CHAPTER-1
INTRODUCTION

The people of economics, commerce and other areas know it very clearly that the foreign exchange, international finance and balance of payments are the realms of international (or say offshore) economics and business. The term ‘foreign exchange’ is frequently used in reference to international finance and payments. The term ‘foreign exchange’ has three principal meanings. Firstly, it is a term used when referring to the currencies or moneys of other countries in terms of any single one currency. Secondly, the term is also commonly used in referring to some instruments used in international commerce, such as bills of exchange, bank drafts, travellers’ cheques, and other means of international remittances. In other words, the term foreign exchange may refer to the system whereby nations discharge their debts to one another. Thirdly, the term ‘foreign exchange’ is also quite often referred to the balances in foreign currencies held by a country.

The subject of foreign exchange is concerned, however, with the exchange of various currencies, one for another. Theoretically, it attempts to explain why these exchanges take place, how the value of one currency is fixed in terms of another currency, and what are the factors which, cause ‘fluctuations in such values. It also attempts to investigate how various national and international economic developments effect the exchange.

Balance of payments

The balance of payments, it may be pointed out, does no tally with, record of foreign exchange transactions between residents and non residents through the country’s banking system. The Balance of Payments is a record of foreign-exchange transactions with the rest of the world. Balance of Payments is a statistical statement that systematically summarizes for a specific time period, the economic transactions of an economy with the rest of the world.

The balance of payments Statistics in India is a systematic record of India’s international economic transactions of residents with the rest of the world on account of merchandise, services, unrequited transfers and transfers of capital. Residents cover nationals as well as non-nationals residing in the country. Foreign students, tourists,
foreign diplomatic officers and international institutions are not considered to be residents but diplomatic officers and armed forces of the country, stationed abroad, are treated as residents notwithstanding their physical location.

India’s balance of payments statistics presented in this section are derived for the most part from Exchange Control Records and the basic data on most of the official transactions, not routed through the banking channels, are obtained from the Government agencies and the Reserve Bank of India. Based on this information, Reserve Bank of India periodically releases the revised/updated data through its Press Release.

Kindleberger, Benham, Sodersten and James O. Ingram they all have defined balance of payments in same sense i.e. “balance of payment is a statistical statement that summarizes, for a specific period (generally a year), all types of economic transactions of an economy with the rest of the world.”

The General Rule in BOPs Accounting:

- If a transaction brings in foreign currency for the nation it will be credited to balance of payments
- If a transaction results in spending of foreign currency it will be debited to balance of payments

Importance of the BOPs

- BOPs may confirm trend in economy’s international trade and exchange rate of the currency. This may also indicate change or reversal in the trend.
- Basically, a balance of payments statement is compiled to measure deficits and surpluses of a country with the rest of the world. In ‘recent years, however, the balance of payments statement has become increasingly important as it has been devised to describe the state of international economic relationship of a country and act as a guide to its monetary, fiscal, commercial, exchange and other policies.
- Those who determine the monetary policy are interested in the balance of payments as one factor in the monetary situation. Changes in a country’s stock
of international liquidity have an important influence on money markets and on bank reserves.

- Those who are concerned with foreign economic policy are interested in balances of payments as indicators of the economic and financial position of foreign countries.

- Those who undertake foreign investments and make foreign loans, Institutions and others, are interested in the balance of payments data as indicators of potential capacity of the beneficiary countries honour their international financial commitments.

- Commercial banks and other operators in the foreign exchange market can make use of balance of payments data in appraising the foreign exchange position of foreign countries and the probable course of foreign exchange rates.

- More recently, with the development of national income accounting the balance of payments state- has been used to measure the influence, of foreign trade and actions on the national income of the country.

**BOPs and Foreign Trade**

There are two concepts relating to international transactions balance of trade and balance of payment. **Balance of Trade** refers to the difference between the value of total imports and export of visible physical goods. Balance of trade, as a matter of fact, is a part of balance of payments. It may be of three kinds:

- Surplus or Favourable Balance of Trade: A country may have favourable or surplus balance of trade when the total value of the goods exported by it is more than the value of goods imported by it. (Exports > Imports)

- Deficit or Unfavourable Balance of Trade: A country may have unfavourable or deficit balance of trade when the total value of the goods exported by it is less than the value of goods imported by it. (Exports < Imports)
• Equilibrium Balance of Trade: A country may have equilibrium balance of trade when the total value of the goods exported by it is equal to the value of goods imported by it. (Exports = Imports)

Components of BOPs

• Current Account: Balance of payments on current account includes the value of imports and exports of both visible (goods) and invisible items (services). Current account transactions are called account of actual transactions of import and export of goods and services. These items have a direct effect on the income, output and employment of an economy.

Balance of payments on current account = (visible + invisible exports) + (visible + invisible imports)

Balance of payments on current account may be both balanced and unbalanced. In case of balanced position of BoP, receipts and payments on account of exports and imports are equal. In case of unbalanced BoP, it can be in deficit or in surplus. Disequilibrium of the balance of payments on current account is usually balanced with the help of transactions in capital accounts.

The current account consists mainly of three sub-groups: (a) merchandise or trade account; (b) invisible account; and (c) unilateral or unrequited transactions account.

In the “merchandise or trade account” only the transactions involving the international movement of tangible goods or merchandise are recorded. However, it includes all transactions which at some stage (whether sooner or later) give rise to settlement, such as exports and imports against credits of varying duration since the financial position of a country, like that of a business, depends not only on its cash but also on what it owes to others and what others owe to it. The difference in the values of merchandise exports and imports is referred to as the “balance on merchandise trade”

The “invisible account” usually comprises the export and import of services. The services account records all the services rendered by the residents to the foreigners and those received by the residents from the foreigners. It consists
of items such as: air and ocean shipping, banking, insurance, counseling, etc.; services provided to the tourists, students, businessmen, etc.; interest and dividends and so on. The difference between the aggregates of the items on the credit side and the items on the debit side is referred to as the “balance of trade”.

The “unilateral or unrequited transactions” refer to the credits and debits for which no corresponding transfer of goods or services is involved. The item includes donations, migrant remittances, legacies, etc.

If unilateral transfers are excluded, the current account section of balance of payments is the record of what happened to that part of national product which was exported and what happened to that part of national income which was spent on goods and services purchased from foreigners. If exports and other credits exceed imports and other debits, the difference is net foreign investment. Conversely, if imports and other debits exceed exports and other credits, the difference is net foreign disinvestment.

- **Capital Account:** Capital account refers to financial transactions. It mainly includes foreign investment and external loans. All kinds of short-term and long-term international capital transfers, foreign debts, foreign investments payments and receipts on account of interest and grants, etc. are also included in capital account. All transactions under capital account are concerned merely with financial transfers, between our country and other foreign countries.

It consists of all such items as may be employed in financing both imports exports, viz., private balances, assistance by international financial agencies and specie flow, and balances held on government account. Accordingly, this account would have four sub-accounts: private capital account, international financial institutions capital account, specie account, government capital account. Balances in these accounts may rise or fall year to year, depending upon the account movements or fluctuations in other items on capital account.

- **Overall balance of payments:** total of country’s balance of payment on current account and capital account is known as overall balance of payments.

A positive balance on current account and capital account, put together, reflects in the accretion to the country’s official stock of gold or foreign exchange reserves or decrease in the country’s liabilities or an increase in its assets with the International Monetary Fund (IMF). Conversely, an adverse balance on current account and capital account, put together, reflects in the decrease in the country’s official stock of gold or foreign exchange reserves an or increase in the country’s liabilities to or decrease in its assets with, the International Monetary Fund.

Format of presentation of Balance of Payments has been changed by R.B.I. from July, 1996. Revised series in the new format has been given for the year 2000-01 to 2009-10.

Table 1.1: Table showing India's Overall Balance of Payments as per BPM5

<table>
<thead>
<tr>
<th>India's Overall Balance of Payments</th>
<th>(Rs. Crore)</th>
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</thead>
<tbody>
<tr>
<td>Items</td>
<td>Credit</td>
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<td>1</td>
<td>2</td>
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<tr>
<td>A. CURRENT ACCOUNT</td>
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<td>I. Merchandise</td>
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<td>II. Invisibles (a+b+c)</td>
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<td>a) Services</td>
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<td>i) Travel</td>
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<td>ii) Transportation</td>
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<td>iii) Insurance</td>
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<td>iv) G.n.i.e.</td>
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<td>v) Miscellaneous</td>
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<td>of which</td>
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<td>Software Services</td>
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<td>Business Services</td>
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</tbody>
</table>
### Financial Services

#### Communication Services

b) Transfers

i) Official

ii) Private

c) Income

i) Investment Income

ii) Compensation of Employees

<table>
<thead>
<tr>
<th>Total Current Account (I+II)</th>
</tr>
</thead>
</table>

### B. CAPITAL ACCOUNT

#### 1. Foreign Investment (a+b)

a) Foreign Direct Investment (i+ii)

i) In India

- *Equity*

- *Reinvested Earnings*

- *Other Capital*

ii) Abroad

- *Equity*

- *Reinvested Earnings*

- *Other Capital*

b) Portfolio Investment

In India

Abroad

#### 2. Loans (a+b+c)

a) External Assistance

i) By India

ii) To India

b) Commercial
<table>
<thead>
<tr>
<th></th>
<th>Borrowings (MT &amp; LT)</th>
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<tbody>
<tr>
<td></td>
<td>i) By India</td>
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<td></td>
<td>ii) To India</td>
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<td>c)</td>
<td>Short Term To India</td>
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<td></td>
<td>i) Suppliers’ Credit &gt;180 days &amp; Buyers’ Credit</td>
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<td></td>
<td>ii) Suppliers’ Credit up to 180 days</td>
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<td>3</td>
<td>Banking Capital (a+b)</td>
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<td>a)</td>
<td>Commercial Banks</td>
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<td></td>
<td>i) Assets</td>
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<td></td>
<td>ii) Liabilities</td>
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<td></td>
<td>of which: Non-Resident Deposits</td>
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<td>b)</td>
<td>Others</td>
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<td>4</td>
<td>Rupee Debt Service</td>
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<td>5</td>
<td>Other Capital</td>
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<td></td>
<td>Total Capital Account (1 to 5)</td>
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<td>C.</td>
<td>ERRORS &amp; OMISSIONS</td>
</tr>
<tr>
<td>D.</td>
<td>OVERALL BALANCE (Total Current Account, Capital Account and Errors &amp; Omissions (A+B+C))</td>
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<tr>
<td>E.</td>
<td>MONETARY MOVEMENTS (i+ii)</td>
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<tr>
<td></td>
<td>i) I.M.F.</td>
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<td></td>
<td>ii) Foreign Exchange Reserves (Increase – / Decrease +)</td>
</tr>
</tbody>
</table>

Concepts and Definitions of various terms appearing in the Table are discussed below:

**Current Account**

All the economic transactions that enter the current account are presented in two parts viz., i) Merchandise and ii) Invisibles. A surplus on current account leads to an acquisition of assets or repayment of debts previously contracted and a deficit involves withdrawal of previously accumulated assets or is met by borrowings.

**Merchandise** - It comprises imports and exports of movable goods. Imports are inclusive of insurance and freight. Although these two elements come, strictly speaking, under the category of services, exports are shown free on board, by removing the estimated portion of freight and insurance from those exports that are booked on cost Insurance and freight basis. Merchandise credit relates to export of goods while merchandise debit represent import of goods.

**Invisibles Travel Credit** - This item represents foreign tourist’s expenditure during their stay in India, expenditure incurred by resident travellers abroad and on the debit side it covers exchange sold for private and official travel.

**Transportation** - Transportation covers receipts and payments on account of international transportation services.

**Insurance** - Insurance comprises receipts and payments relating to all type of insurance services as well as reinsurance.

**Investment Income** - Receipts include interest earned on the investments of RBI and on holdings of SDRs, and payments include interest and commitment charges on foreign loans, on purchases from the IMF and those on cumulative allocation of SDRs.

**Govt. not included elsewhere** - The item includes receipts and payments on account of maintenance of embassies and diplomatic missions and offices of international institutions as well as receipts and payments on government account not included elsewhere.
**Miscellaneous**- This item covers, receipts and payments in respect of all other services such as communication services, construction services, software services, technical know-how, royalties etc.

**Transfers of payments** - (official, private) represent receipts and payments without a quid pro quo. Official transfer receipts represent contra entries for cash receipts and value of aid received in kind from foreign Governments and institutions and debits cover contributions to international organizations and official grants in cash or kind extended to foreign Government. Private transfer receipts include repatriation of savings, remittances for family maintenance, contributions and donations to religious and charitable institutions etc. Receipts also include imports under P.L.480, Title II Programme. Since April 1964, receipts and payments of pension and retirement benefits etc. on private account are also covered under this head. Private transfer receipts also include the contra entry on account of Gold and Silver brought in by Indians returning from abroad. This treatment is effective from the inception of this scheme (i.e. 1992-93 onwards). Since 1996-97 it also includes contra entry for local withdrawals from NRE accounts and local redemptions of NRNRD accounts.

**Investment Income transactions** are in the form of interest, dividend, profit and others for servicing of capital transactions. Investment income receipts comprise interest received on loans to non-residents, dividend/profit received by Indians on foreign investment, reinvested earnings of India FDI companies abroad, interest received on debentures, floating rate notes (FRNs), Commercial Papers (CPs), fixed deposits and funds held abroad by ADs out of foreign currency loans/export proceeds, payment of taxes by non-residents/refunds of taxes by foreign governments, interest/discount earnings of RBI investment etc. Investment income payments comprise payment of interest on non-resident deposits, payment of interest on loans from non-residents, payment of dividend/profit to non-resident share holders, reinvested earnings of the FDI companies, payment of interest on debentures, FRNs, CPs, fixed deposits Government securities, charges on Special Drawing Rights (SDRs) etc.

**Foreign Investment** has two components, namely, foreign direct investment and portfolio investment.
Foreign direct investment (FDI) to and by India up to 1999-2000 comprise mainly equity capital. In line with international best practices, the coverage of FDI has been expanded since 2000-01 to include, besides equity capital, reinvested earnings (retained earnings of FDI companies) and other direct capital (inter-corporate debt transactions between related entities). Data on equity capital include equity of unincorporated entities (mainly foreign bank branches in India and Indian bank branches operating abroad) besides equity of incorporated bodies. Data on reinvested earnings for the latest year (2002-03) are estimated as average of the previous two years as these data are available with a time lag of one year. In view of the above revision, FDI data are not comparable with similar data for the previous years. In terms of standard practice of BoP compilation, the above revision of FDI data would not affect Indias overall BoP position as the accretion to the foreign exchange reserves would not undergo any change. The composition of BoP, however, would undergo changes. These changes relate to investment income, external commercial borrowings and errors and omissions. In case of reinvested earnings, there would be contra entry (debit) of equal magnitude under investment income in the current account. Other capital reported as part of FDI inflow has been carved out from the figure reported under external commercial borrowings by the same amount. Other Capital by Indian Companies abroad and equity capital of unincorporated entities have been adjusted against the errors and omissions for 2000-01 and 2001-02.

Portfolio investment mainly includes FIs investment, funds raised through GDRs/ADRs by Indian companies and through offshore funds. Data on investment abroad, hitherto reported, have been split into equity capital and portfolio investment since 2000-01.

External assistance by India denotes aid extended by India to other foreign Governments under various agreements and repayment of such loans. External Assistance to India denotes multilateral and bilateral loans received under the agreements between Government of India and other Governments/International institutions and repayments of such loans by India, except loan repayment to erstwhile Rupee area countries that are covered under the Rupee Debt Service.

Commercial borrowings cover all medium/long term loans. Commercial Borrowings by India denote loans extended by the Export Import Bank of India [EXIM Bank] to
various countries and repayment of such loans. Commercial Borrowings to India denote drawls/repayment of loans including buyers credit, suppliers credit, floating rate notes (FRNs), commercial paper (CP), foreign currency convertible bonds (FCCBs) issued abroad by the Indian corporate etc. It also includes India Development Bonds (IDBs), Resurgent India Bonds (RIBs) and India Millennium Deposits (IMDs).

A short term loan denotes drawls in respect of loans, utilized and repayments with a maturity of less than one year.

Banking capital comprises of three components: a) foreign assets of commercial banks (ADs) (b) foreign liabilities of commercial banks (ADs), and (c) others. Foreign assets of commercial banks consist of (i) foreign currency holdings, and (ii) rupee overdrafts to non-resident banks. Foreign liabilities of commercial banks consists of (i) Non-resident deposits, which comprises receipt and redemption of various non-resident deposit schemes, and (ii) liabilities other than non-resident deposits which comprises rupee and foreign currency liabilities to non-resident banks and official and semi-official institutions. Others under banking capital include movement in balances of foreign central banks and international institutions like IBRD, IDA, ADB, IFC, IFAD etc. maintained with RBI as well as movement in balances held abroad by the embassies of Indian in London and Tokyo.

Non-resident deposits: Credits under this item include remittances received towards various non-resident deposit schemes viz., Foreign Currency Non-Resident Account (FCNRA) - discontinued in various phases up to August, 1994, foreign Currency Non-Resident Deposits (Banks) (FCNRB) introduced in May, 1993, Non Resident (External) rupee Account (NR(E)RA) (Since February, 1970), Non-resident Non-repatriable Rupee Deposits (NRRND) introduced in June, 1992, foreign Currency (Banks and Others) Deposits (FCBOD) (discontinued in July, 1993) and Foreign Currency Ordinary non-repatriable deposits (FCON) (discontinued in May, 1994).Credits also include interest accrued and credited to these deposits accounts during the year. Debits denote redemption of these deposits.

Others: These include movement in balances of foreign central banks and international institutions like IBRD, IDA, ADB, IFC, IFAD etc. maintained with RBI as well as movement in balances held abroad by the Embassies of India in London.
and Tokyo. This also includes movements in technical credit granted to the erstwhile East European countries and their investments in Government Treasury Bills and deposits with the Government.

**Rupee Debt Service:** Interest payments on and principal repayments on account of civilian and non-civilian debt in respect of Rupee Payment Area (RPA), are clubbed together and shown separately under this item. This is in line with the recommendation of the High Level Committee on Balances of Payments (Chairman: Dr. C. Rangarajan).

**Other capital:** comprises mainly the leads and lags in export receipts (difference between the custom data and the banking channel data). This is a residual item and includes all capital transactions not included elsewhere. It particularly includes funds held abroad, advance receipts under deferred exports, India’s subscription to International institution, quota payments to the IMF, delayed export receipts, remittances towards recouping the losses of branches/subsidiaries etc.

**Movement in Reserves:** Movements in the reserves comprise changes in the foreign currency assets held by the RBI and SDR balances held by the Govt. of India. These are recorded after excluding changes on account of valuation. Valuation changes arise because foreign currency assets are expressed in US dollar terms and they include the effect of appreciation/depreciation of non-US currencies (such as Euro, Sterling, and Yen) held in reserves.

**Table 1.2: Table showing Standard Presentation of BOPs in India as per BPM6**

<table>
<thead>
<tr>
<th>Item</th>
<th>Credit</th>
<th>Debit</th>
<th>Net</th>
<th>Credit</th>
<th>Debit</th>
<th>Net</th>
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<tbody>
<tr>
<td>1.A Goods and Services (1.A.a+1.A.b)</td>
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<tr>
<td>1.A.a Goods (1.A.a.1 to 1.A.a.3)</td>
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<tr>
<td>1.A.a.1 General merchandise on a BOP basis</td>
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<tr>
<td>1.A.a.2</td>
<td>Net exports of goods under merchanting</td>
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<td>1.A.a.3</td>
<td>Nonmonetary gold</td>
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<td>1.A.b Services (1.A.b.1 to 1.A.b.13)</td>
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<td>1.A.b.1</td>
<td>Manufacturing services on physical inputs owned by others</td>
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<td>1.A.b.2</td>
<td>Maintenance and repair services n.i.e.</td>
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<td>1.A.b.3</td>
<td>Transport</td>
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<td>1.A.b.4</td>
<td>Travel</td>
<td></td>
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<td>1.A.b.5</td>
<td>Construction</td>
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<td>1.A.b.6</td>
<td>Insurance and pension services</td>
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<td>1.A.b.7</td>
<td>Financial services</td>
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<td>1.A.b.8</td>
<td>Charges for the use of intellectual property n.i.e.</td>
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<td>1.A.b.9</td>
<td>Telecommunications, computer, and information services</td>
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<td>1.A.b.10</td>
<td>Other business services</td>
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<td>1.A.b.11</td>
<td>Personal, cultural, and recreational services</td>
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<td>1.A.b.12</td>
<td>Government goods and services n.i.e.</td>
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<td>1.A.b.13</td>
<td>Others n.i.e.</td>
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<td>1.B Primary Income (1.B.1 to 1.B.3)</td>
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<tr>
<td>1.B.1</td>
<td>Compensation of employees</td>
<td></td>
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<td>1.B.2</td>
<td>Investment income</td>
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<tr>
<td>1.B.2.1</td>
<td>Direct investment</td>
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<tr>
<td>1.B.2.2</td>
<td>Portfolio investment</td>
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<td>1.B.2.3</td>
<td>Other investment</td>
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<tr>
<td>1.B.2.4</td>
<td>Reserve assets</td>
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<td>1.B.3 Other primary income</td>
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<tr>
<td>1.C Secondary Income (1.C.1+1.C.2)</td>
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<tr>
<td>1.C.1</td>
<td>Financial corporations,</td>
<td></td>
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</table>
nonfinancial corporations, households, and NPISHs

<table>
<thead>
<tr>
<th>1.C.1.1</th>
<th>Personal transfers (Current transfers between resident and non-resident households)</th>
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<tbody>
<tr>
<td>1.C.1.2</td>
<td>Other current transfers</td>
</tr>
<tr>
<td>1.C.2</td>
<td>General government</td>
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4.1 Equity and investment fund shares

4.2 Debt instruments

4.3 Other financial assets and liabilities

5 Net errors and omissions

Note: Explanatory notes on these tables are available in …. Issue of RBI Bulletin, …..

**Note:** The data used for the purpose of the study was taken according to BPM5 because BPM6 was adopted in 2010 but most of the period of the study falls before the adoption of BPM6. Also, the data for period falling after 2010 was given in both the formats but this was not true for period falling before the adoption of BPM6.

**Trends in India’s BOPs**

A country, like India, which is on the path of development generally, experiences a deficit balance of payments situation. This is because such a country requires imported machines, technology and capital equipments in order to successfully launch and carry out the programme of industrialization. The trend in overall BOPs is given in the table given below prepared from the information collected from Economic Survey and RBI Bulletin.

**Table 1.3: Table showing Trends in India’s BOPs**

<table>
<thead>
<tr>
<th>Year</th>
<th>Current Account</th>
<th>Capital Account</th>
<th>Overall BOPs</th>
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<tbody>
<tr>
<td>1990-91</td>
<td>-17366</td>
<td>12898</td>
<td>-4471</td>
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<tr>
<td>1991-92</td>
<td>-2237</td>
<td>10005</td>
<td>7768</td>
</tr>
<tr>
<td>1992-93</td>
<td>-12764</td>
<td>11881</td>
<td>-883</td>
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<tr>
<td>1993-94</td>
<td>-1158</td>
<td>30415</td>
<td>26779</td>
</tr>
<tr>
<td>1994-95</td>
<td>-10583</td>
<td>28743</td>
<td>18160</td>
</tr>
<tr>
<td>1995-96</td>
<td>-19646</td>
<td>15597</td>
<td>-4049</td>
</tr>
<tr>
<td>1996-97</td>
<td>-16282</td>
<td>40502</td>
<td>24220</td>
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<tr>
<td>1997-98</td>
<td>-20883</td>
<td>37536</td>
<td>16653</td>
</tr>
<tr>
<td>1998-99</td>
<td>-16789</td>
<td>35034</td>
<td>18245</td>
</tr>
<tr>
<td>1999-00</td>
<td>-20331</td>
<td>48101</td>
<td>27770</td>
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<tr>
<td>2000-01</td>
<td>-11598</td>
<td>39238</td>
<td>27643</td>
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<tr>
<td>2001-02</td>
<td>16426</td>
<td>40167</td>
<td>56593</td>
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<tr>
<td>2002-03</td>
<td>30660</td>
<td>51377</td>
<td>82037</td>
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<tr>
<td>2003-04</td>
<td>47952</td>
<td>96042</td>
<td>143994</td>
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<tr>
<td>2004-05</td>
<td>-12174</td>
<td>128081</td>
<td>115907</td>
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<tr>
<td>2005-06</td>
<td>-43737</td>
<td>109633</td>
<td>65896</td>
</tr>
<tr>
<td>Year</td>
<td>Balance</td>
<td>Current</td>
<td>Capital</td>
</tr>
<tr>
<td>-------</td>
<td>---------</td>
<td>---------</td>
<td>---------</td>
</tr>
<tr>
<td>2006-07</td>
<td>-44383</td>
<td>208017</td>
<td>163634</td>
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<tr>
<td>2007-08</td>
<td>-63479</td>
<td>433167</td>
<td>369689</td>
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<tr>
<td>2008-09</td>
<td>-127600</td>
<td>305015</td>
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<tr>
<td>2009-10</td>
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<td>2010-11</td>
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<td>2011-12</td>
<td>-375973</td>
<td>307470</td>
<td>-68503</td>
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<tr>
<td>2012-13</td>
<td>-479610</td>
<td>500313</td>
<td>20702</td>
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<tr>
<td>2013-14</td>
<td>-187750</td>
<td>283804</td>
<td>96054</td>
</tr>
</tbody>
</table>

Source: Current Account, Capital Account and Overall BOPs from Statistical tables of Economic Surveys, Government of India.

**Kinds of BOPs**

**Favorable Balance of Payments**: An imbalance in a nation's balance of payments in which payments made by the country are less than payments received by the country. This is also termed a balance of payments surplus. It's considered favorable because more currency is flowing into the country than is flowing out. Such an unequal flow of currency will expand the supply of money in the nation and subsequently cause a decrease in the exchange rate relative to the currencies of other nations. This then has implications for inflation, unemployment, production, and other facets of the domestic economy. A balance of trade surplus is often the source of a balance of payments surplus, but other payments can turn a balance of trade surplus into a balance of payments deficit.

**Unfavorable Balance of Payments**: An imbalance in a nation's balance of payments in which payments made by the country exceed payments received by the country. This is also termed a balance of payments deficit. It's considered unfavorable because more currency is flowing out of the country than is flowing in. Such an unequal flow of currency will reduce the supply of money in the nation and subsequently cause an increase in the exchange rate relative to the currencies of other nations. This then has implications for inflation, unemployment, production, and other facets of the domestic economy. A balance of trade deficit is often the source of a balance of payments deficit, but other payments can turn a balance of trade deficit into a balance of payments surplus.

**Correcting Disequilibrium in the Balance of Payments**

Any disequilibrium (a deficit or a surplus) in a country’s balance of payments, when it persists for a considerable period, has certain undesirable implications for that
country’s economy as ‘well as for, an orderly growth of world trade. One of the basic problems of” international economic policy, therefore, is that of restoring “even balance” to a country whose balance of payments is persistently either in surplus or in deficit. More particularly, a deficit or adverse balance of payments requires immediate attention to be corrected.

**The Causes of Balance of Payments Disequilibrium**

Knowledge of the causes of balance of payments disequilibrium is of immense importance for the purposes of policy in this field, although the measures to be taken cannot be deduced from it automatically. Three main causes have been identified in this respect:

(a) An unduly low or unduly high level of domestic effective demand;
(b) An unduly adverse or unduly favorable competitive position in the international markets; and’
(c) Excessive and speculative capital movements. Some economists believe that a country’s ‘balance of payments’ situation also depends on its stage of economic development. According to them, a debtor country’s current account first shows deficit, then equilibrium and finally surplus. As and when the debtor country become creditor country, the reverse trend is usually observed.

**Measures to Correct Unfavorable Balance of Payments**

Various measures to correct an unfavorable balance of payments may be studied with reference to:

(a) A system of fixed rates of exchange, and
(b) A system of flexible rates of exchange.

Article IV of the IMF Agreement define the par value of currency in terms of a given amount of gold of countries using the **pegged system** (fixed or stable exchange rates or pegged exchange rates or par values). In fact, the IMF was established with the object of stabilising the rates of exchange, with proper safeguards for adjustments whenever necessary.

In a system of fixed rates of exchange as it obtains under the IMF Charter, the art of correction of adverse balance of payments necessitates two pronged attack i.e. encouraging exports and/or discouraging imports. The various measures aimed at correcting unfavorable balance of payments are stated below:

**A. Monetary Measures**

1. Deflation
2. Exchange Depreciation
3. Devaluation
4. Exchange Control

**B, Non-Monetary Measures**
5. Tariffs—Import Duties
6. Import Quotas
7. Export Promotion Policies and Programmes

**Monetary Measures**

Monetary measures usually have a two-edged effect in improving the balance of payments position. They boost up exports as well as check or curtail imports. Monetary measures, however, function indirectly. Non-monetary measures, on the other hand, are directly effective. But they work one way only. Tariffs and quotas, for instance, tend to restrict only imports. Export promotion measures, on the other hand, enhance exports only.

**The following advantages are claimed for the system of stable or fixed exchange rates:**

1. Firstly, stable exchange rates ensure certainty and confidence in the currency, and thereby promote international trade. Although exchange rates under flexible exchanges may remain relatively stable over fairly long periods of time, there is always the chance that they may fluctuate violently. The prospects of violent fluctuations are detrimental to the international movement of commodities and capital. Instability in the exchange rates, it is argued, constitutes an additional risk in international trade which hampers its growth.

2. Secondly, a system of stable exchange rates is essential for the orderly growth of international investment markets. It is alleged that frequent variations in the external value of a currency, as would be expected under a system of flexible exchange rates, may serve to curtail international investment.

3. Thirdly, a system of flexible exchange rates might be subjected to the possibility of competitive exchange depreciation. In the absence of any international co-ordination authority or agreed formula for foreign exchange manipulation, the system might lapse into anarchy as countries seek through currency depreciation to wrest markets from rivals. Such apprehensions are eliminated in the case of a system of fixed exchange rates.
4. Fourthly, fixed exchange rates, by removing dangerous possibilities of speculation, would stabilize the movements of hot money, and thus would stabilize the international monetary situation.

5. Fifthly, a stable exchange rate is also likely to assist in the economic stabilization domestically.

6. Sixthly, small countries like United Kingdom, where a substantial part of the economic activity is accounted for by foreign trade, must aim at stable exchange rates. The wide fluctuations in rates of exchange are likely to bring about substantial fluctuations in their international trade, and hence in the functioning of their economy.

7. Seventhly, the most important objection to flexible exchange rates relates to the terms of trade. Many countries maintain pegged exchange rates through trade and exchange controls at a level much higher than that which will prevail in a free market. The introduction of a system of flexible exchange rates will substantially deteriorate their terms of trade. The loss from the highly unfavorable terms of trade may far outweigh the gain that might result from flexible exchange rates.

8. Lastly, a system of fixed rates of exchange is more appropriate to a world of regional payments groups where a free rate for a key currency may prove embarrassing to other countries operating within the group.

It is claimed that under the system of flexible exchange rates, the correction of balance of payments disequilibrium is accomplished largely through changes in exchange rates and in the price structure of balance of payments, with a much smaller disturbance to internal economies than is required under a system of fixed exchange rates. The argument of the advocates of completely flexible exchange rates runs as follows:

A country is in deficit in its balance of payments; the exchange rate of its currency would depreciate as a consequence; this will make its exports cheaper in terms of foreign currencies and will make its imports dearer in terms of its own currency; exports will thus be encouraged and imports discouraged; and thus adjustment will be achieved.

Conversely, a country is in surplus in its balance of payments; the exchange rate of its currency would appreciate as a consequence; this will make its exports dearer in terms of foreign currencies and will make its imports cheaper in terms of its own currency;
exports will thus be discouraged and imports encouraged; and thus adjustment will be achieved.

Thus, the great appeal of a system of flexible exchange rates is that, in theory at least, it would automatically keep the balance of payments of all countries in equilibrium. It will not be necessary, therefore, to adapt the economic policy for requirements of external equilibrium nor to introduce trade restrictions and exchange control.

It is claimed that the system will solve completely both the problems of international liquidity and of adjustment. Professor Milton Friedman, amongst others, would like to abandon gold reserves and fixed exchange rates and allow the market to determine what a currency was worth.

In recent years, however, there has developed a strong reaction against a system of stable exchange rates.

The following arguments are advanced in favour of a system of flexible exchange rates:

- Firstly, it is argued that since exchange rates are prices, they should be flexible just as prices must be somewhat flexible in a competitive stem. An obvious merit of a system of flexible exchange rates is its simplicity.
- Secondly, under the system of flexible exchange rates, the correction of balance of payments disequilibria is accomplished largely through changes in exchange rates and in the price structure of balance of payments, with a much smaller disturbance to internal economies than is required under a system of fixed exchange rates. The argument of the system of completely flexible exchange rates runs as follows: A country in deficit in its balance of payments; the exchange rate of its currency would depreciate as a consequence; this will make its exports cheaper in terms of foreign currencies and will make its imports dearer in terms of own currency; exports will thus be encouraged and imports discouraged; and thus adjustment will be achieved. Conversely, a country is in plus in its balance of payments; the exchange rate of its currency would appreciate as a consequence; this will make its exports dearer in terms of foreign currencies and will make its imports cheaper in terms of its own currency; exports will thus be discouraged and imports encouraged; and thus adjustment will be achieved. Thus, the great of a System of flexible exchange rates is that, in theory at least, it would automatically keep the balance of payments of all
countries in equilibrium.

- It is claimed that the system will solve completely both the problems of international liquidity and of adjustment. Professor Milton Friedman, amongst others, would like to abandon gold reserves and fixed exchange rates, and allow the market to determine what a currency was worth.

- Thirdly, freely fluctuating exchange rates, it is argued, will obviate necessity of holding excessive foreign exchange reserves—as the very adjustment process provides the necessary liquidity also.

- Fourthly, it is argued that the flexible exchange rates create uncertainty as to the price the importers will have to pay against imports and exporters will obtain against exports. Professor Frank D. Graham argued that the objections to flexible rates are not as serious as is usually assumed, because risks can be reduced by hedging in the forward market. Forward markets develop rapidly under flexible exchange rates. Moreover, as is the case with fixed exchange rates, if rates are made to change at the discretion of the monetary authority whenever a fundamental disequilibrium in the balance of payments develop, uncertainty will be developed as to the future exchange rates. The only difference is that the changes in the exchange rate are relatively less frequent. This advantage will, however, be counter-balanced the larger magnitude of the change. Under flexible exchange rates the changes are small and continuous.

- Fifthly, it is argued that a system of flexible exchange rates encourage destabilizing speculation. Shifts in exchange rates create expectations of further shifts among speculators and lead them to speculative buying/selling of the currency. Although the system of flexible exchange rates could be adversely affected by destabilizing speculation, the magnitude of such speculation would probably be smaller than under the present system of adjustable pegs with inadequate liquidity. Moreover, the central banks of the major countries, acting in co-operation, could easily counter the pressure of destabilizing speculation. Further, under fixed exchange rates combined with trade and exchange restrictions or deflation of internal prices and incomes, the speculation is shifted from exchange rates to the prices of imports and exports.

- Sixthly, stability in exchange rates is not an absolute condition for long-term
investment internationally. The lenders and borrowers cannot expect the exchange rates to remain stable over, a relatively long period. Moreover, if flexible exchange rates can do more than fixed rates to adjust external disequilibrium’s and prevent recurring balance of payments crisis, their effect on international lending may be more beneficial.

- Seventhly, another major drawback of a system of stable exchange rates is that it does not reflect the existing and true cost-price relationship between the two countries. Countries usually follow different economic policies and as such cost-price relationships alter quite frequently, and in the absence of flexible exchange rates, economic stability of the countries may be hampered.

- Eighthly, according to Francis Cassell, fairly obviously, free exchange rates are a system most compatible with the preservation of national sovereignties. Flexible exchanges allow the monetary and fiscal authorities greater latitude in credit and fiscal policies. There is a little danger that an expansionary policy designed to increase income, output and employment will be brought to an untimely end by deteriorating balance of payments position. Whenever domestic prices outrun world prices, the two will be forced into line by changes in the exchange rates. Nor is a policy of internal stabilization likely to be upset by a favourable shift in the balance of payments.

- Lastly, fixed exchange rates are inconsistent with the unrestricted multilateral trade. Any disequilibrium in the balance of payments under fixed exchange rates can be met, broadly speaking, by deflation of internal prices and incomes and/or changes in the foreign exchange reserves/gold holdings and/or drawings upon the IMF, and/or trade and exchange restrictions. It is generally accepted that the deflation of domestic incomes and prices for rectifying disequilibrium in the balance of payments undesirable for it leads to unemployment. The use of monetary reserves can meet only moderate and temporary deficits. The only alternative, that is left, is the institution of trade and exchange restrictions, at discrimination in their application in case the disequilibrium is not general but only with some specific countries.

The problem of the extent to which exchange rates should be flexible and the extent to which stability should be maintained is one on which no complete agreement has been reached. This problem is one of the fundamental and
persistent problems of international finance. It must however, he noted that, in the face of insurmountable complexities of the international monetary system, except for brief intervals, no country can afford to allow its rate of exchange to float continuously, and follow the day to day changes in internal and external economic situations over a relatively long period. A randomly fluctuating exchange rate is no compatible with domestic economic stability. It is likely to upset the smooth flow of international trade and disrupt the functioning of the domestic economy. As for the moderate and temporary disequilibrium in the balance of payments, it can be corrected by using the monetary reserves. Large and protracted deficits may be rectified by changes in the par values allowable by the IMF Charter, or trade and exchange restrictions, or deflation of domestic prices, or any combination of these methods depending upon the needs of the particular circumstances.

**Real and Nominal Effective Exchange Rates**

Usually there are bad headlines in newspapers that rupee is weakened against dollar or rupee is all time low against dollar. However, it doesn’t mean that Indian rupee is a really bogus, weak and fragile currency reason being India doesn’t trade only with USA or trade only in terms of Rupee to Dollar exchange but also trade with various other countries in various other forms of currency. Therefore, in order to measure Rupee’s volatility objectively there is need to compare its price fluctuations with multiple currencies (i.e. Euro, Yen, Pound, etc.) and not just against Dollar only. Secondly: 1$=Rs 60 or 1$=Rs 65 that alone doesn’t decide the demand of goods and services between India and America because the demand also depends on the rate of inflation of both India and USA. NEER and REER indices calculated by RBI help getting a clear picture here. First of all, the NEERs are calculated then using NEERs, REERs are calculated.

**Meaning of NEER and REER**

Nominal Effective Exchange Rate (NEER) is the weighted geometric average of bilateral nominal exchange rates of the home currency in terms of foreign currencies. The weights can be assigned on the basis of exports as well on the basis of trade. Real Effective Exchange Rate (REER) is the weighted average nominal
effective exchange rates, adjusted for difference in inflation rate between the domestic and foreign countries, relates to the purchasing power parity (PPP) hypothesis. If the weights are assigned on the basis of exports then it is called REER Export Based and if the weights are assigned on the basis of trade then it is called REER Trade Based. REER is important, reason being it captures inflation differentials between India and its major trading partners. It also reflects the degree of external competitiveness of Indian products and captures movements in cross-currency exchange rates. RBI calculates two REER indices i.e. REER 6 and REER 36. REER 6 measures Indian rupee against 6 big currencies i.e. US Dollar, Hong Kong dollar, Euro, Pound sterling, Japanese Yen and Chinese Renminbi. REER 36, as the name suggest, measures Indian rupee against 36 currencies which have been selected in the new series based on three broad criteria: (a) their share in India’s exports and trade, (b) their regional representation and (c) the availability of monthly data related to exchange rates and prices on a regular basis. Prior to introduction of Euro notes and coins in 2002 the Reserve Bank of India (RBI) use five-country and thirty six-country indices of NEER and REER as part of its communication policy and to aid researchers and analysts. The indices are published in the RBI’s monthly Bulletin. But three major developments necessitated a review of these indices. 1) Introduction of the Euro with effect from Jan 1, 2002 dictated the need to substitute the existing national currencies of the Euro zone by the common currency for the members, which formed part of RBI’s 5 country and 36 country REER/NEER indices. 2) There has been a momentous shift in India’s trade relations among countries, primarily towards developing and emerging nations during the last decades, demanding a change in the currency basket and also the weights assigned to India’s trading partners included in the REER. 3) Lastly, the base year of the Wholesale Price Index (WPI) of India, was changed to 1993-94, obliging a change in the base year for 36-country REER and NEER indices. As a result of these developments, the Reserve Bank of India decided to replace the existing 5 currency indices with new 6 currency indices of NEER/REER. The 36 currency indices have also been revised and replaced with new 36 currency indices of NEER/REER. In this regard, the RBI Press Release dated November 4, 2005 had set out the broad outline of the revision of the REER/NEER indices. In line with the prevailing practice, the revised indices i.e. 6 currency as well as 36 currency, both use the wholesale price index (WPI) as a substitute for Indian prices and the consumer price index (CPI) as a substitute for foreign partner countries.
The base year is benchmarked as 100 for the monthly average of both REER as well as NEER. As against the practice of having 3 base years in the case of previously existing 5 country indices i.e. 1991-92, 1993-94 and 2003-04, where1991-92, 1993-94 as fixed base years and 2003-04 as a moving base year which is updated every year to make possible comparison with a more recent year, the new 6 currency indices have two base years i.e. 1993-94 and 2003-04, where 1993-94 as fixed base and 2003-04 as a moving base. As far as the broad-based indices are concerned, the old 36 country indices were constructed with 1985 as the base period but the year 1993-94 was chosen as the base year for the revised 36-currency REER/NEER series in line with the WPI base year. The choice of the base year 1993-94 was attributable to the momentous changes in the macroeconomic environment in 1990-91 due to structural reforms introduced in the wake of balance of payments crisis. Since April 1993, India had adopted a market determined exchange rate regime.

The old 5 currency indices use fixed trade weights that were based on the average of India’s bilateral trade i.e. exports plus imports with the countries in the index during the 5 year period from 1992-93 to 1996-97. The new 6 currency indices use a 3 year moving average trade weights in place of the previously existing fixed trade weights so as to correctly replicate the changing pattern of India’s foreign trade with its major trading partners. As in case of the revised indices of the 6 currency REER/NEER, the 36 currency indices also use 3 year moving average normalized weights i.e. both exports weights and trade weights to construct the new series keeping in consideration the swift changes in the direction of India’s foreign trade as against the fixed weights used up till then for purpose of construction REER/NEER series.

The formulas used for the purpose of calculation of NEER and REER are given below:

As we know that the NEER is the weighted geometric average of the bilateral nominal exchange rates of the home currency in terms of foreign currencies, it can be expressed as:

\[
\text{NEER} = \prod_{i=1}^{n} \left( \frac{e_i}{e} \right)^{w_i}
\]
And the REER is the weighted average of NEER adjusted by the ratio of domestic price to foreign prices; it can be expressed with the help of following formula:

$$\text{REER} = \prod_{i=1}^{n} \left( \frac{e}{e_i} \right) \left( \frac{P_i}{P} \right)^{\omega_i}$$

Where,

- $e$: Exchange rate of Indian rupee against a numeraire, i.e., the IMF’s Special Drawing Rights (SDRs) in indexed form,

- $e_i$: Exchange rate of foreign currency ‘$i$’ against the numeraire (SDRs) (i.e., SDRs per currency $i$) in indexed form,

- $\omega_i$: Weights attached to foreign currency/country ‘$i$’ in the index

$$\prod_{i=1}^{n} \omega_i - 1$$

- $P$: India’s wholesale price index (WPI),
- $P_i$: Consumer Price Index of Country $i$ (CPI), and
- $n$: Number of countries/currencies in the index other than India.

It is clear from the above stated methodology that the REER has four parameters pertaining to currency i.e. coverage ($n$), relative prices ($P/P_i$), weights ($\omega_i$) and exchange rates ($e/e_i$).

**Foreign Exchange Reserves**

Foreign exchange reserves or forex reserves or FX reserves are assets held by central banks and monetary authorities, usually in different reserve currencies, mostly the United States dollar, and to a lesser extent in the euro, the United Kingdom pound sterling, and the Japanese yen, and used to back its liabilities, e.g., the local currency issued, and the various bank reserves deposited with the central bank, by the government or financial institutions.

In a strict sense, foreign-exchange reserves should only include foreign currency deposits and bonds. However, the term in popular usage commonly also adds gold reserves, special drawing rights (SDRs), and International Monetary Fund (IMF)
reserve positions. This broader figure is more readily available, but it is more accurately termed official international reserves or international reserves.

External Debts

External debt/foreign debt is that fraction of a country's total debt that was taken by country from various type of foreign lenders like commercial banks of foreign country, government of foreign country or international financial institutions e.g. the International Monetary Fund (IMF) and World Bank. The debtors of the debt can be the government, corporations or private households. External finance is required to supplement and support developing countries’ in mobilization of domestic resource. These loans, including interest, are usually repaid in the same currency in which the loan was taken. In order to repay the amount of loan, the borrowing country sometimes sells and export goods to the country from which loan was taken. A debt crisis may occur, if a country is unable to repay the amount of external debt because of its weak economy as it is unable to produce and sell goods and make a profitable return. The International Monetary Fund (IMF) is one of the agencies that keep track of the country's external debt.

BOPs and Economic Growth

Balance of payments is the accounting record of a country’s’ imports and exports. When a economy experience economic growth, the income of people of the country also increase and they have extra money that will be used to buy products from foreign nations which leads to increase in the imports over the exports. The consequence of which is negative balance of payments (BOPs) implies the economic growth leads to negative BOPs and vice versa.

BOPs and Inflation

The inflation is of two types:

- Demand-pull inflation: is a situation when price of goods and services increases because of increase in aggregate demand in an economy
- Cost-push inflation: is a situation when price of goods and services increases because of increase in costs of production for firms as a result of which there is decrease in the aggregate supply of goods and services.
To understand why inflation results in decrease in exports, it is to be keep into consideration that an increase in the price means a country's goods or services become less competitive at international level. For example: there are two countries X and Y, if country 'X' could supply a good for Rs1000 and country 'Y' could also supply the goods at same price then it can be said that both the countries are equally competitive at international level. However, if country 'X' experiences inflation of 10%, then in the next year the goods from there would cost Rs1100 but still Rs1000 from country 'Y'. Thus, the country 'X' has become internationally less competitive in comparison to country ‘Y’.

**BOPs and Foreign Exchange Reserves**

The country’s ability to import would be limited by the foreign exchange it has earned from its exports, or from what is called the ‘current account’ – unless it chooses, as countries often do, to finance their deficit by borrowings, i.e. from the ‘capital account’. To the extent that the deficit is not financed by the capital account, it will experience a reduction in its foreign currency ‘cash balance’, i.e. a fall in its forex reserves. In the same way, forex reserves will increase if the exports are more than the imports.

**Ultimately:** Deficit/Surplus of the current account + Deficit/Surplus of the capital account = Net change in foreign exchange reserves

**Models of BOPs**

**Thirlwall's law:** Named after Anthony Thirlwall this law states that if long run balance of payments equilibrium on current account is a requirement, and the real exchange rate stays relatively constant, then the long run growth of a country can be approximated by the ratio of the growth of exports to the income elasticity of demand for imports (Thirlwall, 1979).

If the real exchange rate varies considerably, but the price elasticities of demand for imports and exports are low, the long run growth of the economy will then be determined by the growth of world income times the ratio of the income elasticity of demand for exports and imports which are determined by the structural characteristics of countries.
The Thirlwall law of balance of payments constrained economic growth

Thirlwall’s law (1979), which is based on the Harrod trade multiplier, states that the balance of payments constraint on economic growth can be best understood as the equilibrium growth rate at which the country can utilize its full production capacity and simultaneously keep expanding its economy without entering ever increasing debts. If a country manages to keep its balance-of-payments close to this equilibrium, this will allow for a steady growth of output based on expanding the production capacity without a constant capital inflow.

In order to utilise Thirlwall’s law, we need to understand the concept of balance-of-payments. A country’s national account consists of the current account and the capital account. For a balance of payments the following identity should hold:

\[ \text{Current Account} + \text{Capital Account} + \text{Financial Account} = 0 \]  

(1)

The current account consists of the difference between exports and imports of goods and services, while the capital account represents the financial flows and traded capital goods. A balance-of-payments means that any current account deficit is financed by the capital or financial account with foreign-currency reserves or capital inflows like borrowing and investments.

First was looked as the case of balance-of-payments equilibrium on current account. The original Thirlwall model from 1979 makes the major assumption that an open economy has no capital market and that continuous deviation from the balance-of-payments equilibrium on current account will deteriorate the trade balance and income growth further.

The balance-of-payments equilibrium without capital account is derived from the current account balance equation:

\[ P_d X = P_f M E \]  

(2)

Here \( P_d \) is the average domestic price of exports and \( X \) is the quantity of exports. Therefore, the left-hand side \( P_d X \) is the value of exports in domestic currency. \( P_f \) is the average price of imports in foreign currency and \( M \) is the quantity of imports. Please observe, that in the definition of Thirlwall’s law \( M \) is the volume of imports, while in the Harrod model \( M \) is the total value of imports. \( E \) is the exchange rate or the home
price of foreign currency. When the economy grows, the condition for the balance-of-payments to remain in equilibrium is that the rate of growth of export earnings has to be equal to the rate of growth of import expenditures. We will use the continuous rate of change of the variables by taking natural logarithms of both sides of the current account balance equation:

$$\ln P_d + \ln X = \ln P_f + \ln M + \ln E$$  \hspace{1cm} (3)

The next step in our analysis is to express the rates of change of imports and exports alternatively. Thirlwall's model employs the elasticities approach which stresses the importance of trade elasticities as the main factor affecting the current account. This approach is based on the assumption that the exchange rate is fixed and the demand elasticities for imports and exports are constant. Exports usually depend on the home price of exports ($P_d$), the price of similar goods abroad expressed in home currency ($P_f$) and the level of “world” income ($Z$). Here $\varepsilon$ is the income elasticity of demand for exports and $\eta$ is the price elasticity of demand for exports.

$$X = \left(\frac{P_d}{P_f}E\right)^\varepsilon / Z^\eta$$  \hspace{1cm} (4)

Analogically, the import function with constant elasticity is:

$$M = \left(\frac{P_f}{P_d}E\right)^\pi / Z^{\Psi}$$  \hspace{1cm} (5)

$Y$ is the domestic income; $\pi$ and $\Psi$ are respectively the income and price elasticities of demand for imports.

We express these equations in terms of continuous growth rates by taking natural logarithms of both sides in order to obtain the rate of change of exports and imports respectively:

$$\ln X = \eta(\ln P_d - \ln P_f - \ln E) + \varepsilon(\ln Z)$$  \hspace{1cm} (6)

$$\ln M = \Psi(\ln P_f + \ln E - \ln P_d) + \pi(\ln Y)$$  \hspace{1cm} (7)

The equations above represent the rates of export growth and import growth. It is easy to see that export growth depends on “world” income($Z$), the world's income elasticity
of demand for exports ($\varepsilon$), the change of real terms of trade, or how fast domestic prices change relative to foreign prices ($\ln P_f + \ln E - \ln P_d$), multiplied by the price elasticity of demand for exports ($\eta$). Import growth, on the other hand, depends on the domestic income ($y$), the income elasticity of demand for imports ($\pi$), the inverse change in real terms of trade $- (\ln P_f + \ln E - \ln P_d)$ multiplied by the price elasticity of demand for imports ($\Psi$).

If we substitute equations (6) and (7) into (3) we obtain the balance-of-payments equilibrium for income growth:

$$\ln Y = \left( \frac{(1 + \eta + \Psi)(\ln P_d - \ln P_f - \ln E) + \varepsilon(\ln Z)}{\pi} \right) + \frac{\varepsilon(\ln Z)}{\pi}$$

(8)

The income elasticity of demand for imports can be estimated from historical data as the ratio between import growth and income growth. Therefore:

$$\ln Y = \frac{(1 + \eta + \Psi)(\ln P_d - \ln P_f - \ln E)}{\pi} + \frac{\varepsilon(\ln Z)}{\pi}$$

(9)

The first term on the right-hand side represents the elastic effect of terms-of-trade on growth, while the second term is the effect of income changes for the rest of the world.

In his paper from 1979 Thirlwall employs the purchasing power parity (PPP) and assumes that a flexible exchange rate perfectly adjusts for the change in domestic and foreign price levels. This implies that the terms of trade ($EP_f/P_d$) should be constant, or in other words their rate of change is zero, i.e.

$$(\ln P_f + \ln E - \ln P_d) = 0$$

(10)

This leads to a very convenient simplification of the Thirlwall law by cancelling the terms-of-trade effect on trade flows, but only that in the long-run changes in relative prices have relatively small impact on trade. We should bear in mind that this might eventually lead to deviations in the empirical estimates, especially because of the drastic movements in relative prices in the case of Bulgaria. Because we do not have information about the world income and income elasticity of demand for exports, we
assume that $\ln X = \varepsilon (\ln Z)$. According to Thirlwall(2006) the world's income elasticity of demand for a country's exports $\varepsilon$ depends also on various non-price factors such as consumer's taste, characteristics of goods and others.

Eventually we arrive at the simplified formulation of Thirlwall's law, also known as the dynamic Harrod trade multiplier.

$$\ln Y = \ln X / \pi$$ (12)

Since it is very unreliable to test empirically equation (9) with estimated price and income elasticities of demand for exports, we neglect the effect of terms-of-trade on the balance-of-payments constraint on economic growth. We will test our datasets with equation (12).

**Equilibrium Modal:** This model holds that a foreign exchange rate must be at its equilibrium level - the rate which produces a stable current account balance. A nation with a trade deficit will experience reduction in its foreign exchange reserves, which ultimately lowers (depreciates) the value of its currency. The cheaper currency renders the nation's goods (exports) more affordable in the global market place while making imports more expensive. After an intermediate period, imports are forced down and exports rise, thus stabilizing the trade balance and the currency towards equilibrium.

**Fisher effect (Both: National and International)**

An economic theory proposed by economist Irving Fisher that describes the relationship between inflation and both real and nominal interest rates at national as well as international level.

**National Fisher Effect:** The Fisher effect states that the real interest rate equals the nominal interest rate minus the expected inflation rate. Therefore, real interest rates fall as inflation increases, unless nominal rates increase at the same rate as inflation. The Fisher effect can be seen each time you go to the bank; the interest rate an investor has on a savings account is really the nominal interest rate.

For example, if the nominal interest rate on a savings account is 4% and the expected rate of inflation is 3%, then money in the savings account is really growing at 1%. The smaller the real interest rate the longer it will take for savings deposits to grow substantially when observed from a purchasing power perspective.
**International Fisher Effect:** An economic theory that states that an expected change in the current exchange rate between any two currencies is approximately equivalent to the difference between the two countries' nominal interest rates for that time.

For example, if country A's interest rate is 10% and country B's interest rate is 5%, country B's currency should appreciate roughly 5% compared to country A's currency. The rationale for the IFE is that a country with a higher interest rate will also tend to have a higher inflation rate. This increased amount of inflation should cause the currency in the country with the high interest rate to depreciate against a country with lower interest rates.

**Export Promotion Schemes**

Various export promotion schemes (the details of which are given in Part 2 of Section II in Chapter 4) operating during the period of the study are:

**I.** Duty Exemption/Remission Schemes

**II.** Export Promotion Capital Goods (EPCG) Scheme

**III.** Status Holder Incentive Scheme (SHIS)

**IV.** Special Economic Zone

**V.** Free Trade and Warehousing Zone (FTWZ) Scheme

**VI.** Export Oriented Unit (EOU) Scheme, Electronics Hardware Technology Park (EHTP) Scheme, Software Technology Park Scheme or Bio-Technology Park Scheme

**VII.** Assistance to States for Development of Export Infrastructure and Allied Activities (ASIDE) Scheme

**VIII.** High Tech Products Export Promotion Scheme

**IX.** Target Plus Scheme

**X.** Served from India Scheme

**XI.** Vishesh Krishi and Gram Udyog Yojana

**XII.** Focus Market Scheme (FMS)

**XIII.** Focus Product Scheme (FPS)

**XIV.** Market Linked Focus Product Scheme

**XV.** Schemes for Gems & Jewellery Sector

**The controls over dividends, interests, license fees, royalties and other cash disbursements to the foreign firms/investors**
The following are various control provisions over dividends, interests, license fees, royalties and other cash disbursements to the foreign firms/investors given under income tax act 1961:

1. Share of income of a partner form the firm [sec. 10(2A)]. A partner of a firm will be exempt from tax on his share of income in the firm, which shall be computed by dividing the taxable profits of the firm in the same proportion as the profit sharing ratio mentioned in the partnership deed.

2. Interest etc. of different types [Sec. 10(15)]. The following interest etc. are fully exempt from tax:

   (i) Interest and premium on redemption of notified securities, bonds or certificates. Such as:
       a) 12 Year National Savings Annuity Certificates,
       b) National Defence Gold Bonds, 1980,
       c) Special Bearer Bonds, 1991,
       d) Treasury Savings Deposit Certificates (10 Years),
       e) Post Office Cash Certificates (10 Years),
       f) National Plan Certificates (12 Years),
       g) National Plan Savings Certificates (12 Years),
       h) P.O. National Savings Certificates (12 Years),
       i) P.O. Savings Bank Account,
           (i) Individual account- Maximum exemption limit 3,500.
           (ii) Joint account- Maximum exemption limit 7,000.
       j) P.O. Cumulative Time Deposit Account,
       k) Public Account of P.O. Savings Account Rules (interest up to 5,000),
          and
       l) Special Deposit Scheme, 1981 and Non-Resident (Non-Repatriable) Rupee Deposit Scheme.
           (iii) In the case of an individual or H.U.F. Interest on 7% Capital Investment Bonds notified in the Official Gazette by the Central Government before 1.6.2002.
           (iv) Interest on such bonds which are notified before 1.6.2002 and arising to:
(a) A non-resident Indian, being an individual owning the bonds, e.g., N.R.I. Bonds, 1988 issued by the State Bank of India; or
(b) Any individual owning the bonds by virtue of a nominee or survivor of the non-resident Indian; or
(c) Any individual to whom the bonds are gifted by the non-resident Indian.

The above exemption shall be allowed if the prescribed conditions are satisfied.

(v) Interest on Securities held by the Welfare Commissioner, Bhopal Gas Victims Bhopal in the Reserve Bank of India. The amount of compensation to be paid to the victims of Bhopal Gas Tragedy has been deposited in the Reserve Bank of India in the form of Central Govt. Securities in the name of the Welfare Commissioner, Bhopal Gas Victims, Bhopal.

(vi) Interest on deposits with the Reserve Bank of India or with a notified public sector bank, held for the benefit of the victims of the Bhopal gas leak disaster.

(vii) Interest on Gold deposit Bonds issued under the Gold Deposit Scheme, 1999 notified by the Central Government.

(viii) Interest on bonds (a) issued by a local authority or by a State Pooled Finance Entity and (b) specified by the Central Government by notification, shall be exempt.

(ix) Interest received by a non-resident or not ordinarily resident in India on deposit made after 31.3.2005 in an Offshore Banking Unit, shall be exempt.

3. Subsidy from Tea Board [Sec. 10(30)]. In the case of an assessee who carries on the business of growing and manufacturing tea in India, the amount of any subsidy received from or through the Tea Board for the following purposes shall be exempt:

(i) Replantation or replacement of tea bushes; or

(ii) For rejuvenation or consolidation of areas used for cultivation of tea.
Such exemption will be available only if the assessee furnishes to the Assessing Officer with his return a certificate from the Tea Board as to the amount of subsidy received by him during the previous year.

4. Subsidy received by planters [Sec. 10(31)]. The amount of any subsidy received by an assessee engaged in the business of growing and manufacturing rubber, coffee, cardamom or other specified commodity in India, from or through the Rubber Board, Coffee Board, Spices Board or any Board in respect of any other commodity for the following purposes shall be exempt:
   (i) Replantation or rubber, coffee, cardamom or other plants; or
   (ii) For rejuvenation or consolidation of areas used for cultivation of such commodities.

5. Income from units of Unit Scheme, 1964. [Sec. 10(33)] Any income from transfer of a unit of the Unit Scheme, 1964 of the Unit Trust of India, where the transfer takes place on or after 1.4.2002.

6. Dividend Income [Sec. 10(34)]. Dividend received by a shareholder from a domestic company.

7. Income from units [Sec. 10(35)]:
   a. Income received in respect of units of a Mutual Fund specified u/s 10 (23D); or
   b. Income received in respect of units from the Administrator of the specified undertaking; or
   c. Income received in respect of units from the specified company.

However, the income arising from transfer of aforesaid units shall not be exempt.

8. Income from Equity Shares [Sec.10 (36)]. Any income arising from the transfer of a long term capital asset, being equity shares of a company (listed in recognized stock exchange in India) purchased after 28.2.2003 and before 1.3.2004 and held for a period of twelve months or more.

9. Long-term capital gains on transfer of an equity share or a unit [Sec. 10(38)].

   If the following conditions are satisfied, the capital gains shall be exempt:
   (i) Equity shares in a company or units of an equity oriented fund are long-term capital asset.
(ii) The transaction for sale of such equity shares or units is entered into after 30.9.2004.

(iii) Such transaction is chargeable to Securities Transaction Tax.

10. Income of Subsidiary Company [Sec. 10(40)]. Any income of any subsidiary company by way of grant or otherwise received from Indian holding company engaged in the business of generation, transmission or distribution of power shall be exempt if:

(i) The receipt of such income is for settlement of dues in connection with reconstruction or revival of an existing business of power generation;


11. Income from newly established Units in Special Economic Zones.

12. Income of European Economic Community [Sec. 10(23BBB)]. Any income of the European Economic Community derived in India by way of interest, dividends or capital gains from investments made out of its funds under a notified scheme is exempt.

13. Income of SAARC Fund [Sec. 10 (23BBC)]. Any income of the South Asian Association for Regional Co-operation Fund for Regional Projects set-up by the Colombo Plan Declaration shall be exempt.

14. Income of Mutual Fund [Sec. 10(23D)]. Any income of a notified Mutual Fund set-up by a public sector bank or a public financial institution or authorized by the SEBI or the Reserve Bank of India, is fully exempt.

15. Income of Investor Protection fund from recognized stock exchanges [Sec. 10(23EA)]. The following income of such Fund set-up by recognized stock exchanges in India, either jointly or separately, is exempt:

The income by way of contributions received from recognized stock exchanges and the members thereof.

16. Income of Investor Protection Fund from commodity exchanges [Sec. 10(23EC)]. Any income, by way of contributions received from commodity exchanges and the members thereof, of such Investor Protection Fund set-up by the commodity exchanges in India, either jointly or separately as the Central Government may notify shall be exempt.

Where, any amount standing to the credit of the Fund and not charged to
income tax during any previous year is shared, either wholly or in part, with a commodity exchange, the whole of the amount so shared shall be deemed to be the income of the previous year in which such amount is so shared and shall accordingly be chargeable to income tax.

17. Income of Venture Capital Fund or Venture Capital Company (w.e.f. A.Y. 2001-02) [Sec. 10 (23FB)]. Any income of a venture capital company or venture capital fund from investment in a venture capital undertaking shall be exempt.

18. Income received in India in Indian currency:

Any income received in India in Indian currency by a foreign company on account of sale or crude oil to any person in India shall be exempt if the following conditions are satisfied.

(i) Receipt of such income in India by the foreign company is pursuant to an agreement or an arrangement entered into by the Central Government or approved by the Central Government.

(ii) Having regard to the national interest, the agreement or arrangement is notified by the Central Government.

(iii) The foreign company is not engaged in any activity other than receipt of such income in India.
Bibliography and References: