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India's Balance of Payment Position: An Overview

Navpreet Kulaar[1], Dr. Manjinder Kaur[2]

[1]Research Scholar, University School of Financial Studies, Guru Nanak Dev University, Amritsar, Punjab- 143005, India.

[2]Assistant Professor, Department of Commerce, Guru Nanak Dev University College, Chungh, Tarn Taran, Punjab-143304, India.

Abstract

As far as Indian BOP is concerned, over the years generally balance of trade indicated deficit while balance of services remained in services. Main reason being imports of India for the visible items such as crude oil and gold far exceed the exports by India but on services account India being known for skilled force rendering services abroad and being IT hub, net services stood in surplus and similarly private transfer payments in the form remittances usually indicate surplus. However, surplus in BOP does not always guarantee the prosperity and likewise deficit does not always signals danger towards the solvency of a nation. Surplus on current account and favourable balance of payment may be on account of massive foreign debt and unprecedented private capital inflows. Thus, favourable BOP may eventually become fatal if the reasons for surplus not carefully considered by authorities and rather become careless in managing BOP. Similarly, BOP deficit cannot be taken as threat to the domestic economy if it is due to huge amount of financial aid to other countries and capital outflows but otherwise continuous BOP deficit may eventually lead to a critical situation such as BOP crisis. Thus, BOP analysis should be performed carefully and results of analysis should be critically evaluated to take appropriate measures to save the domestic economy at the global level.

Introduction

Balance of payment (BOP) is the systematic record of economic and financial transactions for the specific period of a country with the rest of the world comprising of government, business enterprise and individuals. International Monetary Fund (IMF) provides the basic global framework for maintenance of BOP. In fact, BOP reflects the financial position of a nation and provides details on the flow money between a country and other nations. BOP is based on double-entry system of book keeping consisting of credit side and debit side. Receipts are recorded on the credit side while payments on the debit side.

BOT is a part of the BOP and BOP includes Current Account, Capital Account and + or - Balancing item (Errors and omissions). It covers all monetary transactions whether visible, invisible and capital transfers and always in surplus. Balance of Trade (BOT) is the principal component of a country's balance of payments comprising of Debit items such as imports, foreign aid, domestic spending abroad and domestic investments abroad and Credit items including exports, foreign spending in the domestic economy and foreign investments in the domestic economy. If exports turn greater than imports, BOT is favourable and if imports are greater than exports then it is unfavourable and contributes to the current account deficit. major factors which affect BOP are conditions laid by foreign lenders, economic policy of Govt towards external sector especially besides the factors affecting BOT while factors affecting BOT comprise of cost of production, availability of raw materials, Exchange rate and prices of goods manufactured in the home country.

BOP consists of the following components:

1. Current Account
2. Capital Account
3. Reserve Account
4. Errors & Omissions

1. Current Account Balance

Current account consists of short-term monetary transactions of less than one year which are particularly composed of export less imports of visible goods (merchandise balance), export less import of services (services balance), net investment income in the form of interests, profits, dividends (income balance) and net unilateral transfer in the form of receipts and/or payments from and/or to foreign countries which are gifts from abroad less gifts sent abroad (unilateral transfer balance

2. Capital Account Balance

Capital account is the systematic record of all international monetary transactions that include exchange of assets or liabilities by residents of a nation with residents of another country, reflecting change in the capital stock occurring due to exchange of assets and liabilities. It portrays the difference between the receipts and payments on capital account. It is composed of inflows and outflows relating to investments, short term and medium term to long term borrowing and lending. It can indicate **surplus or deficit** in capital account and includes private capital flows in the form of foreign direct investment and foreign portfolio investment, official capital flows, reserves movement and gold movement etc.

3. Reserve Account

It is further composed of three accounts namely; IMF account, SDRs Account and Reserve and Monetary Gold. The IMF account comprises of purchases (credit items) and repurchases (debit items) from International Monetary Fund. Special Drawing Rights (SDRs) are a kind of reserve asset created by IMF for allocation to member nations which can be used by central banks of two different countries to settle mutual international payments.

4. Errors & Omissions

Under this head the overstated or understated components are offset to restore the balance.

Literature Review

A brief review of literature to have an outlook of the current account position analysis is being presented as below in chronological order:

Yang (2011) explored current account behaviour in eight selected emerging economies, namely India, Korea, Philippines, Malaysia, China, Hong Kong, Singapore and Thailand for the period from 1980 Q1-2009 Q1. The results indicated the heterogeneous behaviour of current account balances in all the Asian countries. The study further revealed that for all the sample countries, the existence of a long-run relationship among the current account, trade openness, initial stock of NFA, real effective exchange rate and domestic relative income. Further, for all the selected economies current account has a self-adjusting mechanism since the error correction term is negative and significant, with China being the only exception.

Arouri et al. (2015) focussed on examining the dynamic relationship between India's real effective exchange rate and real current account deficit based on annual data from 1975–2011. The finding revealed that appreciation in REER reduces the current account deficit and it further emphasised the prevalence of shocks including productivity shocks, technological advancements and shifts in consumer preferences.

Garg & Prabheesh (2017) explored he Twin-Deficit Hypothesis against Ricardian Equivalence and the Feldstein-Horioka Hypothesis. The findings revealed that current account balances in India are influenced by external factors like volatility in oil prices and foreign income and also by some macroeconomic factors such as real effective exchange rate, fiscal balance and private investment. The results further support the twin-deficit theory while contradicting Ricardian equivalence theory.

Behera & Yadav (2019) explored the significance of current account deficit (CAD) from the different perspectives emphasizing on its financing structure, behavioural patterns, sustainability in context of India. The study observed that inflation, trade openness, terms of trade, relative income growth, fiscal deficit, real deposit rate and age reliance factor cause India's current account imbalance. The analysis further highlighted that the decline in corporate investments and household savings were responsible for the mounting CAD.

Riaz et al. (2019) analysed the impact of nominal effective exchange rate, trade openness, domestic relative income and net foreign assets considering subset of South Asian economies from 1984 to 2015. The economies included are India, Bangladesh, Pakistan and Sri Lanka representing the SAARC group of nations. The current account model employed followed the saving-investment model. It has been observed that there is a significant long-term connection between trade openness, domestic relative income, net foreign assets and current account.

Devpura and Narayan (2020) analysed the gradual rise in oil prices in terms of hourly volatility. For this, the hourly data pertaining to opening prices, closing prices, low prices, high prices, bid prices, ask prices as well as total trade volume of global crude oil have been considered. For capturing the impact of covid cases and deaths, covid-19 dummy has been considered. The results revealed that the cases of covid-19 and deaths contributed to a sharp increase in daily oil prices volatility specifically from 8 percent to 22 percent.

Based on the review of above mentioned studies, an attempt is being made to study the balance of payment position of India.

An Overview of Current Account Deficit of India

In India over the years generally balance of trade indicated deficit while balance of services remained in services. Main reason being imports of India for the visible items such as crude oil and gold far exceed the exports by India but on services account India being known for skilled force rendering services abroad and being IT hub, net services stood in surplus and similarly private transfer payments in the form remittances usually indicate surplus. Thus, for India receipts for net services and remittances are major source of foreign exchange inflows in the form of dollar. It implies that if dollar inflows in India on current account exceed dollar outflows, current account will reflect surplus and vice-versa. Overall current account balance of India usually remains in deficit in spite of surplus on services account and net transfers since deficit on merchandise is substantial and surplus on services account and net transfers is not sufficient to make good the deficit on merchandise account. However, capital account component of BOP usually remains in surplus on account of foreign direct investment inflows and foreign portfolio investment inflows. Although India experienced a remarkable and unusual current account surplus in year 2020–21 due to covid-19 effect, it reverted back to a deficit in year 2021-22. Even RBI has anticipated a CAD between 3.3 % to 3.9 % of GDP for fiscal year 2022-23.

CAD for the second quarter of the financial year 2023-24 has dipped to one percent of GDP ($ 8.3 billion) while it remained 3.8 % of GDP ($30.9 billion) in the second quarter of the 2022-23. It implies that outflow of foreign exchange assets has been somehow controlled if it is compared with the corresponding quarter of the preceding financial year. This decline is attributed to decline of merchandise trade deficit from $ 78.3 billion in the second quarter of 2022-23 to $ 61 billion in second quarter of 2023-24. Net services recorded a rise year on year basis as well as sequentially and services exports tanked by 4.2 per cent on a year on year basis as a consequence of rise in exports of software, business and travel services. Net outflows on the primary income account, that is, payments of investment income in the form of interest a, dividends etc., increased to US$ 12.2 billion in the financial year 2023-24 from US$ 11.8 billion in 2022-23. Private transfer receipts mainly consisting of remittances from Indians employed abroad, amounted to US$ 28.1 billion, registering a hike of 2.6 per cent in 2023-24second quarte in comparison to the corresponding period of the preceding year. In the capital account, net foreign direct investment witnessed an outflow of US$ 0.3 billion while there was an inflow of US$ 6.2 billion on account of net FDI in the second quarter of 2022-23.

Foreign portfolio investment recorded net inflow of US$ 4.9 billion as against US$ 6.5 billion during 2022-23. External commercial borrowings to India recorded net outflow of US$ 1.8 billion in the second quarter of 2023-24 as compared with net outflow of US$ 0.5 billion in coinciding period of 2022-23. Likewise, Non-resident deposits recorded net inflow of US$ 3.2 billion as against the net inflow of US$ 2.5 billion in 2022-23 and foreign exchange reserves accumulated to the tune of US$ 2.5 billion in second quarter of 2023-24 as against an exhaustion of US$ 30.4 billion in corresponding period of 2022-23.

Conclusion and Policy Implications

BOP reflects the health of international economic relations since it portrays the results of international economic transactions of a nation. The resultant deficit or surplus guides the government authorities in taking corrective measures through mechanics of credit and fiscal policies such as deflation, controlling inflation, depreciation of exchange rate and in most serious scenario devaluation of home currency. Thus, BOP indicates the solvency position of a nation at the global front. However, caution should be exercised while evaluating the outcome of BOP analysis. For instance, surplus on current account and favourable balance of payment may be on account of massive foreign debt and unprecedented private capital inflows. Thus, favourable BOP may eventually become fatal if the reasons for surplus not carefully considered by authorities and rather become careless in managing BOP.

Similarly, BOP deficit cannot be taken as threat to the domestic economy if it is due to huge amount of financial aid to other countries and capital outflows but otherwise continuous BOP deficit may put the economy into a critical situation such as BOP crisis as it happened with India in 1966 and 1991 leading to devaluation Indian Rupee and incorporation of structural adjustments in the form of economic reforms. Thus, BOP analysis should be performed carefully and results of analysis should be critically evaluated to take appropriate measures to save the domestic economy at the global level. A country facing massive current account deficit have to often admit to home currency decline. Like, If the foreign capital flows to finance the deficit are insufficient, the exchange rate of the country’s currency have to be slashed to compensate the imbalance in foreign financial inflows which in turn will lead to imported inflation in the home country from other countries which are source of inputs and imports.

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