TARGET PRELIMS 2024
BOOKLET-27; ECONOMY-8
EXTERNAL SECTOR

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2. BASICS OF EXTERNAL SECTOR

- **External sector** deals with import and export of goods and services, and financial capital between nations.
  - » The sector in which domestic economy has an advantage over other countries, goods and services of these sector are **exported**.
  - » The sector in which the domestic economy has a disadvantage over other countries, goods and services of these sectors are **imported**.

- **Balance of Payments** (BOP)
  - » BOP, also known as the **Balance of International Payments**, is a statement of all transactions between entities in one country and rest of the world over a defined period of time such as a quarter or a year.
  - » **Note**: Balance of payment thus summarizes all transactions that a country's individuals, companies, and government bodies complete with individuals, companies and government bodies outside the country.

1) BALANCE OF PAYMENT IN ONE TABLE

A. Current Account: (A.1 + A.2)		
	A.1: Merchandize Trade Balance	
		A.1(a): Merchandize Exports
		A.1(b): Merchandize Imports
	A.2: Invisibles	
		A.2(a): Services
		A.2(b): Transfers
		A.2(C): Income
B. Capital Account: B1+B2+B3+B4+B5		
	B.1) Foreign Investment	
		B.1.a) Foreign Direct Investment (FDI)
		B.1.b) Foreign Portfolio Investment (FPI)
	B.2) Loans	
		B.2.a) External Assistance
		B.2.b) Commercial Borrowings (MT & LT)

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		B.2.c) Short term Credit to India
	B.3) Banking Capital	
	B.4) Rupee Debt Service	
	B.5) Other Capital Flow	
C. Errors and Omissions		
D. Overall, Balance (A + B + C)		
E. Reserve Change	**-(A + B +C)** **(-) indicates increase and (+) indicates decrease**	Explaination -> **Positive Balance of payment** would lead to increase in a nation's net foreign asset. And **Negative Balance of Payment** would mean decrease in a nation's net foreign asset.

- **Real Life Example** (see below table from ESI 2021-22)

(US$ Billion)										
Year / Item (Net)	2019-20				2020-21				2021-22 (P)	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
A. Current Account	**-15.0**	**-7.6**	**-2.6**	**0.6**	**19.1**	**15.3**	**-2.2**	**-8.2**	**6.5**	**-9.6**
A 1 Merchandise Trade Balance	**-46.8**	**-39.6**	**-36.0**	**-35.0**	**-11.0**	**-14.8**	**-34.6**	**-41.7**	**-30.7**	**-44.4**
A 1 a Merchandise Exports	82.7	80.0	81.2	76.5	52.2	75.6	77.2	91.3	97.4	104.8
A 1b Merchandise Imports	129.5	119.6	117.3	111.6	63.2	90.4	111.8	133.0	128.2	149.3
A 2. Invisibles	**31.8**	**32.1**	**33.4**	**35.6**	**30.0**	**30.1**	**32.4**	**33.6**	**37.2**	**34.8**
A 2.a) Services	20.1	20.9	21.9	22.0	20.8	21.1	23.2	23.5	25.8	25.6
A 2.b) Transfers	18.0	20.0	18.9	18.4	17.0	18.4	19.3	18.8	18.9	18.9
A 2.c) Income	-6.3	-8.8	-7.4	-4.8	-7.7	-9.4	-10.1	-8.7	-7.5	-9.7
B) Capital Account	**28.6**	**13.6**	**23.6**	**17.4**	**1.4**	**15.9**	**34.1**	**12.3**	**25.5**	**40.1**
B.1) Foreign Investment	18.8	9.8	17.6	-1.8	0.1	31.4	38.6	10.0	12.1	13.3
B.1.a) Foreign Direct Investment	14.0	7.3	9.7	12.0	-0.5	24.4	17.4	2.7	11.7	9.5
B.1.b Foreign Portfolio Investment	4.8	2.5	7.8	-13.7	0.6	7.0	21.2	7.3	0.4	3.9
B.2) Loans	**9.6**	**3.1**	**3.1**	**9.9**	**2.8**	**-3.9**	**0.3**	**7.7**	**2.8**	**7.6**
B.2.a) External Assistance	1.5	0.4	1.3	0.6	4.1	1.9	1.2	4.0	0.3	1.1
B.2.b) Commercial Borrowings (MT & LT)	6.1	3.3	3.2	10.3	-1.2	-4.0	-1.1	6.1	0.6	4.1
B.2.c) Short Term Credit to India	2.0	-0.6	-1.4	-1.0	-0.2	-1.8	0.2	-2.3	1.9	2.4
B.3) Banking Capital	**3.4**	**-1.8**	**-2.3**	**-4.6**	**2.2**	**-11.3**	**-7.6**	**-4.4**	**4.1**	**0.4**
B.4) Rupee Debt Service	**-0.1**	**0.0**	**0.0**	**0.0**	**-0.1**	**0.0**	**0.0**	**0.0**	**-0.1**	**0.0**
B.5) Other Capital	**-3.1**	**2.5**	**5.2**	**13.8**	**-3.7**	**-0.3**	**2.8**	**-1.0**	**6.6**	**18.8**
C) Errors and Omissions	**0.4**	**-0.9**	**0.6**	**0.9**	**-0.6**	**0.4**	**0.6**	**-0.7**	**-0.2**	**0.7**
D) Overall Balance	**14.0**	**5.1**	**21.6**	**18.8**	**19.8**	**31.6**	**32.5**	**3.4**	**31.9**	**31.2**
E) Foreign Exchange Reserves (Increase - / Decrease +)	**-14.0**	**-5.1**	**-21.6**	**-18.8**	**-19.8**	**-31.6**	**-32.5**	**-3.4**	**-31.9**	**-31.2**

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A) CURRENT ACCOUNT

- Current account records a nation's net trade in goods and services, its net earnings on cross border investments, and its net transfer payments over a defined period.

- **Current Account transactions** (like revenue receipt and revenue expenditure) are single time and one way transaction. It means that the transaction (like receipt of payment) happens once and transaction ends there. There is **no future liability/asset created**.
  - » For e.g., when Tata Motors export a car and receives money for that, the transaction comes to an end with respect to this car being exported.

TRADE BALANCE:

- **Export**:
  - » It includes export of merchandize goods to other countries and receipts against it.
  - » Please note that, while considering trade balance, export/import of services are not considered.

- **Import**:
  - » It includes import of merchandize goods from other countries and payments for it.

- **Trade Balance** is the difference between exports receipt and import payments.
  - » In case the trade balance is positive, it is called trade surplus or favorable trade balance.
  - » In case the trade balance is negative, it is called trade deficit or unfavorable trade balance.

INVISIBLES (NET)

- The invisible (net) is that part of balance of trade that refers to services and other products that **doesn't result in transfer of physical assets**.

- **Invisibles** may include **Services, Income and transfer payments.**

SERVICES

I) Travel
II) Transportation
III) Insurance
IV) Government not included elsewhere (GNIE)
V) Miscellaneous Services
   a. It encompasses communication service, construction services, financial services, software services, news agency services, **royalties copyright and license fees** and business services.

INCOME (I.E. INVESTMENT INCOME)

- This income may be from financial assets, labour and property.
- These transactions are in the form of interest, dividend, profit for servicing capital transactions.
- **Interest Payment** represent servicing of debt liabilities. E.g. interest earned (paid) from bank loans to foreign country.
- **Dividend or profit** represent servicing of non-debt (FDI, FPI) liabilities.

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- **Compensation** of employees are also included in "income" category.

TRANSFERS

- They represent one sided transaction i.e. transaction that don't have quid-pro-quo, such as grants, gifts, 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.
- They may be private or official.
- E.g.
    - Grants, donations and other assistance received by government from bilateral and multilateral institutions.

CURRENT ACCOUNT BALANCE = TRADE BALANCE + NET INVISIBLES

- **Positive (+)** Current Account (Current Account Surplus) means that the country is a net exporter of goods and services.
- **Negative (-)** Current Account (Current Account Deficit) means that the country is a net importer of goods and services.
- For e.g.
    - » **USA** had the world's largest Current Account Deficit in 2020 at US$ 616 billion.
    - » **China** had the world's largest Current Account Surplus in 2020 at US$ 274 billion.

B) CAPITAL ACCOUNT

- Capital account transactions are two-way transactions. It means **paid money can be recovered through periodical income** and/or by **disposal of the asset created**. Similarly, the loan has to be repaid periodically and has to be settled finally by paying the full amount.
- It includes **Loans, Banking Capital, Investments (FPIs, FDIs),**

LOANS

External Assistance (official bilateral and multilateral loans), **External Commercial Borrowing** and **Short-term debt**.

- » **External Assistance (net)** means transaction of official (government) bilateral and multilateral loans.
- » **External Commercial Borrowings (ECBs)**:

    It means loan transaction by commercial enterprises.

    - » It includes commercial loans in the form of bank loans, buyers' credit, suppliers' credit, securitized instruments availed from non-resident lenders with a **minimum average maturity of three years**.
    - » **ECB** can be raised only for specific purposes, such as the import of capital goods, implementation of new projects, etc. These restrictions are called **end use restrictions**.

> **Extra Gyan:**
> **Buyers Credit** and **suppliers' credit** are called trade credits. Depending on the source of finance, such trade credits are classified as suppliers' Credit or Buyers' Credit.
> - **Supplier's Credit** relates to credit for imports into India extended by the overseas supplier.

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- **Buyers' credit** refers to loans for repayment of imports into India arranged by the importer from a bank or financial institution outside India.

- Note: Both these credits are for the purpose of import and loan availed by importer.
    - In supplier's credit only two parties namely exporter and importer are involved.
    - In Buyer's credit, a third party namely a bank or financial institution comes into the picture to finance import.

Securitized instruments refer to debt securities like bonds, debentures and preference shares which are not fully or compulsorily convertible.

Bonds and Debentures are debt instruments i.e. means the owner of debt/debentures are creditors to the company and doesn't have any ownership.

Bonds are generally secured by a collateral.

Debentures is a debt security issued by a corporation or government entity that is not secured by an asset. Debentures have higher seniority for liquidation repayment than preferred shares.

Preference Shares are equity instruments known for giving owners preferential rights in the event of dividend payments or liquidation by the underlying company.

» **ECB** also covers **Foreign Currency Convertible Bonds** (FCCB) and **Foreign Currency Exchangeable bonds** (FCEB).

» FCCB and FCEB are both types of bonds issued by companies in foreign currency i.e. principal and interest in respect of these bonds are payable in foreign currency.

» **FCCB:** It provides bondholder with the option to convert the bonds into a predetermined number of shares of the issuing company's stocks at a specified conversion price during or end of bond's maturity.

» If the equity conversion option is used, the bondholder becomes a shareholder of the company, giving them ownership in the form of equity. Conversion Ratio determines the number of shares to be allotted upon conversion, which is usually determined based on a formulae or fixed ratio. FCCBs typically pay regular interest to bondholders until conversion or maturity, similar to conversion bonds.

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» **FCEB**: They are exchangeable into equity shares of another company called the offered company. The word 'Exchangeable' refers to the facility to convert bonds of one company into equity shares of another company.
» Its other features are similar to FCCB. The key difference lies in the type of equity ownership that results from the exercise: direct ownership of the issuing company's shares in the case of FCCBs and ownership of shares in a different company for FCEBs.

» **Short term Debt**: These are trade credits for a maturity less than three years.

BANKING CAPITAL

- It comprises of three components: Foreign assets of Commercial Banks, Foreign Liabilities and Others.
- **Foreign assets of commercial banks**. It consists of:
    » Foreign Currency holdings
    » Rupee overdrafts to non-residents

- **Foreign liabilities** of commercial banks. It consists of:
    » **Non-Resident Deposits**:
        ▪ The deposits received from non-resident Indians comes under this head. At present there are three types of NRI deposit schemes. They are:
            i. **Foreign Currency Non-Resident (Banks) FCNR (B)**: These deposits are **held in the following foreign currencies** - US Dollar, Pound Sterling, Euro, Japanese Yen, Australian Dollar and Canadian Dollar; only term deposits of **1-3 years of maturity** are allowed. The interest rates are pegged to LIBOR/ SWAP rate.
                • **Note:** LIBOR (London Interbank Offered Rate) is a benchmark interest rate at which major global banks lend to one another in the international interbank for short-term loans.

            ii. **Non-Resident External Rupee Account NR (E) A**: These deposits are held in Indian rupees. **Term deposits with maturity of one to three** years as well as s**aving deposits are allowed u**nder the scheme. Its interest rate is also pegged to the LIBOR/SWAP rate.

            iii. **Non-Resident Ordinary Rupee Account:**
                • It is the account held by Indians ordinarily living abroad.
                • An Indian who was an Indian resident but migrated abroad can shift this account to this category. It is held in Indian rupees.
                • It can be opened in **current, saving, recurring or fixed deposit account**s.

    » **Liabilities other than non-resident deposits,** which comprise of **rupee and foreign currency liabilities** to nonresident banks and official and semiofficial institutions.

- **Others**
    » "Others" under banking capital include transactions in **balances of foreign central banks and international institutions** like the IBRD, IDA, ADB, IFC, IFAD etc. mantained with deposit

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account departments (DAD) of RBI as well as transactions in balances held abroad by the embassies of India in London and Tokyo.

FOREIGN INVESTMENT (FDI AND FPI)

OTHER CAPITAL FLOWS

These include **delayed export receipt**s, **leads and lags in export receipts** (the difference between custom data and banking channel data), funds held abroad, and other capital transactions not included elsewhere such as flows arising from cross-border financial derivatives and commodity hedging transactions, and **sale of intangible assets** such as patents, copyrights, trademarks etc.

CAPITAL ACCOUNT BALANCE:

- **Loans** (External Assistance + External Commercial Borrowing (net) + Short term debt (net)**) + Banking Capital** (net) + Foreign Investment (net) + Other outflows (net)
    - **Capital Account Surplus** -> If Capital Account Balance is positive.
    - **Capital Account Deficit** -> If Capital Account Balance is negative.

C) ERRORS AND OMISSIONS

- It includes the differences between debit and credit entries of all transactions.
- Capital Account balance is calculated with and without errors and omissions.

D) OVERALL BALANCE/ BALANCE OF PAYMENTS

- **Balance of Payment =** Current Account Balance + Capital Account Balance
- If the BoP is positive -> it would lead to increase in foreign exchange reserve and vice-versa.

3. FOREX RESERVES

1) COMPOSITION OF INDIA'S FOREX RESERVES

- India's foreign exchange reserves comprise of four components:
    1. **Foreign currency assets (US$, Euro, Pound, and Yen)**: It is expressed in US Dollar or Indian rupee terms.
        - It also includes foreign currency deposits held by RBI with foreign central banks, the BIS and non-resident deposit taking institutions as well as deposit agreements with IMF Trust Accounts that are readily available to meet a BoP financing needs.
        - Securities issued by non-residents and financial derivatives having underlying foreign currency assets also form part of foreign currency assets.

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2. **Gold reserves of RBI**: The RBI has gold stocks as a backup to issue currency and to meet unexpected balance of payment problems.

3. **Reserve Tranche**:
   - It consists of India's quota (member subscription fee) to IMF and lending to the General Resource of IMF.
     - Note: The General Resource Account is the pool of member countries' quota payment.

4. **Special Drawing Rights** (SDR) holdings of the government
   - The IMF member countries are entitled to get a loan from IMF's SDR Account. This loan amount is upto 200% of the member's quota with the IMF. It is also known as **Paper Gold**.
     - In this arrangement IMF doesn't lend directly. It is the member countries, who are in a strong position, lend their SDR holdings to member countries who are in problems for balance of payment.

2) WHO MANAGES FOREX RESERVES?

- **RBI Act and Foreign Exchange Management Act, 1999** set up the legal provisions for governing the foreign exchange reserves.
- **The RBI** functions as the custodian and manager of forex reserves and operates within the overall policy framework agreed upon with the Centre. It allocates the dollars for specific purposes.
  - For e.g., under the Liberalized Remittances Scheme, individuals are allowed to remit up to $2,50,000 every year.
- The Central bank uses its forex kitty for orderly movement of the rupee. It sells the dollar when the rupee weakens and buys dollar when the rupee strengthens.

3) SIGNIFICANCE OF FOREX RESERVES

- It acts a **cushion against domestic currency volatility** once the global exchange rate start rising.
- It increases the **confidence in the monetary and exchange rate policies** of the government.
- During **balance of Payment crisis** foreign exchange reserve come to the rescue of any country so as to absorb the distress related to such crisis.
- Strong forex reserves also helps a country to **adopt more aggressive countercyclical measures** and emerge from a short-lived recession.
- It also **adds to the comfort of market participants** that domestic currency is backed by external assets and hence it also helps the equity markets of the country, because due to strong reserves many people from foreign countries are willing to invest in the country.

4) OTHER ASPECTS RELATED TO FOREX RESERVES

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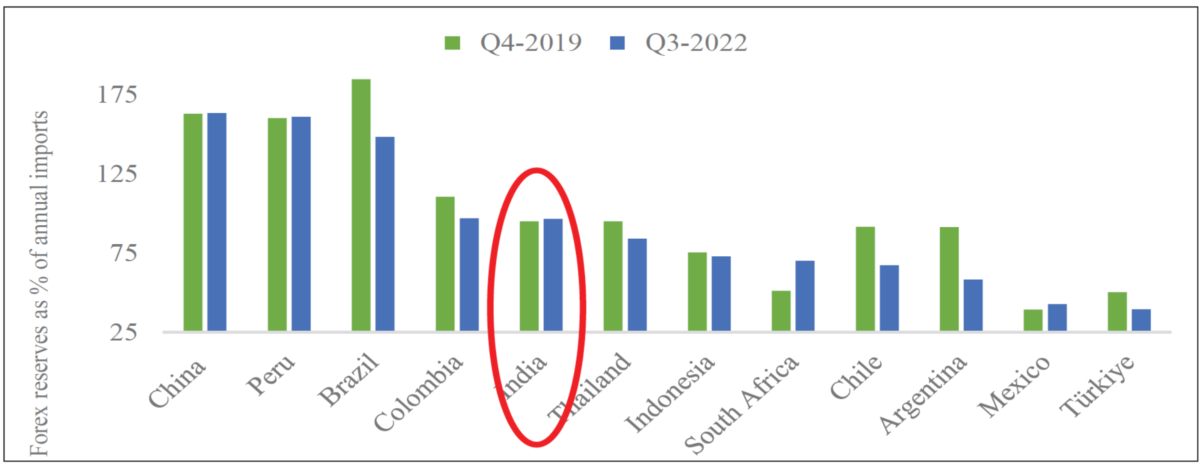
- **However, holding too much foreign exchange reserves is also not advisable -> (Opportunity Cost)**

- **How much Foreign Reserve do we have?**
    - India's forex reserve at $602 billion as of Aug 2023: RBI
        - **Foreign Currency Assets** (FCAs): $534.40 billion
        - **Gold Reserves**: $44.34 billion
        - **SDR**: $18.32 billion
    - **Note:** India's foreign reserve had **peaked in Sep 2021** at $642.45 billion.

    - **Note:** The **import coverage of foreign currency reserves** has declined since the pre-pandemic levels in most emerging market economies; however, that of India has increased from 95% in Q4 2019 to 96.5% in Q3 2022.

Figure XI.15 Adequacy of India's Forex Reserves (as a percentage of Annual Imports): A Cross-country perspective



Source: IMF (forex reserves) and WTO (for imports data)

- **How did India's foreign exchange reserves increase till Sep 2021**?
    - Generally, the current account surpluses result in a building of reserves, as the central bank mops up all the excess foreign currency flowing into the country. **But India is an outlier**. From 2011 to 2021, there was **only one year i.e. 2020 when India had run a surplus**. India accumulated forex reserves despite having aggregate deficit of $400 billion during 11 years.
    - The reserve was built through **import of capital**.
    - **Another source** of reserve accretion or depletion: **Valuation Effect**. Foreign exchange reserves are held in the form of dollars as well as non-dollars currencies and gold, whose value is, in turn, influenced by movements in exchange rates and gold prices. A depreciation of US$ or higher gold prices cause valuation gains.

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SOURCES OF INCREASE IN INDIA'S FOREIGN EXCHANGE RESERVES
(IN BILLION US DOLLARS)

		1990-91 TO 1997-98	1998-99 TO 2005-06	2006-07 TO 2013-14	2014-15 TO 2021-22
1	Trade Balance (1a - 1b)	-72.469	-165.135	-1051.316	-1176.895
	(a) Exports	207.273	472.412	1857.615	2555.150
	(b) Imports	279.742	637.547	2908.931	3732.045
2	Net invisibles	37.527	165.189	713.252	967.989
3	Current Account Balance (1+2)	-34.942	0.054	-338.064	-208.907
4	Capital Flows*	57.887	117.133	479.750	544.290
5	Overall Balance (3+4)	22.945	117.187	141.686	335.383
6	Valuation Effect	2.460	5.068	10.915	-32.297
7	Rise in Reserves (5+6)	25.405	122.255	152.601	303.086

*Including from International Monetary Fund.
Source: Reserve Bank of India.

- **Why the recent drop in the reserves?**
  - **Largely due to steps taken by the Reserve Bank of India to support the rupee**.
  - Increasing trade deficits (and Current Account Deficits)
  - Capital outflow (FIIs have pulled out) [given the rising global interest rates and bond yields on the back of monetary policy tightening by the US Fed and other major central banks.

4. EXCHANGE RATE

1) BASICS OF EXCHANGE RATE

- 'Exchange rate is the price of a nation's currency in terms of another currency'. Thus, an exchange rate has two components, the domestic currency and a foreign currency and can be quoted either directly or indirectly.
  1. **Direct Quotation**
     - The price of a **unit of foreign currency** is expressed in terms of domestic currency.
       - For e.g., in India's context: 1$ = 80 Rs.

  2. **Indirect Quotation**
     - The price of a **unit of domestic currency** is expressed in terms of the foreign currency. For instance, 1Rs = 0.0125%

- Generally, exchange rate is **quoted in value against US dollar**. However, exchange rates can also be quoted against another nations currency.

- **Floating vs Fixed Exchange Rate**

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- A floating exchange rate is where a currency rate is determined by market forces. This is generally followed by most major economies.

- **Fixed Exchange Rate**: In this case, the exchange rate is fixed or peg their currencies to a widely accepted currency like the US dollar.
    - This is done to reduce volatility or better manage trade relations. For e.g. Most GCC countries including Saudi Arabia fixes its currency Riyal to US$ because its main export is oil, which is priced in US$.

- **Depreciation or Appreciation of Exchange Rate**
    - **Depreciation:** Increase in the direct exchange rate (i.e., fall in the external value of domestic currency because of more demand for foreign currency or less supply of foreign currency or more supply of domestic currency or less Demand of Domestic currency).
        - For e.g., rupee depreciation would mean rupee falling from 1$ = 50 rupee to 1$ = 52 rupee.
    - **Appreciation:** Decrease in the direct exchange rate (due to more demand or less supply of home currency; or less demand or more supply of foreign currency).
        - For e.g. Rupee appreciation would mean Rupee appreciating from 1$ = 50 Rupees to 1$ = 48 rupees.

    - **Devaluation**
        - Reduction in the external value of home currency is called Devaluation.
            - This is done to increase export and is usually resorted to correct the deficit in the balance of payment.
            - How?

    - **Revaluation**
        - Increase in the external value of home currency is called revaluation.
        - It is usually resorted to correct the surplus in the balance of payment. This reduces deficit for other countries. This is very rarely done.

- **Note:**
    - Depreciation and Appreciation takes place automatically due to movement in the demand and supply of currencies in the market (i.e. by market forces). If dollar demand exceeds supply, the rupee depreciates with respect to it and vice versa.
    - Devaluation and revaluation are done voluntarily either by the government or monetary authority.

- **Relation between Inflation and Exchange Rate**
    - Class Discussion

2) EFFECTIVE EXCHANGE RATE INDICES OF INDIAN RUPEES

- EER is a summary indicator of **movements of home currency against a basket of currencies** of trading partners.

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- EERs serve as a gauge for assessing the **fair value of currency**, the external competitiveness of an economy and even serve as guideposts for setting monetary and financial conditions.

- **The Nominal Effective Exchange Rate (NEER)** is an index of the weighted average of bilateral exchange rates of home currency vis-a-vis currencies of trading partners, with weights derived from their shares in the trade basket of the home currency.

- A **Real Effective Exchange Rate (REER)** is the NEER adjusted by relative prices and costs, typically captured in inflation differentials between the home economy and trading partners.

- **RBI** is responsible for compilation and dissemination of NEER and REER Indices of the Indian rupee (both trade and export oriented).

- **Key Changes made 2021:**
  - **Base year** was moved from 2004-05 to **2015-16** for NEER/REER indices.

  - **Coverage of NEER/REER basket** has been expanded from **36 to 40 currencies** (8 new additions and 4 removals)
    - The selections are based on **two criterias**:
      i. **Trading partners with extremely high and volatile inflation** are excluded as their currencies tend to experience rapid nominal declines which undermines the stability of NEER/REER indices.
      ii. Data on inflation and exchange rates of trading partners should be available on a regular basis.
    - The new basket represents **88% of India's total trade** as compared to 84% in the case of older 36 currency basket.

- **Note:** To **calculate trade weights**, geometric means of India's trade (exports plus imports) with trading partners during the preceding three years are computed and then normalized to 100. While the Euro area retains its top position in the trade basket, the US assigned the highest weight in the export basket in 2015-16.

Table 1: New 40-Currency NEER/REER Basket – Normalised Weights

(Per cent)

Country/Area	2015-16		2020-21 (P)	
	Trade-based Weight	Export-based Weight	Trade-based Weight	Export-based Weight
1. Euro Area	11.4	14.0	11.6	14.7
2. China	10.0	5.0	12.0	5.6
3. UAE	9.4	12.4	7.8	10.4
4. US	9.1	14.7	11.6	18.4
5. Saudi Arabia	6.4	4.1	4.4	2.1
6. Switzerland	3.7	0.5	2.7	0.4
7. Hong Kong	2.9	4.8	3.9	4.6
8. Indonesia	2.9	1.8	2.8	1.6
9. Singapore	2.8	4.4	3.2	3.7
10. Iraq	2.7	0.4	3.2	0.6
11. Korea	2.5	1.6	2.9	1.7
12. Kuwait	2.5	0.4	1.3	0.5
13. Japan	2.5	2.3	2.3	1.7
14. Qatar	2.4	0.3	1.5	0.5
15. Nigeria	2.3	1.0	1.8	1.0
16. UK	2.2	3.5	2.2	3.3
17. Malaysia	2.2	1.8	2.2	2.2

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18. Iran	2.1	1.5	1.4	1.1
19. Australia	2.0	0.9	2.2	1.2
20. South Africa	1.8	1.9	1.5	1.4
21. Brazil	1.5	2.2	1.1	1.3
22. Thailand	1.3	1.4	1.6	1.5
23. Vietnam	1.1	1.9	1.8	2.3
24. Bangladesh	0.9	2.2	1.3	3.1
25. Taiwan	0.9	0.9	0.9	0.8
26. Angola	0.9	0.2	0.6	0.1
27. Russia	0.9	0.8	1.3	0.9
28. Turkey	0.9	1.7	1.0	1.9
29. Mexico	0.9	0.8	1.2	1.3
30. Israel	0.9	1.3	0.7	1.3
31. Sri Lanka	0.8	1.9	0.7	1.6
32. Canada	0.8	0.8	0.9	1.0
33. Egypt	0.7	1.1	0.6	0.9
34. Oman	0.7	1.0	0.8	0.8
35. Nepal	0.6	1.4	1.1	2.6
36. Kenya	0.6	1.5	0.3	0.7
37. Tanzania	0.5	1.0	0.4	0.6
38. Chile	0.5	0.2	0.3	0.3
39. Ukraine	0.4	0.2	0.4	0.1
40. Ghana	0.2	0.3	0.5	0.2
Total	100.0	100.0	100.0	100.0
Memo Items:				
AE Currencies	41.7	49.7	45.0	52.6
EMDE Currencies	58.3	50.3	55.0	47.4
AE: Advanced economies. EMDE: Emerging market and developing economies. P: Provisional.				
Source: RBI staff calculations.				

- The **methodology of computing** NEER/REER indices:
    - The NEER is calculated as the geometric weighted average of bilateral exchange rates of the home currency in terms of trading partner currencies.

Specifically the NEER can be calculated as follows:	$NEER = \prod_{i=1}^{n} \left(\frac{e}{e_i}\right)^{w_i}$ (1)
REER, which is NEER adjusted by weighted average ratio of the domestic price to foreign prices, is calculated as:	$REER = \prod_{i=1}^{n} \left[\left(\frac{e}{e_i}\right)\left(\frac{P}{P_i}\right)\right]^{w_i}$ (2)
'e' represents the exchange rate of rupee against the IMF's SDR 'e_i' is the exchange rate of the foreign currency 'i' against the IMF's SDR.	A rise in e or (e/e_i) represents an appreciation of the rupee relative to currency 'i' and vice versa. '*P*' and '*P*i' represent price indices of the home economy and the trading partner 'i', respectively. '*wi*' denotes trade-/export-based weight assigned to foreign currency/trading partner 'i', while '*n*' is the number of currencies (other than home currency) included in NEER/REER basket

3) DEPRECIATION AND ASSOCIATED ISSUES

- **Why does depreciation take place?**
  - » **Core Reason - Demand supply gap of foreign currency (US$)**
    - ▪ **Increasing Current Account Deficit** (More imports, less exports).
    - ▪ **Monetary and Interest rate hikes by the US Fed**
      - ▪ This makes US treasury investment more attractive and leads to **FII's moving funds from emerging economies back to US**.
  - » **Other traditional factors affecting India's exchange rates**
    - ▪ Mounting External Debt
    - ▪ Tightening global liquidity
  - » Further, since India is an emerging market, **inflation rate** here would be higher when compared to developed countries and there will be a long term depreciation.

- **Why the recent depreciation in rupee?**
  - » Since March 2022, **the US Federal Reserve has been raising its benchmark interest rate** causing investors seeking higher returns to pull capital away from emerging markets such as India and back into the USA. This puts pressure on emerging market economies.
  - » Consistently high domestic inflation

- **Negative Impacts**
  1. **Decline in forex reserves**

  2. **Negatively impacts Current Account Deficit -> Vicious Cycle**

  3. **Pulling out of Foreign Portfolio Investments**

  4. **Inflation: Increased prices of imported products**
     - ▪ Further, increases the cost of crude oil import.
  5. **Negatively impacts business' taking loans from abroad.**
  6. **Difficulty in financing external debt**
  7. **Increase in RBI's monetary policy rates.**
  8. **Challenges for students studying or wanting to study abroad**

- **Positives of declining rupee**
  - » Depreciation helps in **increasing exports** as exports become cheaper for importing foreign country.
    - ▪ Therefore, some sectors like IT, Pharma, hospitality can actually benefit from depreciating rupee.
    - ▪ This may help in chipping away of trade deficit imbalance.
  - » **Tourism and hospitality** sector may get a boost
  - » **Remittances tend to increase** during the depreciating phase

- **Sectoral Impact**
  1. **Export based industry would benefit.**

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- Depreciation acts as booster for IT and Pharma sector which are export based. Further hospitality sectors such as tourism, hotel etc can benefit as foreign tourists would now find in cheaper to visit India.

2. **Problems for Oil Marketing Companies**
   - Rise in crude oi prices and depreciation of rupee is a double jeopardy for oil marketing companies. The lack of pricing power during major elections further exacerbate the problems for OMCs.
3. **Auto sector**
   - Companies having high export shares will benefit from this depreciation.
   - On the other hand, operating procedure margins of vehicle manufacturers such as Maruti Suzuki which import most of their components and focus on domestic market are going to face problems.
4. **Aviation sector will be hit**
   - Increasing cost of Crude oil (thus Aviation Turbine Fuel)
   - The big capacity additions on the anvil will also face problems.

- **Steps taken by Government.**
  - » Steps to fight trade deficit [see Trade Deficit Topics]
  - » Steps to attract investments [See currency depreciation topic]

5. INTERNATIONALIZATION OF RUPEE

- **What is Internationalization of Rupee?**
  - Internationalization is a process that involves increasing the use of the rupee in cross-border transactions. It involves promoting the rupee for import and export trades, and then other current account transactions, followed by its use in capital account transactions.
  - It will also require:
    - » F**ull capital account convertibility** (currently India allows only full current account convertibility, capital account convertibility is limited).
    - » **Availability in sufficient quantities**
    - » **Opening up of currency settlement and a strong swap and forex market**.

- **Advantages of Internationalization of Rupee**:
  - **Reduces exchange rate risks**, while curtailing the demand for US dollar.
    - **Reduces risk to economy** due to sudden withdrawal of capital from market.
  - **Reduces the need of forex war chest** to meet the external vulnerabilities.
  - **Lower cost of capital** due to better access to international financial markets.
  - **Promotes ease of doing business** but also improves the chances for Indian businesses to grow globally.
    - **Bargaining power of Indian businesses** will increase, adding weight to Indian economy and enhancing India's global stature and respect.
  - **Reduced transaction costs**: They will not have to incur exchange rate fees.

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- **Geopolitical Significance**: US-dollar dominated global currency system can become limitations for the economy if India's relations with US and Europe becomes tense in future. In that scenario, business in domestic currency can be a savior.

- **Internationalization of currency is closely linked with a nation's economic progress**.
  - Currently, the US $, the Euro, the Japanese Yen and the pound sterling are the leading reserve currencies in the world. China's efforts to make its currency renminbi (yuan) a reserve currency has met with only limited successes so far.
  - **Factors behind US$ being the most common currency of reserve and exchange:**
    - **Size of US Economy** (largest in the world)
    - **Reach of its trade and financial market**
    - **Depth and liquidity** of the US financial market
    - History of macro-economic stability
    - Currency convertibility
    - Lack of viable alternative.

- **China's Experience**:
  - Before 2004, RMB couldn't be used outside China.
    - By 2007, the **"Dim Sum" bond** and offshore RMDB bond market had been created.
  - **Post 2008**, China pursued a phased approach:
    - **First**, it allowed use of RMB outside China for Current account transactions and for select investment transactions (FDI, outward direct investment) etc.
    - **By 2009**, it had signed currency swap agreements (i.e., an exchange of an equivalent amount of money, but in different currencies) with countries like Brazil, UK etc.
    - Then, **Central banks, offshore clearing banks and offshore participating banks** were allowed to invest excess RMB in debt securities.
    - **Sanghai Free Trade Zone** was launched in 2013, to allow free trading between non-resident onshore and offshore accounts.
  - **In this way**, overtime RMB was internationalized, with reserve currency status increasingly enabled. For e.g. in Q2, 2022, the RMB's share of international reserves had reached around 2.88%.

- **Steps Taken towards Internationalization of Rupee:**
  - **Liberalization of Capital Account**: Over the years, government has relaxed FII and FDI norms, facilitating greater cross-border investment and trade.
  - Enabling of **ECB in rupee**.
  - **Currency Swap Agreements** with several countries, which allow for the exchange of rupee and foreign currency between the central banks of the two countries.

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- RBI allowed banks from 18 countries to open **Special Vostro Rupee Accounts** (SVRAs) for settling payments in Indian Rupees.
- RBI constituted Inter-departmental group (IDG) headed by RBI Executive Director **Radha Shyam Ratho** to frame roadmap for the Internationalization of Indian Rupee has submitted its report.
- During PM Modi's visit to UAE in July 2023, Reserve Bank of India (RBI) signed two MoUs with Central Bank of UAE. One of the MoU focuses on establishing a framework to promote the use of local currencies from cross-border transactions, the other was for linking payment systems.

- **Challenges in achieving internationalization:**
  - **Little traction for international trade in rupee**:
  - **Large Trade Deficit**
  - **Lack of Liquidity**
  - **Underdeveloped Financial Markets**: India's financial market are still relatively under-developed when compared to major economies, which can limit the range of products and services available to international investors.
  - **IDG has also highlighted following limitations that may arise due to internationalization of Rupee:**
    - **Exchange rate volatility in rupee's exchange rate** will increase in initial stages of internationalization.
    - **Triffin Dilemma**: Obligation of a country to supply its currency to meet the global demand may come in conflict with its domestic monetary policies.
    - **Accentuation of external shock** may take place due to open channel of flow of funds into and out of the country and from one currency to another.
  - However, the IDG itself said that the advantages of internationalization far outweigh the above limitations. Moreover, the internationalization of rupee will be a long-drawn process and would enable timely redressal of these challenges.

- **Recommendations given by RBI's Inter-Departmental Group:**
  - **Short term measures:**
    - Adoption of Standardized approach for examining the proposals on bilateral and multilateral trade arrangements for invoicing, settlement, and payment in the rupee and local currencies.
    - Encouraging the opening of the rupee accounts for non-residents both in India, and outside India.
    - Incentivizing exporters to use Indian currency for trade settlements.
    - Integrating payment systems to provide seamless cross border transactions.
    - Strengthening the financial markets by fostering a global 24X5 rupee market
    - Recalibration of FPI regime.

  - **Medium Term Measures (2-5 years targets)**
    - Synchronizing tax regimes of India and other financial centres.

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        - A review of taxes on masala bonds
    - Allowing banking services in the rupee outside the country
        - Allowing international use of RTGS for cross border trade
    - Inclusion of Indian government bonds in global bond indices

- **Long Term**
    - Measures to have rupee included in the IMF's SDR.

6. EXPORT SECTOR

- **Current Situation**:

		2022-23 (USD Billion)	**2021-22** (USD Billion)
Merchandize	**Exports**	447.46	422
	Imports	714.24	613.05
Services	**Exports**	322.72	254.53
	Imports	177.94	147.01
Overall Trade (Merchandize + Services)	**Exports**	770.18	676.53
	Imports	892.18	760.06
	Trade Balance	-122.00	-83.53

- **Why does India face such huge trade Deficit**:
    - **Huge Dependency on Fossil fuel imports**
    - **Underperformance in Exports** (India's global export share is only 1.8%, China has 13% share).
        - Manufacturing sector not well developed.
        - Less diversification in export basket (10 principal exports account for 78% of total merchandize exports)
    - **Less focus on scientific research and development**
        - This hinders complex and unique exports.
    - **High cost of logistics** -> Reduces cost competitiveness of Indian products.
    - **Not able to utilize its demographic dividend** due to poor skill levels in the country.

- **Some steps taken to promote exports** and reduce import dependency.
    - **Various Schemes** to promote exports.
        A. **Remission of Duties and Taxes** on Exported Products (RoDTEP) Scheme.
        B. **Export Promotion in Capital Goods Scheme**
    - **Steps to improve infrastructure.**
        - National Logistic Policy
    - **Focus on Manufacturing sector** - Atmanirbhar Bharat; Various **PLI Schemes**
    - **Increased focus on renewable Energy**

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7. FOREIGN TRADE POLICY, 2023

- India's new FTP i.e. **Foreign Trade Policy, 2023** has come into force from 1st April 2023.

- This policy is based on continuity of time-tested schemes **facilitating exports** as well as a document which is **nimble and responsive** to the requirements of trade.

- **The Key Approach** to the policy is based on these **4 pillars**:
  1. **Incentive to Remission**
  2. **Export Promotion** through collaboration - Exporters, States, Districts, Indian Missions
  3. **Ease of Doing Business, reduction in transaction cost and e-initiatives**.
  4. **Emerging Areas** - E-commerce, Developing Districts as export Hubs and **streamlining SCOMET Policy**.
     - **Note: SCOMET stands for Special, Chemicals Organisms, Materials, Equipment, and Technologies (SCOMET) policy.**

- **Key Aims and Objectives of India's FTP, 2023 are**:
  - » Boost India's **exports to USD 2 trillion by 2030**.
  - » Strengthen India's **export competitiveness.**
  - » **Diversify export basket**, **expand** export markets, and **promote sustainable exports**.
  - » Focus on promoting exports from small and medium enterprises (SMEs). For this policy envisages support in the form of access to finance and markets.
  - » Provide for several **incentives for exporters**, including duty drawback, export promotion capital goods (EPCG) scheme, and interest subvention schemes.
  - » **Encourage collaboration** between exporters, states, and districts to promote exports.
  - » **Simplify and streamline the process** of exporting goods and services:
  - » **Focus on emerging areas of export**, such as e-commerce, green technology, and defence and aerospace. These are the areas where India has a competitive advantage, and the policy aims to help businesses take advantage of these opportunities.

- **The Policy aims to boost India's exports through** several **measures:**
  - » **Process Re-engineering and Automation** (technology enablement) for facilitating exporters.
  - » **Expanding the scope of Town of Export Excellence (TEE)** by including Faridabad, Mirzapur, Moradabad and Varanasi in the existing list of 39 towns listed as Towns of Export Excellence (TEE).
  - » **Promoting Exports from districts** by building partnerships with state government and taking forward the **District as Export Hubs initiative** to promote exports at the district level.
  - » A **robust export control system** in India would provide **access of dual use High end goods and technologies** to Indian exporters while facilitating exports of controlled items/technologies

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under **SCOMET** (Special Chemicals, Organisms, Materials, Equipment, and Technologies) from India.

» **Facilitating E-Commerce Exports** through establishment of e-commerce hubs and other related elements.

- The consignment wise cap on E-commerce exports through courier has been raised from Rs 5 Lakh to Rs 10 lakh.
- A comprehensive e-commerce policy addressing export/import ecosystem is planned to be brough soon.

» **Export Promotion of Capital Goods (EPCG) Scheme** has been rationalized.

- Prime Minister Mega Integrated Textile Region and Apparel Parks (**PM MITRA) scheme** has been added as an additional scheme eligible to claim benefits under CSP(Common Service Provider) Scheme of Export Promotion capital Goods Scheme(EPCG)
- **Battery Electric Vehicles (BEV) of all type**s, Vertical Farming equipment, Wastewater Treatment and Recycling, Rainwater harvesting system and Rainwater Filters, and Green Hydrogen are added to Green Technology products – will now be **eligible for reduced Export Obligation requirement under EPCG Scheme.**

» **Introduction of provisions for merchanting trade**.

- **Note:** Merchanting trade involves **shipment of goods from one foreign country to another foreign country without touching Indian ports, involving an Indian intermediary**.

» **Amnesty Scheme** to provide relief to exporters who have been unable to meet their obligations under EPCG and Advance Authorization schemes. This will reduce litigations and foster trust based relationship.

1) VARIOUS SCHEMES FOR PROMOTING EXPORTS

A) REMISSION OF DUTIES AND TAXES ON EXPORTED PRODUCTS (RODTEP)

- **Why in news?**
  » Government of India notifies extension of Remission of Duties and Taxes on Exported Products support to Advanced Authorization Holders, Export Oriented Units and Special Economic Zone Units (March 2024)

- **About RoDTEP:**
  » It is an initiative to promote export launched by Ministry of Commerce and Industry. It was announced in 2019 but came into effect on 1st Jan 2021.
  » Under this reimbursement is made of unrefunded taxes and duties (central, state, or local) incurred in the process of manufacture and distribution of exported products
  » It is a WTO compliant scheme. This is based on the globally accepted principle that taxes and duties should not be exported. It thus provides a level playing field to Indian industries abroad
  » **Past WTO challenges?**

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- India's past export subsidy was challenged in the WTO by the USA.
- Therefore, RODTEP was introduced which is WTO complaint.
- Two older schemes which has been merged inside this scheme are - Merchandize Export from India Scheme (MIES) and the Rebate of State and Central Taxes and Levies Scheme (RoSCTL).

- **The RoDTEP support which was notified till 30th Sep 2023** is now being **extended till 30th June 2024** at the same rates to the existing export items (Sep 2023)

- **RoDTEP Committee**
  - » In line with the framework of the scheme, the RoDTEP committee has again been constituted in the Department of Revenue to review and recommend the ceiling rates under the RoDTEP scheme for different export sectors.

- **Extension of RoDTEP to other sectors** (March 2024)
  - » In March 2024, government announced extension of the RoDTEP Scheme support to additional export sectors i.e. Advanced Authorization Holders, Export Oriented Units (EOU), and Special Economic Zone (SEZ) Export Units. These sectors contribute to around 25% of India's exports. Sectors such as Engineering, Textiles, Chemicals, Pharmaceuticals, & Food Processing and many others stand to benefit from the measure.
  - » This extension will help export community in handling the international headwind.
  - » Keeping budgetary allocation in view, the extension of RoDTEP to additional sector is presently till 30/09/2024

B) AUTOMATIC 'STATUS HOLDER' CERTIFICATE UNDER FOREIGN TRADE POLICY, 2023

- **In Oct 2023**, Ministry of Commerce & Industry has unveiled a significant initiative to issue system based automatic '**Status Holder**' certificate under FTP, 2023.

- **What was happening till now?**

  - **Till now**, the exporter is required to file an online application along with an export certificate from a Chartered Accountant for grant of Status. The DGFT Regional Offices, as per the laid down timelines are supposed to issue the certificate in 3 days.

- **New Regime:**

  - The new arrangement will lead to a **simplified regime where no applications are invited from exporters** and the **certification is granted every year in August based on annual export figures available with the partner government agency i.e. DGCIS**.

- **Advantages:**

  - » **Exporter will not be required to apply to office of Directorate General of Foreign Trade (DGFT)** for a status certificate and the **export recognition will be provided by the IT system** based on available Directorate General of Commercial Intelligence and Statistics (DGCIS) merchandize export electronic data and other risk parameters.

» It thus reduce compliance burden and promote ease of doing business,

- **What is the significance of Status Holder Certificate?**

  » The Status Holder certification program provides credibility to the Indian exporters in the international markets. Status holders are business leaders who have excelled in international trade and have successfully contributed to India's foreign trade.

  » In addition, it provides **certain other privileges** including simplified procedures under FTP 2023 and priority custom clearances on self-declaration basis, exemption from compulsory negotiation of documents through banks, exemption from filing Bank Guarantee for FTP schemes etc.

8. FOREIGN INVESTMENT (FDI AND FPI)

1) FOREIGN DIRECT INVESTMENT (FDI)

- Foreign Direct Investment (FDI) is the **investment through capital instruments** by a person who is a resident outside India:
  A. In an unlisted Indian company
  B. In 10% or more of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company
     » (If the investment comes below 10% subsequently the FDI shall be continued to be classified as FDI. It will not be reclassified as FPI), i.e., **once an FDI, always an FDI**.

- **Key Facts about India's FDI Policy (Remember for Preliminary Exams)**
  » **Eligible Investors**
    - **A non-resident entity can invest in India, subject to FDI policy**, except in those sectors/activities which are prohibited.
    - However, a citizen/entity from Bangladesh can only invest under the Government Route.
    - Further, a citizen/entity from Pakistan can invest, only under government route, in sectors/activities other than defence, space, atomic energy, and prohibited sectors for foreign investment.

  » **Prohibited Sectors**
    - FDI is prohibited in:
      i. Lottery business including Government/private lottery, online lotteries, etc.
      ii. Gambling and betting including Casinos.
      iii. Chit Funds
      iv. Nidhi Company
      v. Trading in Transferable Development Rights
      vi. Real Estate Businesses and Construction of Farmhouses

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- 'Real Estate Businesses' shall not include development of township, construction of residential/commercial premises, roads or bridges and Real Estate Investment Trust (REITs) registered and regulated by SEBI.

vii. Manufacturing of Cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes.

viii. Activities/sectors not open to private investment e.g. Atomic Energy, Railway Operations (other than permitted activities)

A) FDI SITUATION IN INDIA (CURRENTLY)

- **FY23**: $70.97 billion
- **Top Source Countries** (FY23)
  - Singapore ($17.2 billion); Mauritius ($6.13 billion); the US ($6 billion), the UAE ($3.35 billion), the Netherlands ($2.5 billion).
  - Other important source countries include Japan, UK, Cyprus, Cayman Islands, and Germany.
- **Top Five Sectors** to receive FDI
  - **Computer Software ($9.4 billion)**; (Dip from last year)
  - **Service Sector** ($8.7 billion) (Rise from last year)
  - **Trading, Telecommunication, pharma and Chemicals** have also recorded growth in FDI inflow.
- **Statewise FDI reception**:
  - **Maharashtra** received the highest inflows of $14.8 billion during the last fiscal year (though the inflow are down when compared to $15.44 billion) of last year.
  - **Karnataka, Delhi, TN, Haryana, Telangana** and WB also saw a dip in FDI inflow.
  - **Gujarat** saw an increase in FDI to **$4.71 billion** (against $2.7 billion in FY22).
  - **Rajasthan** also saw a positive growth.

- **Why decline in FY23** and **what are FDI threats for future:**
  - » Escalation in **geopolitical** stress
  - » Enhanced volatility in global financial systems
  - » Sharp Price corrections in global stock market
  - » High magnitude of El-Nino
  - » Frail Global Demand

B) WHY HAS INDIA EMERGED AS AN ATTRACTIVE DESTINATION OF FDI

- **Liberalization of investment restrictions**
  - In India FDI upto 100% is allowed in non-critical sectors through the automatic route, not requiring clearance from the Ministry of Home Affairs (MHA).
  - Even in strategic sectors like Defence, government has allowed FDI of upto 74% through automatic route and 100% through government route.
  - Consultation activities with representation of different sectors
- **Make in India**, **Atmanirbhar Bharat, PLI** Schemes, **PM GatiShakti** etc.
- **Reforms in Indirect and Direct taxes:**
  - Corporate tax for most companies have been reduced to 25% and for new companies in manufacturing, it has been reduced to 15%
  - GST system has been streamlined, leading to simple tax regime.
- **Increased public capex expenditure** - It is also crowding in private and foreign investment.

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- Strengthening of **India's footing in global supply chains**
- **Elimination of Regulatory barriers**
- **Improved Ease of Doing Business**
- **Improved International Relations**

C) NEED OF FDI IN INDIA

- **Lack of Domestic Resources:**
    - » Neither the government, nor the private sector in India has enough resources to fulfill India's infrastructure and industrial needs. For e.g. infrastructure sector alone needs more than 1 trillion dollars over the next few years. COVID-19 crisis has further deteriorated the situation.
- **Diffusion of new Technology:**
    - » FDI, along with it brings in new technology which is very important for the growth and advancement of India.
- **Virtuous Cycle of Investment:**
    - » High FDI in any country gives confidence to other investors and creates a virtuous circle of more investments. So, increasing FDI will also increase private investments which has gone stagnant over the years.
- **Other advantages associated with FDI**
    - » **Economic Growth:** More Investment leads to more growth which in turn leads to higher incomes, more employment etc.
    - » **Improved performance of governments at state level:** Increases competition among states to attract FDI -> promotes good/efficient business practices among the states
    - » **Provides opportunity to government to focus more on social sector**

D) MAIN PROBLEMS THAT ARE RESTRICTING FDI INFLOWS IN THE COUNTRY

- **Complex and rigid Labour Laws**
- **Significant Delay in Land Acquisition** due to slow environmental clearance and difficult Land Acquisition Act.
- **Bureaucratic Red Tapism and Corruption** still dissuades foreign investors from investing in the country
- **Regulatory framework also needs simplification** as it is still too complex for many investors.
- **Regulatory Certainty** is something the investors crave the most.
    - Frequent rule changes, including retrospective changes worry the investors.

E) PROBLEMS ASSOCIATED WITH INCREASED FDI DEPENDENCY

1. **Volatile Investments:** Unreliable in the long term
    - FDI tend to switch to countries where there is more profit, cheap labor and cheap land.
2. **Diffusion of technology is limited :**
    - It is in the interest of foreign firm to withhold profitable technology. Thus generally diffusion of new technology is very less.
    - Moreover, in a developing country like India, where the state of both physical and human capital is not yet on a par with advanced countries, the diffusion also becomes difficult.
3. **Job Creation Not very effective due to FDI ->** FDI is mostly coming in service sector or capital-intensive sector.
    - Despite the central government's push to boost manufacturing sector through 'Make in India' and various PLI initiatives, FDI's continue to chase bets in the services sector.
        - For e.g. in FY23, the highest FDI came in sectors like IT, Services etc.

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- Further, the bulk of FDI in manufacturing is not greenfield.

4. **Regional inequities are perpetuated** -> Most FDI come in already industrialized regions.
    - For e.g. Maharashtra, Karnataka, Gujarat and Delhi - collectively accounted for 83% of the FDI between Oct 2019 and March 2022.
    - This further leads to metro - non metro divide and inequitable distribution of opportunities throughout the country.

2) FOREIGN PORTFOLIO INVESTMENT (FPI)

- **Introduction**
    - Foreign Portfolio Investment (FPI) is any investment made by a person resident outside India in capital instruments where such investment is
        - Less than 10 percent of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company or

Gyan	**Fully diluted basis** means the total number of shares that would be outstanding if all possible sources of conversion are exercised. For e.g. if the company had issued 100 shares as on today. However, there are debentures that are yet to be converted into shares. If it happens say the total number of shares may go up to 1500. The 10% calculation is to be made against 1500 which is called total number of shares on fully diluted basis.

        - Less than 10 percent of the paid-up value of each series of capital instruments of a listed Indian company
    - **Note:**
        - FPI reflect capital gain but doesn't lead to lasting interest in the company.
        - FPI includes investment in stocks, bonds (government or corporate), infrastructure securities etc.
    - Since FPI is easily withdrawable/cashable, it is also called **hot money** and is considered less stable when compared to FDI.

- **Type of FPIs:** In India, FPIs include Foreign Institutional Investment (FII) and Qualified Foreign Investment (QFI).
    1. **Foreign Institutional Investment**
        - It involves foreign institutional investors going for FPI.
        - **Only institutional investors** like investment companies, investment funds etc are allowed to invest in Indian stock market directly. These investors have to get a license from SEBI.

    2. **Qualified Foreign Investment (QFI)**
        - The concept of QFI was introduced in 2000, which allowed individual foreign investor to invest in Indian stock market **without a sub-account** in FII.
        - However, they have to open a Demat account and Trade Account with the depository participant in India.
        - A QFI can be individual, group or an association.
        - QFI should satisfy following conditions.

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i. QFI should be <u>resident in a foreign country</u> that is compliant with the standards of Financial Action Task Force.
ii. QFI must be a signatory to <u>International Organization of Securities Commission's Multilateral Memorandum of Understanding (MMoU)</u>.

- **Note: According to Regulations by SEBI**
  i. **Investments in unlisted companies** are treated as **FDI.**
     - FPIs <u>are not allowed to invest in unlisted shares and investment in unlisted entities will be treated as FDI.</u>
  ii. Any equity which is less than or equal to 10% of capital in a company is portfolio investment. While <u>investment above 10%</u> of capital in a company will be counted as <u>Foreign Direct Investment</u>.
  iii. **Investment by a FPI** cannot exceed <u>10% of the paid up capital</u> of the Indian company.
  iv. **All FPI** taken together <u>can't acquire more than 24 percent</u> of the paid-up capital of an Indian Company.
  v. **Investment by NRIs** will not be considered FPI.

- **Advantages of FPI**
  i. **For investor**
     - **Portfolio diversification**
     - **Easy access to international credit**
       - If investor holds FPI they can access credit in the foreign country. Ability to get credit on <u>favorable terms and quickly</u> can determine the business expansion opportunities for the investor.
     - **More Liquid and thus less risky**

  ii. **For Domestic Economy**
     - **More capital to country's capital market** will lead to <u>more development of capital market thereby resulting in more capital flowing into the real economy</u> thereby leading to overall development of the country.
     - **Diverse Investment, large scale investments**
       - FIIs are big and hence they have the capacity to make large scale investment.
     - **Strengthening of domestic currency**

- **Limitations of FPI**
  i. **For Investors**
     - **Lack of control** over business
  ii. **For domestic country**
     - Easy liquidity of investments comes with **vulnerability for economy**.
       - E.g. East Asia crisis of late 1990s.
     - Sudden withdrawal also leads to <u>beating up of the domestic currency</u>.
     - **Chances of round tripping of funds**
       - Sometimes, round tripped capital is re-invested in the Indian Stock markets using the FPI route.

- **Situation in FY23**:

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- As per annual report of SEBI released in Aug 2023, **FPIs pulled out Rs 37,632 crore** from Indian equities during FY23. This is a decline in outflow of **73.1%** as compared to FY22.
    - **Why the recent outflow**:
        - **Rise in Inflation worldwide** led to tightening of monetary policies among all major economies.
        - **Global uncertainty** due to geopolitics of Europe have also led to withdrawals.
        - **COVID-19** resurgence in China has also added to negative sentiments

- **But** the **stock markets haven't fallen much** and are trading near its highest ever.
    - This is because DII flows are compensating the FII outflows. They invested a **total of Rs 2.55 lakh crore** during the fiscal year.
        - DIIs now own a record 15% of the BSE-500 shares, just 3.3% points below the share of FPIs, which has now declined to nine-year lows.
        - This highlights India's economic resilience and attractiveness to local investors.

9. CURRENCY CONVERTIBILITY: CURRENT ACCOUNT AND CAPITAL ACCOUNT CONVERTIBILITY

- **What is Convertibility of a currency?**
    - » Currency convertibility is the ease with which a country's currency can be converted into gold or another currency.
    - » **A convertible currency** (e.g. $US, Euro, Japanese Yen, and British Pound) can be easily traded on forex markets with little or no restrictions. It is also seen as a reliable store of value, meaning that investor will have no trouble buying or selling the currency. A convertible currency is highly liquid instrument as compared with currencies that are tightly controlled by the country's central bank. A convertible currency is also sometimes referred as a hard currency**.**
    - » **A partially convertible currency** (for e.g. Indian Rupee, South Korean Won, and the Chinese Yuan) is the legal tender of a country that is traded in low volumes in the global forex market. The government of these countries put capital controls that limit the amount of currency that can exit or enter the country.

- **Currency Convertibility is important in external sector**:
    - » When a country has poor currency convertibility, it means it is difficult to swap it for another currency, it poses a risk and barrier to trade with foreign countries who have no need for the domestic currency.

1) CURRENT ACCOUNT CONVERTIBILITY

- » Current account convertibility allows free inflows and outflows for all purposes other than for capital purposes such as investments and loans. In other words, it allows residents to make and receive trade-related payments -- receive dollars (or any other foreign currency) for export of goods and services and pay dollars for import of goods and services, make sundry remittances, access foreign currency for travel, studies abroad, medical treatment and gift.

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- **Since 1994 full current account convertibility is allowed in India. That is Indian Rupee is fully convertible in Current Account.** This means one can import and export goods and receive or make payments for services rendered without limitations. There is no quantitative restriction on this.

- **Some Minor Restriction on Current Account Convertibility under FEMA**
    - Not allowed on betting, gambling, prohibited items
    - Travel to Nepal/Bhutan -> only upto $10K could be converted and taken. Rupee can be carried in any quantity.
    - Travel to other countries -> only upto $25K (beyond this permission from RBI needed)
    - Education, Medical treatment, employment -> $1 Lakh
    - Gift Sending: Rs 5 Lakh worth.

- **Advantages of Current Account Convertibility**
    - Facilities to send foreign earnings to India freely.
    - International trade flourishes
    - Imports and exports can be done at fair rates determined by the market.

2) CAPITAL ACCOUNT CONVERTIBILITY

- Meaning: It means the freedom to convert **local financial assets into foreign financial assets** and vice versa at market determined rates of exchange.

- **India does not allow full Capital Account Convertibility, i.e. Indian Rupee is not fully convertible on the capital account.**

    - **External Commercial Borrowing** has sector wise limitations and RBI's approval is required.
    - **FDI restrictions, FII restrictions**
        - No restrictions on investment in Bhutan
        - In other countries: Maximum $75 K per year (individuals) e.g. buying shares, opening foreign bank accounts etc.
    - **Financial Action Task Force: " Non cooperative countries" ->** No investment is allowed in such country.
    - **Liberalized Remittance Scheme (2004)** (Above FEMA limits both on Current and Capital Convertibility)
        - Applies on Indian Residence
        - Under this $2.5 Lakh can be taken per year per person abroad.

- **Debate over whether Capital Account Convertibility should be liberalized.**
    - **Arguments in Support of liberalization**
        - **SS Tarapore Committee** (or Committee on Capital Account Convertibility) was formed by RBI in 1997 to examine the viability of capital account convertibility in India.
            - Bring Capital account convertibility **in phases** (98,99,00)
            - **Preconditions**
                - Fiscal deficit (limit it to 3.5% by 2000)

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        - Inflation average (3-5%) (in 3 years)
        - Interest rates by banks should be decontrolled
        - Enough Forex to sustain 6 months imports
        - NPAs of banks should be brought down to 5% of total asset
        - CRR should be brought down to 3%
    - **Second Tarapore** Committee: **Committee on Fuller Capital Account Convertibility** (2006)
        - Its approach was same again. It recommended capital account convertibility implementation in a phased manner, in 3 phases from 2006 to 2011.

    - **Need of Easy Capital Account Convertibility**:
        - **Foreign Direct Investment Needs** of India
        - **Easy ECB** can reduce the cost of borrowing for Indian businesses.
        - **More investment** can lead to increased GDP.
        - **Development of more MNCs from India**. Easy capital account convertibility will allow Indian companies to easily acquire foreign companies and thus develop into multinationals.
        - **Portfolio diversification for Indian investors**.
    - **Other Arguments in Support of Capital Account Convertibility**
        - All developed countries are capital account convertible; hence this is an inevitable destiny of the developing countries in their path to development.
        - Better and most efficient flow of global pool of savings to the more productive uses.
        - It will facilitate portfolio diversification by investors in developed as well as developing country.
        - Feasibility of capital account convertibility rests on sound macroeconomic policy, it creates a sort of commitment for the country concerned to ensure better macroeconomic management, lest it is punished by the investors.

- **Arguments against making rupee full convertible on Capital Account**
    - **HR Khan (deputy governor of RBI)**
    - **BoP Crisis** (like the 1990s East Asian Crisis) was exacerbated by the full capital account convertibility.
        - Most of these countries has full capital account convertibility.
        - India and China didn't have the full capital account convertibility, thus these countries were saved from this kind of crisis.
    - Capital flows are sensitive to macroeconomic conditions. Any deterioration in fiscal conditions, inflation management, balance of payments, or any other macroeconomic shock may cause a cessation or reversal of capital flow.
    - **May hamper interest of domestic economy** as funds may easily flow outside the country affecting employment and other opportunities.
    - **Instability in Rupee** may be another outcome of full capital account convertibility.

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