The relevance of the structuralist versus monetarist approach to the balance of payments has been extensively explored themes of discussion among the economists throughout the world particularly due to persistent rise in the price level and deterioration in the balance of payments of the developing countries. The empirical works of both the schools of thought about the causes of balance of payments problems have failed to throw conclusive evidence. In monetary terms, a balance of payments deficit may be seen as an indication of an excessive real supply of money relative to demand. Creation of money at a rate faster than the rate at which real domestic output is increasing will tend to cause inflation, and will tend to generate a balance of payments deficit. In the case of India, it can hardly be denied that the monetary management is an extremely important element of the macroeconomic policy scenario particularly when the country is undergoing substantial current account deficits year after year. Against this background, the objective of this study is to discern the line of reasoning and approach behind the course of monetary management which have had bearing on India’s balance of payments position. More precisely, we test the hypothesis of monetary management has exerted significant influence on the India’s balance of payments. This study has some limitations mainly owing to the absence of a consistent and comparable series on monetary aggregates for the period under study. Therefore, despite all efforts to make this study up to date, comprehensive and analytical deficiencies are bound to remain.
In order to identify and analyse the important factors which have contributed to the fluctuations in the price level, demand for money and various components of the balance of payments, simple and multiple regression models are resorted. The specification of the equations used in this study have been drawn from the studies of Mohsin Khan (1974), Sohrab Uddin (1985), Kannan (1989) and Raghavan and Saggar (1989) with slight variation. The behavioural equations are estimated by the method of Ordinary Least Squares (OLS). Significance of the estimates has been tested at 5 per cent level. The suitability of the equations is examined through economic criteria like appropriateness of the sign of the regression coefficient according to a prior theory and statistical criteria like coefficient of determination adjusted for degrees of freedom ($R^2$), Durbin Watson Statistic (DW), Standard Error of Estimate (SEE), F-value and t-value of the regression coefficients. To estimate the equations we have used time series data for the period 1960-61 – 1985-86. We selected this period because it has been the most crucial period in the field of Money, Banking and International Trade of India. The basic data are taken from the various issues of the Reserve Bank of India publications like the RBI Bulletin, Annual Reports and Reports on Currency and Finance. Also from Economic Survey of Government of India, National Accounts Statistics of CSO, International Financial Statistics of IMF and UNCTAD Handbook of International Trade and Development Statistics (New York: United Nations).

Since independence India’s balance of trade has shown an adverse trend with the exception of the years 1972-73 and 1976-77 when there were some surpluses on this account. The effects of this trade gap on the balance of payments position
has been adverse and increasingly disturbing. During the last few years India's international trade has undergone considerable change in regard to composition, direction, and volume of trade. But still India has for long been facing problems in regard to her share in total world exports, prices of her product exported, terms of trade and increasing debt burden etc.

The Reserve Bank of India, during the period under consideration, endeavoured to moderate the expansion of credit and money supply in such a way as to ensure the legitimate requirements of industry and trade and curb the use of credit for speculative and inflationary activities. During the Third Five Year Plan period (1961-62 – 1965-66) money supply (M1) rose at an annual average rate of 9.59 per cent and M3 rose at the rate of 9.11 per cent as against growth in real national income (Y1) of 2.41 per cent and an annual rise in the wholesale price index of the order of 5.65 per cent. Under such circumstances a relatively tight monetary policy was opted. The Reserve Bank of India raised the Bank Rate to 4.5 per cent in January 1963 to 5 per cent in October 1964 and to 6 per cent in March 1965. The Statutory Liquidity Ratio (SLR) was raised from 20 per cent to 25 per cent in September 1964. Credit Authorisation Scheme was also introduced in November 1965 with a view to regulate the credit flows to the different borrowers. Despite the various restrictive credit policy measures adopted by the Reserve Bank of India inflationary pressures could not be contained during the Third Plan period. During this period annual average exports amounted to Rs. 1178 crores and imports valued at Rs.1950 crores which resulted in an adverse trade balance of Rs.772 crores. The balance of payments deficit amounted to Rs.1972 crores. Measures related to control and
regulation of imports and promotion of exports were adopted to correct the disequilibrium in the balance of payments. The devaluation of rupee in June 1966 by 36.5 per cent improved India’s trade balance substantially by 1968-69. The India exports started moving up while imports registered a continuous decline.

During the Three Annual Plans (1966-67 – 1967-68 and 1968-69) average annual increase in M1 was 8.46 per cent and M3 rose at the rate of 10.63 per cent. National Income at constant prices rose at an annual average of 3.74 per cent and prices rose by 8.86 percent per annum on the average. The average annual imports during this period amounted to Rs. 1991 crores and the exports totalled only Rs. 1247 crores which resulted in the annual average adverse trade balance of Rs. 744 crores.

During the Fourth Five Year Plan period (1969-70 – 1973-74) M1 rose at the average rate of 14.11 per cent per annum and M3 rose at the average rate of 16.18 per cent, while the real national income grew at 3.29 per cent and prices rose at 7.69 per cent. During this period Reserve Bank of India followed restrictive credit control measures in the form of a rise in the Net Liquidity Ratio from 31 per cent to 40 per cent in eight stages between February 1970 and September 1973. The Bank Rate was raised from 6 per cent to 7 per cent in May 1973 and the Cash Reserve Ratio was raised from 3 per cent to 7 per cent in September 1973. The Statutory Liquidity Ratio was raised from 25 per cent to 32 per cent in Six stages between February 1970 to December 1973. During this period as a whole there was a surplus of Rs. 100 crores in India’s balance of payments.
During the Fifth Five Year Plan (1974-75 – 1978-79) period as a whole M1 rose at an annual average of 9.53 per cent, and M3 rose at 17.89 per cent while national income rose at the average rate of 5 per cent per annum and the rise in prices averaged 7.54 per cent per annum. In order to check spiralling inflation Reserve Bank increased the Bank Rate from 7 per cent to 9 per cent in July 1974. Statutory Liquidity Ratio was raised from 33 per cent to 34 per cent in December 1978. The Cash Reserve Ratio was adjusted five times between June 1974 and November 1976.

The first oil price hike in 1973-74 and resultant strain owing to the heavy import bill caused some pressure on India’s balance of payments. During the Fifth Plan period average annual imports amounted to Rs. 5479 crores and exports valued at Rs. 4698 crores. But due to increase in earnings from invisibles the current account position for the period as a whole turned into a surplus of Rs. 3082 crores.

During the Sixth Five Year Plan (1980-81 – 1984-85) period as a whole M1 rose by 17.96 per cent, M3 by 16.87 per cent, national income by 4.93 per cent and prices by 10.28 per cent on an annual average basis.

The analysis of all the major monetary control techniques during the period of our study discloses that there was heavy reliance on changes in the Cash Reserve Ratio (CRR). It has been frequently used for checking rapid growth of liquidity in the economy. However, the monetary policy which has been followed in India has resulted in an upward pressure on the growth of money supply. This has resulted in the rapid rise in the price level.
The major findings regarding the price function from Chapter 2 emerging out of the regression analysis are:

1. The coefficient of the explanatory variable price with one year lag (P-1) is found to be statistically significant with positive sign. The variable explained 97.6 per cent of the variation in the function.

2. The explanatory variable money Supply with one year lag [M1-1] explained 96.9 per cent of the variation in the function. The coefficient of the variable is statistically significant and has positive sign.

3. The explanatory variable Net National Product (Y1) explained 96.5 per cent of the variation in the function. The coefficient of the variable is statistically significant and has positive sign.

4. The coefficient of the explanatory variable Money Supply (M1) without any lag is found to be statistically significant with positive sign. The variable explained 96.4 per cent of the variation in the function.

5. The two explanatory variables, viz. M1 and P-1 together explained 98.3 per cent of the variation in the function. The coefficients of the variables are statistically significant and both have positive signs.

6. There is a slight decrease in the explanatory power of the function to 98.1 per cent, when the variable Y1 is considered instead of P-1 along with the variable M1. The coefficients of both the variables are statistically significant and have positive signs.

7. The overall results show that the lagged variables have larger explanatory power than the variables without any lag.

From Chapter 4, in which an econometric model of India's balance of payments is presented, the major conclusions emerging out of the regression analysis are:

8. Among the various explanatory variables considered in the import function real income is the only explanatory variable which explain the emergence of a large proportion of total imports. It is also found that the
value of income elasticity of demand for imports is higher than the price elasticity of demand for imports.

9. Estimated results of the export demand equations suggest that a major portion of growth in export volume is due to the growth in world real income.

10. Estimated results reveal that merchandise imports and external debt outstanding are the two main determinants of the import of services.

11. World real income and the ratio of consumer price index in India to the world are the two main determinants of the export of services.

12. Growth in net foreign exchange assets is found to be a significant factor in explaining net long term capital flow.

13. Estimated results show that the aggregate imports into India have a high income elasticity while the demand elasticity for exports of Indian goods with respect to world real income is low.

From Chapter 5 the major conclusions emerging out of the regression analysis are:

14. Changes in the price level (P) and the 12 month time deposit rate of commercial bank (R₁₂) do not explain the variation in demand for real money balances, while the change in real national income (Y₁) does effect to demand for real balances.

15. Results reveal that the income elasticity of real demand for money is more than proportionally as income rises.

16. The overall results of the estimated reserve flow equations show that the value of the offset coefficient is approximately -1 and it is statistically highly significant. This confirms the proposition of the monetary approach to the balance of payments theory that the changes in the domestic component of the reserve money (D) will cause opposite and equal change in the international reserve (R).
The overall results of the estimated sterilisation equations show that the value of the sterilisation coefficient is very near to -1 and statistically significant. While for monetary approach to the balance of payments validity it should be zero. Therefore monetary approach to the balance of payments is not an appropriate model for explaining movements in net foreign assets in the Indian case.

To sum up, we can say that there is a strong confirmation of the hypothesis that the course of monetary management significantly affect the India's balance of payments. The slow rate of growth in exports together with deterioration in terms of trade had made India's export earnings inadequate to meet the country's growing import bills. A massive escalation in foreign exchange expenditure on oil import and steady increase in the interest payments on foreign loans and credit have added fuel to the fire of balance of payments disequilibrium.