UNIT 4 INTERNATIONAL TRANSACTIONS AND BALANCE OF PAYMENTS

Structure

4.0 OBJECTIVES

After studying this unit you should be able to :

- explain the concept of balance of payments
- indicate accounting for international transactions in balance of payments
- outline the format of balance of payments statement
- identify the relationship between balance of payments and exchange markets
- carve out the balance of indebtedness
- spell out adjustment policies vis-a-vis balance of payments.

4.1 INTRODUCTION

Balance of payments is an accounting system that measures economic transactions between the residents of given country and the residents of the other countries during a given period of time. Economic transactions include exports and import of goods and services; gifts between the countries and international movements of financial assets and liabilities. The balance of payment position of a country is important as it helps to predict country's market potential. In this unit you will learn about the concept of balance of payment, accounting for international transaction in balance of payments and the format of balance of payment. You will also learn about the relationship between balance of payments and exchange markets, balance of indebtedness and the adjustment policies vis-a-vis balance of payments.

4.2 BALANCE OF PAYMENTS CONCEPT

The concept of balance of payments (BOP) has emanated from commercial and financial transactions between nations. The balance of payments comprise three types of financial flows. First, the value of visible exports can be balanced against the value of visible imports to determine trade balance. Trade in merchandise represents these visible items like grain, oil, jewellery, garments and machines.

Second, the value of invisible exports can be balanced against the value of invisible imports to determine invisible balance. Invisible trade is represented by services like shipping, insurance, tourism and consultancy. When merchandise exported from India is carried in foreign ships or insured by foreign underwriters, the charges paid for these services constitute invisible imports or say import of services. On the other hand, charges received by Indian ships or underwriters for carrying foreign merchandise, or for insuring it, get counted as invisible exports or say export of services. Likewise, foreign tourists visiting India generate invisible exports for her, while Indian tourists going abroad create invisible imports for their country. When foreign consultants are hired by Indian firms, Governments or other agencies, consultancy fees amount to invisible imports. As against this, when fees for such services are received here by Indians from abroad, these fall in the category of invisible exports. Total visible and invisible exports balanced against visible and invisible imports is called current account balance. If these combined exports exceed these combined imports, there is favourable current account balance. In case, such imports exceed such exports, we have unfavourable current account balance. It is rare that both these variables are just equal or perfectly balanced.

Thirdly, the balance of payment consists of balance of investment and other capital flows, called capital account balance. If such inflows into a country exceed the outflows there from, the amount of "net inflow" would either push up the (otherwise) favourable 'current account balance' into a more favourable balance of payments, or the (otherwise) unfavourable current account balance would be transformed into a less unfavourable balance of payments. Conversely, when there is net outflow on capital account, an unfavourable current account balance would turn into a more unfavourable balance of payments. In case there had been a favourable current account balance it may either become less favourable BOP, or an unfavourable BOP, depending on whether the net outflow is smaller or bigger than the erstwhile current account balance.

Sometimes, a distinction is made between market balance of payments and accounting balance of payments. The latter may be defined as a periodic statement summarising all the external (commercial and financial) transactions in which a country is involved during a year or any other period of time. The net result may be favourable (surplus/plus) or unfavourable(deficit/minus), to be appropriated or financed in some way so that the two sides of the account are always equal, even if a suspense account has to be raised to cover up some discrepancy (say, funds in transit) or accounting error. This is in line with the conventional code of double entry book-keeping. The market balance of payments signify the current or ongoing relationship between what comes in(inflows) and what goes out (outflows) as a result of both capital and current (visible and invisible) account transactions.

In effect, BOP signify supply and demand of foreign currency (say, US dollar, British pound sterling or Japanese yen). The supply is generated, in the normal course, through (visible and invisible) exports and capital inflows, while demand emanates from (visible and invisible) imports and capital outflows. Normal supply may be diminished when foreign exchange accounts get blocked in emergent situations such as wars or hostile policies of certain countries. By the same token such supply may get augmented when blocked or frozen accounts are permitted to melt (like the release of India's sterling balances accumulated during the Second World War with the Bank of England). Normal demand, too, may get augmented when special or extraordinary payments have to be made to a foreign country or in a foreign currency (say, reparation payments imposed on Germany after the First World War, or subscriptions to United Nations and its Agencies since 1945). Likewise, the demand may diminish when certain (re)payments are rescheduled or waived (fully or in part) to give relief to a country stricken by droughts, floods, earthquakes, epidemics or other mishaps. Whether guided by humanitarian or political consideration, other (donor) countries may even make (discretionary/ex gratia) transfer payments which may strengthen the current account position of the (donee) country.

In effect, the demand and supply relationship may reflect itself in an upward or downward movement of the exchange rate and/or in the level of external reserves. For example, the cost of one US dollar went up from about 35 to roughly 40 Indian rupees between August 1997 and February 1998. There was some loss of foreign exchange reserves when the Reserve Bank of India intervened to resist fall in the external value of the rupees. As such, official reserves account stands separately from current account and capital account. Official reserve account measures charges in the holdings of foreign currency, SDRs and gold by central bank of the country. In all these three accounts currency inflows may be viewed as credits, while outflows as deemed to be debits. During any period of time aggregate credits should be equal to aggregate debits. That is why deficits/surpluses in current and capital accounts lead to depletion/augmentation of official reserves. In the ultimate analysis, balance of payments summarises all the economic transactions between residents of the home country (say, India) and residents of all other countries and signify demand and supply of foreign currency/currencies.

The BOP can be expressed as follows :

$$\text{BOP} = \underset{\text{(current account balance)}}{\text{CRA}} + \underset{\text{(capital account balance)}}{\text{CPA}} + \underset{\text{(official reserve account balance)}}{\text{ORA}}$$

The BOP must always balance, since it is an accounting identity in a fixed exchange rate system. If the sum current account and capital account is not zero then the government must take action by adjusting the official reserve account to balance BOP. It does so by buying or selling foreign currency and gold depending upon the situation, up to a total that equals the difference between current account and capital account.

In a floating rate system, market forces act to adjust the exchange rate as necessary to force the BOP back to zero.

4.3 NATURE OF INTERNATIONAL TRANSACTIONS

Let us now briefly understand the nature of international economic transactions. There is a basic difference between domestic and international transactions. In a domestic deal the two (or more) parties belong to the same country, so that the foreign exchange problem does not come into the picture (unless the deal itself is drawn in terms of a foreign currency). When two (or more) individuals/

organisations belonging to two (or more) different countries enter into an international transaction, it is usual to take note of the foreign exchange element with its several dimensions. First, the particular currency (or currencies) in which the amounts are to be stated would need to be agreed upon. This problem could be avoided if a common currency (say, Euro in the European Union) is used (and all the individuals/organisations concerned belong to that very Union). Second, the cross-currency rate(s) of exchange may have to be identified (for the present and, possibly, for future also) along with risks of fluctuation being covered by hedging or some other mechanism. Third, foreign currency may have to be bought, sold or surrendered in conformity with governmental regulations through authorised banks or other agencies.

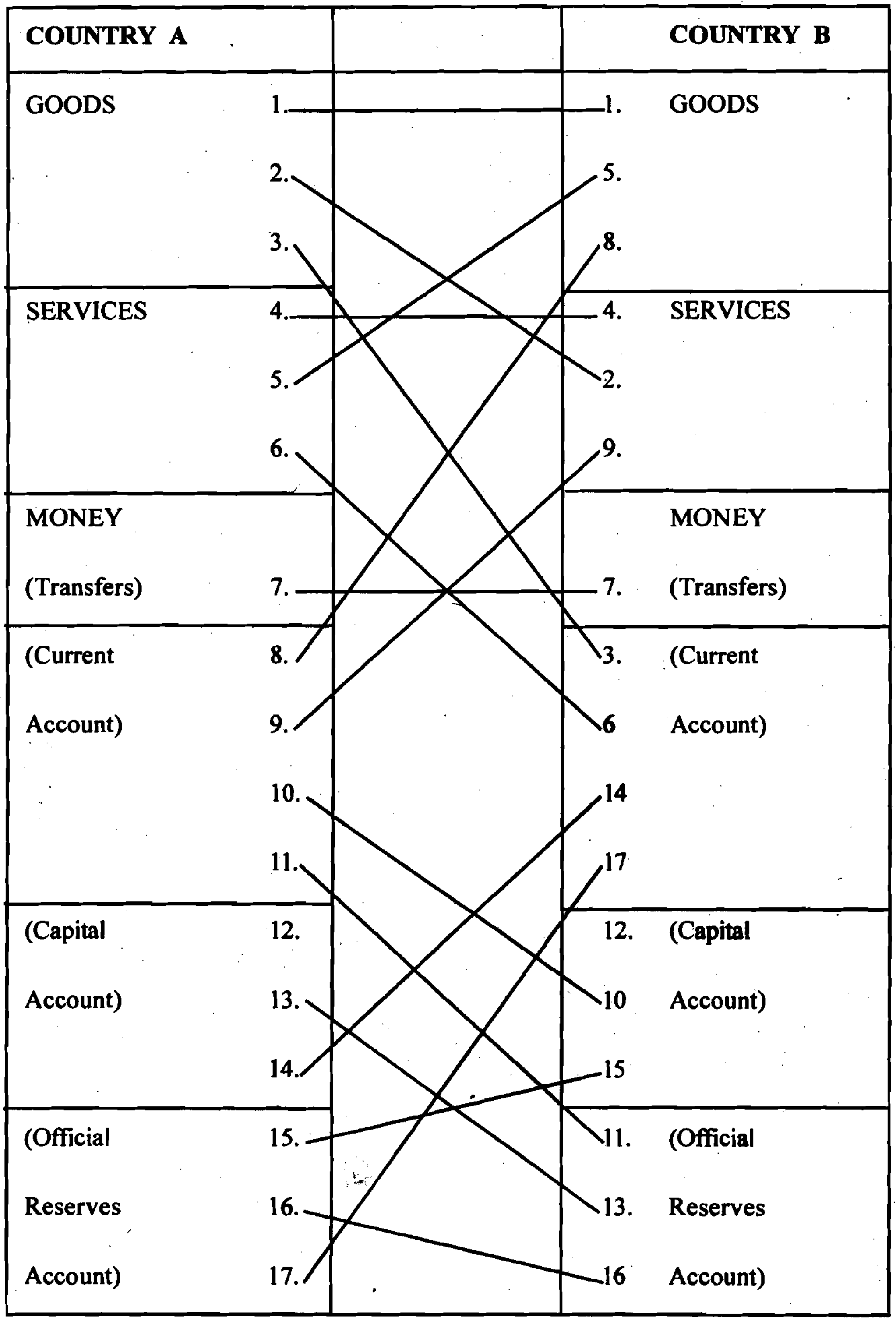
Sometimes, the international monetary mechanism may be obviated or short-circuited by adoption of barter trade or smuggling. When two nations (or their traders) are unable to arrive at an agreement regarding the monetary value of certain goods/services, or in respect of some commonly acceptable rate of exchange (conversion), they may resort to barter arrangements. Here there are three main possibilities. First, goods of one country may be exchanged for goods of another country (say, Indian rice for Russian oil). Second, goods may be exchanged for services (like consultancy). Third, services may be exchanged for services (like those of teachers under the cultural exchange programme).

Even those international transactions which are, in a micro-sense, based on monetary values, may, at the macro-level, appear to be close to barter arrangements. That is, central bank (or other foreign exchange agencies) of two countries tend to settle their accounts only in aggregates and not for each individual transaction in isolation. Moreover, in the absence of a perfectly free multilateral trading system, even a country with an overall surplus in its balance of payments may fall short of a particular foreign currency. For example, if (imagine that) India has a surplus BOP with Russia (and also an overall surplus globally), she (India) may still fail to get enough imports from the USA (on monetary basis) if Russian rouble is not freely convertible into US dollar.

Figure 4.1 on next page indicates some alternative situations in international transactions:

In this model, there are only two countries (for the sake of simplicity). Transactions revolve around goods, services and money, while settlements (besides barter) are made via current account, capital accounts, and official reserves account. In this process, money has a dual role, first as a medium of transfer payments which constitute a part of the current account (the other two constituents being goods and services), and, secondly, as a balancing device under all the three accounts (current, capital and official reserves). Country A has more goods than services, while country B has more services than goods. This dissimilarity may be deemed to indicate (though not necessarily) that Country B is more developed or advanced than country A. This may be further supported by the fact that country B has a bigger official reserves account than country A. Perhaps, for the same reason country A is trying to encourage capital inflows not only to build up a bigger capital account (for investment needs), but also to meet current account requirements. However, there is an apparent similarity in the matter of transfer payments from country A to country B and vice versa, as also with regard to the overall size of the current account.

Figure : 4.1 : A Two-country Model



In Figure 4.1, barter transactions are represented by Line 1 (goods for goods),Line 2 (goods for services), Line 4 (services for services) and Line 5 (services for goods). Line 3 represents goods for money (current account), while Line 6 represents services for money (current account). Transfer payments between country A and country B are typified by Line 7.

For country B, Line 8 indicates exchange of goods for money (current account), while Line 9 refers to exchange of services for money (current account). Line 10 may mean country B's support, from its capital account, to country A's current account (which may be in deficit). Similar support can be visualised to country A's current account, from Country B's official reserves account, through Line 11. As against this, Line 12 symbolises straight capital flows between country A and country B. Normally, one may expect bigger inflows into Country A (less developed) from country B (more developed). But, there may be fairly substantial cross-flows, particularly when the disparity between the (relative) levels of development in the two countries is not too much (as appears to be in the instant case), or each country has unique expertise (and capacity for capital investment) in different types of goods/services. Again, in the event of a stock exchange crisis or other manifestation of shaking financial confidence, there could be massive outflow of funds from capital importing countries. The (South/East) Asian financial crisis of 1997-98 is a case in point. In 1996, the five most (adversely) affected countries (Indonesia, the Philippines, Malaysia, South Korea and Thailand) had received an aggregate of net capital inflows amounting to $ 93 billion. They suffered a net outflow of $ 12 billion during 1997.

Line 13 in Figure 4.1 refers to the possibility of a link between the official reserves account of country B and the capital account of country A. Such a link could mean that a part of official reserves flow to another country by way of investment; or, that capital inflows from another country (A) are used to build official reserves by the capital importing country (B). This may not be surprising even if B is manifestly more advanced a country; for, these inflows may be repatriation or withdrawal of capital (as also profits) earlier invested. Again, adverse BOP may be in store for an advanced country whose currency (like U.S. dollar) is widely in demand and held as reserve by a host of other countries.

Line 16 dwells on the possibility of official reserves of one country moving to another country. For example, in the wake of the 1991 crisis a part of the reserve stock of gold with the Reserve Bank of India was pawned with the Bank of England to meet immediate commitments. Again, in 1997 central banks of certain Western countries chose to unload some of their gold in reserve stock (now deemed unnecessary), thus depressing gold prices internationally. Lines 14 and 15 are the opposite movements of Lines 10 and 13 respectively. Likewise, Line 17 is the opposite of line II. We thus note fairly complex nature of international transaction BOP statement captures them periodically. Let us now discuss balance of payments statement.

4.4 THE BALANCE OF PAYMENTS STATEMENT

Double-entry book-keeping is the basic tenet behind the balance of payments statement. Every transaction, as visualized in figure 4.1, gets recorded as a credit on one side and as an offsetting debit on the other side. As such, the two sides of the BOP format should tally. This is to be so even if, on the last day of the accounting period, some goods and funds are in transit, or there is an arithmetical error in recording/adding up (for which a suspense account may have to be raised and maintained until the discrepancy is ironed out). For example, if India exports ten million (one crore) readymade shirts to the USA at a price of one dollar for each piece, and the exchange rate is Rs. 40 for a dollar, India's foreign exchange earnings amount to $ 10 million or Rs. 40 crore. For this item the following entry can be passed :

Private foreign assets (Debit)	Rs. 40,00,00,000	
To Goods exported (credit)		Rs. 40,00,00,000

If these earnings are required surrendered to the Reserve Bank of India (RBI), another journal entry may be made as follows:

Official foreign assets
Debit) Rs.40,00,00,000
To Private foreign assets
(credit) Rs. 40,00,00,000

In case India imports the services of American consultants from the USA costing $12 million or Rs. 48 crore, this international transaction may be entered in the following manner (presuming that the RBI has agreed to release this amount from the official holdings of foreign currency).

Services imported
(Debit) Rs. 48,00,00,000
To official foreign assets
(Credit) Rs. 48,00,00,000

Now, if these are the only two commercial transactions between India and the USA during a certain accounting period, there is an adverse balance of trade on services (invisible) account which is more than the favourable balance of trade (visible) on goods account by two million US dollars (or eight crore Indian rupees). This can be met either by drawing from the official reserves account (of the RBI) or through some unilateral transfer from the USA. The relevant entries, with appropriate narrations, are given below (presuming that official reserves account is separate from official foreign assets account):

First situation
Official foreign assets
(Debit) Rs. 8,00,00,000
To Official reserves account
(credit) Rs. 8,00,00.000

(For drawings from reserves to meet current account deficit)
Second situation
Official foreign assets
(Debit) Rs. 8,00,00,000
To Unilateral transfer
(Credit) Rs. 8,00,00.000

(For unilateral transfer of funds from the USA)

The BOP statements in the two situations would appear as follows:

Table 4.1 : First situation

Debits					**Credits**
	US $ (million)	Indian rupee (crore)		US$ (million)	Indian rupee (crore)
Services Imported	12	48	Goods Exported	10	40
			Drawings on reserves from (RBI)	2	8
	12	48		12	48

Table 4.2 : Second situation

Debits					Credits
	US $ (million)	Indian rupee (crore)		US$ (million)	Indian rupee (crore)
Services Imported	12	48	Goods Exported	10	40
			Unilateral transfer from abroad	2	8
	12	48		12	48

Both the above-mentioned situations contain only current account transactions (goods, services and unilateral transfer from abroad). Of course, the uncovered current account deficit impinges on the official reserves account in the first situation. Now, we can extend the example to capital account transactions also. These go to determine the 'wealth' of a nation along with an indication of 'net debtor' or 'net creditor' position based on public lending, private lending and investment activities. Reference may be made to the following three well-known categories of such activities:

i) Foreign Direct Investment

Foreign direct investment (FDI), which is supposed to build up a lasting relationship (say, for a decade or more) between two (or more) countries. The major medium for such investments may be multinational corporations through their subsidiaries. These may be wholly owned by foreigners as now permitted in India in a number of lines as part of the economic reforms initiated in 1991. The earlier (cautious) approach sought to limit foreign control to 24%, so that the Indian partners in a joint venture could retain not only the power to pass an ordinary resolution with bare 51% majority put also a special resolution with 75% majority in terms of the Companies Act. Under the US rules, at least 10% of the equity has to be owned by the investors under a FDI arrangement which has management control as its distinguishing feature. It is also looked upon as the most visible form of investment manifesting itself in the establishment or extension of existing entities designed to produce goods or provide services.

ii) Portfolio Investment

Portfolio Investment involves purchases of financial assets (securities) generally with a maturity greater than one year. Of course, in the absence of a minimum lock-in-period, these assets can change hands myriad times within a financial year. In this game, foreign institutional investors (FIIs) are the main players.

iii) Short-term Investment

Short-term investments involves securities with a maturity of less than one year. These are the most vulnerable items in the capital account, so much so that several "tiger economies" of (South/East) Asia were suddenly impoverished during 1997-98, consequent upon the massive withdrawal of (short-term) foreign investments. India's caution and conservatism in this score limited the extent of damage to the Indian economy.

As on March 31, 1996, India's short-term debt was only about five percent of the total external debt. Deposits (upto one year maturity) made by Non-Resident Indians (NRIs) constituted the major part of such short-term investments.

India's Balance of Payment Position

India had an adverse trade balance (visible) in 1993-94 (the usual story between 1949-50 and 1997-98 with the precarious exception of two years, 1972-73 and 1976-97). The invisible balance in 1993-94 was unfavourable. But taking into account both visibles and invisibles there was a current account deficit. In the capital account inflows were more than twice the outflows resulting in a very substantial surplus.

The international trading and financial situation remained very unfavourable since the economic and financial crisis of East Asia in July 1997. All over the world, developing countries have been experiencing significant pressures on the balance of payments. Despite this, India's balance of payments remained comfortable in both 1998-99 and 1999-2000 partly due to anticipatory policy actions, such as issue of Resurgent India Bonds as is evident from Table 4.3

Table 4.3 : Balance of Payments : Summary

	1990-91 (P)	1993-94 (P)	1994-95 (P)	1995-96 (P)	1996-97 (P)	1997-98 (P)	1998-99 (P)	Apr-September 98-99(P)	Apr-September 99-00(P)
1. Exports	18477	22683	26855	32311	34133	35680	34298	16515	17808
2. Imports	27915	26739	3594	43670	48948	51187	47544	24663	25339
of which : POL	6028	5754	5928	7526	10036	8164	6433	2910	4460
3. Trade balance	–9438	–4056	–9049	–11359	–14815	–15507	–13246	–8148	–7531
4. Invisibles (net)	–242	2898	5680	5449	10196	10007	9208	5009	4073
Non-factor services	980	535	602	–197	726	1319	2165	1073	36
Investment income	–3752	–3270	–3431	–3205	–3307	–3521	–3544	–1412	–1848
Pvt. transfers	2069	5265	8093	8506	12367	11830	10280	5234	5762
Official Grants	461	368	416	345	410	379	307	114	123
5. Current Account Balance	–9680	–1158	–3369	–5910	–4619	–5500	–4038	–3139	–3458
6. External assistance (net)	2210	1901	1526	883	1109	907	820	–46	113
7. Commercial borrowing (net)@	2248	607	1030	1275	2848	3999	4362	4328	62
8. IMF (net)	1214	187	–1143	–1715	–975	–618	–393	–199	–156
9. Non-resident deposits(net)@	1536	1205	172	1103	3350	1125	1742	46	932
10. Rupee debt service	–1193	–1053	–983	–952	–727	–767	–802	–588	–521
11. Foreign investment (net)	103	4235	4807	4615	5963	5353	2312	868	2406
of which :									
(i) FDI (net)	97	586	1228	1954	2651	3525	2380	1408	1057
(ii) FIIs	0	1665	1503	2009	1926	979	–338	–601	954
(iii) Euro equities & others	6	1984	2076	652	1386	849	270	61	395
12. Other flows (net) +	2284	2800	2604	–2235	–1131	–606	–174	–1352	1411
13. Capital account total (net)	8402	9882	8013	2974	10437	9393	7867	3057	4247
14. Reserve use (-increase)	1278	–8724	–4644	2936	–5818	–3893	–3829	82	–789

(P) : Prelliminary Actuals.
@ Figures include receipts on account of India Development Bonds in 1991-92 and Resurgent India Bonds in 1998-99 and related repayments, if any, in the subsequent years.
+ Include, among others, delayed export receipts and errors & omissions.

Check Your Progress A

1 What is meant by balance of payments?

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2 Identify visible exports, invisible imports' amongst the following (for India):
i) X and Mrs. X fly from Mumbai to Madrid for honeymoon.
ii) Sri Lanka exchanges her one million pounds (lbs.) of tea for 10,000 tonnes of Indian rice.
iii) An Indian goes to Kuwait and earns one million dinars(KD) as a management consultant.
iv) Mr. Brown of Britain flies to Kathmandu for scaling Mount Everest. He spends one million Nepali rupees (NRs) during the trip.

3 During a particular month, India exported goods worth \$1,200 million, imported goods worth \$1,500 million, and had a favourable invisible balance to the tune of \$100 million. Net capital inflows amounted to \$200 million. Mark the correct answer:

i) Reserves fell by \$ 300 million

ii) Reserves rose by \$ 300 million

iii) Reserves rose by \$ 100 million

iv) None of the above.

4 Collect statistics from Government of India's Economic Survey (or, any other official/authentic source) and draw up a BOP statement on the lines of Table 4.1 for the year 1999-2000.

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4.5 THE BALANCE OF INDEBTEDNESS

It is a concept used to measure and assess the burden of external debt for a country. The total debt liabilities of a debtor nation are measured by 'debt stock' or 'debt outstanding and disbursed'. Payment obligations arising therefrom are symbolised by 'debt service' comprising interest and principal (re) payments. This, in turn, is influenced not only by the quantum of debt stock, but also by the maturity structure, interest rates, currency revaluations and other variables of an economic, financial or commercial character. Political factors, too, may creep into the picture.

As a measure of the balance of indebtedness, the term 'net flows' stands for disbursements minus principal repayments. If an indebted country is still having net inflows, it means that new financing is more than the (old) debt retired, so that the total quantum of debt is going up. Conversely, if there are net outflows, it is an indication that the total amount of indebtedness is going down the term "net transfers" takes interest payments also into the reckoning. So, it can be represented as : Disbursements – (interest + principal repayments).

Net transfers may be negative or positive. If a nation is experiencing net negative transfers, it means that total debt service payments exceed gross inflows, so that net real resources are being transferred abroad. To counter balance such capital account deficits, it may be incumbent to build up (or augment) current account surplus, that is, favourable (visible/invisible) trade balance. Conversely, if there are net positive transfers from abroad in favour of a country, the implication is that net real resource are flowing to it from foreign countries. That has been India's position between the years 1991-92 and 1997-98. As against a fall in reserves by (US) $ 1,278 million in 1990-91, there was an increase in reserves to the tune of $ 3,756 million during 1991-92. The current account deficit was reduced from $ 9,680 million in 1990-91 to $ 1,178 million in 1991-92. Capital account surplus also fell (from $ 8,402 million to $ 4,754 million), but, while it fell short of current account deficit in1990-91, the surplus on capital account during 1991-92 was higher than the deficit on current account, thus resulting in an increased level of reserves. The changeover at the cut-off point (1991, when Economic Reforms were introduced in the current context), as also the position in 1994-95 is depicted in the Tables 4.4 to 4.6 with regard to the balance of indebtedness:

Table : 4.4 year 1990-91

Debits	US million dollars	Credits	US million dollars
Current account deficit	9,680	Capital account surplus	8,402
		Decrease in reserves	1,278
	9,680		9,680

Table : 4.5 year 1991-92

Debits	US million dollars	Credits	US million dollars
Current account deficit	1,178	Capital account surplus	4,754
Increase in reserves	3,576		
	4,754.		4,754

Table : 4.6 year 1994-95

Debits	US million dollars	Credits	US million dollars
Current account deficit	2,624	Capital account surplus	7,381
Increase in reserves	4,757		
	7,381		7,381

However, it needs to be noted clearly that these increases in reserves are borrowings-based and not earnings-based. As such a surplus on capital account may be followed, in the years to come, by a deficit on capital account. Even the tiger economies of Asia have experienced this discomfiture during 1997-98; hence, the need to build up current account surplus (favourable balance of trade).

It is also important that external assistance, whether in the form of (concessional) loans or (outright) grants, is fully/appropriately utilised; otherwise, it creates a national burden bereft of benefit, besides its inflation-potential. Aid authorised to India was at the fairly high level of $ 6,503 million in 1989-90; but, only about half of it ($ 3,485 million) was utilised. By 1995-96, authorisation had fallen to $ 3,649 million, but the utilisation rations rose to about 90% ($ 3,306 million).

India's external debt had continuously risen from $ 75,857 million in 1989-90 to $ 99,008 in 1994-95. But, as on March 31, 1996, it was lower at $ 92,199 million. However, the rupee burden in this regard has increased thereafter on account of the marked fall in the external value of the Indian rupee during 1997-98. The ratio of India's external debt to GNP stood at 33%, and to NNP at 37%, during 1995-96., (visible) export earnings were only about one-sixth of the rupee burden of external debt as on March 31, 1996 (Rs.3,15,435 crore).

4.6 ADJUSTMENT POLICIES

What kinds of adjustments are required when a country is faced with an enormous and/or persistent adverse balance on current account and/or capital account or balance of indebtedness? Some measures, designated as reforms or structural adjustments, can be adopted by the concerned country unilaterally, such as taxation and budgetary policies. Of course, other countries may be (adversely) affected by such adjustments and they may retaliate or follow suit. Bilateral measures are those which require some kind of an agreement with another country. For example, India and Nepal may permit free trade, transit and even acceptance of currencies (in circulation). Regional adjustments require an organisation of a number of neighbouring countries such as the Europeon Union or SAARC to promote economic liberalisation on a cooperative basis. Multilateral arrangements are global in character, such as the World Trade Organisation which became operational in January 1995.

4.6.1 Unilateral Adjustments

Almost every economic measure can be unilateral, at least on the face of it, such as fiscal policy, monetary policy, commercial policy (including exchange rate adjustment), price policy, wage policy, industrial policy (including privatisation, foreign investment, role of multinationals, technology and infrastructure development), rural/agricultural policy, as also the approach toward small scale enterprises and employment. But in many cases, these policy measures have been influenced by persuasive or even coercive impact of international agencies like IMF, IBRD, IDA, as also of affluent nations like the USA.

Exchange rate adjustment is a case in point. Very often, it is another name for devaluation, say of the Indian rupee, on so many occasions during 1991-98. At times, official spokespersons have argued that, under a floating exchange rate system, there is no formal devaluation or upvaluations; and that ups and downs emanate from market forces of demand and supply. But this is only a half-truth. There is no free floating, for the RBI and many other central banks have intervened time and again. It is often the case of "a snake in the tunnel" that is, floating is permitted only within limited bands. Again, semantics apart, there is no difference between "de jure" and "de facto" devaluation, so far as its impact on the BOP position is concerned.

Now, let us face the basic question, "whether devaluation can correct an unfavourable balance current account. Suppose that the choice is between Rs.40 and Rs. 45 as the cost of one US dollar. We have to ascertain if India's dollar earnings will be higher through exports, and whether the import bill in terms of US dollars would be lower, if the rupee is devalued (and the cost of a dollar goes up from Rs.40 to Rs.45). Such expectations can materialise only when the (price) elasticity of demand (of our exports in foreign countries, and of our imports in India) is greater than one (>1). Otherwise, the BOP gulf may further widen, since the import bill may stay near-constant in dollar terms (and be much higher in rupee terms), while export earnings may fall phenomenally in dollar terms (and may be near-constant or rise only marginally in rupee terms). This may be because our essential imports like oil may not be curtailed to any signifant extent in spite of their higher rupee cost. On the other hand, if the price of a ready-made shirts (made in India and exported to the USA) falls from, say, \$ 2.25 to \$ 2.00, and we still sell the same number of skirts (say one million), our export earnings will actually, fall (from \$ 2.25 million to \$ 2 million). Even if the exports rise to 1.1 million shirts, the export earnings will be lower (at \$2.20 million as against the erstwhile figure of \$ 2.25 million). However, if the sales can be pushed up to, say, 1.2 million shirts, the foreign exchange earned would stand higher at \$ 2.4 million. Again, it is also necessary to take note of the inflation-potential of devaluation which may, as well, recoil on exports through higher costs. In this process, the nation may fall into a vicious circle, "devaluation leading to inflation, and further devaluation". The plight of the Indonesian rupiah during 1997-98 is an instant case in point.

4.6.2 Bilateral Adjustments

In the midst of a BOP crisis, two countries may enter into barter agreements for the exchange of essential imports/exports. These may, as well, offer ad hoc solutions when exchange rates are highly volatile. Alternatively, two countries may, explicitly or implicitly, agree to keep the exchange rate between their currencies pegged at a particular level. For example, India devalued her rupee in 1949, and again during 1966, in sympathy with the devaluations of British pound sterling. Such a "following suit" may not, necessarily, be based on the love for a leading nations; it may, often, be more in the nature of a defensive response of a less-developed country highly dependent on a developed one(which may be a major trading partner).

At times, the more advanced country may purposely appear to be benevolent and make free gifts or concessional loans by way of aid to a (relatively) backward economy. Such unilateral (capital) transfers may, obviously be guided by the need to preserve or promote cordiality in bilateral relations. In effect, however, they may perpetuate economic dependence. A country receiving "tied aid" may be obliged to buy goods or services from the donor country even though it is not the cheapest or best source of supply. The donee nation may also be called upon to part with some of its essential primary produce so that it is, at the same time, exporting (relinquishing) its employment potential (in terms of opportunities for employment in the value added sectors) to the donor country.

4.6.3 Regional Adjustments

The world had witnessed too many barriers to trade during the period of about three decades elapsing between the beginning of World War I and end of World War II. The volume of World Trade Index (1913=100) was as low as 82 during

1921-25 and 93 during 1931-35. Foreign exchange earnings of some countries were frozen in Hitler's Germany under the banner of "blocked accounts". It could be looked upon as a reaction to the huge repatriation payments which Germany had been called upon to make (though later put under a moratorium). So, the balance of payments problem was at the top of global agenda from 1945 onwards. Besides the birth of multilateral agencies like IMF, regional cooperation also manifested itself in a big way through the connotations like common market, customs union, and free trade area. The European Union, emanating from the Treaty of Rome (1957), has been in existence for more than four decades under a variety of nomenclatures. When a common currency (Euro) gets freely circulated amongst member countries, the foreign exchange problem might be resolved in a big way. This gives a cue to the creation of a "Rupee Area" with India as its nucleus, notwithstanding the Asian financial crisis of 1997-98.

4.6.4 Multilateral Adjustments

Numerous efforts have been made to ensure multilateral convertibility of currencies since 1944, when the Bretton Woods conference prepared the ground for the creation of an International Monetary Fund, designed to correct temporary disequilibria in the balance of payments, and other sister agencies like the World Bank. Britain's Labour Government, which came into power with a thumping majority in 1945 (almost synchronising with the end of World War II), also attempted to address itself in a big way to the problem of dollar shortage and other hard currencies so much in demand at that time. But, Great Britain had to suspend the free convertility of sterling on August 18, 1947, suddenly through a radio broadcast. The British Minister, Sir Stafford Cripps, uttered the following warning in Octoner 1947:

"We have begun to dip into our reserve of gold and dollars, a reserve which is none too big and which serves the whole sterling area; unless, therefore, there is some new availability of dollars before long, we shall be obliged upon further cuts. Other countries are faced with the same problem and indeed will not be able to feed their people..... Take the problem of feeding India and Pakistan. The food may only be available in South America in which case it can only be bought for dollars."

However, the quarter-century following the General Agreement on Tariffs and Trade (GATT) of 1948 could be looked upon as the golden age of global trade, whose volume index (1913=100) touched a high watermark of 520 in 1971 when President Nixon's emergency measures of August 15, 1971 sought to close the gold window, followed by the devaluation of US dollar in December 1971. Prior to that, a system of Special Drawing Rights had become operational in 1970 with a view to augmenting international liquidity. However, these book-entries (being proportional to the respective quotas of member countries) did not improve the relative position of poor countries vis-a-vis the rich world. Two important developments followed during the next three years : first, the floating exchange system became fashionable; and, second, it was the phenomenal rise in oil price (kindling a Great Inflation) in 1973, at the instance of OPEC (Organisation of Petroleum Exporting Countries). Though formally established as early as 1960, OPEC came into limelight only in the (nineteen) seventies. Of course, it also provided loans through the OPEC Special Fund to finance both BOP deficits and development projects in non-OPEC developing countries during the following quarter-century (1973-98), the OPEC magic witnessed both its waxing and waning. As a case in point, Saudi Arabia's current account balance rose from a paltry $ 71 million(favourable) to a mammoth $ 41,503 million (favourable) in

1980. By 1995, it had turned unfavourable to the tune of $ 8,108 million. Her merchandise exports had dwindled from $ 109,000 million in 1980 to $ 46,624 million in 1995.

The WTO accord which, after prolonged negotiations, became operational in 1995, seems to have shifted the focus from trade as such to investments, intellectual property rights (patents in particular), social clauses (like child labour and human right) and adjudication of complaints/disputes (over 100 during the first three years—1995,1996 and 1997) . Commotion has been created by the patenting, in the USA, of native Indian plants/produce like Haldi, Neem (since annulled) and Basmati rice (under dispute since February 1998).

4.7 RISE OF MARKET POWER

According to survey results published by the Bank for International Settlements (Basel, 1996), the daily average of trading volume on foreign exchanges (global figure) was $ 1.19 trillion as against $ 0.26 trillion a decade back (1986) and only $0.01 trillion about a quarter century back (1973). Thus, foreign exchange market grew well over four time since 1986 and much more than one hundred time since 1973. Both the size of the market and its growth are staggering and unique. There way not be a parallel case over the entire financial horizon of this globe.

The three biggest foreign exchange markets are London (with a daily turnover estimated at $ 464 billion for 1995), New York ($ 244 billion) and Tokyo ($ 161 billion). A small city state like Singapore occupied the fourth place (with a turnover of about $ 100 billion), followed by Hong Kong, Zurich, Frankfurt and Paris. Of course, there have been major ups and downs. On October 19, 1987 (Black Monday), the New York Stock Exchange recorded a turnover of only $ 21 billion (less than one-tenth of its own daily average for 1995). The 1997 crisis was even deeper, specially in (South/East) Asian markets. At the Wall Street, Bill Gates (the Microsoft Chairman, reported to be earning Rs. 157 crore a day) is said to have lost $ 1.76 billion (about Rs 7,000 crore) on October 27, 1997, and to have regained $ 1.25 billion (about Rs. 5,000 crore) on October 28, 1997.

In terms of Indian rupees, the daily turnover in world's foreign exchange markets (at Rs.40 for one US dollar) amounts to roughly Rs.50,00,000 crore (more than five times of India's gross domestic product for the year 1995-96). In relation to USA's GDP for 1995 ($ 7.3 trillion), the daily (global) turnover of foreign exchange was about one-sixth. As compared to global trade amounting to $ 5.2 trillion for the year 1995, the daily turnover in foreign exchange market of the world ($1.19 trillion) was in the neighbourhood of one-fourth. As compared to the daily average of global trade, which works out at about $ 15 billion, operations in foreign exchange markets are roughly 80 times. It means that bulk of business in foreign exchange is for non-trade purposes even if invisible imports (services) are taken into account. The centre stage has come to be occupied by cross-country capital flows (mostly short-term/hot money) and speculation. By way of defence the role and power of the central bank interventions (whether wise or otherwise) have became limited. The power of the market progress, particularly, speculations have been on the rise. The powers of people like George Soros, with US $ 400 billion under his hand, are immense. The power of the central banks of quite a few countries having foreign exchange reserves, all put together, much lower than US $ 400 billion, shows the limits of the government to government adjustments. We will discuss foreign exchange markets, in detail in block 2.

Check Your Progress B

1 Discuss the implications of the following situations, their relative merits, and your own choice (with brief arguments) of the best debt:
   i) Creditor country A with rising overseas' lending;
   ii) Debtor country B with rising external debt;
   iii) Debtor country C with declining external debt;
   iv) Country D which is neither borrowing from, nor lending to, other countries.

2 Collect material from World Development Report, World Investment Report, Annual Reports of World Trade Organisation/other publications, and write an essay on Multilateral Adjustment Policies with reference to a select group of countries during 1988-98. Also give specific suggestions for the Indian situation.

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4.8 LET US SUM UP

In common parlance, the term balance of trade is often used for the difference (favourable or unfavourable) between exports and imports of merchandise. However, in a comprehensive sense, trade includes both merchandise (visible items) and services(invisible items). The two put together go to determine the current account balance.

The balance of payments is arrived at after taking into account capital account items also (besides current account). Net capital inflows strengthen the BOP position of a country for the time being. When followed by net capital outflows, there is strain on BOP.

International transactions may take the form of barter, implying exchange of goods for goods, services for services, goods for services and vice versa. Alternatively, goods and services may be exchanged for money, involving buying/selling of foreign currencies, besides money transfer forming part of the current account. Capital account and official reserves account may also be represented in money terms.

Double-entry book-keeping is the basic tenet behind the BOP statement. As such, the two sides of the format (debit and credit) should tally even if there is a discrepancy (suspense account), or, drawings have to be made from the official reserves account to meet current account/capital account/overall deficit in BOP. The capital account may include, inter alia, foreign direct investment (FDI, say from MNCs), portfolio investments (say, through FIIs), and short-term investments.

The size and growth of the foreign exchange market have been staggering and unique since 1973. In 1995, the three biggest foreign exchange markets were London, New York, and Tokyo, followed by Singapore, Hong Kong, Zurich, Frankfurt and Paris. A deep financial crisis enveloped these markets, specially in

(South/East) Asia during 1997. The Indian rupee, too, suffered a skirmish. The power of the market players, particularly speculators have been on the rise. As a consequence, the role and power of the Central Bank to intervene and adjust the exchange rate have declined.

A country's balance of indebtedness is determined by "net transfers" which may be positive or negative. If the inflows (of international debt) exceed the outflows (including payment of interest and repayment of debt), the instant impact on BOP would be favourable; but, the total amount of indebtedness would rise. Conversely, if the outflows exceed the inflows, the BOP would be trained; but, the total quantum of indebtedness would be reduced. In any case, it is important that external assistance is fully and appropriately utilised.

Adjustment policies for ameliorating the BOP position may be unilateral, bilateral, regional or multilateral in character. These may include, inter alia, fiscal policy, monetary policy and commercial policy (including exchange rate adjustment). Devaluation, though a widely used remedy, is a double-edged weapon. It may deliver the goods only if the (price) elasticity of demand (for a country's exports abroad and for its imports at home) is greater than one (>1). Otherwise, the position regarding BOT/BOP may further worsen.

Barter traders used occasionally as a solution of the BOP problem. The best regional solution may be the introduction of a common currency (say, EURO within the European Union) or the creation of a Rupee Area. For the world as a whole, free multilateral convertibility of all currencies would be an effective solution of BOP difficulties. The IMF and other multilateral agencies have strived towards this end since 1945. The quarter century following the appearance of GATT (1948) can be looked upon as the golden age of global trade. However, the WTO accord, which became operational in 1995, seems to have shifted the focus from trade to investment, intellectual property rights (patents in particular), social clauses (like child labour and human rights), and adjudication of complaints/ disputes (over 100 during the first three years 1995, 1996 and 1997).

4.9 KEY WORDS

Balance of indebtedness : Inflows of debt minus outflows by way of interest and repayment of debt.

Balance of payments (BOP) : All inflows minus all outflows on current account and capital account.

Balance of trade : Exports minus Imports

Barter trade : Direct Exchange of goods/services.

Bilateral adjustment : Policy agreement between two countries.

Blocked accounts : Foreign exchange earnings of a country frozen in another country.

Capital account : Investment inflows and outflows

Current account(BOP) : Exports/Imports of Goods/Services and other non-capital transfers.

Devaluation : Reduction in the external value of a currency.

Floating Exchange Rates : Foreign exchange rates allowed to rise or fall freely (or within a band) without any official intervention.

Foreign Direct Investment : Investment in production of goods/services along with management control (full, or in the nature of a joint venture), in a foreign country.

Forward transactions : Contracts involving buying/selling of currencies at specified dates in future at agreed rates of exchange.

GATT : General Agreement on Tariffs and Trade (1948).

Hedging : Offsetting transactions to cover foreign exchange exposure (risk).

Hot money : Funds flowing into another country to take advantage of favourable rate of interest, essentially short term.

Intellectual Property Rights (IPRs) : Patents, copyrights and such other rights.

Margin requirement : Money which an operator is required to deposit before entering into a transaction in an exchange (to cover a possible loss).

Multilateral Convertibility : A situation in which any currency can be (freely) converted into any other currency of the world.

Multinational Corporations (MNCs) : Firms making investments in operating units, often through their subsidiaries, in a number of other countries.

Official Reserves Account : Reserves held in gold, SDRs, dollars and other (convertible) currencies to meet exigencies of adverse balance of payments which the Government Central Bank of a country (like RBI) may be called upon to meet.

OPEC : Organisation of Petroleum Exporting Countries.

Option deals : An agreement permitting a party to buy (call option) or sell (put option), or to exercise any one of these rights (double option) in an exchange market.

Portfolio Investment : Purchase and sale of securities in the secondary market, essentially short term.

Prime lending rate : The rate of interest payable by high quality borrower. It may be used as a benchmark of various types of loan carrying different levels of risk and other considerations.

Short-term investments : Deployment of funds with a maturity of less than one year.

Special Drawing Rights : An 'accounting creation (against physical currency based on a portfolio of widely used currencies.

Unilateral adjustments : Policy decisions arrived at by a country at its own level.

WTO : World Trade Organisation (1995).

4.10 ANSWERS TO CHECK YOUR PROGRESS

2. i) Invisible imports ii) Visible exports as also visible imports
   iii) Invisible exports. iv) None (for India)

3. iv) None of the above (no change)

4.11 TERMINAL QUESTIONS/EXERCISES

1. Distinguish between 'balance of trade' and 'balance of payments' with the help of specific illustrations.

2. Explain and illustrate the inter-relationship between current account, capital account and official reserves account. Also show how international transactions differ from domestic deals.

3. Examine the relative merits of Foreign Direct Investment (FDI), Portfolio Investment and short-term investments.

4. "Devaluation is the most effective remedy for correcting and adverse BOP situation". Critically examine this statement with the help of appropriate illustrations.

SOME USEFUL BOOKS

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