APPENDIX 28

SOME INTERNATIONAL ECONOMIC ISSUES IN INDIA

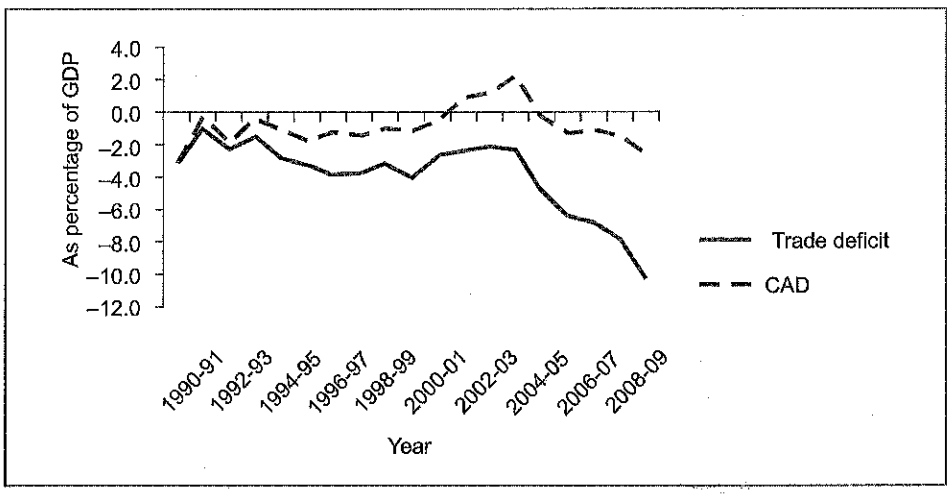
Particularly after the abolition of restrictions on imports of goods, services, and capital after the Economic Reforms in 1991, the Indian economy has become much more open as we have seen in the appendix to Chapter 27. This is in line with the expectations of reforms. But the behavior of some of the open economy macroeconomic variables is a matter of concern.

Figures 28A-1 shows the balance in India's current account in recent years. Trade deficit (excess of merchandise exports over imports) as a percentage of GDP has deteriorated particularly since 2004-05 and by 2008-09 had reached an alarmingly high level of over 10%.

Thanks to the surplus in the invisibles account (Table 27A-1), the current account deficit is much lower at around -2.5% in 2008-09.

The two main items contributing to the surplus in the invisibles account are remittances of Indians working abroad and software exports. As a percentage of GDP, both are currently at about 3.5%. Figure 28A-2 shows how software exports have been increasing at a very high rate of growth in the last few years but how the growth of remittances has slowed down.

Though the current account deficit is much lower than the trade deficit, it too has started deteriorating from about +2.5% in 2003-04 to -2.5% in 2008-09. This is almost the same level as during the balance of payments crisis in early 1991. In fact if the trade deficit worsens and the flow of remittances continues to slow down, the current account deficit may be far worse than the situation in 1991. At that time India was about to default in international payments. But thanks to capital inflows since then, the situa-



FUGURE 28A-1. India's Trade and Current Account Balance

Source: Reserve Bank of India, *Handbook of Statistics on Indian Economy*, available at the website of RBI, www.rbi.org.in. Trade deficit and CAD (current account deficit) are as percentages of GDP at market prices.

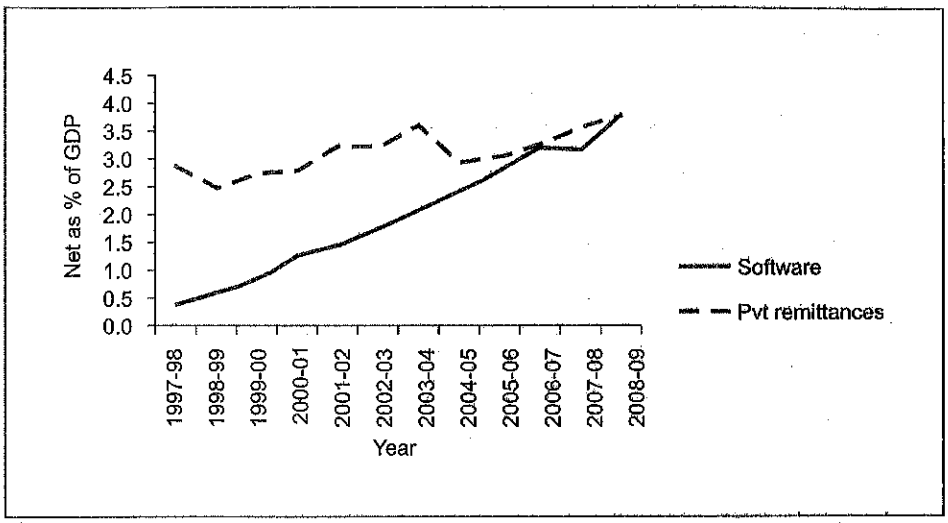


FIGURE 28A-2. Software Exports and Private Remittances

Source: Same as in Figure 28A-1. These are net software exports and net private remittances as percentages of GDP at current market prices. Separate figures for software trade are provided in the BOP data only since 1997-98.

tion is very different today though it remains a matter of concern as mentioned below.

As can be seen from Table 28A-1, the surplus in the capital account due to capital inflows has far exceeded the deficit in the

TABLE 28A-1. *Sources of Accretion of Foreign Exchange Reserves since March 1991*

Item	1991-92 to 2009-10 (March 1991 to September 2009) US $ million
A. Reserves as at end-March 1991	5.8
B.I Current Account balance	-97.9
B.II Capital Account balance	357.5
(a) Foreign investment	185.7
(i) FDI	90.4
(ii) FII	66.9
(b) NRI deposits	36.9
(c) External assistance	19.2
(d) External commercial borrowings	68.7
(e) Errors and omissions and others	47.0
B.III Valuation change	15.8
Reserves as at end-September, 2009 (A+B.I+B.II+B.III)	281.2

Source: Reserve Bank of India, "Half Yearly Report on Management of Foreign Exchange Reserves, April-September, 2009", accessed from RBI website, www.rbi.org.in.

current account, leading to an accumulation of foreign exchange reserves of US $281.2 million by end-September, 2009. Such capital inflows and reserve accumulation is considered to be a success story of reforms in India. In fact foreign exchange reserves have systematically gone up after reforms except for some decrease due to capital outflows mainly of FII in 2008-09 in the aftermath of the US financial crisis (Figure 28A-3).

Reserve Bank of India[1] finds India's foreign exchange reserves as comfortable using both the import cover index and the ratio of volatile capital. In end-December 1990, reserves were adequate for only three weeks of imports. By end-September 2009, the import cover of reserves had gone up to 12.4 weeks, i.e., much beyond what is considered to be safe. RBI considers portfolio investment and short-term debt as volatile and found that these account for only 48.9% of the total reserves in September 2009. The implication is that even if there is a capital flight and portfolio investments and short-term debt flow out at short notice, India's foreign exchange situation will still be quite comfortable.

But RBI's estimates are at accounting or historical data. India's potential liability of FII will go up or down depending on market prices in the stock markets when the capital is taken out. Another limitation of the RBI method is that NRI deposits are not considered as volatile because the maturity exceeds one year. But in case of loss of confidence, even longer term deposits may be withdrawn as indeed was the case during India's foreign exchange crisis in 1991. Massive flight of NRI deposits was one of the important factors that contributed to the crisis in early 1991. If FII is measured at current stock market prices and if NRI deposits are also considered as volatile, then as a study[2] found, volatile capital exceeds the foreign exchange reserves by 7.7% in end-November, 2007. Thus, India seems to be in a vulnerable situation. Capital flight as witnessed in other countries can put India in a serious economic crisis. In the light of the lessons from the external crisis of 1991, the encouragement to FII as mentioned in appendix to Chapter 27 is surprising.

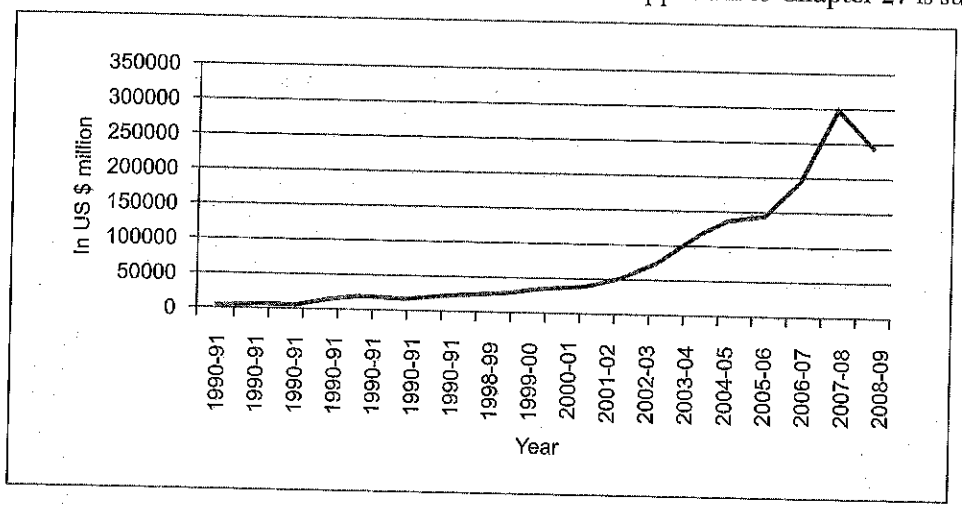


FIGURE 28A-3. Foreign Exchange Reserves

Source: Same as in Figure 28A-1. Reserves as on financial year end.

[1] Report cited in Table 28A-1.

[2] See Nirmal Kumar Chandra, "India's Foreign Exchange Reserves: A Shield of Comfort or an Albatross?", in *Economic and Political Weekly*, April 5, 2008 for the critique of the RBI method and the estimate.