reserves account records the current stock of reserve assets (and often simply referred to as foreign exchange reserves) available to and controlled by the country's authorities for financing of international payment imbalances, foreign exchange intervention and other uses. Reserves include official gold reserves, foreign exchange reserves, and IMF Special Drawing Rights (SDRs), all denominated in foreign currency (although the amounts may be expressed in any relevant unit). Changes in the official reserves account for the differences between the capital account and current account, and effectively represent foreign exchange interventions; the magnitude of these changes will depend on monetary policy.

### **Financial Account**

- The financial account is the *net change in foreign ownership of domestic financial assets*. If foreign ownership of domestic financial assets has increased more quickly than domestic ownership of foreign assets in a given year, then the domestic country has a **financial account surplus**. On the other hand, if domestic ownership of foreign financial assets has increased more quickly than foreign ownership of domestic assets, then the domestic country has a **financial account deficit**
- The accounting entries in the financial account record the purchase and sale of domestic and foreign assets. These assets are divided into categories such as Foreign Direct Investment (FDI), Portfolio Investment (which includes trade in stocks and bonds), and Other Investment (which includes transactions in currency and bank deposits).

*Financial account =*

- Increase in foreign ownership of domestic assets - Increase of domestic ownership of foreign assets

### **The Balance for Official Financing**

- If the exchange rate is *fixed*, and there is a BoP deficit  $\Rightarrow$  outflows  $>$  inflows  $\Rightarrow$  supply of Rs.  $>$  demand for Rs.
- The Central Bank must offset this excess supply of Rs. by buying them with foreign currency (\$); i.e. runs down its reserves of foreign exchange

A **Balance of Payments Equilibrium** is defined as a condition where the sum of debits and credits from the Current Account and the Financial Account equal to zero; in other words, equilibrium is where Current Account + Financial Account = 0

This is a condition where there are no changes in Official Reserves. When there is no change in Official Reserves, the balance of payments may also be stated as follows:

$$\text{Current Account} = - \text{Financial Account } or$$

$$\text{Current Account Deficit (Surplus)} = \text{Financial Account Surplus (Deficit)}$$

Trade Deficit

Trade deficit = government deficit + priv. sector deficit

An increase in govt. expenditure ( $G$ ) or a reduction in private saving ( $S$ ) worsens the trade balance (i.e. rises trade deficit)

- Mercantilists believed that a country should accumulate reserves (in the form of gold) through trading
- A trade deficit is not necessarily a bad thing (e.g. when growing domestic industries attract foreign investments)
- However, if a country persistently runs a trade deficit this is something to worry about (e.g. vulnerability to loss of foreign investors' confidence)

The external balance of payments is made up of the current account (principally trade and transfers), and the capital flows (FDI, portfolio flows, external loans) needed to finance it. Their sum determines whether India accumulates or loses reserves.

The strength, resilience and stability that the country's external sector faces are reflected by various sectors. These factors include reserves, level of current account deficit, capital inflows composition, exchange rate flexibilities, and external debt levels.

The current account has followed an inverted "U" shaped pattern during the period 2001 to 2007, with a current account deficit of 1.1 per cent of GDP in 2006-07. The capital inflow as a proportion of GDP has been on the uptrend during the same period 2001 to 2007, reaching a high of 5.1 per cent of GDP in 2006-07. The net result of these two trends has been a gradual raise in reserve over the period, reaching 4 per cent of GDP in 2006-07.

The current account deficit (CAD) is attributable to the widening trade deficit which is primarily driven by the rise in the international prices of petroleum products and gold. In 2007-08 the trade deficit was \$91.6 bn however due to surplus in services trade, the current account deficit (CAD) was contained within the 1.5% of GDP in 2007-08. In 2008-09, the trade deficit increased to \$119.4 bn because of high oil prices in H1 and declining export demand for both goods and services in H2 in the wake of global slowdown. Hence, the current account deficit may widen to 3% of GDP. This situation is quite different from the one that existed in 1991 when India's CAD had breached the 3% level pushing the country into a liquidity crisis. We did not have the comfort of large foreign exchange reserves of \$252 bn then, which we do have now. Secondly we now have a much more healthy inflow of FDI than we had in 1991. It should be noted that a current account deficit of the order of 3% is not sustainable so we should not be complacent especially in the context of the global crisis.

The global crisis has led to a situation where we have excess capacities to our west as well as our east due to demand recession in the world economy. The India's economy is still growing at a rather robust rate of around 7%, and this could become tempting for global suppliers to dump their goods in India. Hence, it is of critical importance to ensure that we do not become a dumping ground for cheap goods destroying our domestic industry in this period of global gloom.

An example would be China which has raised tariffs on a number of goods such as luxury watches from 10% to 30%, cosmetics from 20% to 50% from January 2009 to avert such possibilities. India's position is more precarious compared to China that has been running large current account surpluses for years building up a trillion dollar foreign exchange reserve.

WTO provides the possibility of imposing safeguards such as import surge protection, quantitative restrictions under Articles XII and XVIII B of GATT in the context of BoP crisis. The recent depletion in India's forex reserves by around \$60 billion is an adequate justification under GATT (Art XVIII B) for imposing safeguards.

In addition, we could raise tariffs to take advantage of high, bound tariffs that we have or evolve product standards and other non-tariff measures, or just imposing anti-dumping duties.

We should make it clear to our trade partners that the objective of such temporary measures is not the protectionist intent but to protect the Indian economy from falling into a severe BoP crisis in the context of global recession.

The progressive reductions in peak tariff rates on imports have provided Indian industry access to new technology and inputs. The positive developments in the external sector enable a further rationalisation of tariffs with a view moving to a single, uniform rate on imports and further simplifying procedures in line with best global practices. The current external environment, including the level of the foreign exchange reserves, enables such a move to be made with minimal downside risks.

The other aspect of addressing the current BoP crisis is to promote our exports more vigorously. In the present scenario of global slowdown this has its limitations as seen in the falling exports. The 12% decline registered in exports during October 2008, the first time such a phenomenon has occurred in the past seven years, seems to be the tell-tale sign of the global economic crisis having reached Indian shores.

Therefore, the focus should also be on developing new industries by leveraging our large and expanding market to contain imports.

It is well-known that falling oil prices will reduce the import bill. What is less well known is that India's imports are heavily dependent on its exports. Our main merchandise exports are of refined petroleum, gems & jewellery and textiles which have a large import content — a 1% fall in exports leads to a 0.95% fall in imports. Both of these imply that the current account deficit will be lower going forward thus complicating the issue further.

India has done rather well in terms of diversification of trade away from very high dependence on Europe and North America in favour of developing countries. East Asia has emerged as our largest trading partner. But our exports are still dominated by relatively simple, slow moving and low value adding products such as textiles, garments, leather goods, iron ore, some other primary agricultural commodities. We have not been able to diversify our export basket especially in favour of more technology and knowledge intensive goods that are less susceptible to price pressures and are much more value adding and faster growing. India should consolidate its presence in traditional export industries and move up the value chain in traditional products. We should also consolidate Indian advances in generic pharmaceuticals, small cars, two-wheelers, and metals.

In 2007-08, India imported nearly \$60 bn of capital goods — non-electrical machinery and electronic equipment, many of which could have been competitively produced in the country especially when there is a large domestic demand. Our domestic market is able to support world-scale competitive manufacturing units, so in case of products such as personal computers, telecommunication and power generation equipment, and even in commercial aircraft, ship building and rigs, it is necessary to have domestic production which caters to the local market.

India has emerged as one of the largest markets for telecommunication equipment in the world. While a domestic mobile handset production base has been built up in the country, the network equipment that is largely imported. The same would apply to personal computers, civil aircraft, ship building and rigs, power generation (and nuclear power) equipment of higher rating where domestic market size is now able to support world scale competitive local manufacturing units.

This could encourage exporters of equipment to start local manufacturing units by offering pioneer industry incentives and offsets programmes as is done by the East-Asian countries to generate local value-added products and jobs while saving foreign exchange.

India industries should identify a few products for developing revolutionary designs giving great value for money, using our globally recognised 'frugal engineering' or 'reverse engineering' skills that have led to development of cheapest generic medicines, satellites and their launch vehicles, and indeed the Nano. These products will in addition to the domestic market also have major markets in developing countries around the world.

In terms of trade policy priorities, it is of utmost importance that we become part of the emerging regional trade bloc in East Asia. Combining three of the four largest economies of the world, an East-Asia Summit-based regional trade arrangement has the big potential to emerge as a centre of gravity in the world economy. India, therefore, should work actively towards building a regional trade

arrangement in East Asia, which could evolve into a pan-Asian economic community over time.

India is one of the largest recipients of inward remittances from expatriates, amounting to a massive \$40 billion in FY08. Although they can be expected to decline somewhat in a global recession, remittances remain the least volatile of inflows.

The large increase in current account deficit raises yet another concern — the ways and means of financing it. The possibilities of fund flows into India to finance this deficit would be critically dependent on the ability of the Indian economy to present itself as an attractive destination. Given that global financial markets are currently afflicted with a serious crisis of confidence, as a result of which they are likely to remain the quality of their borrowers even after major financial institutions are bailed out through the extensive refinancing being worked out by the major economies this is a dicy situation. In such a scenario India has very few options but to make efforts, and urgently at that, to provide the much needed fillip to its domestic economy. Here the economic revival packages that the government is working out would be the key to finding a way out of the current problems facing India.

The focus of these packages thus far has been to improve the available liquidity in the system, but this is a welcome step in the short run, the government would have to recognise that the liquidity crunch is not the only constraint that India is confronted with.

The Government package needs to focus on issues relating to sustained improvements in the country's production enterprises that can, in turn, lend to the vibrancy of the markets through creation of jobs. The government must finance projects that are aimed at ensuring that the country can build its competitive edge in the integrated world economy, in conjunction with the private sector. The public-private partnerships have to; therefore, assume a new dimension in order to give effect to these projects. In doing so, the government must raise the necessary resources by making a departure from its usual norms of fiscal discipline, for we are living in extraordinary times.

Indeed, more than half of the recent decline has been due to valuation losses as the dollar has strengthened against other currencies. These losses are not likely to continue in 2009. Critically, policy has to continue to be proactive in dealing with the crisis. The government needs to liberalise NRI deposit rates, allow greater foreign ownership of domestic debt, and remove the remaining restrictions on FDI inflows. A rough and bumpy ride lies ahead, so India needs to buckle up.

The policies for FDI are critical since relative to portfolio flows they are less volatile. While the emphasis is on dismantling of regulatory entry barriers, it is necessary to ensure that they are not portfolio flows in the garb of FDI. It must be recognised that overall investment climate must be improved so that both domestic and foreign investors are attracted. In the final analysis, well over ninety per cent of our investment has to be funded by domestic saving. Hence, generalised improvements in investment climate are crucial and FDI flows will also be enabled by such an environment. Overall, consistency in legal framework within the country and in line with international standards modified to suit our needs, and accompanying State level reforms would be useful in this regard. Overall, flexibilities are essential for supply and demand responses to price signals, which are critical for improving

investment climate and more generally, for an open economy that best serves the national interest.

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<b>KEY INDICATORS OF INDIA'S BALANCE OF PAYMENTS</b>			
	April-March		
	2008-09	2007-08	2006-07
<b>Merchandise Trade</b>			
Exports (\$ on BoP basis) Growth Rate (percent)	5.4	28.9	22.6
Imports (\$ on BoP basis) Growth Rate (percent)	14.3	35.2	21.4
Crude Oil Prices, Per Barrel (Indian Basket)	82.4	79.5	62.4
Trade Balance (\$ billion)	-119.4	-91.6	-61.8
<b>Invisibles</b>			
Net Invisibles (\$ Billion)	89.6	74.6	52.2
Net Invisibles Surplus/Trade Deficit (Percent)	75.0	81.4	84.5
Invisible Receipts/Current Receipts (Percent)	48.1	47.2	47.1
Services Receipts/Current Receipts (Percent)	30.0	28.6	30.3
Private Transfers/Current Receipts (Percent)	13.7	13.8	12.7
<b>Current Account</b>			
Current Receipts (\$ Billion)	337.7	314.8	243.4
Current Payments (\$ Billion)	367.6	331.8	253.0
Current Account Balance (\$ Billion)	--29.8	-17.0	-9.6
<b>Capital Account</b>			
Gross Capital Inflows (\$ Billion)	302.5	433.0	233.3
Gross Capital Outflows (\$ Billion)	293.3	325.0	188.1
Net Capital Flows (\$ Billion)	9.1	108.0	45.2
Net FDI/Net Capital Flows (Percent)	191.3	14.3	17.0
Net Portfolio Investment/Net capital Flows (Percent)	-153.4	27.4	15.6
Net ECBs/Net capital Flows (Percent)	89.2	21.0	35.5
<b>Reserves</b>			
Import Cover of Reserves (In months)	10.3	14.4	12.5
Outstanding Reserves as at end period (\$ Billion)	252.0	309.7	199.2

SOURCE: Reserve bank of India Report on Balance of Payment, December 2008