

STUDY OF BALANCE OF PAYMENT IN INDIAN PERSPECTIVE

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Abstract: Decline in gold imports and turnaround in exports helped narrow India's current account gap sharply to \$5.2 billion, or 1.2 percent of GDP, in the July-September quarter of this fiscal 2013-14. The paper intended to analyze the theoretical background that why India is facing current account deficit and the role of devaluation in the balance of payment position of India. It suggests that certain external and internal factors are more important than the devaluation of exchange rate. It highlights the role of capital flight in the figuring out balance of payment. Further. This paper also has policy implications suggesting the importance of improving technological merchandise and quality of product... Whether BOP A/C will be in surplus will depend upon external as well as internal factor. Presently it will depend on the length of the global financial crisis and the strength of the policy response. Interestingly, the reduction in current account deficit in the present year also validates the theoretical background given by this paper.

Keywords: *Current Account Deficit, Devaluation, Capital Flight*

I. Introduction

The balance of payments of a country is a systematic record of all transactions between the residents of a country and the rest of the world carried out in a specific period of time. India's balance of payment worsened in the early 1990's but now the situation is under control. In fact, India has a good foreign exchange reserves mainly due to capital inflows from foreign financial institutions or the stock exchange.

Main Components of India's Balance of Payments

1. Trade Balance

Trade balance was in deficit throughout the period shown in the table as imports always exceeded the exports. Within the imports the POL items

constituting a sizeable position continued to increase throughout. Exports did not achieve the required growth rate. Trade deficit in 2005-06 stood at \$ - 51,841 billion US \$.

2. Current Account

Current account balance includes visible items (trade balance) and invisibles are in a more encouraging position. It declined to \$ -2,666 million in 2000-01 from \$-9680 million in 1990-91 and recorded a surplus in 2003-04 to the extent of \$ 14,083 million. In 2005-06, once again there was a deficit of \$ 9,186 million. The main reason for the improvement during 2001-05 was the success of invisible items.

3. Invisible

The impressive role placed by invisibles in covering trade deficit is due to sharp rise invisible receipts. The main contributing factor to rise in invisible receipts is non factor receipts and private transfers. As far as non factor services receipts are concerned the main development has been the rapid increase in the exports of software services. As far as private transfers are concerned their main constituent is workers remittance from abroad. During this period the private transfer receipts also increased from \$ 2,069 million in 1990-91 to \$ 24,102 million in 2005-06. The current trend of outsourcing a number of jobs by the developed countries to the developing ones is also helping us to get more jobs and earn additional foreign exchange.

4. Capital Account

Capital account has been positive throughout the period. NRI deposits and foreign investment both portfolio and direct have helped to a great extent. The main reasons for huge increase in capital account is due to large capital inflows on account of Foreign direct investment (FDI); Foreign Institutional Investors (FIIs) investment on the stock markets and also by way of Euro equities raised by Indian firms. The Non-resident deposits also form a part of capital account.

5. Reserves

Reserves have changed during this period depending on a balance between current and capital account. An increase in inflow under capital account has helped us to build up our foreign exchange reserve making the country quiet comfortable on this count. In April 2007 we had \$ 203 billion foreign exchange reserves.

The year 2005-06 registered the highest trade deficit so far running into \$ 51,841 million, because of rising Oil prices; As a result despite impressive positive earnings of as much as \$ 42,655 million from invisibles, the current account deficit in this year was \$ 9,189 million which is 1.1% of GDP.

The balance of payment situation started improving since 1992-93. There was a satisfactory balance of payment position in that period; the reasons are (i) High earnings from invisibles, (ii) Rise in external commercial borrowings, and (iii) Encouragement to foreign direct investment.

The positive earnings from invisibles covered a substantial part of trade deficit and current account deficit reduced significantly. The external commercial borrowings were extensively used to finance the current account deficit. The net nonresident deposits were positive throughout the ten year period. There has been a growing strength in India's balance of payment position in the post reform period in spite of growing trade deficit and current account deficit.

Table 1 CLASSIFICATION OF BALANCE OF PAYMENT

Current account:	
1. Trade in goods	
a) Exports of goods	a
b) Imports of goods	-b
Balance on trade in goods	$c = a - b$
2. Trade in services	
a) Exports of services	d
b) Imports of services	e
Balance on trade in services	$f = d - e$
Balance on trade in goods and services	$c + f$
3. Net income flows (wages and investment income)	g
4. Net current transfers (government and private)	h
Current account balance	$i = c + f + g + h$
Capital account :	
Net capital transfers	J
Capital account balance	j
Financial account:	
1. Investment (direct and portfolio)	k
a) Net investment from abroad	-l
b) Net investment abroad	$m = k - l$
Balance of direct and portfolio investment	
2. Other investment and financial flows (mainly short-term)	n
a) Net deposits from abroad and borrowing from abroad	-o
b) Net deposits abroad and lending overseas	$p = n - o$
Balance of other financial flows	q
3. Drawing on (+) and adding to	

(-) reserves	
Financial account balance	$r = m + p + q$
Total of all three accounts	$i + j + r$
Net errors and omissions	s
Balance	$i + j + r + s = 0$

II. OBJECTIVES

a) Our objective in this paper is to see whether devaluation of exchange rate leads to balance of payment surplus,

b) We want to find what are the key factors influencing balance of payment,

c) We also try to find what are the policies needed to improve India's balance of payment position.

d) We will also compare India, china and Russia current account position,

e) We will also try to find out the limitation of capital flight in balance of payment and

f) We also try to find out the effect of exchange rate devaluation.

III. REVIEW OF LITERATURE

Jayati Ghosh (1990), His findings were exchange rate instrument alone as a means of improving current deficits is unlikely to prove successful.



Figure 1

1. The behavior of the nominal exchange rate bears little relationship to the behavior of the real exchange rate or to important domestic price ratios such as the relative prices of traded and non-traded goods which provide the mechanism through which balance of payment adjustment is meant to occur. . Indeed, they have frequently moved in opposite directions, and in the 1980s the divergence has been especially marked. This is significant because it suggests that nominal devaluations do not play the intended role of altering domestic price ratios in favour of tradable.
2. Policy of continuous nominal devaluation creates expectations of future depreciation which in turn operate to increase current

import expenditure and exert other negative influences on the current account.

3. Even the real exchange rate does not appear to be a major factor in determining export growth, which appears to be more strongly related to real economic variables.

EXPLANATION

It is increasingly apparent however, that exchange rate manipulation by itself is certainly not sufficient to increase export growth rates dramatically. The pattern of behavior of real exchange rates, including the important turning points and trends, do not show the expected relationship with export value growth. Other factors behind export growth have also been identified, even for the recent

- period. These include the importance of supply conditions, in particular infrastructural and agricultural output, and the crucial role played by non-price factors including marketing and quality control.
4. The relative price of traded goods appears to be strongly inversely related to the terms of trade, a variable largely outside the control of the government.

EXPLANATION

In the 1980s, for instance, the fall in the relative price of traded goods would seem to have been caused by the improvement in India's external terms of trade. Here the major role is played by variations in unit import prices, as unit export prices have been relatively stable. The fall in international oil prices, which operated to reduce unit import values, is one major element in this explanation. In any case, the conclusion is that this important domestic price ratio between tradable and non-tradable is not related to changes in the nominal exchange rate, but rather to world relative prices as reflected in India's external terms of trade. The point of this discussion is to argue that policy action oriented to nominal devaluations of the exchange rate may have very limited impact on the price variables that really matter: the real exchange rate and the domestic relative price of tradable/ non-tradable.

5. Clearly attempts to influence the first set of price variables must form an important part of any attempt to adjust the balance of payments. But it is necessary to be aware of the limitations of specific policy instruments in the context of the structure of the Indian economy, and in particular the limited role the nominal exchange rate can play in influencing both other relative price ratios and real variables in the economy. Domestic macroeconomic policy must be the most important planks of any adjustment strategy. In this context the role of fiscal incentives, specifically the tax concession on exports, has undoubtedly played an important role

Prabirjit Sarkar (1992) in

1. His study casts some doubt on the effectiveness of the current policy of devaluation and depreciation under the LERM (Liberalized exchange rate mechanism) in solving India's trade and payment deficits.

2. Simple regression analysis done by him confirms that during the period 1971-90 the depreciation of the rupee had no favorable effect on the dollar value and volume of exports and no contractionary effect on the value and volume of imports.
3. Hence it had no influence on the balance of trade. Over the period of 20 years since 1971 when the rupee started to depreciate under the 'managed' float system, the dollar values (at current and constant prices) of exports grew rapidly but India's share in world exports remained at a meagre level. As the dollar values of imports rose at a higher speed, the trade and payments deficits mounted. In the 80s, the process of depreciation of the rupee accelerated. But there was no sign of acceleration in the growth of exports valued in dollar. However, the growths in the trade deficit decelerate due to a deceleration in the growth of imports valued in dollars which in turn was due to a deceleration in the growth of crude oil imports. The payment deficit mounted partly due to a deceleration in the growth of private foreign remittances which was a fall-out of declining oil prices and the consequent declining prosperity of the Gulf.

Explanation (reasons are other factors)

Under the 'managed' float, the rupee started to slide down against the US dollar and other major currencies of the OECD countries. Available data show that the rupee value of US dollar (i e, Rs per dollar) rose at the annual average rate of about 5 per cent over the two decades of 'managed' float, 1971-90 . One US dollar was equal to Rs 4.76 during 1961-65. It rose to Rs 7.50 in 1966 and remained at that level till the end of 1970. Since 1971, the rupee started to float and by the end of 1990, one dollar became equal to Rs 18.07. That means, the rupee depreciated more in terms of other major currencies of the industrialized countries

The period of 20 years since 1971 experienced rapid growth of India's foreign-trade. Available data show that the dollar value of India's exports, exhibited an average rate of growth of 12 per, cent per annum over the period. 1971-90. In spite of this rapid growth of India's exports, its average share in world exports over the period 1971-90 was only 0.5 per cent. During the same period (1971-90), the dollar value of India's imports rose at the rate of 14 per cent. Due to this higher rate of growth of imports, India's balance of trade

exhibited trend decline. Roughly during the same period, 1971-89, the import volume grew at the average rate of 8.5 per cent per annum while the export volume rose at the rate of 6.5 per cent.

Manufactured exports

Over the period 1971-85, the dollar value of India's manufactured exports rose at the rate of 10 per cent per annum but there was no statistically significant rate of growth experienced by manufactured export volumes (dollar values at 1980 prices).. During the same period, the value of manufactured imports exhibited an annual average rate of growth of 16 per cent while the volume grew at the rate of about 9 per cent. Evidently, the exchange of manufactures for manufactures was one important source of rising trade deficit of India. It is this product category, Manufactures, which dominated India's export and import trade.

Food and Beverages

The dollar value of exports rose at the average annual rate of 12 per cent while the volume grew at the annual rate of about 6 per cent over the period, 1971-85. On the import side there was a significant growth neither in value nor in volume. This product category consisted of more than one-fourth of India's exports and less than one-tenth of India's imports.

Raw Materials

The dollar value of exports grew at the rate of 10 per cent per annum but the volume did not experience any statistically significant growth. For imports, neither the value nor the volume exhibited a statistically significant growth.

Fuels

A large part of which is crude petroleum, there is no growth in volumes of exports and imports. Hence only through the price hike, the dollar value of imports grew sharply at the average rate of 41.5 per cent per annum. Hence its share in India's total imports rose from 12 per cent in 1971-73 to 33 per cent in 1983-85. The share of Fuels in India's total exports rose from a meagre value of less than 1 per cent in 1971-73 to 12 per cent in 1983-85. This was due to a rapid rate of growth in the dollar value of exports 62.5 per cent per annum.

WHY WORSENING BOP IN 1980?

1. increased cost of insurance and freights

2. the rise in the interest payments:
3. Fall in foreign remittance (private foreign transfer) to India

EXPLANATION (point 3)

Growth of foreign remittance to India in the 1970s can be taken as a direct fall-out of the oil price hike and the prosperity of the OPEC countries. A large number of skilled and unskilled workers from India got their placement in the Gulf and remitted a large part of their income to India. With the decline in the oil price and the reduction in the prosperity of the Gulf countries, the scope of employment in the Gulf became limited. Hence the growth of foreign remittance stopped. Taking the import bill of crude oil as the proxy for the prosperity of the Gulf, a regression analysis of foreign remittance has been done. It finds a highly significant positive relationship between foreign remittance and the import bill of crude petroleum over the period 1971-87-the higher the import bill of crude petroleum, the higher was the amount of foreign remittance to India

A large part of the increased fuel import bill has been paid for by foreign remittance-in fact, by 1978 71 per cent of increased fuel import bill due to the first oil price shock of 1973-74 was paid for by foreign remittance

The conclusion that follows is that the value of India's exports did not rise nor did the value of imports fall due to a significant depreciation of the rupee during 1971-90.

REASONS

Export expansion may not be possible through devaluation for a number of reasons:

1. Devaluation of the currency of a less developed country (LDC) may increase the export volume by reducing the dollar price of export goods but due to the problem of inelastic demand, the value of exports may fall

2. Devaluation by one country may generate a spiral of competitive devaluation by others producing and exporting similar kinds of products. This may result in over-supplies of the commodities in the inter-national market and price crashes. This is the 'fallacy of composition. In fact, the structural adjustment programmes of the IMF/World Bank often suffer from this 'fallacy of composition'. For instance in 1975, copper exporting countries such as Zaire, Zambia, Chile and Peru approached the IMF for help in the face of their balance-of payments crisis. The IMF advised them to devalue and expand copper exports under its country-by-country approach. As a result, there was a sharp fall in the

price of copper in the international market. Consequently, these countries were plunged into more debt [Dell, 1982].

3. Devaluation may not reduce the export prices in dollar because of a number of factors. Due to devaluation, imported in-puts required in the export sector will be more costly. Moreover, costlier imports of food, fertilizers and fuels will create an inflationary situation in a country that relies much on imports of these necessary goods. This may result in an inflationary spiral-wages chasing prices and prices chasing wages. There is another reason for inflation in a country due to devaluation. In the process of devaluation, the budgetary burden of debt servicing rises. The government may have to create money to cover the increased budget deficit under devaluation. This will also feed the inflationary process. The combined effect of all these may create a situation where in spite of devaluation the dollar prices of export goods do not fall. This may induce the policy-makers to devalue further for the of achieving a 'real' devaluation, leading to a further inflation and again more devaluation. This kind of situation can be observed in many Latin American countries. Some data assembled show that in spite of very high nominal devaluation, these countries had moderate real devaluation in the first half of the 1980s. Even some countries faced real appreciation of their currencies.

4. Even if dollar prices of exports fail and demand rises due to devaluation, e x-port supply may not rise, particularly in the short or medium term, due to different structural reasons such as power shortage, transport constraint and inelastic supply of some specific inputs.

5. Lastly, one can mention the protectionist policy of the developed countries (DCs). As the World Bank [1989, p 15] has admitted, the protectionist policies of the DCs are increasingly discriminating against the exports of the LDCs. Hence, just through devaluation it may not be possible to penetrate the market of the DCs which often take protectionist action in the name of anti-dumping.

On the import side

1. Devaluation does not have much effect on the import of necessary goods
2. Moreover, in a country such as India where there is high income inequality and a huge sum of unaccounted money in the hands of some people, it is very difficult to control imports by devaluation accompanied by import liberalization.
3. In spite of devaluation and price rise, increasing imports of luxury goods and inputs

and machines to produce these goods cannot be checked.

4. Moreover, devaluation-led inflation creates a situation where imports may not be much costlier than domestic goods.
5. Besides all these, in LDCs such as India, there is always a craze for 'foreign' goods (coming from the west) among a large section of the population partly due to the colonial legacy and partly due to the international demonstration effect.

Due to all these factors, devaluation may fail to control imports. Thus his study casts serious doubts on the effectiveness of the regime of LERM (expected to be followed by the full convertibility of the rupee in near future) and import liberalization to cure the current crisis of the Indian economy

Prabirjit Sarkar (1994) in

1. His study of India's external accounts over the period 1971-91 shows that India's export earnings, private foreign remittances, import costs, etc, items of balance of trade and payments are stochastic processes (random)
2. There is no fundamental force inherent in the system that creates the problem of balance of trade and payments deficit.
3. These series do not have any meaningful relationship with India's nominal and real exchange rate behavior

EXPLANATION

Application of recently developed tests of stationary reveals that India's exports and imports do not have any deterministic trends. The implication is that their trend growth in the last two decades followed from random events. India's balance of trade and payments, and FOREX reserves are also random walk. There was also no evidence of accentuation of India's payments deficit in the 1980s. Hence arises the question whether India needed any structural adjustment in the 1990s for her balance of payment crisis.

1. India's export earnings, net receipt through private foreign remittances, import spending, etc, are highly volatile since shocks have permanent effects. Hence in-creased opening up of the economy means increased vulnerability to international shocks.
2. His co integration study reveals that the real (and nominal) exchange rate movements do not have any meaningful relationship with India's export performance and inflow of foreign funds by way of private remittances;

nor these have any relationship with India's balance of trade and payments behavior

R Kannan (1989) in his study explained that:

$M_D > M_S \longrightarrow$ BOP SURPLUS

$M_S > M_D \longrightarrow$ BOP DEFICIT

EXPLANATION

The basic view is that the BP is essentially a monetary phenomenon, i.e., the demand for and the supply of money play a fundamental role in its determination. Hence the BP position of a country reflects the decisions on the part of its residents either to accumulate or to run down their stock of money balances. It is this process of adjustment to the desired stock of money balances that results in BP deficits or surpluses. When the demand for money balances exceeds the money stock, this excess demand is to be satisfied from either domestic sources by increasing domestic assets of the high power money or by increasing the foreign assets of the high-power money. If the excess demand for money is not satisfied from domestic sources, funds will be attracted from abroad. Such an inflow can be generated by a surplus on any component of BP. This surplus will continue until money stock rises to the required level to satisfy the demand. In a similar manner, a BP deficit reflects excess supply of money. The deficit/surplus of BP is temporary and self-correcting, provided that the monetary authorities do not replace the out flowing funds by creating new domestic credit (known as 'sterilization').

SOLUTION

To reduce the impact of monetary disequilibrium factor on the balance of payments, Reserve Bank credit to the government should be reduced, which implies either budget deficit should be reduced or RBI financing of the budget deficits should be curtailed. The latter point goes strongly in favour of monetary targeting. This goes well with an important suggestion of 'the Committee to Review the Working of Monetary Systems in India. This exercise comes out with a solution that to attain sustainable balance of payments and to reduce its fluctuation, monetary disequilibrium factor should be controlled through monetary targeting. Thus the monetary targeting is a solution not only to attain internal stability but also external stability.

Meenakshi Rishi and James K Boyce (1990) explained about an examination of available data for the period 1971 to 1986 indicates that India's official balance-of- payments accounts do not record a number of hidden foreign exchange flows between India and the world economy. The authors' estimates indicate that total capital flight in this sixteen-year period amounted to \$ 21.1 billion in 1986 dollars, and

that the cumulative stock of flight capital with imputed interest earnings amounts to \$ 28.6 billion. These are equivalent, respectively, to 52 per cent and 71 per cent of the external debt accumulated during the same period.

CAPITAL FLIGHT

"The movement of private capital from one jurisdiction to another in order to reduce the actual or potential level of social control over the capital"

MECHANISMS OF CAPITAL FLIGHT Capital flight can be achieved by a number of mechanisms, including the following:

- (1) Cash transfers
- (2) Trade misinvoicing
- (3) Kickbacks
- (4) Inter-bank transfers

EXPLANATION

An examination of available data for the period 1971 to 1986 indicates that the official balance-of-payments accounts do not record a number of hidden foreign exchange flows between India and the world economy. Trading partner data comparisons indicate export under invoicing until 1982, since when there appears to have been a shift to small net over invoicing of exports. Imports have been consistently under invoiced throughout the period. The net result generally has been understatement of the country's trade deficit. His estimates indicate that total capital flight in this sixteen-year period amounted to \$21.1 billion in 1986 dollars, and that the cumulative stock of flight capital with imputed interest earnings amounted to \$28.6 billion. These are equivalent, respectively, to 52 per cent and 71 per cent of the external debt accumulated during the same period. In the light of the above, it does not seem surprising that "the deposits of Indians, not resident in Switzerland, in Swiss banks rose by nearly 1,149 million Swiss francs between 1979 and 1984, from 788 million Swiss francs to 1,937 million Swiss francs".

Capital outflows directly affect growth in two ways:

Capital shipped abroad does not contribute to domestic investment. In addition, when scarce foreign exchange is used to finance capital flight, it is clearly not available for financing essential imports. Moreover, capital flight removes stocks of wealth and earnings upon them from the economy, thus contributing to an erosion of the tax base.

S Kumarasundaram (1986) explained the situation India was facing in 1985-86, with large trade deficits and considerable withdrawals of foreign exchange reserves, has many elements.

1. Continuance of a large bill of petroleum imports, despite an increase in domestic production, reflecting a near lack of success in efforts so far to contain consumption through price restraints and failure to mount effective conservation measures. Indian consumption of petroleum products has been increasing at the rate of 5 per cent annually between 1979-80 and 1984-85, and, in respect of products like kerosene and high speed diesel, at rates of 8 per cent and above. Elsewhere in the world, developed and developing countries achieved economic growth without virtually any increase in petroleum consumption since 1981.
2. Secondly, India's non-petroleum imports, including capital goods and intermediates and components and certain bulk imports like vegetable oils and fertilizers had expanded considerably. Some of the increases are the result of a process of liberalization initiated over the years.
3. Thirdly, a new element in India's payments in 1985-86 is the already well publicized hump in debt service payments on account of the repayments of the IMF borrowings which started during the year. These payments reach a peak in 1986-87, but a point to be remembered is that India's debt service payments was not likely to shrink back to the levels of earlier years as the country's overall foreign debt (including the NRI debt) was still growing, and its composition was also changing in favour of shorter-maturity obligations with interest terms harder than those obtaining in the past.
4. Fourthly, a word about India's invisible transactions. These have yielded large surpluses ever since the first petroleum crisis in 1973. Indian remittances from the oil exporting countries, the main source of these surpluses, was currently stagnating but may not show a precipitate decline in the near future (notwithstanding the decline in their Oil incomes), as these economies have found it difficult to shed Indian labour quickly. There were indications that invisible payments (particularly travel, transportation and miscellaneous transactions) are increasing at a faster pace. All in all, India's net invisible surpluses could well stagnate from 1986-87 onwards.

In this sense, India's trade deficits will no more enjoy the cushion of invisible surpluses, and will have to be entirely financed by foreign borrowings.

5. Finally, the emerging trade deficit of 1985-86 confirms certain incapacity on the part of Indian exports to perform in the international markets. In recent years, export values had grown nominally as a result of certain volatile movements in the exchange rates and inclusion of certain petroleum exports.

Alok Ray (1987) explained how in late 1980s a gradual shift from import-substituting industrialization towards a more liberalized economic regime had beginning to take place in India. The author says that policy should be toward sustenance of liberalization. His study is contrary to previous studies as the author prefers devaluation as policy to improve Balance of goods traded. Selective export subsidies can also bring about a change in the bias towards ex-ports but devaluation is preferable for a number of reasons:

Advantages of Devaluation

- (i) Devaluation would affect the profitability of potential and new export industries whereas selective export subsidies affect only some existing export industries.
- (ii) Devaluation would affect capital account transactions also and may induce capital inflow. With liberalization, capital account transactions will become more and more important
- (iii) An ad valorem uniform export subsidy provided by devaluation is considered better than a differentiated (and often haphazard) export subsidy structure from the resource allocation point of view.
- (iv) Devaluation (even when it has the same implicit export subsidy rate), by eliminating a whole range of diverse export subsidy schemes, would make the operation of export-subsidization less cumbersome and less time-consuming making exports that much more attractive.
- (v) Export subsidies as provided in India under various schemes have been highly unstable As the rates and the rules governing the coverage of industries and products have varied a lot and also because the incentive value of import replenishment schemes has changed with changes in import premium on various commodities over time. A devaluation of the currency would provide a constant ad valorem rate of export subsidy (compared to an overvalued ex-change rate) until the exchange rate is changed again.
- (vi) Export subsidy schemes have allegedly led to "faked" exports and over invoicing of

exports to earn export subsidies. This may also have harmed India's long-term export interests by pushing bad quality Indian goods in foreign markets at "what they could fetch prices". Similarly, the problem of over and under invoicing of imports will also vanish to the extent ex-change rate adjustment replaces import duties.

- (vii) Export subsidies imply a drain on government budget. Devaluation will mean greater payment of domestic currency for a unit of foreign exchange to exporters but that would be made good by additional receipts of domestic currency for a unit of foreign exchange from importers. Hence, devaluation will not pose any revenue problem to the government so long as imports are not less than exports.
- (viii) If the producers of exportable know for certain that the domestic currency will be devalued in the future at the rate at which inflation will take place so that their price competitiveness in the world market will not be jeopardized, they can more confidently build up additional capacity for future production than if they know that the government's policy is to maintain a fixed nominal exchange rate. Certainly about a fixed real exchange rate is the crucial factor for producers of exportable. In principle, changes in export subsidies can also achieve this but a more automatic commitment to change ex-change rate will be easier to trust as it does not involve a drain on government budget (see point vii above).
- (ix) Devaluation is better than export subsidies and import tariffs (or quota) as it breeds less corruption and is also less costly in terms of real resources to operate.
- (x) Export subsidies are more visible means of subsidization than devaluing the currency. So, the chances of attracting countervailing duties on imports of Indian goods by other importing countries and off-setting subsidization policies by other exporting countries will be more with export subsidization than with a straightforward ex-change rate adjustment

LIMITATION OF EXPORT INCENTIVES

Exports will take time to respond to changed incentives

(a) The investors would like to be certain before making investment in ex-port industries that the changed incentives will continue,

(b) Creation of capacity takes time,

(c) There are various lags between capacity creation and generation of output, and

(d) It also takes time to develop foreign markets.

Robert Flood (1977) said it was noted that countries with rapidly growing industrial sectors had relatively high rates of increase in consumer prices.

EXPLANATION

When we note that industrial goods bulk larger in traded goods output than in output as a whole, the notion emerges that rapid advances in industrial capacity relative to output as a whole produce a type of growth which has a production bias toward the traded goods sector. Under the assumption that the marginal and average propensities to consume non-traded goods are similar, a production bias toward the traded goods sector implies traded-goods-biased growth. Incomes expand but the output of the non-traded goods sector is unable to keep pace without relative price increases). Robert Flood for this identification is that non-traded goods will appear in the consumer price index but will not appear in either import or export price indices. Thus increases in non-traded goods prices relative to traded goods prices will be reflected in increases in the ratio of consumer prices to import and export prices. The simple model predicts that countries with growth biased toward traded goods require increases in the relative price of non-traded goods in order to move toward full equilibrium. The increase can be accomplished in either of two ways. First, an asset expansion brought about either through a sustained current account surplus or through money creation will stimulate spending by domestic residents. A portion of this spending falls on non-traded goods, causing their relative prices to rise. Second, an exchange rate revaluation directly lowers the home price of traded goods, thus accommodating the increase in relative prices of non-traded goods and increasing home expenditure relative to income. In a period when world prices of traded goods are rising, this analysis implies that high growth countries require non-traded goods prices to rise even faster in order to bring about an increase in the relative price of non-traded goods. Of course, a country which revalues its exchange rate reduces the size of the increase in nominal prices of non-traded goods required to move toward full international equilibrium. As a group, countries experiencing the most growth in industrial output have had the largest increases in consumer prices relative to import or export prices. It must be pointed out that no country in the sample followed exclusively a policy of either exchange rate adjustment or monetary expansion the basic theme of this paper is that price movements, exchange rate adjustments, and the balance of payments are the accommodating results of changes in real and monetary factors in an economy.

Growth, prices, and the balance of payments necessary to establish international equilibrium. The balance of payments requires examination of the interactions of real forces, such as output growth, with the financial sector

CURRENT BOP SITUATION

Although pressures on India's balance of payments will likely persist, India's low external debt, falling imports due to both weaker exports and lower commodity prices, and a still sizeable war-chest of reserves may allow it to muddle through and survive the crisis. However, a lot will depend on the length of the global financial crisis and the strength of the policy response. The external balance of payments is made up of the current account (principally trade and transfers), and the capital flows (FDI, portfolio flows, external loans) needed to finance it. Their sum determines whether India accumulates or loses reserves. For instance in FY08, the BoP was in massive surplus due to large scale capital inflows more than compensating for the deficit on the current account, and therefore we accumulated \$110 billion in reserves.

In FY09, these forces reversed. A high import bill due to rising oil prices has pushed up the current account deficit, while capital flows have turned negative due to outflows from the stock market, the drying up of trade credit, and difficulty in obtaining overseas loans. These have led to a large decline in international reserves.

As the global financial system goes into 2009 in poor shape, capital inflows into India may not appear anytime soon. In addition, rapidly falling exports may increase the current account. So, how will India's external balance survive this double whammy?

1. Imports are also on a downward trajectory. It is well-known that falling oil prices will reduce the import bill. What is less well known is that India's imports are heavily dependent on its exports. Our main merchandise exports are of refined petroleum, gems & jewellery and textiles which have large import content - a 1% fall in exports leads to a 0.95% fall in imports. Both of these imply that the current account deficit will be lower going forward.

2. Second, India is one of the largest recipients of inward remittances from expatriates, amounting to a massive \$40 billion in FY08. Although they can be expected to decline somewhat in a global recession, remittances remain the least volatile of inflows.

3. Third, India's external debt, and especially its short term debt remains low at 7% of GDP. Even with trade credit drying up, the amount of external payments falling due in the near term remains manageable.

4. Fourth, India's reserves are still adequate. Although, they have fallen significantly, the remaining war chest of \$246 billion is still 10 months of import cover. Indeed, more than half of the recent decline has been due to valuation losses as the dollar has strengthened against other currencies. These losses are not likely to continue in 2009.

Akira Uegaki (2009) explained how China's current account has been in surplus in the last fifteen years and it has grown rapidly since 2005 reaching a historically high level, about US\$ 400 billion. Russia's current account also recorded surplus in almost all the years since 1994, but it has relatively stagnated since 2005 compared to the trend of China, although Russia's absolute current account surplus is still large enough to merit attention. Showing another trend, India's current account balance has been fluctuating around zero indicating a recent downward trend. In the framework of a macro economy, the current account balance is the increase in financial claims of the residents against the rest of the world and equals the sum of fiscal surplus and excess of residents' savings over investment.

Therefore, we get

$$CA = (T - G) + (S - I)$$

Where CA = current account balance, T = tax revenue, G = government expenditure,

S = private savings, I = investment including government investment.

In China, the surplus of the S-I balance has been too great to cover the fiscal deficit; therefore, the remaining financial resources have been pushed out of the country, which has resulted in a large current account surplus.

On the other hand, in India, the S-I balance slightly exceeded the fiscal deficit in the first

Four years, but more recently, it is insufficient to cover the fiscal deficit and the shortage is being covered by foreign capital. India is now showing the features of a typical capital-shortage developing industrial country, in which investment is actively conducted and fiscal spending is growing to cover social needs in a rapidly changing society.

The most striking point of Russia's structure is that it has been producing a large fiscal surplus in the last several years

Therefore, we can conclude that China and Russia have had the same problem: how to

deal with a large current account surplus. The structure of India is totally different from that of China and Russia in the sense that it needs inflows of

financial resources to cover the current account Deficit

and inputs). To finance deficit it have to rely on foreign fund (Capital and Financial account surplus)

In stage 1 a country like India, remains in current a/c deficit as it require more imports (goods, service,

Table 2

		<i>Current Account</i>	<i>Goods and Services</i>	<i>Investment income</i>	<i>Capital and Financial account</i>	
<i>Stage I</i>	<i>Immature Debtor Countries</i>	-	-	-	+	<i>Cambodia, Mongolia, India, Brazil</i>
<i>Stage II</i>	<i>Mature Debtor Countries</i>	-	+	--	+	<i>Germany</i>
<i>Stage III</i>	<i>Debt Repayment Countries</i>	+	++	-	-	<i>Canada, China, South Korea</i>
<i>Stage IV</i>	<i>Immature Creditor Countries</i>	++	+	+	--	<i>France, Japan, Switzerland</i>
<i>Stage V</i>	<i>Mature Creditor Countries</i>	+	-	++	-	
<i>Stage VI</i>	<i>Credit Disposing Countries</i>	-	--	++-	+	<i>United Kingdom, United States</i>

IV. FINDINGS/CONCLUSION

1. It has been found that devaluation as a mechanism of current account surplus i.e. improving export and reducing import is not sufficient because empirical studies prove that there exist no significant relationship b/w exchange rate devaluation and current account surplus. Hence we have to consider other factor discussed below
2. Other factor which improve balance of payment are
 - a. Real economic factors i.e. supply side policies, quality of product traded etc
 - b. World economic factor i.e. world demand for export
 - c. Terms of trade: this in turn depends upon relative price ratio of tradable to non tradable goods. i.e. if price of oil falls then this ratio will fall and terms of trade will improve
 - d. Foreign remittance i.e. if price of oil rises then foreign remittances from gulf nations will increase
 - e. FDI & FII
3. Export oriented policies: We have not been able to diversify our export basket especially in favour of more technology and knowledge intensive goods that are less susceptible to price pressures and are much more value adding and faster growing. India should consolidate its presence in traditional export industries and move up the value chain in traditional products. We should also consolidate Indian advances in generic pharmaceuticals, small cars, two-wheelers, and metals .We need to leverage the large market size for developing new industries. We should encourage exporters of equipment to start local manufacturing units by offering pioneer industry incentives and offsets programmes as done by the East Asian countries to generate local value added and jobs while saving foreign exchange
4. India current account surplus has been low as compare to china and Russia because India is in the stage of industrial development requiring foreign capital.
5. Balance of payment deficit is underestimating it due to capital flight
6. Exchange rate devaluation has following effect:

A. Short term

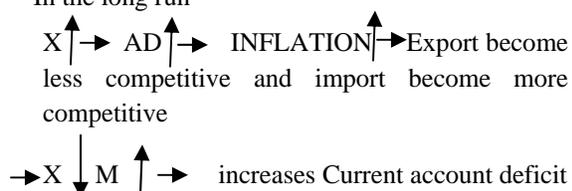
Export become cheaper and import become expensive but both export and import are inelastic in volume as in a short period, since terms cannot be changed. It result in rise in value of import and fall in value of export. Hence it leads to more current account deficit

B. Medium term

Both export and import becomes elastic, it is possible to increase cheaper export and decrease expensive import. Hence it leads to current account surplus.

C. long term

In the long run



7. As a policy India should try to accelerate export particularly manufacturing items which have a significance effect on balance of goods traded

8. Prediction for India's BOP A/C :

The problem India is facing is a large current A/C deficit. It needs inflows of financial resources to cover the current account Deficit. Since India is in stage of developing capital needed country, it will continue to face current a/c deficit & fiscal deficit to finance its development project.

As far as BOP A/C is concerned it will have to in surplus in order to finance current a/c deficit, otherwise, bop crisis will emerge

Whether BOP A/C will be in surplus will depend upon external as well as internal factor. Presently it will depend on the length of the global financial crisis and the strength of the policy response.

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