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SUMMARY SHEET

OPENING UP OF THE INDIAN ECONOMY, BALANCE OF PAYMENTS

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1 Part I: Balance of Payment

1.1 Meaning of Balance of Payment

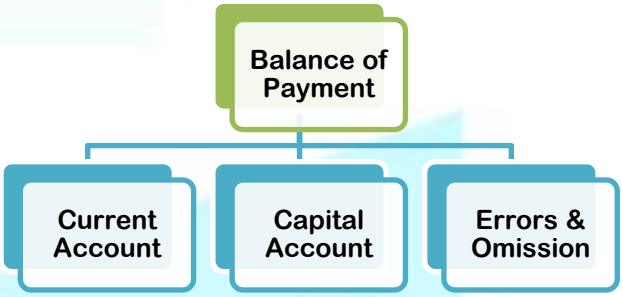
In the modern world, there is hardly any country which is self-sufficient in the sense that it produces all the goods and services it needs. **Every country import from other countries** the goods that cannot be produced at all in the country or can be produced only at an unduly high cost as compared to the foreign supplies.

- Similarly, a **country exports to other countries** the commodities which those countries prefer to buy from abroad rather than producing at home. Besides, **trade of goods and services**, there are **flows of capital.** Foreign capital flows are in the form of **portfolio investment (think of investment by an American Insurance Company in India's stock market) by foreign institutional investors** or in the form of **foreign direct investment (think of an American Car Manufacturer establishing a factory in India)**.
- The **balance of payments** is a systematic **record of all economic transactions** of **residents of a country** with the **rest of the world** during a given period of time.
- This record is so prepared as to **measure the various components of a country's external economic transactions.** Thus, the aim is to present an **account of all receipts and payments** on account of goods exported, services rendered, and capital received by the residents of a country, and goods imported, services received, and capital transferred by residents of the country.

- The main purpose of keeping these records is to **know the international economic position of a country** which helps the Government in making decisions on monetary and fiscal policies on the one hand, and trade and payments policies on the other.

Components of India's Balance of Payment Account are as follows:

- There is a **new classification** in which the **balance of payments** has been divided into **three accounts** — the **current** account, the **financial** account, and the **capital** account.
- This is as per the **new accounting standards** specified by the International Monetary Fund **(IMF)** in the sixth edition of the ***Balance of Payments and International Investment Position Manual (BPM6).***
- India has also made the change, but the **Reserve Bank of India** continues to publish data accounting to the **old classification**.



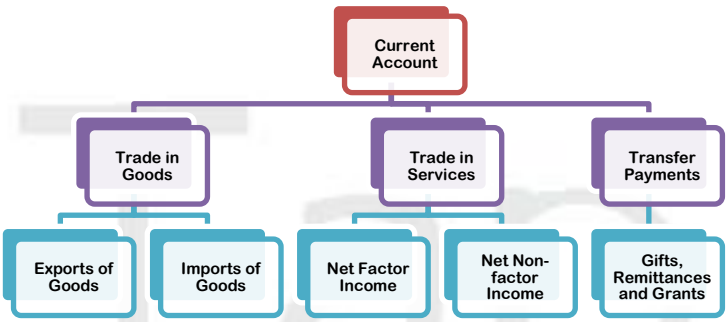
- The most important change is that **almost all the transactions** arising on account of trade in **financial assets** such as **bonds and equity shares** are now placed in the **financial account**. However, RBI continues to publish the balance of payments accounts as per the old system also, therefore the details of the new system are not being given here. The details are given in the **Balance of Payments Manual for India** published by the **Reserve Bank of India** in **September 2010**.

Concept Check
Q. The balance of payments equals
(a) The difference between household spending and income
(b) The difference between government spending and income
(c) A measure of the value of economic transactions between residents of a country and the rest of the world
(d) The difference between inflation and unemployment
(e) None of the above
Answer: C

1.2 Current Account

The current account is a **record of all trade between one nation and other nation**s. It includes payments for **imports and exports** of both **goods and services**. It also includes **monetary gifts or transfer payments** to and from other nations. The **current account** of the balance of payments is record of the **flow of payments between one country and other countries** that result from:

1. The **exchange of goods** (exports and imports), which is the **balance of trade**,
2. The **exchange of services**, summarized as the **balance of invisibles**, and Any **gifts or transfer payments** that do not involve the exchange of goods and services, which is **unilateral transfers**.



1.2.1 Trade in Goods

Trade in goods includes exports and imports of goods.

1.2.1.1 Exports of Goods

Exports of goods is **sale of domestically produced goods to a foreign country**. India, for example, sells a lot of the stuff produced within our boundaries to other countries. In general, **domestic producers** (and their workers) are **elated** with the prospect of **selling their goods to foreign countries**--leading to **more buyers, a higher price, and more profit.**

- **Major exports from India include** precious stones and metals, Refined petroleum, Automobiles, Machinery and mechanical appliances, Organic chemicals, pharmaceutical products, Iron and steel, Textiles and Electrical machinery.

1.2.1.2 Imports of Goods

Imports of goods refer to **goods produced by the foreign sector and purchased by the domestic economy**. In other words, imports are goods purchased from other countries. India, for example, buys a lot of the stuff produced within the boundaries of other countries.

- **Major imports into India include** Petroleum Oil and Lubricants, Capital Goods (Machinery, Base metal, Transport equipment), Gems and Jewellery, Chemical and Related Products (Organic chemicals, Fertilizers), Electronic Goods, Agriculture and Allied Products and Ores and Minerals (Coal, Coke, etc.)
- **Buying foreign goods is expenditure from our country** and it becomes the **income of that foreign country**. Hence, the purchase of foreign goods or imports **decreases the domestic demand for goods and services produced in our country.**
- **Imports, together with exports**, are the essence of **foreign trade**--goods and services that are traded among the citizens of different nations. **Imports and exports** are frequently combined into a **single term, net exports (exports minus imports).**

1.2.2 Trade in Services

Trade in services includes factor income and non-factor income transactions.

1.2.2.1 Net Factor Income from Abroad

While **most production** within a **nation's political boundaries** is undertaken by **resources owned by citizens** of that nation, there are **exceptions**. Some **citizens own resources that do their production in the foreign sector**. And some **resources owned by foreign citizens do their production within the political boundaries of the domestic economy**. Net factor income captures these exceptions.

- Suppose, for example, that a **foreign citizen is employed in the domestic economy**. For example, suppose that **Yuri Boyka**, a **citizen of Russia**, has found **employment in India**. Boyka's productive efforts is included in gross DOMESTIC product of India, but not gross NATIONAL product of India. **Boyka's income falls under the heading of factor payments made to foreign citizens for domestic production**.
- Alternatively, suppose a **domestic citizen is employed in the foreign sector**. For example, suppose that **Vijendar Singh**, a citizen of India, finds **employment in Russia**. Singh's productive efforts are included in gross NATIONAL product of India, but not gross DOMESTIC product India. **Singh's income falls under the heading of factor payments received from the foreign sector by domestic citizens.**
- If Boyka earns Rs 15 lakhs in a given year for his productive efforts in India, while Singh earns Rs 20 lakhs for his work in Russia, then net factor income from abroad is Rs 5 lakhs (Rs 20 lakhs – Rs 15 lakhs). As such, gross DOMESTIC product is Rs 5 lakhs LESS than gross NATIONAL product.
- **Net factor income from abroad** (NFIA) captures the **net flow of income payments (or factor payments) between the domestic economy and the foreign sector**. It is the difference between foreign factor payments to domestic citizens and domestic factor payments to foreign citizens.

- **NFIA is usually quite small**. However, the two **components of net foreign factor income**: (1) foreign payments to domestic citizens and (2) domestic payments to foreign citizens **are more substantial**. Net foreign factor income is small because the **two larger components almost cancel out.**

1.2.2.2 Net Non-Factor Income from Abroad

Non-factor services comprise **shipment, passenger and other transport services, and travel**, as well as current account transactions not separately reported (e.g., not classified as merchandise, nonfactor services, or transfers).

Software exports are classified within invisibles under the sub-head `miscellaneous non-factor services. **Non-factor services refer to all invisible** receipts or payments **not attributable** to any of the **conventional `factors of production'**, i.e., **labour** (remittances from overseas migrants) and **capital** (income from investments, interest payments, dividend repatriation). Thus, non-factor services include **forex earnings and expenses on account of tourism, shipping/freight and various `miscellaneous' sub-heads, under which export of software features.**

KEY DEFINITION

- **Factor Services:** Comprises services of labour and capital, thus covering income from direct investment abroad, interest, dividends, and property and labour income.
- **Net Factor Income from Abroad:** The difference between factor payments received from the foreign sector by domestic citizens and factor payments made to foreign citizens for domestic production. Net factor income from abroad (NFIA) is the key difference between gross DOMESTIC product and gross NATIONAL product
- **Invisibles:** Payments and receipts resulting from international trade in 'invisible' services instead of 'visible' goods. Invisibles include banking, franchising, insurance, interest (on foreign investments), licensing, profit repatriation (from foreign subsidiaries), salary remittances (from nationals employed abroad), shipping, and tourism.

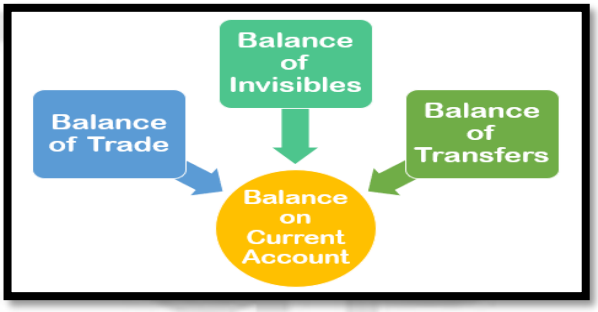
1.2.3 Transfer Payments

Transfers represent **one-sided transactions**, i.e., transactions that **do not have any quid pro quo**, such as **grants, gifts, and migrants' transfers** by way of remittances for **family maintenance, repatriation of savings** and transfer of financial and real resources linked to change in resident status of migrants. **Official transfer** receipts include **grants, donations and other assistance** received by the Government from **bilateral and multilateral institutions**. Similar transfers by Indian Government to other countries are recorded under official transfer payments.

1.2.4 Balance on Current Account

Current Account is in **balance** when **receipts** on current account are **equal to the payments** on the current account. **Current account surpluses** refer to **positive current account balances**, meaning that a country has **more exports than imports** of goods and services. A **current account deficit** refers to **negative current account balances** and indicates that a country is **importing more than it is exporting**.

Current Account Surplus	Balanced Current Account	Current Account Deficit
Receipts > Payments	Receipts = Payments	Receipts < Payments



Balance on Current Account has three components:

- Balance of Trade or Trade Balance
- Balance of Invisibles
- Balance of Transfers

1.2.4.1 Balance of Trade

Balance of Trade (BOT) is the **difference between the value of exports and value of imports of goods** of a country in a given period of time. **Export of goods** is entered as a **credit item in BOT,** whereas **import of goods** is entered as a **debit item in BOT.** It is **also known as Trade Balance**.

- **BOT** is said to be in **balance** when **exports** of goods are **equal** to the **imports** of goods.
- **Surplus BOT or Trade surplus** will arise if country **exports more** goods **than** what it **imports**.
- Whereas **Deficit BOT** or **Trade deficit** will arise if a country **imports more goods than** what it **exports**.

1.2.4.2 Balance of Invisibles

Net Invisibles is the **difference** between the **value of exports and value of imports of invisibles** of a country in a given period of time.

- **Invisibles** include **services, transfers, and flows of income** that take place between different countries. **Services** trade includes both **factor and non-factor income.**
- **Factor income** includes **net international earnings** on **factors of production** (like labour, land, and capital).
- **Non-factor income** is **net sale of service** products like **shipping, banking, tourism, software services,** etc.

1.2.4.3 Balance of Transfer

This is the **difference between gifts or transfers received from other nations and transfers sent** to other nations. In includes gifts or transfers between **individuals**, and perhaps more important, it includes transfers between **governments**.

Note: Difference between Balance of Trade & Current Account

Basis	Balance of Trade (BOT)	Current Account
Components	Balance of trade **includes only visible items.**	Current Account records **both visible and invisible items.**
Scope	It is a **narrow** concept as it is **only a part of current account**	It is a **wider** concept, and it **includes BOT**.

Concept Check

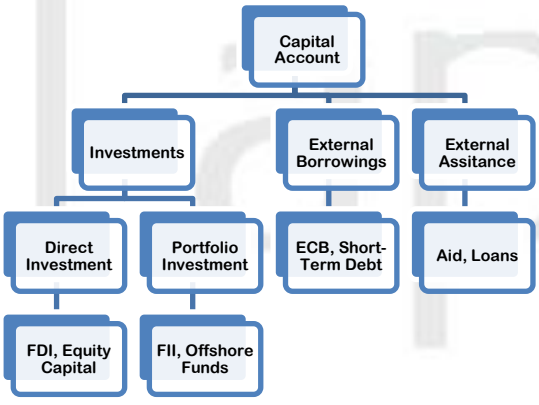
Q. With reference to Balance of Payments, which of the following constitutes/constitute the Current Account?

[A] Balance of trade
[B] Foreign assets
[C] Balance of invisibles
[D] Only B and C
[E] Only A and C

Answer: E

1.3 Capital Account

Capital Account records all **international transactions of assets**. An asset is any one of the forms in which wealth can be held, for example: **money, stocks, bonds, Government debt etc. Purchase of assets** is a **debit item** on the **capital account**. If an **Indian buys a UK Car Company**, it enters **capital account** transactions as a **debit item** (as **foreign exchange is flowing out of**



India). On the other hand, **sale of assets like sale of share** of an **Indian company to a Chinese customer** is a **credit** item on the **capital account.** Following figures classifies the items which are a **part of capital account transactions**. These items are **Foreign Direct Investments (FDIs), Foreign Institutional Investments (FIIs), external borrowings and assistance**.

1.3.1 Investments

Foreign investment involves **capital flows** from **one country to another**, granting extensive **ownership stakes** in **domestic companies and assets**. Foreign investment denotes that foreigner have an active role in management as a part of their investment.

1.3.1.1 Direct Investments

Direct Investment is the **acquisition of controlling interest** in **foreign firms and businesses** from one country in another country. Abbreviated FDI, foreign direct investment can also take the form of **constructing factories, structures, and equipment** (or any form of **physical capital**) in **foreign soil**.

- **Domestic Direct Investment in Foreign Sector:** This is the **net flow of payments** used by **those in the domestic economy** to **purchase physical assets** in **other nations**. (Example: TATA acquisition of Jaguar and Land Rover)
- **Foreign Direct Investment in Domestic Sector:** This is the **net flow of payments** used by those in the **foreign sector** to **purchase physical assets** in the **domestic economy**. (Example: British telecom company picking up stake in an Indian telecom company)

1.3.1.2 Portfolio Investments

Portfolio Investment is the **acquisition of financial assets** (which includes **stock, bonds, deposits, and currencies**) from one country in another country. In contrast to foreign direct investment, which is the acquisition **of controlling interest in foreign firms and businesses**, portfolio investment is foreign **investment into the stock markets**. Most economists consider foreign direct investment more useful than portfolio investment since the latter is generally **regarded as temporal** and can **leave the foreign country** at the **first sign of trouble**.

- **Domestic Portfolio Investment in Foreign Sector:** This is the **net flow of payments** used by those in the **domestic economy** to **purchase financial assets** in **other nations**.
- **Foreign Portfolio Investment in Domestic Sector:** This is the **net flow of payments** used by those in the **foreign sector** to **purchase financial assets** in the **domestic economy.**

Concept Check
Q. Which of the following would include Foreign Direct Investment in India?
[A] Subsidiaries of foreign companies in India
[B] Majority foreign equity holding in Indian companies
[C] Companies exclusively financed by foreign companies
[D] Portfolio investment
[E] All of the above except (d)
Answer: E

1.3.2 External Borrowings

External debt is the portion of a country's debt that was **borrowed from foreign lenders**, including **commercial banks, governments, or international financial institutions**. These loans, including interest, must usually be **paid in the currency in which the loan was made**. To earn the needed currency, the borrowing country may sell and export goods to the lender's country.

- External Commercial borrowings cover all medium/long term loans. It denotes **drawls/ repayment** of loans including **buyers' credit, suppliers' credit**, **floating rate notes (FRNs)**, **commercial paper (CP), bonds, foreign currency convertible bonds (FCCBs)** issued abroad by the Indian corporates etc.

1.3.3 External Assistance

External assistance by India denotes aid extended by India to other foreign Governments under various agreements and repayment of such loans. External Assistance to India denotes **multilateral and bilateral loans received under the agreements between Government of India** and other **Governments/International institutions and repayments of such loans by India.**

1.3.4 Balance on Capital Account

Capital account is in **balance** when **capital inflows** (like receipt of loans from abroad, sale of assets or shares in foreign companies) are **equal to capital outflows** (like repayment of loans, purchase of assets or shares in foreign countries). **Surplus** in **capital account** arises when **capital inflows are greater than capital outflows**, whereas **deficit** in capital account arises when **capital inflows are lesser than capital outflows.**

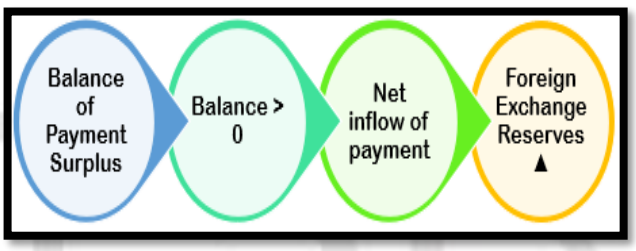
1.4 Representative Balance of Payment for India

No.	Item	Million USD
1.	Exports (of goods only)	150
2.	Imports (of goods only)	240
3.	Trade Balance [2 – 1]	–90
4.	(Net) Invisibles [4a + 4b + 4c]	52
	a. Non-factor Services	30
	b. Income	–10
	c. Transfers	32
5.	Current Account Balance [3+ 4]	–38
6.	Capital Account Balance [6a + 6b + 6c + 6d + 6e + 6f]	41.15
	a. External Assistance (net)	0.15
	b. External Commercial Borrowings (net)	2
	c. Short-term Debt	10
	d. Banking Capital (net) of which	15
	Non-resident Deposits (net)	9
	e. Foreign Investments (net) of which [6eA + 6eB]	19
	A. FDI (net)	13
	B. Portfolio (net)	6
	f. Other Flows (net)	–5
7.	Errors and Omissions	3.15
8.	Overall, Balance [5 + 6 + 7]	0
9.	Reserves Change	0

1.5 Balance of Payment Surplus & Deficit

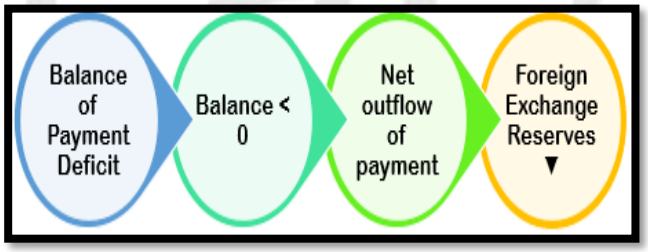
1.5.1 Balance of Payment Surplus

A **balance of payments surplus** would occur if the **balance is greater than zero**. This means that the country has a **net inflow of payments**. More **payments** are **coming in**to the country for **exports, transfers, or investments** than are going out.



1.5.2 Balance of Payment Deficit

Alternatively, a **balance of payments deficit** would occur if the **balance is less than zero**. This means that the country has a **net outflow of payments**. **More payments** are **going out** of the country for **imports, transfers, or investments** than are coming in.



1.5.3 Balance of Payment - Achieving a Balance

The essence of international payments is that just like an **individual who spends more than her income** must **finance the difference** by **selling assets** or by **borrowing**, a country that has a **deficit** in its **current account** (spending more than it receives from sales to the rest of the world) must **finance** it by **selling assets** or by **borrowing abroad**. Thus, **any current account deficit** must be **financed** by a **capital account surplus**, that is, a **net capital inflow**.

Current account + Capital account = 0

In this case, in which a country is said to be in balance of payments equilibrium, the **current account deficit** is **financed** entirely by **international lending without any reserve movements.**

Balance on Current Account Vs. Balance on Capital Account:

Balance on current account and balance on capital account are interrelated.

- A deficit in the current account must be settled by a surplus on the capital account.
- A surplus in the current account must be matched by a deficit on the capital account.

1.5.4 Official Reserve Sale

Alternatively, the country could use its **reserves of foreign exchange** in order to **balance any deficit** in its balance of payments. The **central bank sells foreign exchange** when there is a deficit. This is called **official reserve sale**. The **decrease** (increase) in official reserves is called the **overall balance of payments deficit** (surplus).

- The basic premise is that the **monetary authorities** are the **ultimate financiers** of any deficit in the balance of payments (or the recipients of any surplus). We note that **official reserve transactions** are **more relevant under a regime of fixed exchange rates** than when exchange rates are floating.

1.5.5 Autonomous & Accommodating Transactions

International economic transactions are called **autonomous** when transactions are made due to some **reason other than to bridge the gap in the balance of payments**, that is, when they are **independent of the state of BoP**. One reason could be to **earn profit**. These items are called **'above the line'** items in the BoP. The **balance of payments** is said to be in **surplus** (deficit) if **autonomous receipts** are **greater** (less) than **autonomous payments**.

- **Accommodating transactions** (termed **'below the line' items**), on the other hand, are **determined by the gap in the balance of payments**, that is, whether there is a **deficit or surplus** in the balance of payments. In other words, they are **determined by the net consequences of the autonomous transactions**. Since the **official reserve transactions** are made to **bridge the gap in the BoP**, they are seen as the **accommodating item** in the BoP (all others being autonomous).

1.6 Errors & Omissions

It is difficult to record all international transactions accurately. Thus, we have a **third element of BoP (apart from the current and capital accounts)** called errors and omissions which reflects this.

BoP Deficit	Balanced BoP	BoP Surplus
Overall Balance < 0	Overall Balance = 0	Overall Balance > 0
Reserve Change > 0	Reserve Change = 0	Reserve Change < 0

Note: If there is a positive outcome at the end of the year, the money is automatically transferred to the foreign exchange reserves of the economy. And if there is any negative outcome, the same foreign exchange is drawn from the country's forex reserves.

2 Part II: Exchange Rate

So far, we have considered the accounting of international transactions on the whole, we will now take up a single transaction.

Let us assume that a **single Indian resident** wants to **visit London on a vacation** (an import of tourist services). She will have to **pay in pounds** for her stay there. She will need to know **where to obtain the pounds** and at **what price**. This **price** is known as the **exchange rate**. The market in which national currencies are traded for one another is known as the **foreign exchange market.** The major **participants** in the **foreign exchange market** are **commercial banks, foreign exchange brokers** and other **authorised dealers** and **monetary authorities**.

2.1 Meaning of Exchange Rate

An exchange rate is the **value of one nation's currency versus the currency of another nation** or economic zone. For example, **how many Indian Rupees does it take to buy one dollar**? Suppose the exchange rate is 80, meaning it takes Rs 80 to buy $1.

2.2 Demand & Supply of Foreign Exchange

People demand foreign exchange because they want to **purchase goods and services** from other countries; they want to **send gifts abroad**; and they want to **purchase financial assets** of a certain country. A **rise in price of foreign exchange will increase the cost** (in terms of rupees) of purchasing a foreign good. This **reduces demand for imports** and hence demand for foreign exchange also decreases, other things remaining constant.

- Foreign currency flows into the home country due to the following reasons: exports by a country lead to the **purchase of its domestic goods and services by the foreigners**; **foreigners send gifts** or **make transfers**; and the **assets** of a home country are **bought by the foreigners**.
- A **rise in price of foreign exchange** will **reduce the foreigner's cost** (in terms of USD) while purchasing products from India, other things remaining constant. This **increases India's exports** and hence **supply for foreign exchange may increase.**

2.3 Determination of Exchange Rate

Different countries have different methods of determining their currency's exchange rate. It can be determined through Flexible Exchange Rate, Fixed Exchange Rate or Managed Floating Exchange Rate.

2.3.1 Flexible Exchange Rate

A flexible exchange rate is a **"hands off," non-intervening policy** that allows the **foreign exchange market to adjust to equilibrium** through the **balance of demand and supply** with **no explicit government actions**. The presumption is that the resulting exchange rate generates a better outcome for international trade, the balance of trade, and the balance of payments than what could be achieved through government intervention.

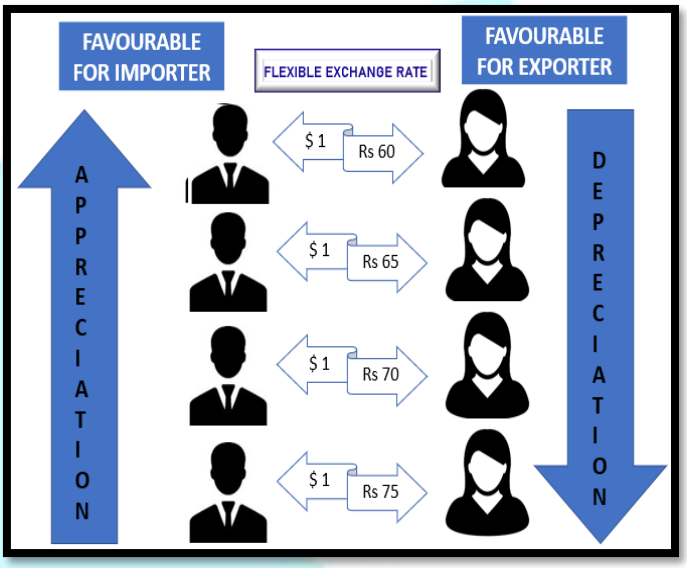
- **Depreciation: Increase in exchange rate** implies that the **price of foreign currency** (dollar) **in terms of domestic currency (rupees) has increased.** This is called **Depreciation of domestic currency** (rupees)

in terms of foreign currency (dollars). This means that the **value of rupees relative to dollar has fallen** and we need to **pay more rupees in exchange for one dollar.**

- **Note:** There is another sense in which we use the term Depreciation in Economy. In domestic economy, depreciation means an asset losing its value due to either its use, wear and tear or due to other economic reasons. Depreciation here means wear and tear. This is also known as capital consumption.
- **Appreciation:** Similarly, in a flexible exchange rate regime, when the **price of domestic currency** (rupees) **in terms of foreign currency (dollars) increases**, it is called **Appreciation** of the **domestic currency** (rupees) in **terms of foreign currency** (dollars). This means that the **value of rupees relative to dollar has risen** and we need to **pay fewer rupees in exchange for one dollar.**

Example of Appreciation/Depreciation

	Exchange Rate (Rs/$) on 01.01.20	Exchange Rate (Rs/$) on 31.01.20
Appreciation	70	65
Depreciation	70	75



Impact of Appreciation/Depreciation on Exports/Imports

	Exports	Imports
Appreciation	Discouraged	Encouraged
Depreciation	Encouraged	Discouraged

Steps that can be taken to control too much Depreciation

- **RBI can start supplying US dollars** in the market to cool down the exchange rate. **Increase in supply of US dollars will pull down the price of US dollars (FOREX Rate)** in the Indian FOREX market. In other words, **depreciation of rupee against US dollar will be checked.**
- **The second measure** which can be taken is to **talk the market down**. In the situation of depreciation, there is a **tendency** for **importers** to **rush in to buy dollars** and **exporters** to **hold back remitting** their earnings on the expectation that the rupee will depreciate further. This **exacerbates the demand-supply matrix** for foreign currency and drives down the rupee further. The RBI can ensure that export earnings come back to the country on time while importers should be urged not to rush in to buy dollars in advance. Alternatively, asking the importers to hedge can be attempted though it cannot be made mandatory. Making **such statements will help lower the speculative element** which comes into the picture every time the rupee keeps falling.
- **Third,** the **government should focus on exports** and to the extent possible, especially on the **tax credit/refund part**, clear the coast for exporters. SMEs (small and medium enterprises) which are dominant in the export market have had **tax refund issues** and this needs to be sorted out. Also, **export finance** is another problem which has been bothering exporters and impediments on this front too need to be removed. But this will work only in the medium term and cannot deliver result immediately because export markets tend to be relatively inelastic and are driven by demand factors.
- RBI would have to **monitor** the other components of **demand for dollars** to ensure that there are limits to the drawal of dollars for other purposes such as **travel, investment, and education.**
- Channels for **external commercial borrowing** should be looked at judiciously. While **urging companies to explore the market** makes sense, it should be noted that un-hedged positions can put on pressure on debt servicing. Nevertheless, in these conditions, **such borrowings would be helpful.**

- Channel for **considering a sovereign bond** or any such scheme for **getting expatriates to invest in such bonds** should be planned in advance — which may not be required if conditions stabilise.
- **Capital flows** need to be **monitored proactively** and this is where **FPIs (foreign portfolio investments)** matter. The strong inflow of FPIs has the power to rein in the rupee.

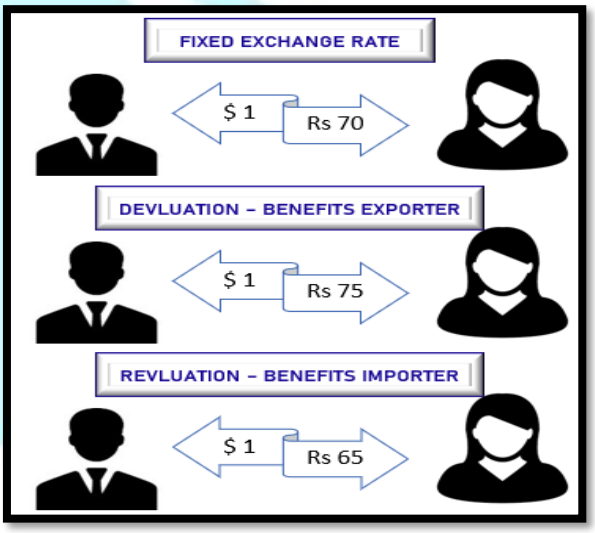
2.3.2 Fixed Exchange Rate

A fixed exchange rate is an **exchange rate that is established at a specific level and maintained through government actions** (usually through monetary policy actions of a central bank). To fix an exchange rate, a **government must be willing to buy and sell currency** in the foreign exchange market in **whatever amounts** are necessary to keep the exchange rate fixed.

1. **Devaluation:** The act of **reducing the price (exchange rate) of one nation's currency in terms of other currencies.** This is usually done by a government to **lower the price of the country's exports** and **raise the price of foreign imports**, which ultimately results in **greater domestic production**. A government devalues its currency by **actively selling it and buying foreign currencies** through the foreign exchange market.
2. **Revaluation:** The act of **increasing the price (exchange rate) of one nation's currency** in terms of other currencies. This is done by the government if it wants to **raise the price of the country's exports** and **lower the price of foreign imports**. This is an appropriate action if the country is running an **undesired trade surplus** with other countries. The procedure for revaluation is for the government to **buy the nation's currency and/or sell foreign currencies** through the foreign exchange market.

Example of Devaluation/Revaluation

	Exchange Rate (Rs/$) on 01.01.20	Exchange Rate (Rs/$) on 31.01.20
Devaluation	70	75
Revaluation	70	65



Impact of Devaluation/Revaluation on Exports/Imports

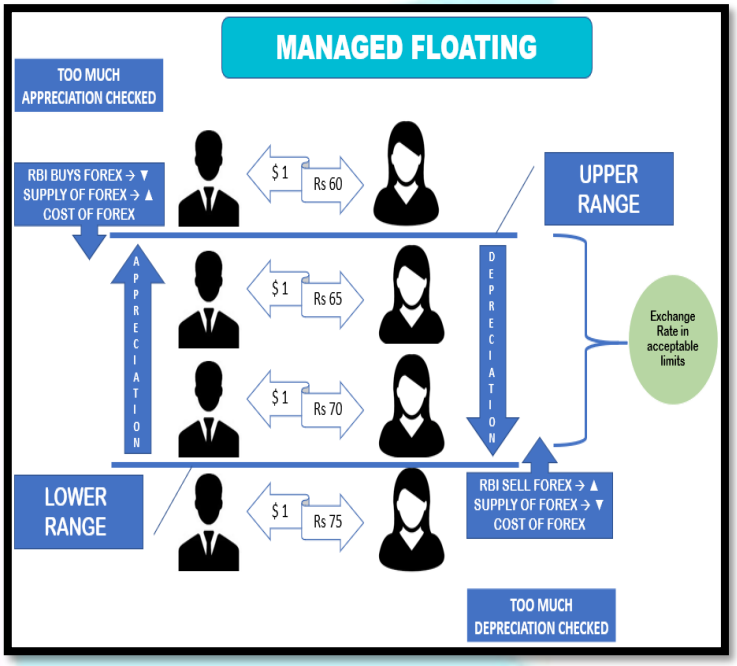
	Exports	Imports
Devaluation	Encouraged	Discouraged
Revaluation	Discouraged	Encouraged

- **Fixing the currency exchange rate below the flexible exchange rate equilibrium** level not only **generates** a balance of **trade surplus** (as the relatively low exchange rate **encourages exports** and **discourages imports**), but it can also temporarily generate a **balance of payments surplus** (as **more payments come in for exports** than go out for imports).
- **Fixing the currency exchange rate above the flexible exchange rate equilibrium** level not only **generates** a balance of **trade deficit** (as the relatively high exchange rate **discourages exports** and **encourages imports**), but it can also temporarily **generate a balance of payments deficit** (as **fewer payments come in for exports** than go out for imports).
- **Note: Some economies**, particularly small ones, **peg their currencies to a major currency or to a basket of currency** in a fixed exchange rate—known as the **pegging of currencies**. At times, the **peg is allowed to glide** smoothly upward or downward—a system which is known as **gliding or crawling peg**. Some economies have a **hard fix of a currency board**. A currency board is working well in Hong Kong while the same failed in Argentina in 2002.

Concept Check
Q. One potential problem for a country with fixed exchange rates is that
(a) a decrease in the demand for its currency can create a drain on foreign exchange reserves used to maintain the exchange rate
(b) the currency is probably prone to depreciation
(c) exchange rates are fixed as a result of the devaluation of the currency
(d) a current account deficit will result
(e) merchandise imports will exceed merchandise exports
Answer: A

2.3.3 Managed Floating (Managed Flexible Exchange Rate)

A **managed flexible exchange rate** is a **combination** of two other exchange rate policies -- **fixed and flexible**. It recognizes the **benefits** of a **flexible exchange rate** automatically **adjusting to equilibrium** in response to foreign exchange market disruptions. However, it also **recognizes** that the **resulting exchange rate** might **not always** generate **desired international trade patterns** and that **government** might need to **step in** to **fix the rate temporarily**.



A managed float exchange rate policy is much like a mother who allows her young son to play outside but does not allow him to leave the backyard. Freely playing in the backyard is the flexible part and not leaving the backyard is the managed/fixed part.

This policy evolved from the **historical inclination** of most **nations to fix exchange rates**, which was then countered with the **theoretical benefits** of **unrestricted flexible exchange rates**. Nations have been prone to fix exchange rates above equilibrium levels as a means of encouraging exports and discouraging imports. But this strategy cannot be simultaneously undertaken by all nations and is usually detrimental to global trade.

A **flexible exchange rate** policy is generally **more efficient** and **lessens** the likelihood of **global trade conflicts**. However, problems can occur if exchange rates **rise or fall substantially in a short period**. As such, **governments step in** to **limit exchange rate changes**, keeping them **within "acceptable" bounds**, keeping them from leaving the backyard where they might run into a street and be injured by a moving vehicle.

With a managed float, the foreign exchange markets carry on normal day-to-day activity as exports, imports, investors, and speculators buy and sell the currencies needed to conduct their business activities. If, however, an exchange rate looks to be rising or falling too much, moving outside the range that the policy players deem acceptable, then they are likely to step into the fray, doing whatever buying and selling of currency is necessary to keep the exchange within bounds.

Suppose, for example, that the Reserve Bank of India and Government of India officials by consensus decide that an exchange rate of Rs 70 (+/- 3) per US dollar is a fair exchange rate. If the exchange rate is floating within this band, no action will be taken to affect it. However, if the exchange rate starts to diverge beyond the limits in either direction, action will be taken to restore it within the band.

2.4 Nominal & Real Exchange Rate

2.4.1 Nominal Exchange Rate

The nominal exchange rate is defined as:

- The **number of units of the domestic currency** that are **needed to purchase** a unit of a given **foreign currency.**
- For example, if the **value of the US Dollar** in terms of the **INR** is **70**, this means that the **nominal exchange rate** between the **dollar** and the **rupee** is **70**. We need to give 70 rupees to buy one dollar.
- It's called nominal because it **takes into account only the numerical value** of the currencies. It **doesn't take into account the purchasing power** of the currencies. There is another exchange rate called "real exchange rate" that takes the purchasing power into account.

Concept Check
Q. The rate at which you can exchange your domestic currency with the foreign currency at any financial institutions like banks, NBFCs etc. is known as…
(a) Real effective exchange rate
(b) Nominal effective exchange rate
(c) Real exchange rate
(d) Nominal exchange rate
(e) None of the above
Answer: D

2.4.2 Real Exchange Rate

The real exchange rate is a bit more complicated than the nominal exchange rate. While the nominal exchange rate tells how much foreign currency can be exchanged for a unit of domestic currency, the real exchange rate tells **how much the goods and services in the domestic country can be exchanged for the goods and services in a foreign country**.

- The difference between the nominal and the real exchange rate is that the **real exchange rate takes into account the domestic and foreign prices**, as summarized in the following formula:

$$\text{Real Exchange Rate} = \text{Nominal Exchange Rate} \times \frac{\text{Price of Good X (abroad)}}{\text{Price of Good X (home)}}$$

- Real exchange rate can be defined as the rate that **takes into account inflation differential** between the countries. Suppose the **rupee was trading at Rs 70 to a dollar** at the beginning of 2019.
- Assuming a **10% inflation in the Indian economy** and **5% inflation in the US economy** for the whole year, then this model says the **rupee should depreciate by 5% (10%-5%) to Rs 73.50 to a dollar**, other things being equal.

2.5 NEER & REER

2.5.1 Nominal Effective Exchange Rate

The nominal effective exchange rate (NEER) is an **unadjusted weighted average rate** at which **one country's currency exchanges for a basket of multiple foreign currencies**. The nominal exchange rate is the amount of domestic currency needed to purchase foreign currency. In economics, the NEER is an **indicator of a country's international competitiveness in terms of the foreign exchange (forex) market.**

- **Unlike the relationships in a nominal exchange rate, NEER is not determined for each currency separately.** Instead, one individual number, typically an index, expresses how a domestic currency's value compares against multiple foreign currencies at once.

- If a **domestic currency increases against a basket of other currencies** inside a floating exchange rate regime, **NEER is said to appreciate**. If the **domestic currency falls** against the basket, the **NEER depreciates.**

Concept Check
Q. With reference to Nominal Effective Exchange Rate (NEER), which of the following options is not correct?
(a) It is an indicator of a country's international competitiveness
(b) NEER is not determined for each currency separately.
(c) A rise in NEER indicates appreciation of currency
(d) It does not account for the varying levels of inflation in different countries.
(e) None of the above
Answer: E

2.5.2 Real Effective Exchange Rate

The NEER may be **adjusted to compensate for the inflation rate** of the home country relative to the inflation rate of its trading partners. The resulting figure is the real effective exchange rate (REER).

In India, **Reserve Bank of India compiles NEER & REER indices.**

Following Indices of Real Effective Exchange Rate (REER) and Nominal Effective Exchange Rate (NEER) of the Indian Rupee are published by the RBI:

1. **36-Currency Export and Trade Based Weights (Base: 2004-05=100)**
   - **1.1. Trade-Based Weights**
     - 1.1.1. NEER
     - 1.1.2. REER
   - **1.2. Export-Based Weights**
     - 1.2.1. NEER
     - 1.2.2. REER
2. **6-Currency Trade Based Weights**
   - **2.1. Base: 2004-05 (April-March) =100**
     - 2.1.1. NEER
     - 2.1.2. REER
   - **2.2. Base: 2017-18 (April-March) =100**
     - 2.2.1. NEER
     - 2.2.2. REER

- For 6-Currency index, base year 2016-17 is a moving one, which gets updated every year.
- REER figures are based on Consumer Price Index (combined).
- A rise in the level of index indicates appreciation of currency and vice-versa.
- The indices are also a better reflection of the position of a currency in comparison with the countries in which India has large export and trade interest.

3 Part III: Types of Currency

In this part we will be developing an understanding of different types of currencies - hard, soft, hot, heated, dear and cheap. These are fascinating topics. Same currency bill can be termed as hard, heated, dear or cheap depending upon the context of discussion and the prevailing scenario. Let us learn more!

3.1 Hard Currency

- It is the international currency in which the **highest faith** is shown and is needed by every economy. The **strongest currency** of the world is one which has a **high level of liquidity**.

- Basically, the **economy** with the **highest as well as highly diversified exports** that are **compulsive imports for other countries** (as of high-level technology, defence products, life saving medicines and petroleum products) will also create high demand for its currency in the world and become the hard currency. It is **always scarce**.
- Up to the second world war, the best hard currency was the **Pound Sterling (£)** of the UK, but soon it was replaced by the **US Dollar**. Some of the best hard currencies of the world today are the **US Dollar, the Euro (€), Japanese Yen (¥) and the UK Sterling Pound (£).**

3.2 Soft Currency

- Soft currency is a currency which is **hypersensitive and fluctuates** frequently. Such currencies **react very sharply** to the **political or the economic situation** of a country. It is also known as **weak currency** due to its **unstable** nature. Such currencies mostly exist in **developing countries** with relatively **unstable governments**.
- Soft currencies cause high volatility in exchange rates as well, making them **undesirable** by **foreign exchange dealers**. These currencies are the **least preferred for international trade or holding reserves.**

3.3 Hot Money

- Hot money signifies currency that **quickly and regularly moves between financial markets**, that ensures investors lock in the **highest available short-term interest rates**. Hot money continuously shifts from **countries with low-interest rates to those with higher rates**.
  - These financial transfers **affect the exchange rate** and potentially impact a **country's balance of payments**. Hot money can **also refer to stolen money** that has been especially marked, so that it may be traced and identified.
- **Hot money** is a term of the forex market and is a **temporary name for any hard currency**. Due to certain reasons, if a **hard currency is exiting an economy at a fast pace** for the time, the hard currency is known to be **hot**.
- **Foreign Portfolio Investment** is often **referred to as 'hot money'** because of its tendency to **flee at the first signs of trouble** in an economy or improvement in investment attractiveness elsewhere in the world.

3.4 Heated Currency

A term used in the forex market to denote the domestic currency which is **under enough pressure (heat) of depreciation** due to a hard currency's high tendency of exiting the economy (since it has become hot). It is also known as currency under heat or under hammering.

3.5 Cheap Currency

A term first used by the **economist J. M. Keynes (1930s).** If a government starts re-purchasing its bonds before their maturities (at full-maturity prices) the money which flows into the economy is known as the cheap currency, also called cheap money. In the banking industry, it means a period of comparatively lower/softer interest rates regime.

3.6 Dear Currency

This term was popularised by economists in early 1930s to show the opposite of the cheap currency. When a government issues bonds, the money which flows from the public to the government or the money in the economy in general is called dear currency, also called as dear money. In the banking industry, it means a period of comparatively higher/costlier interest rates regime.

4 Part IV: Exchange Rate Management in India

Are Indians free to convert their currency into, let us say, the US dollar and vice versa? Or are there some restrictions? Should Indians have this freedom? What are the costs of this freedom? These are some of the

questions that we will be answering in this part when we discuss the concept of convertibility. We will end this part by looking at India's Foreign Exchange Reserve - its importance and its constituents.

4.1 The Indian Experience

- India's exchange rate policy has evolved in line with international and domestic developments.
- **Post-independence**, in view of the prevailing **Bretton Woods system**, the **Indian rupee was pegged to the pound sterling** due to its historic links with Britain. A major development was the devaluation of the rupee by 36.5 per cent in June 1966. With the **breakdown of the Bretton Woods** system, and the **declining share of UK in India's trade**, the **rupee was delinked from the pound sterling in September 1975**.
- During the period between **1975 to 1992**, the **exchange rate** of the rupee was officially **determined by the Reserve Bank** within a **nominal band of plus or minus 5 per cent** of the **weighted basket of currencies** of India's major **trading partners**.
- The Reserve Bank intervened on a day-to-day basis which resulted in wide changes in the size of reserves. The exchange rate regime of this period can be described as an **adjustable nominal peg with a band.**
- The **beginning of 1990s** saw significant **rise in oil prices** and **suspension of remittances** from the Gulf region in the wake of the Gulf crisis. This, and other domestic and international developments, led to **severe balance of payments problems** in India.
- The **drying up of access to commercial banks and short-term credit** made financing the current account deficit difficult.
- India's **foreign currency reserves fell rapidly** from **US $ 3.1 billion in August to US $ 975 million on July 12, 1991.**
- Apart from measures like **sending gold abroad**, **curtailing non-essential imports**, approaching the **IMF and multilateral and bilateral sources for loans**, introducing **stabilisation and structural reforms (often referred to as Liberalisation, Privatisation & Globalisation (LPG) reforms)**, there was a **two-step devaluation of 18–19 per cent of the rupee on July 1 and 3, 1991.**
- In March **1992, the Liberalised Exchange Rate Management System (LERMS)** involving dual exchange rates was introduced. Under this system**, 40 per cent of exchange earnings** had to be **surrendered at an official rate** determined by the Reserve Bank and **60 per cent** was to be **converted at the market determined rates.**
- The **dual rates were converged into one from March 1, 1993**; this was an important step towards **current account convertibility (a concept that we will be discussing in the next section)**, which was finally achieved in August 1994 by accepting **Article VIII of the Articles of Agreement of the IMF.**
- The **exchange rate of the rupee thus became market determined**, with the Reserve Bank ensuring orderly conditions in the foreign exchange market through its sales and purchases.

4.2 Convertibility of Rupee

4.2.1 Concept of Convertibility

Convertibility of currency means when **currency of a country** can be **freely converted** into **foreign exchange** at **market determined rate of exchange**. For example, convertibility of rupee means that **those who have foreign exchange** (e.g., US dollars, Pound Sterling etc.) can get them **converted into rupees and vice-versa** at the **market determined rate of exchange.**

4.2.2 Concept of Current Account Convertibility

- Current account convertibility means when **foreign exchange** (e.g., Pound Sterling, U.S.Dollar etc) received for **export of merchandise and services** can be **freely converted into Indian rupees** and **vice-versa** in case of imports.
- At the **beginning of the 1991 'LPG' reforms (Liberalisation, Privatisation & Globalisation)**, the **rupee** was made **partially convertible** for goods, services, and merchandise only. During the **mid-1990s**, the

rupee was **fully made current account convertible** (operationalised on 19 August 1994) for all trading activities, remittances, and invisibles.

- It means that the **full amount of the foreign exchange** required by someone for **current account transaction purposes** will be made **available to him at official exchange rate** and there could be an **unprohibited outflow of foreign exchange** (earlier it was partially convertible).
- India was obliged to do so as per **Article VIII of the IMF** which prohibits any exchange restrictions on current international transactions (keep in mind that India was under pre-conditions of the IMF since 1991).

4.2.3 Concept of Capital Account Convertibility

- By **capital account convertibility** we mean that in respect of **capital flows** (that is, flows of **portfolio capital**, **direct investment flows**, flows of **borrowed funds**) a **currency is freely convertible into foreign exchange** and vice-versa at market determined exchange rate.
- After the recommendations of the **S.S. Tarapore Committee (1997) on Capital Account Convertibility**, India has been moving in the **direction of allowing full convertibility in capital account**, but with required precautions. India is still a country of **partial convertibility in the capital account.**
- **Rupee** continues to remain **capital account non-convertible**. One can still bring in foreign capital or take out local money for these purposes, but there are **ceilings imposed by the government** that **require approvals**. Note the following points in this regard:
  1. Indian corporates are allowed **full convertibility in the automatic route up to $500 million** overseas ventures (investment by Ltd. companies in foreign countries allowed) per annum.
  2. Indian corporates are allowed to **prepay their external commercial borrowings (ECBs) via automatic route if the loan is above $500 million per annum.**
  3. **Individuals are allowed to invest** in foreign assets, shares, etc., up to the **level of $2,50,000 per annum.**

4.2.4 Is Indian National Rupee Convertible?

Until the early **1990s** (pre-reform period), anyone willing to **transact in a foreign currency** would need **permission** from the Reserve Bank of India (**RBI**), regardless of the purpose. People wanting to engage in foreign travel, foreign studies, the purchase of imported goods, or to get cash for foreign currencies received (like with exports) were all required to go through the RBI. All such **forex exchanges** occurred at **pre-determined forex rates finalized by the RBI**.

- **After liberal economic reforms** were introduced in **1991**, many significant developments occurred that impacted the way forex transactions were conducted. **Exporters and importers** were allowed to **exchange foreign currencies** for the trade of unbanned goods and services, there was **easy access to forex for studying or traveling abroad**, and a **relaxation** on foreign business and investments with minimal (or no) restrictions depending on the industry sectors.
- However, **Indians still require regulatory approval** if they want to **invest an amount above a pre-determined threshold level** for the purpose of investments or purchasing assets overseas. Similarly, **incoming foreign investments** in certain sectors like insurance or retail are **capped at a specific percentage** and require **regulatory approvals** for higher limits.
- As of **present**, the Indian **rupee** is a **partially convertible currency**. This means that although there is a lot of freedom to exchange local and foreign currency at market rates, a **few important restrictions remain for higher amounts**, and these still **need approval**.
  - The **regulators** also **intervene** from time-to-time to **keep the exchange rates** within **permissible limits** instead of keeping the INR as a completely free-floating currency left to market dynamics. In the case of **extreme volatility in rupee exchange rates**, the **RBI swings into action** by purchasing/selling U.S. dollars (kept as foreign reserve) to stabilize the rupee.

- **Full convertibility** would mean the **rupee exchange rate would be left to market factors without any regulatory intervention**. There may be **no limit on inflow or outflow of capital** for various purposes including **investments, remittances, or asset purchases/sales.**

4.2.5 Advantages of a Fully Convertible Currency

- **Sign of Stable and Mature Markets:** Regulators like to keep control over their territories. Free and open entry to an enormous number of global market participants would increase the risk of losing regulatory control due to large market size and a huge flow of capital. Opening up to a fully convertible currency is a solid sign that a country and its **markets are stable and mature** enough to **handle the free and unrestricted movement of capital**, which attracts investments making the economy better.
- **Increased Liquidity in Financial Markets:** Full capital account convertibility opens up the country's markets to global players including **investors, businesses, and trade partners**. This allows **easy access to capital** for different businesses and sectors, positively impacting a nation's economy.
- **Improved Employment and Business Opportunities:** With **increased participation** from **global players**, new businesses, strategic partnerships, and direct investments flourish. It also helps in the **creation of new employment opportunities** across various industry sectors, as well as **nurturing entrepreneurship** for new businesses.
- **Onshore Rupee Market Development:** The growing international interest in the Indian rupee is evident from the development of offshore rupee markets in locations like Dubai, London, New York, and Singapore. Trading of the INR is still far lower than other currencies such as the euro. In 2018, INR contracts traded against the dollar an average of 11,666 times per day compared to 193,512 contracts converted from Euro to USD. **Making the rupee fully convertible would enable greater trades and global flow of the Indian currency**, helping national markets with improved liquidity, better regulatory purview, and reduced dependence and risks from offshore market participants.
- **Easy Access to Foreign Capital:** Local businesses can benefit from **easy access to foreign loans at comparatively lower costs**—lower interest rates. Indian companies currently have to take the ADR/GDR route to list on foreign exchanges. After full convertibility, they will be able to directly raise equity capital from overseas markets.
- **Better Access to a Variety of Goods and Services:** Amid current restrictions, one does not see much variety in India for foreign goods and services. Walmart (WMT) and Tesco stores aren't that common, although a handful exist in partnership with local retail chains. Full convertibility will **open doors for all global players to the Indian market**, making it more **competitive** and better for consumers and the economy alike.
- **Progress in Multiple Industry Sectors:** Sectors like **insurance, fertilizers, retail, etc. have restrictions on foreign direct investments (FDIs).** Full convertibility will open the doors of many big international players to invest in these sectors, enabling much-needed reforms and bringing variety to the Indian masses.
- **Outward Investments:** Fancy buying a house on the coast of Florida or buying a million-dollar yacht in London? At present, any Indian individual or business would need permission from authorities to do so. After full convertibility, there will be **no limits on the amounts exchanged and no need for approvals**.
- **Improved Financial System:** The **Tarapore Committee**, which was tasked with **assessing the full convertibility of the rupee**, has noted these benefits after full rupee convertibility, including:
  - ✓ Indian businesses will be able to issue **foreign currency-denominated debt to local Indian investors.**
  - ✓ Indian businesses will be able to **hold foreign currency deposits in local Indian banks for capital requirements.**
  - ✓ Indian banks will be able to **borrow and/or lend to foreign banks in foreign currencies**.
  - ✓ Easy options to **buy/sell gold freely** and offer **gold-based deposits and loans** with higher (or even uncapped) limits.

4.2.6 Disadvantages of a Fully Convertible Currency

- **High Volatility:** Amid a lack of suitable regulatory control and rates subject to open markets with a large number of global market participants, **high levels of volatility, depreciation, or appreciation in forex rates** may happen, challenging the country's economy.
- **Foreign Debt Burden: Businesses can easily raise foreign debt**, but they are **prone to the risk of high repayments if exchange rates become unfavorable**. Imagine an Indian business taking a U.S. dollar loan at a rate of 4%, compared to one available in India at 7%. However, if the U.S. dollar appreciates against the Indian rupee, more rupees will be needed to get the same number of dollars, making the repayment costly.
- **Effects on Balance of Trade and Exports**: A **rising, unregulated rupee** makes Indian **exports less competitive** in the international markets. **Export-oriented economies** like India and China prefer to **keep their exchange rates lower to retain the low-cost advantage**. Once the regulations on exchange rates go away, India risks losing its competitiveness in the international market.
- **Lack of Fundamentals:** Full capital account convertibility has worked well in well-regulated nations that have a robust infrastructure in place. India's basic challenges—a **high dependence on exports, burgeoning population, corruption, socio-economic complexities, and challenges of bureaucracy**—may lead to economic setbacks post-full rupee convertibility.

4.3 India's FOREX Reserves

4.3.1 What are FOREX Reserves?

Most countries have adopted the definition suggested by the International Monetary Fund (Balance of Payments Manual, and Guidelines on Foreign Exchange Reserve Management, 2001) which defines **forex reserves** as **external assets** that are **readily available to and controlled by monetary authorities** for **direct financing of external payments imbalances**, for **indirectly regulating** the **magnitudes of such imbalances** through **intervention in exchange markets** to affect the **currency exchange rate**, and/or for other purposes.

4.3.2 RBI Act 1934 & FOREX Reserves

In India, the **Reserve Bank of India Act 1934** contains the **enabling provisions** for the **RBI to act as the custodian of foreign reserves** and **manage reserves** with defined objectives. The powers of being the custodian of foreign reserves is enshrined, in the first instance, in the preamble of the Act. The **'reserves'** refer to both foreign reserves in the form of **gold assets** in the **Banking Department** and **foreign securities** held by the **Issue Department**, and **domestic reserves** in the form of **'bank reserves'**. The composition of foreign reserves is indicated, a minimum reserve system is set out, and the instruments and securities in which the country's reserves could be deployed are spelt out in the relevant Sections of the RBI Act.

4.3.3 Objectives of Holding FOREX Reserves

- Maintaining **confidence in monetary and exchange rate policies**.
- Enhancing **capacity to intervene in forex markets**.
- **Limiting external vulnerability** by maintaining **foreign currency liquidity** to absorb shocks during times of crisis including national disasters or emergencies.
- **Providing confidence** to the markets especially **credit rating agencies** that **external obligations can always be met**, thus **reducing the overall costs** at which **forex resources are available** to all the market participants.
- Adding to the **comfort of the market participants**, by **demonstrating the backing of domestic currency by external assets**.
- **Forex reserves provide an import cover.** Import Cover measures the number of months of imports that can be covered with foreign exchange reserves available with the central bank of the country.

At a formal level, the objective of reserve management in India could be found in the RBI Act, where the relevant part of the preamble reads as 'to use the currency system to the country's advantage and with a view to securing monetary stability'.

4.3.4 Components of India's FOREX Reserves

1. **Foreign currency assets (FCAs)**: The foreign currencies which are held as forex reserves include US dollar, Euro, British pound sterling, Japanese yen, and Chinese Yuan.
2. **Special Drawing Rights with IMF**: Special drawing rights, or SDR, are an artificial currency instrument created by the International Monetary Fund, which uses them for internal accounting purposes.
   - The value of the SDR is calculated from a weighted basket of major currencies, including the U.S. dollar, the euro, Japanese yen, Chinese yuan, and British pound.
   - SDR interest rate (SDRi) provides the basis for calculating the interest rate charged to member countries when they borrow from the IMF and paid to members for their remunerated creditor positions in the IMF.
3. **Gold reserves**
4. **Reserve Bank of India's reserve position with the IMF**: Reserve tranche is a portion of the required quota of currency each member country must provide to the International Monetary Fund (IMF) that can be utilized for its own purposes.

The largest component of the **Foreign Exchange Reserves** constitutes of **foreign currency assets (FCAs).** Changes in FCAs occurs due to the selling and purchasing of foreign exchange by the Reserve Bank of India, externally received income of the Government of India from the deployment of foreign exchange reserves and income due to the revaluation of assets.

Concept Check
Q. Which one of the following groups of items is included in India's foreign-exchange reserves?
(a) Foreign-currency assets, Special Drawing Rights (SDRs) and loans from foreign countries
(b) Foreign-currency assets, gold holdings of the RBI and SDRs
(c) Foreign-currency assets, loans from the World Bank and SDRs
(d) Foreign-currency assets, gold holdings of the RBI and loans from the World Bank
(e) None of the above
Answer: B