CHAPTER - I
INTRODUCTION

Economic development is a pattern of economic, social and behavioural changes. It is a multidimensional process involving the reorganization and reorientation of the entire system (Haberler, 1959). It can also be treated as a process whereby people of a country or region come to utilize the resources available to bring about a sustained increase in per capita production of goods and services. Though it is a complex process, yet different economic factors like capital stock, labour skills, technology, capital output ratio, agriculture surpluses and foreign trade etc. largely determine the pace and pattern of development process of countries (Hodgson & Herander, 1983). Economic development has been a major consideration underlying economic policies since Second World War. It has become an important objective of both poor and rich nations.

The objective of rapid economic development cannot be achieved without assigning significant role to foreign trade in the process. Foreign trade provides a link between the domestic economy and the outside world. There are many ways in which it can contribute to economic development of developing nations which include (1) Trade can lead to full utilization of otherwise underemployed domestic resources; (2) By expanding market, trade makes possible division of labor and reaping benefits of economies of scale; (3) International trade is the vehicle for transmission of new ideas, new technology and new managerial skills; and (4) Trade facilitates and stimulates the international flow of capital from developed to developing nations (Salvatore, 1988). Cairncross (1962) has opined that, “Over the past century and a half, the growth of international trade has continued to open up new opportunities of specialization and development for countries engaged in it.” Trade allows a country to export surplus produce and buy back in return the produce for which there is demand. “Trade gives value to their superfluities, by engaging them for something else, which may satisfy a part of their wants and increase their enjoyments (Smith, 1937).

However, critics of international trade provide an impressive list of alleged harmful effects of trade. On the basis of trading experience of developing nations with the advanced nations, an asymmetry is observed in the division of gains from trade between the developed nations and less developed nations. The developed nations,
being the larger economies with an extremely favorable external environment, have
greater ability to have comparative advantage, specialize in R&D intensive product
and export structure so that they can significantly derive the lion’s share of the gains
from international trade. On the contrary, LDCs have several limitations both at the
internal as well as external front (Das, 1999). With the increased global market
integration, one would have expected that the gaps between the developed and
developing nations would narrow. However, the gap between the two has been
widening over the past few decades. GDP of high income economies was 19.7 times
than that of low income economies in 1990. This disparity was around 22 times in
1999 and 27 times in 2004 which further increased to 50 times in 2007. Household
final consumption expenditure of high income countries was 18.25 times than that of
low income economies in 1990. This disparity had been 20 times in 1999 and 25
times in 2004 and 32 times in 2007 (World Bank, 2009).

The reason behind this increase in disparities between the two is that the
developed countries and their multinationals retain with them the initiative of rigidly
maintaining their structures and the policy frameworks. The burden of structural
adjustment on the developing countries has been increasing extensively and has not
suitably been shared by all the participating countries. Instead, imports from
developed countries to European Community (EC), Japan, U.S.A. and other
developed countries are subject to low non-tariff barriers as compared to imports from
developing countries (Varma, 1993). For example, India has to face various non-tariff
barriers for its exports to U.S.A., EEC, Japan and Canada despite reduction in tariff
barriers by these countries (Sinate, 1994). Other major problem faced by developing
nations is that their exports are concentrated in only one or a few primary products. A
decrease in market demand for that product can significantly reduce export revenues.
So these economies suffer from problem of unstable export markets.

Another aspect brought out by Prebisch, Singer & Mydral is that the terms of
trade of these nations have tended to deteriorate. The reason is that whatever the
improvement in technological progress which takes place in these nations in the form
of lower export prices has been shifted to developed nations (Carbaugh, 2002).
Despite export instability and worsening terms of trade, new protectionist policies,
including those based on health standards and labor standards have been adopted by
developed countries for depriving the advantages of comparative advantage to the
external competitors. Increasing volatility of external environment and frustration of
policy autonomy are other such problems faced by developing countries which will lead to persistence of acute balance of trade problem and continuation of debt crisis in the developing world (Panchmukhi, 1998).

An unfavorable balance of trade may many times co-exist with adverse balance of payments and mounting external debt for LDCs. For most of the developing countries, import demand has increasingly exceeded the capacity to generate sufficient revenues from the exports. In recent years, the debt burden of repayment of international loans has become increasingly acute. Trade balance deficit of LDCs increased from $8416 billion in 1990 to $39,839 billion in 2004. Similarly, external debt of LDCs increased from $332 billion in 1990 to $426 billion in 2004 (World Bank, 2002, 2005). Merchandise trade deficit magnitude of LDCs which specialize in agricultural exports considerably worsened in 2005 and 2006. Their equivalent merchandise trade deficit in 2005-06 was equivalent to 18 percent of GDP (World Bank, 2008). The net trade surplus of oil exporting LDCs rose from $11 billion in 2004 to $29 billion in 2006, while merchandise trade deficit of oil importing LDCs increased from $25 billion to $31 billion during the same period. Thus import of oil has led to huge deficits in the balance of trade position of these economies vis-à-vis rest of the world. In a number of LDCs, severe deficits on current and capital accounts have led to increase in external debt, decrease in external assistance and a slowdown in their economic activity.

In India, during seventies and eighties, current account deficit rose from 1.8 percent to 2.2 percent of GDP. This increase in deficit was financed by an increase in external commercial borrowing (0.3 percent of GDP), NRI deposits (0.3 percent of GDP) and other capital (0.3 percent of GDP). External assistance declined by about 0.1 percent of GDP during the eighties, primarily because of a decline in concessional IDA lending by the World Bank. Foreign debt of the country increased from 14.4 percent (10.5 percent) of GDP at the end of March 1986(1980) to 19 percent of GDP at the end of March 1989 (Virmani, 2005). Thus the external financial position of India (balance of payment account) became much more vulnerable during this period thereby affecting the development of the economy.

BOP is a quantitative summary of a country’s international transactions over a period of time. It reveals various aspects of international financial position of a country. According to Kindleberger (1973), “The balance of payments of a country is
a systematic record of all transactions between the residents of the reporting country and the residents of foreign countries during a given period of time”. Further, as explained by Salvatore (1975), “A nation’s BOP is a systematic record of all its economic transactions with the outside world in a given year.” Usually, a country’s BOP account distinguishes between current account, capital account and official settlement account.

The current account includes trade in goods and services, interest and dividend payments, private gifts and so on i.e. trade balance and invisibles account. Balance of trade is defined as the difference between the value of merchandise exports and merchandise imports. It is the balance of goods or balance of merchandise trade. The balance of current account is difference between value of goods and services exported by home country in exchange of imports of goods and services by it from abroad. The capital account balance includes the net private non-banking short term and long term capital, net banking receipts or payments excluding those of central bank (R.B.I.) and net miscellaneous government receipts and payments. Official settlement account measures the change in a nation’s liquid and non-liquid liabilities to foreign official holders and the change in a nation’s official reserve assets during the year. A nation’s official reserve assets refer to its gold, convertible currencies, special drawing rights and gold tranche position in the IMF.

A country’s BOP accounts follow the principles of double entry book keeping. Double entry book keeping should cause total credits to equal total debits when all three accounts of the BOP are taken together. Nation’s total receipts and payments for any given period of time must always be in equilibrium. There may exist disequilibrium in BOP either on the credit side or debit side and that disequilibrium may be either of temporary nature or permanent nature.

The BOP surplus or deficit depends on the balance of autonomous items. Induced or accommodating transactions are made with the intention of settling imbalance in the current account and maintaining an overall balance in BOP. All transactions in the capital account are not induced by profit motive. If current account deficit is accompanied by deficit in the long term capital account then long term capital account generate profits, dividends and interest payments which will improve current account deficit.
If there is a surplus in BOP position, it depicts that country’s receipts are more than payments. This surplus can improve the competitiveness of the economy in the international market. If there is a deficit in BOP position, it shows that its liabilities are more than its assets, it will lead to increase in capital inflows which in turn leads to mounting repayment obligations. Thus, it is important that balance of payments disequilibrium is dealt with appropriate policy measures, lest there will be disruption of international trade apart from economic strains that deficit will generate. The study of BOP account, which is an integral part of our national income, assumes a great importance in the development of an economy.

If a country has deficit and accommodating capital inflow, it must in general try to implement policy measures aimed at reducing the deficit. The country with deficit in BOP can use devaluation (expenditure switching policies) at discrete intervals to correct the disequilibrium in the BOP. The disequilibrium can also be well tackled with expenditure reducing policies. Further, deficits are largely met by foreign assistance. This in turn led to mounting repayment obligations. Countries with deficit in its BOP are considered as weak countries and they lose prestige and confidence in the international market. These countries also face difficulties in securing loans from foreign resources which lead to erosion of international competitiveness of these economies.

At the international level, high income countries like U.S.A. and U.K. were having current account surpluses in 80s but in recent years, these surpluses have not only reduced but also huge deficits have been witnessed by these countries, making U.S.A. as the topmost country in the ranking of countries with largest current account deficits in the year 2005. U.S.A. has accounted for more than half of the world’s current account deficits. The U.S. current account deficit increased from 4.3 percent of GDP in 2000 to an average of 6 percent in 2005-07. Spain’s deficit rose from 4 percent to 9 percent of GDP. While China is the topmost country in the ranking of countries with largest current account surpluses with an average surplus of $372 billion. Consequently, U.S.A. has been putting pressure upon Japan to revalue its currency and adopt such measures as can enable U.S.A. to overcome its staggering BOP deficit. Australia and Greece also witnessed increase in current account deficit after 80s (World Bank, 2009). Many countries like Sweden, Switzerland, Japan, Netherlands witnessed not only reduction in deficit but also showed current account surpluses in 2005 as well as in 2007 and were in the list of top 15 countries with
largest current account surpluses. Similarly, sharp improvement has been witnessed by Norway during the same period. On the other side, countries like South Korea and Malaysia, which were having current account deficits in 1980 and 1995 improved at faster pace and became 14th and 15th country respectively with highest current account surpluses in 2007. Oil and gas exporters such as the Russian Federation and Saudi Arabia also saw surpluses ballooning. Unlike many high income economies, Germany went from a deficit of 1.5 percent of GDP in 2000 to a surplus of 6 percent during 2007. But some countries with strong export growth had equally strong import growth, with India and Mexico maintaining small current account deficits. From 2005 to 2007, the five largest surplus economies namely China, Germany, Japan, Saudi Arabia, Russian Federation accounted for 71 percent of total current account surpluses, and the five largest deficit economies for 79 percent of total current account deficit (World Bank, 2009).

If we consider the case of middle income economies, there is 4 times increase in trade account surplus from 1990 to 2003 while there is decrease in deficit of trade balance in low income economies. But in the case of high income economies, there is 4 times increase in trade account deficit during 1990 to 2003 (World Bank, 2005). The search for improvement in BOP on current account if successful would ease the problem of these economies to an extent. Most of the developing economies are still dependent on net flow of finances from abroad to accelerate their social and economic progress. Like many other developing countries, India is also faced with the persistent BOP deficit since independence (except two or three years).

With the introduction of planning in India, the BOP position has been recording considerable changes. Bimal Jalan (1993) divides the period after 1956-57 into three sub-period depending on the nature of balance of payments problem, the overall macro economic environment and external aid situation. The three sub-periods are: 1956-57 to 1975-76 (Period I), 1976-77 to 1979-80 (Period II) and 1980-81 to 1990-91 (Period III). While periods I and III were characterized by persistent balance of payments problem, period II saw a substantial improvement in the BOP and foreign exchange reserve position. Jalan used the following two criteria as a rough measure of the BOP problem in a particular year: (i) the current account deficit being more than one percent of GDP and (ii) the foreign exchange reserves being less than necessary to cover three months’ imports. During period II, the current account deficit was less than one percent of GDP and reserves, were sufficient to cover more than three
months’ imports. As against this, the current account deficit was more than one percent of GDP in periods I and III. However, on the whole, the overall BOP situation continued to be difficult.

Period I (1956-57 to 1975-76) comprising the second, third and fourth plans and first two years of the fifth plan saw heavy deficits in BOP and an extremely tight payment position. Though the government resorted to severe import controls and foreign exchange regulations, the current account deficit stood at 1.8 percent of GDP. Foreign exchange reserves were at a low level, generally less than necessary to meet three months’ imports. Period II (1976-77 to 1979-80) was a relatively short and golden period as far as balance of payment had a small current account surplus of 0.6 percent of GDP and also possessed foreign exchange reserves equivalent to about seven months’ imports. However, the second oil shock came in 1979-80 which had a serious negative impact on Indian economy. The full impact of this hike in oil prices was reflected in trade balance of 1980-81. Period III (1980-81 to 1990-91) was marked by severe balance of payments difficulties. Current account which stood at surplus in previous period has shown a deficit of 1.8 percent of GDP during this period. The import cover of foreign exchange reserves was only 3.3 months. Trade balance as a percent of GDP has shown a deficit of 3.1 percent during this period. Invisibles balance showed a surplus of 2.1 percent during the same period.

In 1991, India was in the midst of full blown BOP crisis. Indian economy was under the pressure of growing trade deficit, which was estimated at 2.6 percent of GDP in 1991. As a result, the country was left with low foreign currency assets in 1991. This economic crisis led to erosion of international confidence in the country. India has to take various short term and long term measures to correct its BOP in order to correct structural weaknesses of the economy. In 1991, fiscal deficit which was 4 percent of GDP in 1970-71 increased to 8.5 percent of GDP in 1990-91 leading the country to debt trap and high rate of inflation. Burden of national debt exceeded 60 percent of GDP in 1991 while inflation increased at an average annual rate of 12 percent per annum (GOI, 1992-93).

New Economic Policy in the form of ‘Liberalization, Privatization and Globalization’ (LPG) was adopted in July 1991. The government devalued the rupee by 18 percent against the basket of five currencies. The Finance Minister announced the Liberalized Exchange Rate Mechanism System (LERMS) in the budget 1992-93.
This system introduced partial convertibility of rupee. Under this system, a dual exchange rate was fixed under which 40 percent of foreign exchange earnings were to be surrendered at the official exchange rate while remaining 60 percent were to be converted at a market determined rate. On the recommendations of High Level Committee on BOP constituted by the Government of India under the Chairmanship of Dr. C. Rangrajan, the 1993-94 budget introduced full convertibility of the rupee on trade account. As a result, the dual exchange rate system was dispensed with and a unified exchange rate system was introduced. Later, India achieved full convertibility on current account on August 19, 1994. There has been further relaxation of restrictions on current transactions in 1995-96 and 1996-97.

While India has achieved convertibility on current account, it is moving slowly and cautiously towards convertibility on capital account. Capital account convertibility refers to a liberalization of a country’s capital transactions such as loans and investments, both short term and long term as well as speculative capital flows. The budget 2002-03 has adopted a continuous step towards capital account convertibility by allowing NRIs to repatriate their Indian income. But considering the present condition, the government is of the opinion that although it intends to move towards full convertibility of rupee on capital account as early as possible but caution is very necessary because convertibility can lead to substantial flight of foreign exchange from the country. Government also announced comprehensive modifications and liberalizations to export-import policy in April 1997, in 2002 and in 2007 as well.

Due to all these policy measures taken by the Government since 1991, the balance of payments situation has been distinctly different from the situation which prevailed in the earlier period. During the period 1992-93 to 2000-01, the balance of payments remained in surplus for almost all the years. This surplus has been recorded on the grounds of surplus in the capital account. Current account deficit has also decreased from 1.8 percent in 1980-81 to 1990-91 to 1.1 percent of GDP during 1992-93 to 2000-01. There was increase in invisibles balance from 1.2 percent in previous period to 1.9 percent during this period. The import cover of foreign exchange reserves was also 7.1 months in this period which was more than double of the previous period. According to the Economic Survey 2001-02, “This improvement in current account deficit was made possible largely because of the dynamism in
export performance, a sustained buoyancy in invisible receipts, reflecting sharp increases in software service exports and private transfers, and partly due to the subdued non-oil import demand” (GOI, 2001-2002).

In the period 2001-02 to 2008-09, current account balance has shown a deficit to the tune of 4.3 percent of GDP. The period also witnessed increase in trade balance deficit. This was due to sustained demand for non-oil imports and escalation in international crude prices. Continuous uptrend in prices in the international markets and rise in the price of gold were the major contributors in this process. Net surplus under invisibles, however, led by high growth in private transfers and software exports, remained buoyant, thereby offsetting a significant part of the trade deficit. Net surplus in invisibles increased to 4.98 percent of GDP. Import cover of foreign exchange reserves of 14 months was comfortable.

**Rationale of Present Study**

The justification for the present study on “Trends and Determinants of Balance of payments in India” is manifold. Firstly, most of the empirical works done so far concentrated only at the aggregate level and therefore they do not shed light on the empirical analysis of balance of payments at disaggregated level (i.e. components of balance of payments). Secondly, previous studies have not compared balance of payments position for pre-liberalization and post-liberalization period. Thirdly, most of the studies on the determinants of balance of payments have also concentrated only on aggregate accounts (i.e. balance of payments, current account and capital account). Fourthly, most of the studies regarding balance of payments effect on economic growth have concentrated only one aspect of balance of payments i.e. effect of exports on gross domestic product. The effect of all the major components of balance of payments on gross domestic product (or economic growth) has not drawn much attention.

As no in-depth and comprehensive study has been conducted on the above said aspects of balance of payments in India; thus the present study is an endeavor in this direction to enrich the existing literature on the trends and determinants of balance of payments in India.
Objectives of the Study

1. To study the balance of payment problem in terms of various accounts viz. current account and capital account as a whole.

2. To examine growth of receipts and payments of various components of current and capital accounts and their contribution to study importance of various items in financing balance of payments.

3. To bring out structural changes in components of balance of payments, if any.

4. To identify various factors influencing movements in major components of balance of payments.

5. To estimate the impact of various components of balance of payments on economic growth of India.

6. To suggest policy measures for curing balance of payments deficit.

Hypotheses

In the light of above-mentioned objectives, the study attempts to test the following hypotheses in the context of Indian economy:

1. Liberalization measures have significantly improved the balance of payments position.

2. There are sizeable structural changes in components of balance of payments during the whole period (1980-81 to 2005-06).

3. Balance of payments position is significantly affected by various external and internal factors.


Plan of the Study

The study has been divided into ten chapters including the present one. Second chapter reviews the literature about various issues of balance of payments. Third chapter gives the database and methodology used in the analysis. Fourth chapter studies the balance of payments position of India since independence period. Fifth chapter studies the trends in current account and the structural changes therein during pre-liberalization and post-liberalization periods. Sixth chapter studies trends and structural changes in capital account and its components. Seventh chapter is devoted
to various determinants of BOP viz. its accounts at disaggregated level. Eighth chapter brings out the impact of current account, trade balance, invisibles account and capital account on the economic growth of India. Ninth chapter critically examines the external sector reforms in India and last chapter summarizes the study and brings out policy implications.