CHAPTER

17

BALAN
PAYM
REFER

Chapter Outline

(A) Introduction;
(B) Components of Balance of Payments;
(C) Disequilibrium in the Balance of Paym
(D) Methods of Correction of Disequilibriu
(E) India's Balance of Payments Crisis of 1

Learning Objectives

(A) INTRODUCTION

A balance of payments is a double en
the residents of a country and the rest of tl
of Payments Statement presents a classifie

- all receipts on account of goods expo
- services rendered
- capital received by residents
- payments made by the residents due to
- capital transferred to non-residents/fore

The IMP publication on, *"Balance of P*
payments as:

The balance of payments is a statistical s

- Transactions in goods and services and in
- Changes of ownership and other changes and liabilities to the rest of the world, and needed to balance, in the accounting se changes which are not naturally offsetting

A balance of payments is a double entry system of record of all economic transactions between the residents of a country and the rest of the world carried out in a specific period of time.

BALANCE OF TRADE AND BALAN

The balance of trade is a narrow term. It imports. Thus, balance of trade takes into accoun import of visible items. In other words, balance o invisible items like services of banking sector, in interest payments and receipts, dividend payments

Balance of trade deals with export and import of visible items only.

like. Current account contains credits and debits. Credits of current account include: merchandise exports (money income from sale of goods) and invisible exports (income from services). Invisible exports consists of transport services, insurance services, foreign tourist services and other services sold abroad and/or to foreigners and income received on loans and investment abroad.

Debits of current account include: merchandise imports, payments for goods purchased from foreign countries, and invisible imports (payments to services received from foreign countries). Invisible imports consists of transport services, insurance services, tourism abroad and other services purchased from foreign countries and payments on loans and investments of foreigners in our country.

The two major items of current account are merchandise exports and imports and invisible exports and imports. Merchandise exports include the sale of goods to foreign countries. Most of these transactions are on credit basis. All these transactions give rise to monetary claims on foreign importing companies. *These claims are credits*. Contrary to these transactions, merchandise imports include purchase of goods from foreign countries. Debit entries are made for these transactions as they rise to foreign exchange claims on the home country. *These claims are debits.*

Invisibles include cost of services, income and transfer payments. The IMF Manual classifies invisible account into as many as 121 items while the Indian authorities classified into eight heads. They are: travel, transportation, insurance, investment income, government not included elsewhere, miscellaneous (receipts/payments for patents and royalties), transfer payments official and transfer payments private.

Invisible exports include the sale of services to the foreigners like insurance, tourism, ansportation, banking, financial services, salaries, etc. *Similarly,* invisible exports also include terest and dividends received from the foreign countries. These items are the debits. Invisible nports include the purchase of services from the foreigners like insurance, tourism, transportation, nking and financial services, payment of interest and dividend to the foreigners. These items e placed on the credit side of the balance of payments.

Table 17.1 presents summary of balances of current account for selected groups of countries d individual countries. It is observed from *Table 17.1* that the balance of current account of vanced economies was negative during the period 2002 to 2010. It was also estimated that the rent account balance of advanced economies will be negative in 2011 and 2015. Similarly, in American and Caribbean countries and Sub-Sahara African countries (with minor deviations) fer from negative balances. The reason for the negative balance was due to excess of chandise and/or invisible imports over merchandise exports.

However, it is interesting to note that the current account balance of the Euro area, newly strialized economies, developing economies and Middle East and North-African countries positive during the period 2002 to 2010. It was also estimated that they would enjoy positive nces in 2011 and 2015. The reason for the negative balance was due to excess of merchandise or invisible exports over merchandise imports. As far as individual countries are concerned, was suffering from negative current account balance and Japan was enjoying surplus balance urrent accounts during the period.

TABLE 17.1 SUMMARY OF BALANCES OF CURRENT ACCOUNT FOR SELECTED COUNTRIES. *(In billions of US dollars)*

Country	*2002*	*2004*	*2007*	*2009*	*2010*	*2011*	*2015*
World	-136.4	-0.2	310.8	216.6	202.3	296.6	489.4
Advanced Economies	-216.3	-219.9	-343.5	-122.6	-110.1	-28.6	-274.4
Euro Area	43.4	76.6	18.6	-77.9	21.3	57.2	22.5
Newly Industrialized Asian Economies	55.9	82.9	113.7	136.2	132.1	137.1	150.7
Developing Asia	67.1	92.9	418.3	321.7	273.2	308.1	731.2
Latin America and Caribbean	-16.2	21.4	15.1	-21.9	-56.6	-80.2	-109.8
Middle-East and North Africa	31.3	103.2	272.3	52.3	97.1	127.1	234.5
Sub-Sahara Africa	-12.4	-8.0	9.7	-15.1	-11.3	-21.4	-24.9
USA	-458.1	-630.5	-718.1	-378.4	-466.5	-400.4	-601.7
Japan	112.6	172.1	211.0	141.8	166.5	133.3	121.5

Note: Figures for the years 2011 and 2015 are estimations.

Source: *World Economic Outlook:* Recovery, Risk and Rebalancing, October 2010, International Monetary Fund, p.194.

Table 17.2 presents balance of current accounts as a percentage of GDP for selected countries. It is observed from this table that USA, France, UK, Canada, Italy and India experience negative percentages (with minor deviations) due to negative current account balance. However, Germany, China and Japan had positive balances. In fact these three countries fare better in exports.

TABLE 17.2 BALANCES OF CURRENT ACCOUNT AS PERCENTAGE OF GDP FOR SELECTED COUNTRIES.

Country	*2002*	*2004*	*2007*	*2009*	*2010*	*2011*	*2015*
USA	-0.8	-0.7	-0.9	-0.3	-0.3	-0.1	-0.6
Germany	2.0	4.7	7.6	4.9	6.1	5.8	3.9
France	1.2	0.5	-1.0	-1.9	-1.8	-1.8	-1.8
UK	-1.7	-2.1	-2.6	-1.1	-2.2	-2.0	-1.1
Canada	1.7	2.3	0.8	-2.8	-2.8	-2.7	-1.8
Italy	-0.8	-0.9	-2.4	-3.2	-2.9	-2.7	-2.4
Japan	2.9	3.7	4.8	2.8	3.1	2.3	1.9
China	2.4	3.6	10.6	6.0	4.7	5.1	7.8
India	1.4	0.1	-0.7	-2.9	-3.1	-3.1	-2.2

Note: Figures for the years 2011 and 2015 are estimations.

Source: *World Economic Outlook:* Recovery, Risk and Rebalancing, October 2010, International Monetary Fund, pp.195-196.

Table 17.3 presents the balance of payments position of India on current account during 1979-80 to 2008-09.

TABLE 17.3 BALANCE OF PAYMENTS OF INDIA ON CURRENT ACCOUNT

(₹ crores)

Year	Trade Balance	Net Invisibles	Balance of Payments
1979-80	–3374	+3140	–254
1980-81	–5967	+4310	–1657
1981-82	–6121	+3804	–2317
1982-83	–5776	+3480	–296
1983-84	–5871	+3609	–2262
1984-85	–6721	+3869	–2852
1985-86	–9586	+3630	–5956
1986-87	–9354	+3524	–5830
1987-88	–9296	+3003	–6293
1988-89	–13555	+1975	–11580
1989-90	–12413	+1025	–11388
1990-91	–16934	–435	–17369
1991-92	–6495	+4258	–2237
1992-93	–17238	+4474	–12764
1993-94	–12723	+9087	–3636
1994-95	–28420	+17837	–10583
1995-96	–38061	+18454	–19607
1996-97	–52559	+36720	–15839
1997-98	–60751	+36196	–24555
1998-99	–51825	+33305	–18580
1999-00	–69883	+47538	–22345
2000-01	–56287	+42648	–13639
2000-02	–49758	+50833	+1075
2002-03	–47037	+74,954	+27,917
2003-04	–67,997	+114466	+46469
2004-05	–111,928	+125,328	+13,400
2005-06	–184,300	+170,620	–13,680
2005-06	-184,300	+170,620	-13,680
2006-07	- 279,962	+235,579	-44,383
2007-08	-368,532	+299,618	-68,914
2008-09*	-472,773	+307,726	-165,047

* *2008-09 data relates to April 2008 to December 2008.*

Source: Calculated from *Economic Survey*, Government of India, 2006-07.

Balance of Payments Position of India on Current Account

- The balance of payments position of India relating to current account during the First Five-Year Plan was quite satisfactory. During this period the inflow of foreign capital was ₹ 13.60 crore and the foreign exchange reserve was ₹ 127 crore. The deficit of the current account was only ₹ 42.30 crore. India enjoyed surplus in current account of balance of payments during 2001-02 to 2004-05 due to increase in net invisibles, but suffered from deficit in 2005-06.
- The balance of trade experienced a deficit of ₹ 2,339 crore during the Second Five-Year Plan. The invisible positive balance reduced this deficit. The current account had a deficit of ₹ 1,725 crore.
- The current account deficit during the Third Five-Year Plan was ₹ 1,941 crore.
- The Fourth Five-Year Plan experienced a surplus position of ₹ 100 crore in the current account of the Balance of Payments position. The reason for this position was the export promotion measures taken by the Government and increase in the invisible receipts.
- During the Fifth Plan period the trade deficit increased to a maximum of ₹ 3,179 crore. This position was due to increase in oil prices. However, the increase in net invisible to ₹ 6,221 crore, resulted in favourable balance of payments to the tune of ₹ 3,082 crore.
- The Sixth Five-Year Plan set a different trend of experiencing heavy deficits. In fact, it was started in the year 1979-80.
- The trade deficit during the Sixth Plan was ₹ 30,456 crore. But the net invisibles (₹ 19,072 crore) helped to reduce the deficit of balance of payments to ₹ 11,384 crore.
- The period during 1985-86 to 1989-90 witnessed a trade deficit of ₹ 54,204 crore. The net invisibles of ₹ 15,891 crore stopped the deficit of balance of payments at ₹ 38,313 crore.

Reasons for Deficit Balance

The data presented in *Table 17.3* reveal that Indian economy has been facing the problem of heavy deficits in the balance of payments. The problem has been acute since Fifth Five-Year Plan. The mounting deficits in the balance of payments had been due to:

- The Government of India liberalised imports in 1985 by announcing liberalised export-import policy. This policy led to the increase in imports significantly.
- Despite the growth of the Indian economy and exports, the increased demand resulted in widening of import base. In fact, the rate of imports (annual growth rate was 16.8 per cent) was lower than that of the exports (annual growth rate is 18.7 per cent) during the Seventh Plan.
- The Gulf War has influenced the Indian economy adversely. This has contributed vitally for the 1990-91 balance of payments crisis.
- The rapid industrialisation led to the import of capital goods, import of technology, machinery, technical personnel, etc. This factor, in turn, resulted an increase in imports.
- The slow growth of invisible accounts and increase in the interest burden also increased the deficit of balance of payments.
- The devaluation/depreciation of rupee against the currencies of the countries from which we have been importing, increased the value of our imports. This, in turn, enhanced the balance of payments deficit.
- The 1990-91 balance of payments crisis and the political instability made the Government to borrow massively (to the tune of $ 1.2 billion) from the IMF.
- The discouraging export performance after 1991-92, despite the positive steps taken by the government, resulted an increase in the deficit of balance of payments. These factors resulted in

fall a foreign exchange reserves. However, increase in net invisibles and FDI enhanced foreign exchange reserves.

- Heavy imports of capital goods due to the fast growth of the economy during 2005-06 to 2008-09 was the main reason for deficit balance on current account.

Having discussed the current account, the trends in the current account and the reasons for the deficit in the balance of payments, we shall now discuss the capital account.

CAPITAL ACCOUNT

Capital account is divided into three parts, *viz.*, *(i)* private capital *(ii)* banking capital, and *(iii)* official capital.

Capital account is divided into three parts:
- Private capital
- Banking capital
- Official capital

Private capital is further divided into long-term and short-term. Long-term private capital is with the maturity period of more than one year and short-term capital is with the maturity period of one year or less.

Long-term private capital includes:

- Foreign investments — both direct and portfolio
- Long-term loans
- Foreign currency deposits
- Estimated portion of the unclassified receipts allocated to the capital account.

Banking capital covers movements in the external financial assets and liabilities of commercial and cooperative banks authorised to deal in foreign exchange.

Official capital, Reserve Bank of India's holdings in terms of foreign currency, and Special Drawing Rights held by government are categorised into: loans, amortisation, and miscellaneous receipts and payments.

Capital outflow from the home country to a foreign country is treated as a debit item and the inflow of capital from a foreign country to the home country is treated as a credit item. *For example*, if, Reliance Industries invests ₹ 1 billion in the Kingdom of Saudi Arabia, it will be represented as debit item in India's balance of payments and as a credit item in the balance of payments of the Kingdom of Saudi Arabia.

Capital account basically consists of credits and debits. Credits include foreign long-term investment in the home country (like foreign direct investment in home country, foreign investments in domestic securities, other investments of foreigners in home country and foreign governments loans to home country) and foreign short-term in home country.

Debit side of the capital account includes long-term investments in foreign countries (like direct investment abroad, investment in foreign securities, other investments abroad and government loans to foreign countries) and short-term investments abroad.

There would be either interest payments or dividend payments on the capital inflow. *For example*, if Reliance Industries invests its capital in the United Arab Emirates, India receives interest or dividend. The interest received would be a credit item for India in the current account of its balance of payments. This item would be a payment of interest to the UAE and hence it would be shown on the debit side of its current account of UAE.

Table 17.4 presents net international investment position as a percentage of GDP of selected countries during 2004 to 2009. It is clear from this table that USA, UK, Republic of Korea, Italy, India, France Euro area countries, Brazil and Australia experienced negative balances (with minor deviations) due to excess of debits over credits. However, Japan, China, Germany and Argentina experienced positive balances.

TABLE 17.4 NET INTERNATIONAL INVESTMENT POSITION (BALANCE ON CAPITAL ACCOUNT) OF SELECTED COUNTRIES AS PERCENTAGE OF GDP

Country	2004	2005	2006	2007	2008	2009
Germany	10.6	20.9	27.8	27.0	(918,651)26.6	(1,270,320)37.4
Japan	38.7	33.6	41.4	50.1	(2,484.971)50.8	(2,891,836)57.4
China	14.5	18.1	23.0	34.0	(1,493,816)33.0	(1,821,946)36.1
Argentina	2.0	11.6	10.2	13.1	(57,735)17.6	(56,174)18.2
Australia	-57.1	-52.8	-61.0	-60.4	(-499,136)-48.0	N.A.
Brazil	-44.9	-35.9	-33.9	-40.3	(-283,800)-17.3	(-605,659)-38.5
Canada	-15.9	-12.5	-5.7	-8.9	(5,501)0.4	(-114,015)-8.5
Euro Area	-10.7	-8.6	-11.4	-13.3	(-2,230,268)-17.3	(-2,074,175)-15.5
France	-1.0	1.1	1.1	-1.5	(-322,478)-11.9	(-315932)-10.9
India	-6.1	-5.6	-6.3	-6.2	(-85,880)-6.7	(-122,901)-9.5
Italy	-16.3	-15.7	-20.6	-21.5	(-468,148)-21.5	(-434,238)-19.4
Republic of Korea	-11.6	-20.2	-19.6	-21.9	(-113,065)-12.1	(-148,026)-17.8
Russia	-1.8	-4.1	-3.9	-11.7	(255,473) 15.2	(118,387)9.5
UK	-19.4	-19.1	-31.0	-23.0	(-147,990)-5.6	(492,771)-22.7
USA	-19.0	-15.3	-16.4	-13.6	(-3,493,884)-24.3	(2,737,843)-19.4

Note: Figures in brackets for 2008 and 2009 indicate net investment position in millions of US dollars
NA = Not Available

Source: Adapted from http://www.principalglobalindicators.org

Reasons for Deficit in Capital Account

Capital account structure has changed considerably over the period. Most of the deficit was financed through the inflow of concessional assistance during the period 1956-57 to 1979-80. This facility reduced the debt servicing burden. But, almost the entire deficit was financed through loans at market rate of interest during 1980-81 to 1997-98. The loans at concessional interest rates was nearly 90 per cent of total in 1980 and it declined to 35 per cent in 1990.

The average maturity period of loans was 40.8 years in 1980 and it dwindled to 29.1 years in 1990.

- Interest rates were increased during the period 1980-81 to 1998-99 compared to that of 1956-57 to 1979-80.
- Decline in the quality of 'external financing' during 1980-81 to 1998-99.
- Total debt increased from ₹ 19,470 crore in 1980-81 to ₹ 3,36,646 crore in 1996-97.
- Substantial amount of the current account deficit has been financed from the inflow of capital since 1984-85.
- Current account deficit was financed from the funds drawn under Extended Fund Facility from International Monetary Fund during 1980-81 to 1984-85. The amount drawn was SDRs 5 billion.

- Government of India has drawn substantially from the International Monetary Fund in 1990-91 consequent upon the deteriorating balance of payments position due to the impact of Gulf War.
- Our country has drawn ₹ 3,334 crore from IMF under Compensatory and Contingency Financing Facility (CCFF) in 1990-91.
- India received ₹ 2,077 crore in 1991-92 and ₹ 3,363 crore in 1992-93 under the stand by arrangement from the Fund.
- The increasing trade deficits, declining private remittances and decreasing concessional aid to finance the balance of payments deficit, made to India resort to high cost sources of finances like commercial borrowings, NRI deposits and loans from IMF. NRI deposits and commercial borrowings represent a substantial future liability.
- Increasing outflow of foreign capital and declining inflow during 1990-91, to 1992-93 seriously affected the foreign exchange reserves position. This in turn downgraded India's credit rating.
- There has been a slight improvement in the India's external debt position. It declined from US $ 99.00 billion at the end of March 1995 to US $ 92.2 billion at the end of March 1997.
- There is the structural change in the capital account. This change relates to reduction in debt creating flows and an enhanced resource to non-debt creating foreign investment flows since 1993-94.

Table 17.5 presents net (difference between inflows and outflows) on capital account.

The major strength of capital account in recent years is capital flows in the form of direct foreign investments. Larger inflow of direct foreign investment helps in clearing the current account deficit without imposing an excessive burden on the external debt management.

Thus, India experienced disequilibrium both in the balance of payments.

TABLE 17.5 NET FLOW (DIFFERENCE BETWEEN INFLOWS AND OUTFLOWS) ON CAPITAL ACCOUNT (₹ CRORE)

Item	*2005-06*	*2006-07*	*2007-08*	*2008-09**
Net Foreign Investment (Inflow-outflow)	68782	66791	180788	14148
Net Loans (Inflow-outflow)	7592	7973	8465	8568
Net Commercial Borrowings (Inflow-outflow)	26805	102461	160058	33086
Net Banking (Receipts-Payments)	5795	8477	47148	-3606
Rupee Debt Service	-2557	-725	-488	-138
Other Capita (Net) (Inflow-outflow)	5548	18696	37802	10696
Errors and Omissions	-2332	4334	4830	3685
Net Capital	109633	208017	438603	66439

Note: Data relate to April to December 2008

Source: www.indiabudget.ni.in (Accessed on 31/03/2011).

Observations from *Table 17.5* includes:

- Net foreign investment flow (excess of inflow over outflow) increased from ₹ 68,782 crore in 2005-06 to ₹141,148 crore in 2008-09.
- Net loans increased from ₹ 7,592 crore to ₹ 8,568 crore during 2005-06 to 2008-09.

» Total flows on capita account increased from ₹ 1,09,633 crore to ₹ 4,38,603 crore during 2005-06 to 2007-08.

Table 17.6 presents India's balance of payments during 1993-94 to 2008-09.

TABLE 17.6 INDIA'S BALANCE OF PAYMENTS : 1993-94 TO 2008-09

(US $ million)

Year	*Current Total (Net)*	*Capital Account (–increase)*	*Reserve Use*
(1)	*(4)*	*(5)*	*(6)*
1993-94	–1158	9882	8724
1994-95	–3369	8013	4644
1995-96	–5910	2974	2936
1996-97	–4619	10437	5818
1997-98	–5500	9393	3893
1998-99	–4038	7867	3829
1999-2000	–4698	10840	6142
2002-03	6345	10640	16985
2003-04	10561	20860	31421
2004-05	–2470	28,629	–26,159
2005-06	–9186	24,238	–15,052
2006-07	–9,565	46171	36,606
2007-08	–17,034	109198	92,164
2008-09*	–36,469	16,089	-20,380

* Data indicate for April to December 2008.

Source: Government of India, *Economic Survey*, 2005-06.

Observations from *Table 17.6* includes:

» Unfavourable trade balance increased from US $ 4056 million to US $ 15,454 million duri 1993-94 to 2003-04, but declined in 2005-06.

» Net invisibles increased from US $ 2898 million to US $ 42,655 million during 1993-94 to 200 06.

» Net capital inflow increased from US $ 9882 million to US $ 20,860 million in 2003-04.

» Net accretion of foreign exchange reserves increased from US $ 8,724 million in 1992-93 US $ 31,421 million in 2003-04, but declined in 2005-06.

» Increase in inflow of foreign investment more than that of outflow resulted an increase in n capital flows. This resulted in positive balance during 2006-07 and 2007-08. Howeve increased deficit balance on current account resulted in negative overall balance of paymen during April to December 2008.

♦ UNILATERAL TRANSFERS ACCOUNT

ateral
isfers are
ing the gifts.

Unilateral transfers are 'giving the gifts'. These include government grants, reparations, priva remittances, disaster relief, etc. India gave grant to Uganda in 1998. This item would be on the deb side of India's balance of payments and credit side of the Uganda's balance of payments.

Unilateral transfers account basically consists of credits and debits. Credits include private remittances received from abroad (like savings of Indians working in various countries), pension payments received from abroad and government grants received from abroad. Debits include private remittances to abroad, pension payments to abroad and government grants to various countries.

OFFICIAL SETTLEMENTS ACCOUNT

Official settlements account represent the official sales of foreign currencies and other reserves to foreign countries or official purchase of foreign currencies or other reserves from foreign countries.

Credits of this account are the money received from official sale of foreign currencies and offer reserves in foreign countries. Debits of this account include official purchases of foreign currencies and other assets.

(C) DISEQUILIBRIUM IN THE BALANCE OF PAYMENTS

When the demand for and supply of foreign currency of a country are equal, it is viewed that the balance of payments of that country is in equilibrium position. Some countries enjoy a surplus position (supply of foreign currency is more than that of the demand for foreign currency). Both the surplus and deficit positions represent the disequilibrium in the balance of payments. Almost all the countries in reality experience either a deficit position or a surplus position. Only a few countries experience equilibrium position in the balance of payments.

CAUSES OF DISEQUILIBRIUM

The causes of disequilibrium in the balance of payments are: economic factors, political factors and sociological factors.

Economic Factors

The economic factors responsible for disequilibrium are development disequilibrium, cyclical disequilibrium, secular disequilibrium and structural disequilibrium.

- **Development Disequilibrium:** Developing countries mostly take up the developmental activities like establishment of industries, construction of roads, bridges, power plants and other infrastructural facilities like hospitals, educational institutions, etc. These activities primarily increase import of capital goods, machinery and equipment. Also, the expenditure in developmental activities results in income of the people, aggregate demand, prices, and increase of import of consumer goods. Thus, developmental expenditure results an increase of capital goods and consumer goods imports. This, in turn, leads to deficit in the balance of payments.

- **Cyclical Disequilibrium:** Cyclical disequilibrium is concerned with the fluctuations in imports and exports due to business cycles. The boom in the business activity in one country increases consumption, aggregate demand, and prices more than the production. Therefore, the countries experiencing boom conditions import consumer goods immediately to meet the increased aggregate demand. Later it increases the import of capital goods in order to establish new or expand the existing production capacities. Thus, the boom condition increases the import of capital goods in order to establish new or expand the existing production capacities. The boom condition increases imports. In contrast, the depression conditions contribute to the growth in ... the production is higher than the aggregate demand and consumption. ... in disequilibrium in the balance of payments. ... USA is one of

Economic factors of Disequilibria include:

- Development disequilibrium
- Cyclical disequilibrium,
- Secular disequilibrium
- Structural disequilibrium

Cyclical disequilibrium is concerned with the fluctuations in imports and exports due to business cycles.