Ref: Samuelson, P. & Nordhaus, W.: Economics, Indian Adaptation, 19th Edition

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APPENDIX 27

TRENDS IN FOREIGN TRADE

Growing openness of the Indian economy is reflected in Figure 27A-1. Exports of goods and services as a percentage of GDP declined in the 1950s and the 1960s. After a moderate increase in the 1970s, a sharp upward trend is observed since the mid-1980s. The import ratio too shows an upward trend from the 1970s. With an export share of more than 20%, the Indian economy is more open than the United States economy.

INDIA'S BALANCE OF PAYMENTS

A summary of India's Balance of Payments (BOP) for 2008-09 is provided in Table 27A-1. It is classified into the following items:

A. Current Account
B. Capital Account
C. Errors and Omissions
D. Overall balance
E. Monetary movements

Current Account

It is classified into merchandise and invisibles.[1] The latter comprises of services, transfers, and

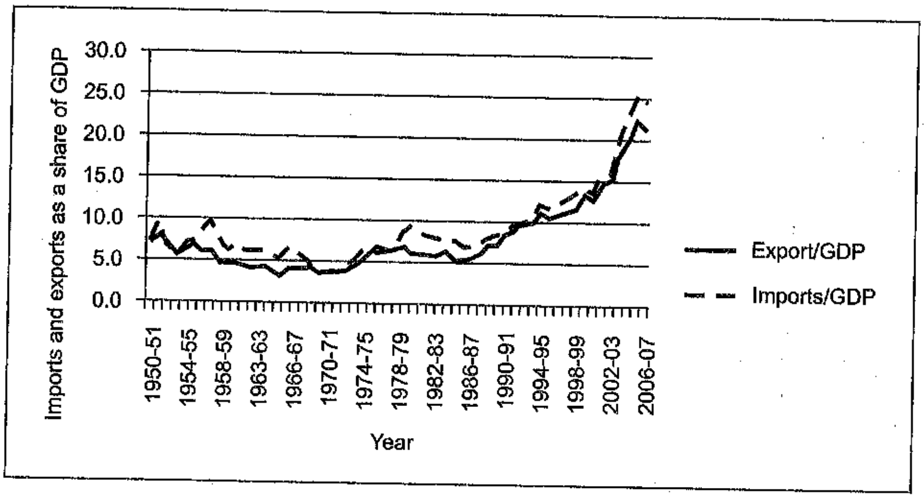

FIGURE 27A-1. Growing Openness of the Indian Economy

Source: *National Accounts Statistics,* available at the website of the Ministry of Statistics and Programme Implementation, Government of India, www.mospi.gov.in. These shares are exports and imports of goods and services as a percentage of GDP at current market prices.

[1] For the definitions of the different terms used in BOP table and also for an understanding of the conceptual issues involved see, *Balance of Payments Manual,* accesses from the website of the International Monetary Fund, www.imf.org and *Manual on Financial and Banking Statistics,* March 2007, Chapter V on External Sector Statistics, accessed from the RBI website, www.rbi.org.in. National BOP tables are prepared using IMF guidelines.

income. Services include a diverse range—travel, transportation, software services, and other business, financial, and communication services. Transfers are classified into official transfers [such as grants/donations received from other countries (credit) or given to other countries (debit)] and private transfers which include remittances by Indians abroad back home. Income comprises mainly of investment income and also includes compensation of employees, i.e., payments received by residents for work done abroad (credit) and payments to non-residents for work done in India (debit). (Whether a person is resident or not is decided not by nationality but where the person resides. Thus, Indians working in USA are treated as residents of USA for the purpose of balance of payments.) As can be seen from Table 27A-1, India has a deficit (excess of debits over credits) in the merchandise account, but a surplus in the invisibles trade. Two important factors contributing to this are India's exports of software services and private transfers (remittances). India is now one of the largest exporters of software services and her proficiency in the sector is internationally recognized. Remittances by Indians working in places such as the United States and the Middle East are a major source of foreign exchange earnings by India.

Capital Account

It is classified into foreign investment, loans, banking capital, rupee service debt, and other capital. Foreign investment is further

TABLE 27A-1. *India's Balance of Payments, 2008-09 in Rs Crores*

Items	Credit	Debit	Net
A) Current Account	1544992	1677263	-132271
A.1) Merchandise	798956	1341069	-542113
A.2) Invisibles	746036	336194	409842
A.2.a) Services, of which	465795	237017	228778
Software Services	215588	12698	202890
A.2.b) Transfers, of which	214736	12556	202180
Private Transfers	211705	10655	201050
A.2.c) Income, of which	65505	86621	-21116
Investment Income	61717	80557	-18840
B) Capital Account	1373684	1341303	32381
B.1) Foreign Investment	743485	731725	11760
B.1.a) Foreign Direct Investment	164473	87651	76822
B.1.b) Foreign Portfolio Investment	579012	644074	-65062
B.2) Loans	276833	257549	19284
B.2.a) External Assistance	23535	11100	12435
B.2.b) Commercial Borrowings (MT & LT)	71626	33617	38009
B.2.c) Short-term Credit to India	181672	212832	-31160
B.3) Banking Capital	294488	314356	-19868
B.4) Rupee Debt Service	0	476	-476
B.5) Other Capital	58878	37197	21681
C) Errors and Omissions	2775	0	2775
D) Overall Balance	2921451	3018566	-97115
E) Monetary Movements	97115	0	97115
E.1) I.M.F	0	0	0
E.2) Foreign Exchange Reserves (decrease)	97115	0	97115

Source: Reserve Bank of India, ***Handbook of Statistics on Indian Economy***, available at the website of RBI, www.rbi.org.in.

categorized into foreign direct investment and portfolio investment. The former is mainly foreign equity capital in companies in India in which majority voting stock is held by a single foreign company or a group. The latter includes not only FII (foreign institutional investment) in India's stock market, but also funds raised through GDRs (global depositary receipts) and ADRs (American depositary receipts) by Indian companies and through off-shore funds. Bilateral (government to government) and multilateral (from agencies such as IMF and the World Bank) loans are included under external assistance. A distinction is made between short-term (less than one year), medium-term (MT), and long-term (LT) commercial loans. Deposits made by non-residents in banks in India are considered as a credit item under banking capital. The latter also includes items such as rupee over draft to non-resident banks and foreign currency holdings. Rupee service debt is the remnant of rupee trade with the erstwhile USSR and some other countries. The debit item is the repayment of the principal and payment of interest. Other capital includes items such as leads and lags in export receipts, and India's subscription to international agencies.

Overall Balance

It shows the aggregate figures after adding up all the items in the current and capital accounts adjusting for errors and omissions. In 2008-09, India had an overall deficit of Rs. 97,115 crores. Monetary movements reflect the nature of financing of the deficit/surplus. If India had taken a loan from the IMF to pay for the deficit, then there would have been a credit entry in IMF head of the BOP table by that amount. But India actually paid for the deficit in 2008-09 by using the foreign exchange reserves held by RBI leading to a decrease in the reserves. The decrease in foreign exchange reserves is shown as credit—this made available foreign exchange for the purpose of the BOP deficit financing. Similarly in case of overall surplus, foreign exchange reserves go up and this is shown as a debit item in the BOP table. It may also be pointed out in this context that 2008-09 has been an exception in recent years. India lately has been experiencing a surplus in overall balance (see the appendix to Chapter 28). In 2007-08, for example, India had a surplus of Rs 369,689 crores. This resulted in accumulation of foreign exchange reserves by that amount and is shown accordingly as a debit item under 'monetary movements.'

Current and Capital Account Convertibility

In accordance with the planning strategy adopted in India, restrictions were imposed both on current account and capital account transactions. After the reforms since 1991 the situation has changed dramatically. India now is almost fully convertible in current account—restrictions on current account transactions, for example, on imports of goods, travel abroad have been eliminated or drastically reduced. Capital inflows and outflows too have been liberalized significantly but some restrictions still exist and India is not yet fully convertible in the capital account. Much of the restrictions which existed earlier on foreign direct investment have been removed. But an entirely new development in the 1990s relates to portfolio investment. This was practically non-existent earlier but such inflows are very important now. FIIs in particular have been actively encouraged since the early 1990s though some restrictions still exist. Corporate external commercial borrowings have been liberalized and such inflows are rising despite some ceilings and the requirements of prior permission from the RBI. But the preference has been for long-term loans. Short-term loans in fact are restricted. Commercial banks in India are not permitted to accept foreign currency denominated deposits or provide such loans. One area where perhaps restrictions are stricter now than in the 1980s is the NRI deposits. Unlike in the past, the exchange rate risk is not underwritten and the interest rate differentials have been eliminated. In fact, there are ceilings on the deposit rate.

Capital account convertibility has remained controversial and further liberalization has been intensely debated.[2]

Before the 1980s, capital flows into India were primarily external assistance. During the 1980s, India went for external commercial borrowings including short-term loans and NRI deposits. As we have mentioned in the appendix to Chapter 22, such external debts contributed to the external crisis in early 1991. Since the 1990s, a conscious attempt has been made to restrict short-term credit and NRI deposits. Non-debt creating flows such as FDI and FII have been specifically targeted to attract capital. In fact, the latter's importance has significantly gone up. In the light of the lessons from the external crisis of 1991, this is surprising because FII is essentially volatile in nature and capital flight can lead to a serious crisis in India as mentioned in the appendix to Chapter 28.

FOREIGN EXCHANGE RATES

India's foreign exchange rate regime can be classified into the following:

- Par value system from 1947 to 1971
- Basket peg from 1975 to 1992
- Market determined since 1992

Like other countries in the world, under the par value system, India's foreign exchange rate was kept fixed till the early 1970s. In fact during the entire 1950s and till June 1966, the foreign exchange remained unchanged at Rs. 4.76. In June 1966, rupee was devalued and the new rate of Rs. 7.5 remained fixed till the breakdown of the Breton Woods system and the floatation of major currencies in the early 1970s. In December 1971, rupee was linked to the pound sterling and in September 1975 to a basket of currencies. The currencies included in the basket and their weights were left to the discretion of the RBI and were never made public.

As a part of the process of economic reforms of the 1990s, the system of market determined exchange rates was started. In 1992, a dual exchange rate was introduced, with one fixed rate at which exporters were expected to surrender 30 percent of export earnings and a floating rate at which all other transactions took place based on the demand and supply of foreign exchange. In March 1993, the dual exchange rate was replaced by a single exchange rate that was effectively market-determined.[3]

Figure 27A-2 shows how after India gave up the fixed exchange rate system in the early 1970s, rupee has systematically lost in value vis-à-vis US dollar, i.e., dollar has gained in value. From Rs. 7.5 per $ in the early 1970s, the exchange rate went up to almost Rs. 50 by 2002-03. Currently it is around Rs. 45.

The fact that exchange rate is market determined in India does not mean that government/RBI do not intervene. RBI does intervene in the market. The primary purpose is to curb volatility due to demand–supply mismatch. But by demanding foreign exchange or by supplying foreign exchange in the market, RBI can also attempt to influence the rate as a matter of policy.

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[2] For a review of the situation and some of the issues involved, see the "Report of the Committee on Fuller Capital Account Convertibility" (Chairman S S Tarapore), available at the website of RBI, www.rbi.org.in.

[3] A good introduction to India's foreign exchange rate system in historical perspective is RBI, *Report on Currency and Finance, 2005-06*, Chapter VI, available at the website of the RBI, www.rbi.org.in.

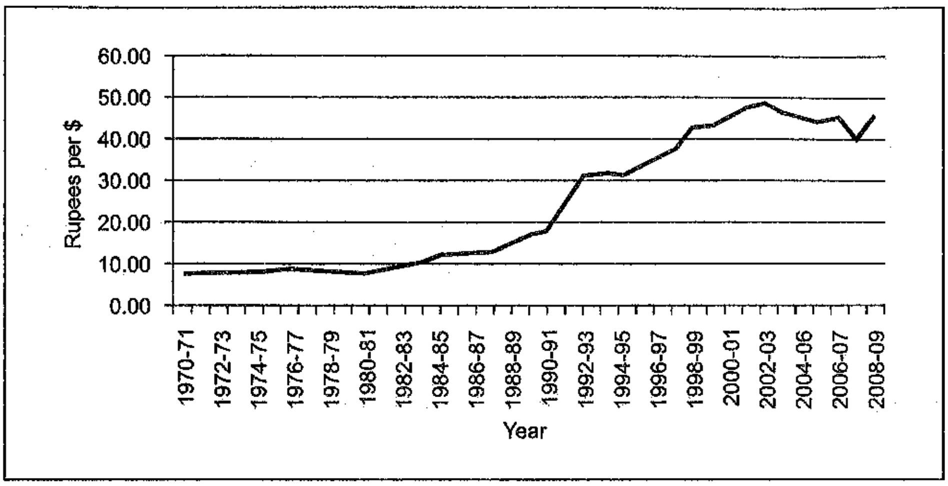

FIGURE 27A-2. Trends in Rupee-dollar Exchange Rate

Source: Same as in Table A27.1. These rates are financial year averages.