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ANALYSING THE BALANCE OF PAYMENT POSITION OF INDIA

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ABSTRACT

The balance of payment position is an essential measure of the sound health of an economy and can be studied under the major heads of Current Account, Capital Account and international reserves. This analytical paper attempts to study the current position in the components of the Balance of payment. It is observed in the current account that despite moderation in India's exports, India's external sector position has been comfortable, with the current account deficit progressively contracting from 4.8 per cent of Gross Domestic Product in 2012-13 to 1.1 per cent of Gross Domestic Product in 2015-16. It is further observed in the capital account that despite higher net repayments on overseas borrowings and fall in banking capital (net) with building up of foreign currency assets by banks & decline in Non Resident Indian deposits (net), robust inflow of foreign direct investment and net positive inflow of foreign portfolio investment were sufficient to finance Current Account Deficit leading to an accretion in foreign exchange reserves in H1 of 2016-17. Thus the ability to face global financial crisis is stronger than earlier with greater depth in the financial markets, more foreign exchange reserves and inflow of foreign investments.

KEYWORDS

balance of payment, capital account, current account deficit, foreign capital.

1. INTRODUCTION

The balance of payments, also known as the balance of international payments and abbreviated B.O.P., of a country is the record of all economic transactions between the residents of the country and the rest of the world in a particular period (over a quarter of a year or more commonly over a year). These transactions are made by individuals, firms and government bodies. Thus the balance of payments includes all external visible and non-visible transactions of a country.

The basic structure of the Balance of Payments (BOP) of India consists of:

(i) Current account: exports and imports of goods, services, income (both investment income and compensation of employees) and current transfers;

(ii) Capital account: assets and liabilities covering direct investment, portfolio investment, loans, banking capital and other capital;

(iii) Statistical discrepancy;

(iv) International reserves and IMF transactions.

The Balance of payment can be better appreciated in terms of the national income accounting identity: GDP = C+G+I+X-M. In other words, domestic output (GDP) is equal to private consumption (C), plus government consumption (G), plus domestic investment (I), plus net exports (X-M). When the net exports of goods and services (X-M) are negative, the domestic economy is absorbing more than it can produce. In other words, absorption (C+G+I) by the domestic economy is greater than domestic output (GDP). This is reflected in current account deficit (X-M) which needs to be financed by external borrowings and/or investments. (Mohanty 2012). After the financial liberalisation in 1991, external borrowings are easily available and investments have been flowing in the form of FDI, Portfolio and FII. However, in such situations the domestic economy is more prone to react to global imbalances. Import substitution is also necessary in order to control the domestic absorption. Ganguli (1957) maintained that the pull of the comparatively free play of domestic demand upon exportable commodities, combined with rising costs, has created a situation where there is a tendency for diversion of goods from the external to the domestic market.

1.1 BALANCING MECHANISM

REBALANCING BY CHANGING THE EXCHANGE RATE

An upwards shift in the value of a nation's currency relative to others will make a nation's exports less competitive and make imports cheaper and so will tend to correct a current account surplus. It also tends to make investment flows into the capital account less attractive so will help with a surplus there too. Conversely a downward shift in the value of a nation's currency makes it more expensive for its citizens to buy imports and increases the competitiveness of their exports, thus helping to correct a deficit. Exchange rates can be adjusted by government in a rules based or managed currency regime, and when left to float freely in the market they also tend to change in the direction that will restore balance. When a country is selling more than it imports, the demand for its currency will tend to increase as other countries ultimately need the selling country's currency to make payments for the exports. The extra demand tends to cause a rise of the currency's price relative to others. When a country is importing more than it exports, the supply of its own currency on the international market tends to increase as it tries to exchange it for foreign currency to pay for its imports, and this extra supply tends to cause the price to fall. BoP (Balance of Payments) effects are not the only market influence on exchange rates however; they are also influenced by differences in national interest rates and by speculation.

REBALANCING BY ADJUSTING INTERNAL PRICES AND DEMAND

When exchange rates are fixed by a rigid gold standard, or when imbalances exist between members of a currency union such as the Eurozone, the standard approach to correct imbalances is by making changes to the domestic economy. To a large degree, the change is optional for the surplus country, but compulsory for the deficit country. In the case of a gold standard, the mechanism is largely automatic. When a country has a favourable trade balance, as a consequence of selling more than it buys it will experience a net inflow of gold. The natural effect of this will be to increase the money supply, which leads to inflation and an increase in prices, which then tends to make its goods less competitive and so will decrease its trade surplus. However, the nation has the option of taking the gold out of economy (sterilising the inflationary effect) thus building up a hoard of gold and retaining its favourable balance of payments. On the other hand, if a country has an adverse BoP it will experience a net loss of gold, which will automatically have a deflationary effect, unless it chooses to leave the gold standard. Prices will be reduced, making its exports more competitive, and thus correcting the imbalance. While the gold standard is generally considered to have been successful up until 1914, correction by deflation to the degree required by the large imbalances that arose after WWI proved painful, with deflationary policies contributing to prolonged unemployment but not re-establishing balance. Apart from the US most former members had left the gold standard by the mid-1930s.

A possible method for surplus countries to contribute to re-balancing efforts when exchange rate adjustment is not suitable is to increase its level of internal demand (i.e. its spending on goods). While a current account surplus is commonly understood as the excess of earnings over spending, an alternative expression is that it is the excess of savings over investment. That is:

$CA = NS - NI$

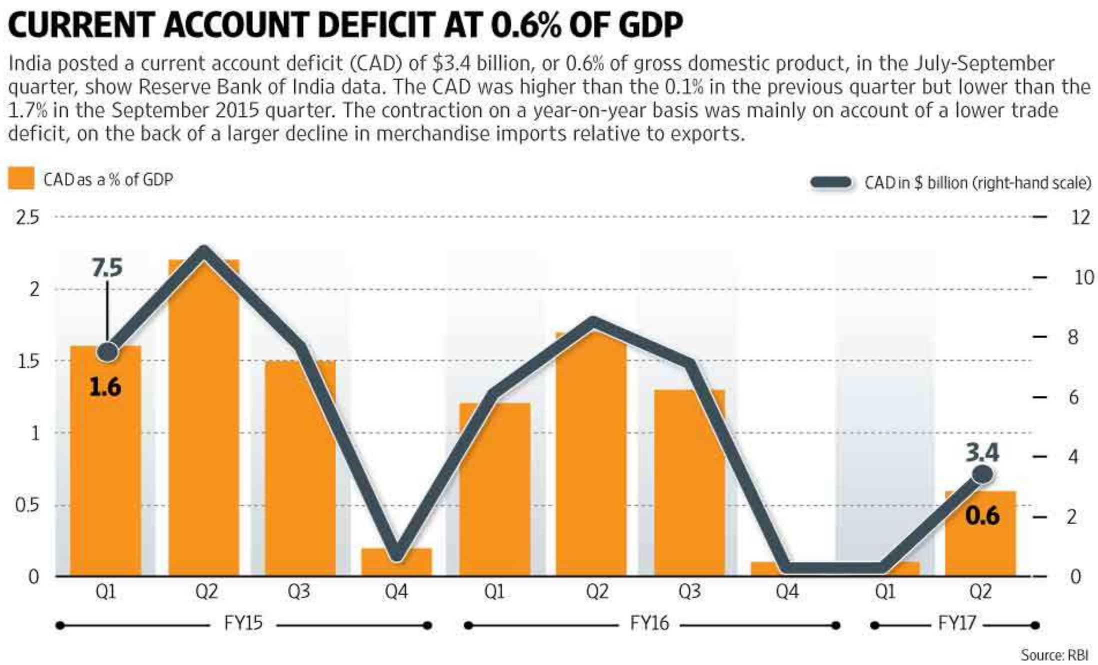
Where *CA* = current account, *NS* = national savings (private plus government sector), *NI* = national investment.

If a nation is earning more than it spends the net effect will be to build up savings, except to the extent that those savings are being used for investment. If consumers can be encouraged to spend more instead of saving; or if the government runs a fiscal deficit to offset private savings; or if the corporate sector divert more of their profits to investment, then any current account surplus will tend to be reduced. In their April 2010 world economic outlook report, the IMF presented a study showing how with the right choice of policy options governments can shift away from a sustained current account surplus with no negative effect on growth and with a positive impact on unemployment.

2. CURRENT ACCOUNT DEFICIT

he current account records revenue transactions of the country with the rest of the world which has short term implications. It includes export and import of goods and services, repayments and dividends from loans and investments. The current account is an important indicator about an economy's health. If an economy is running a current account deficit (CAD), it is absorbing (absorption = domestic consumption + investment + government spending) more than that it is producing. This can only happen when other economies are lending their savings to it (in the form of debt to or direct/ portfolio investment in the economy) or the economy is running down its foreign assets such as official foreign currency reserve. On the other hand, if an economy is running a current account surplus it is absorbing less than that it is producing. This means it is saving. As the economy is open, this saving is being invested abroad and thus foreign assets are being created. India had always recorded a current account deficit which has varied from almost 5% to less than 1%. The present scenario of CAD is much more sustainable with a stronger financial system, increased foreign exchange reserves and a decline in the merchandise imports as compared to exports.

FIGURE 1: CURRENT ACCOUNT DEFICIT



A nation's current account balance is influenced by numerous factors like its trade policies, exchange rate, competitiveness, forex reserves, inflation rate and others. Since the trade balance (exports minus imports) is generally the biggest determinant of the current account surplus or deficit, the current account balance often displays a cyclical trend. During a strong economic expansion, import volumes typically surge; if exports are unable to grow at the same rate, the current account deficit will widen, which is typically the state of India. Conversely, during a recession, the current account deficit will shrink if imports decline and exports may increase to stronger economies. The currency exchange rate plays a significant influence on the trade balance, and therefore, on the current account. An overvalued currency makes imports cheaper and exports less competitive, thereby widening the current account deficit (or narrowing the surplus). An undervalued currency, on the other hand, boosts exports and makes imports more expensive, thus increasing the current account surplus (or narrowing the deficit). Let us take the case of India where emphasis on heavy industrialisation in the second five-year Plan led to a sharp increase in imports. On top of this, the strains of Indo-China conflict of 1962, Indo-Pakistan war of 1965 and severe drought of 1965–66 triggered a major BoP crisis. India's international economic relations with advanced countries also came under stress during the Indo-Pak conflict. Withdrawal of foreign aid led to contraction in capital inflows. Given the low level of foreign exchange reserves and burgeoning trade deficit, India had no option other than to devalue. Rupee was devalued by 36.5 per cent in June 1966(Official rate increased from Rs.4.76 per US dollar to Rs.7.50 per US dollar).

Action to reduce a substantial current account deficit usually involves increasing exports (goods going out of a country and entering abroad countries) or decreasing imports (goods coming from a foreign country into a country). Firstly, this is generally accomplished directly through import restrictions, quotas, or duties (though these may indirectly limit exports as well), or by promoting exports (through subsidies, custom duty exemptions etc.). Influencing the exchange rate to make exports cheaper for foreign buyers will indirectly increase the balance of payments. Less obvious methods to reduce a current account deficit include measures that increase domestic savings (or reduced domestic borrowing), including a reduction in borrowing by the national government.

However, a current account deficit is not always a problem if it is majorly driven by the private sector. It is also known as the "consenting adults" view of the current account, as it holds that deficits are not a problem if they result from private sector agents engaging in mutually beneficial trade. A current account deficit creates an obligation of repayments of foreign capital, and that capital consists of many individual transactions.

It is also worth noting that if we have a current account deficit, in a floating exchange rate this must be balanced by a surplus on the financial / capital account.

3. CAPITAL ACCOUNT

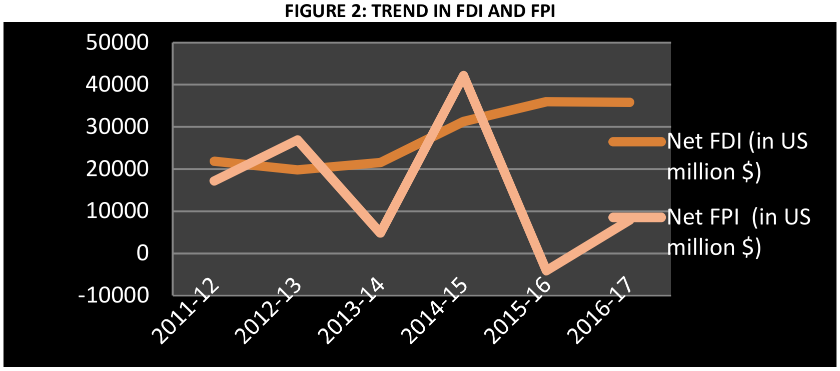
The capital account records the net change in ownership of foreign assets i.e. changes in foreign ownership of domestic assets and changes in domestic ownership of foreign assets. It includes the reserve account (the foreign exchange market operations of a nation's central bank), along with loans and investments between the country and the rest of world. If a country purchases more foreign assets for cash than the assets it sells for cash to other countries, the capital account is said to be negative or in deficit. The capital account includes the foreign direct investment, the portfolio and other investments and the reserve account. Thus foreign investment (direct or indirect) plays a major role in determining the capital account position of a country.

TABLE 1: FOREIGN INVESTMENT INFLOW (US$ Million)

Sl	Items	2016-17	2015-16	2014-15	2013-14	2012-13	2011-12
A	FDI to India	43770	44907	35284	30762	26953	32958
B	FDI by India	7896	8886	4031	9199	7134	11097
C	Net FDI (A-B)	35874	36021	31253	21563	19819	21861
D	GDRs/ADRs	--	373	1271	20	187	597
E	FIIs	7735	-4016	40923	5009	27582	16813
F	Offshore funds and others	--	--	--	--	--	--
G	FPI by India	-177	487	-11	207	878	238
H	Net FPI(D+E+F-G)	7912	-4130	42205	4822	26891	17171
I	FII (C+H)	43786	31891	73458	26385	46710	39032

Data source: RBI

FIGURE 2: TREND IN FDI AND FPI



The foreign investment inflow comprising of the direct and portfolio investment has been on a rising trend since the financial liberalisation in 1991. However, a lot of financial products have been added with time mainly to the capital account which has been leveraged by the corporate sector to access foreign capital. As seen in figure 2 the volatility of portfolio investment is the larger concern for which the country needs to sterilise foreign capital and control capital account transactions.

3.1 CONTROL OF FOREIGN CAPITAL

Capital controls are measures imposed by a state's government aimed at managing capital account transactions. They include outright prohibitions against some or all capital account transactions, transaction taxes on the international sale of specific financial assets, or ceilings on the size of international sales and purchases of specific financial assets. Countries without capital controls that limit the buying and selling of their currency at market rates are said to have full capital account convertibility.

Following the Bretton Woods agreement established at the close of World War II, most nations put in place capital controls to prevent large flows either into or out of their capital account. Both advanced and emerging nations adopted controls; in basic theory it may be supposed that large inbound investments will speed an emerging economy's development, but empirical evidence suggests this does not reliably occur, and in fact large capital inflows can hurt a nation's economic development by causing its currency to appreciate, by contributing to inflation, and by causing an unsustainable "bubble" of economic activity that often precedes financial crisis. The inflows sharply reverse once capital flight takes places after the crisis occurs. Several emerging economies such as Brazil and India have begun to implement or at least signal the possible adoption of capital controls to reduce the flow of foreign capital into their economies.

The Indian economy like many developing nations has gone through a massive restructuring with regard to capital flows in the last ten years. It has also witnessed major financial global crisis. While many developing countries have indeed benefited greatly from inflows of foreign capital, sudden stops and reversals of these flows have resulted in costly crises in some of these countries.

3.2 STERILISATION OF FOREIGN CAPITAL

It refers to the actions/interventions by the country's central bank to safeguard the economy against potential harmful impacts of foreign capital inflows. The key issue under consideration of the monetary authority is to determine whether the capital inflows are of a permanent and sustainable nature or whether such inflows are temporary and subject to reversal. The appropriate management of monetary policy may require the monetary authorities to consider offsetting the impact of such foreign exchange market intervention, partly or wholly, so as to retain the intent of monetary policy through such intervention. Most techniques to offset the impact of forex inflows can be classified as either market based or non-market based approaches. The market based approach involves financial transactions between the central bank and the market, which leads to withdrawal or injection of liquidity, as the case may be. The non-market based approach involves the use of quantitative barriers, rules or restrictions in market activity, which attempt to keep the potential injection of liquidity outside the domestic financial system. The market based approach aimed at neutralising part or whole of the monetary impact of foreign inflows is termed as sterilisation. The steps in the sterilisation process are:

a. decision of the monetary authority to intervene by substituting foreign currency with domestic currency in case of excess capital inflows, and
b. decision to intervene further in the bond or money market to substitute domestic currency so released out of the intervention in forex market with bonds or other eligible paper through open market operation.

Apart from exchange rate flexibility and forex market intervention there are several other policy responses that can be used to manage large capital inflows like trade liberalisation, investment promotion, liberalisation of the capital account, management of external debt, taxation of inflows, and use of foreign exchange reserve and so on.

4. INTERNATIONAL RESERVES

Foreign exchange reserves of a country or the reserve of international currencies other than the home currency facilitate external trade and payment and promote orderly development and maintenance of foreign exchange market. The foreign exchange reserves of India consist of four categories namely a. Foreign Currency Assets, b. Gold, c. Special Drawing Rights (SDRs) and d. Reserve Tranche Position in the IMF. The total foreign exchange reserves reached the milestone of 100 $ billion only in 2004 whereas it took just four years to reach the 300 $ billion mark owing to the immense amount of foreign funds flowing into the country due to opening up the current account and a lot of capital account transactions too. However, the forex reserve fell sharply immediately after the global financial crisis of 2008. India was forced to sell dollars close to U$35 billion in the spot markets in Financial Year 2009 due to 22% depreciation in rupee (against the dollar) in the same fiscal year 2009. Therefore, the stability in foreign exchange rate, reduction in trade deficits, favourable foreign investment options and above all a stable financial system is essential to maintaining foreign exchange reserves as it acts as the first line of defence in case of an economic slowdown. The various crises of the past two decades have highlighted the need for the EMEs to maintain a healthy forex reserve cover as this helps in inspiring confidence of the market in the ability of the central bank to contain volatility at the time of any crisis (Anand Prakash 2012).

5. CONCLUSION

The balance of payment position of India has undergone considerable amount of periodic pressures and evolved through the instabilities arising out of various internal and external crisis. There have been structural changes to address volatility in foreign capital, exchange rate movements, and current account deficits and to have a stronger forex reserve.

TABLE 2: SUMMARY OF BALANCE OF PAYMENTS (US$ Billions)

	2013-14	**2014-15**	**2015-16**	**2015-16 H1**	**2016-17 H1**
Current Account Balances	-32.4	-26.9	-22.2	-14.7	-3.7
Total Capital Account (Net)	47.9	88.3	40.1	25.3	19.2
Reserve Movement (- increase) and (+ decrease)	-15.5	-61.4	-17.9	-10.6	-15.5
Trade balance/GDP (%)	-7.9	-7.1	-6.3	-7.1	-4.6
Invisible Balance/GDP (%)	6.2	5.8	5.2	5.7	4.3
Current Account Balance/GDP (%)	-1.7	-1.3	-1.1	-1.5	-0.3
Net Capital Flows/GDP (%)	2.6	4.3	1.9	2.5	1.8

Source: Economic Survey 2016-17

The summary of balance of payments shows not so worrying figures at present. While the CAD has progressively contracted to 1.1% in 2015-16, the same trend can be expected to be followed and the figure could even be below the 1% level. In 2016-17 (H1), sharp contraction in trade deficit outweighed the decline in net invisible earnings. The downward spiral in international crude oil prices resulted in a decline in oil import bill by around 18 per cent which together with a sharp decline in gold imports led to a reduction in India's overall imports (on BoP basis).According to study (Rajan Goyal 2012), CAD between 2.4 to 2.8 per cent of GDP is sustainable over the medium term under the assumptions that GDP growth ranges between 6.0 and 8.0 per cent, inflation hovering around 5.0 per cent level and interest rate and size of capital flows broadly following their trends in the recent past.

In H1 of 2016-17, India's foreign exchange reserves increased by US$ 15.5 billion on BoP basis (*i.e.*, excluding valuation effects), while in nominal terms (*i.e.*, including valuation effect) the increase was to the tune of US$ 11.8 billion. The loss due to valuation changes of US$ 3.7 billion mainly reflects the appreciation of the US dollar against major currencies.

In the capital account, robust inflow of foreign direct investment (FDI) and net positive inflow of foreign portfolio investment (FPI) were sufficient to finance CAD leading to an accretion in foreign exchange reserves in H1 of 2016-17. Inflows on account of FIIs, particularly into the equity segment, and positive sentiments generated by a narrower CAD in

H1 of 2016-17 also helped the rupee to move in a narrow range. The rupee depreciation has been the lowest among other emerging market economies. There was net inflow of portfolio investment of 7900 US$ Million in 2016-17 as against negative 4100 US$ Million in 2015-16. Thus the balance of payment position looks comforting to the government and promising to foreign investors with constant vigilance from the central bank.

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