Distance Learning Programme

UPSC Prelims

Indian Economy – II

drishti

INDIAN ECONOMY - II

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4 CHAPTER

EXTERNAL SECTOR

Foreign Exchange Reserves

Foreign exchange reserves are the foreign currencies held by a country's central bank. They are also called foreign currency reserves or foreign reserves. One of the most important reasons for holding reserves is to manage the currency's value.

Foreign Exchange reserves consist of:

- Foreign Currency Assets
- Gold
- Special Drawing Rights (SDR) holdings of the government
- Reserve Tranche

Foreign Currency Assets (FCAs)

- The currencies of various countries held in foreign exchange reserve are called foreign currency assets. For example, reserves held in US Dollars, Euro, Japanese Yen, etc.
- Apart from currencies, it includes foreign bank deposits, foreign treasury bills and short term and long term foreign government securities.
- The deposit agreements with IMF trust is also a part of FCAs and are readily available to meet a BOP financing need.

Gold

The RBI uses its gold stock as a back up to issue currency and meet the unexpected Balance of Payment problems.

Special Drawing Rights (SDRs)

- The SDR is an international reserve asset, created by the IMF in 1969 to supplement its member countries' official reserves, and help countries meet Balance of Payment problem.
- The member countries contribute to this account to avail this benefit. The contribution is in proportion of their IMF quota (membership fee).
- SDRs can be exchanged for freely usable currencies. The value of the SDR is based on a basket of five major currencies – the US dollar, the euro, the Chinese renminbi (RMB), the Japanese yen, and the British pound sterling.
- The SDR is neither a currency, nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members.
- Holders of SDRs can obtain these currencies in exchange for their SDRs in two ways:
  - Through the arrangement of voluntary exchanges between members
  - By the IMF, designating members with strong external positions, to purchase SDRs from members with weak external positions.

Reserve Tranche

- It is the proportion of the required quota of currency that each IMF member country must provide to the IMF, but can designate for its own use.
- The reserve tranche portion of the quota can be accessed by the member nation at any time, whereas the rest of the member's quota is typically inaccessible.
- If any money was lent over and above the quota to the IMF's General Resource Account, it becomes part of Reserve Tranche.

Exchange Rate Regime

- Exchange rate regime refers to the 'way' the value of the domestic currency in terms of foreign currencies is determined.
- It is closely related to monetary policy and the two are generally dependent on many of the same factors.
- Exchange rate regimes can broadly be categorized into two extremes, namely fixed and floating.

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- **Foreign Exchange:** It refers to money denominated in a currency other than the domestic currency.
- **Exchange Rate:** Like any other commodity, foreign exchange has a price. The exchange rate is the price of one currency in terms of another. For example, if the exchange rate between the rupee and the US dollar (USD) is Rs. 65, this means that Rs. 65 is required to purchase 1 Dollar.

Fixed Exchange Rate Regime

- In a fixed exchange rate regime, the domestic currency is tied to another foreign currency such as the U.S. dollar, Euro, the Pound Sterling or a basket of currencies.
- In a fixed exchange rate system, the government (or the central bank acting on the government's behalf) intervenes in the foreign exchange market to ensure that the exchange rate stays close to a predetermined target.
- Under this system, exchange rate stability is achieved, but if the exchange rate is fixed at the wrong rate it may be at the expense of domestic economic stability.
- In a fixed exchange rate system, a rise in the exchange rate of the domestic currency vis-à-vis another foreign currency is called a devaluation. This means that in order to buy 1 unit of a given foreign currency more of the domestic currency is needed. On the other hand, when the exchange rate falls it is termed as a revaluation.
- Fixed rates provide greater certainty for exporters and importers as there are no or limited exchange rate risks. However, a significant gap between the official rate and that determined by the market can promote black markets. In a black market, the bulk of foreign exchange transactions are carried out outside the banking system. This may force the government to draw down on reserves to meet its obligations and cause scarcity of foreign exchange.

Floating Exchange Rate System

- It is an exchange rate system in which market's supply and demand of currencies determines the exchange rate.
- There is no pre-determined exchange rate target of the government or the Central Bank.

- The Central Bank (RBI) or government can indirectly influence the exchange rate by managing the level and volume of foreign and domestic currencies in the banking system
- Under a floating exchange rate system, a rise in the exchange rate of the domestic currency vis-à-vis another foreign currency is called depreciation. This means that more rupees are required to buy one unit of foreign currency.
- On the other hand, appreciation is the fall in the exchange rate of the domestic currency vis-à-vis another foreign currency. This means that fewer rupees are required to buy one unit of foreign currency.

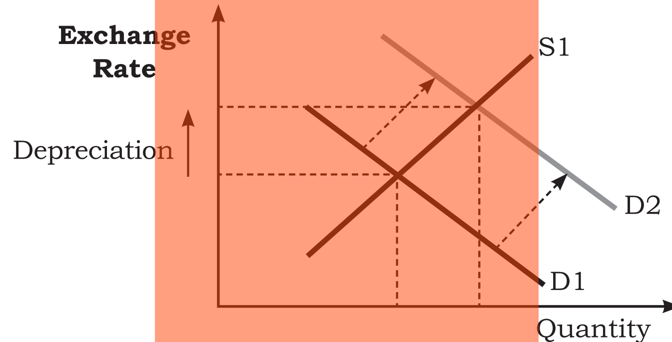

Fig: *Effect of demand for and/or supply of foreign currencies and exchange rate*

- The above figure depicts the graph between the exchange rate and quantity of foreign currencies. In the figure, demand for foreign currency increases as a result of market forces, demand curve moves from D1 to D2. As a result, local currency depreciates. Hence, exchange rate increases.

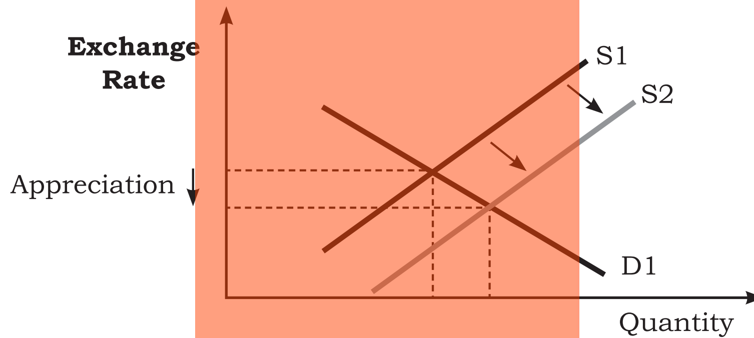

Fig: *Relation between exchange rate and quantity of foreign currencies*

- The above figure depicts the graph between the exchange rate and quantity of foreign currencies. In the figure, the supply of foreign currency increases as a result of market forces, supply curve moves from S1 to S2. This puts downward pressure on the market value of the exchange rate and exchange rate decreases. Hence, the local currency appreciates.

Relationship of Exchange Rate and Exports/Imports

If a country has a high dependence on imports, e.g., India, more foreign currency leaves the country than what enters. This puts downward pressure on the exchange rate and can cause depreciation of the local currency. When depreciation occurs, imported goods will become more costly in the local currency. But depreciation will benefit the exporters as they will get more revenue in rupees when they exchange the dollars they got by exporting their products. The reverse case happens in the case of appreciation.

Managed Floating Exchange Rate System

- In between the two extreme exchange rate regimes, there is the managed floating (semi-fixed exchange rate) exchange rate system. It is the mixture of fixed and floating exchange rate system.
- In this system, the exchange rate is given a specific target and a central bank keeps the rate from deviating too far from a target band or value.
- Under this regime, the exchange rate is the main target of economic policy making (interest rates are set to meet the target).
- Governments attempt to affect the exchange rate directly by buying or selling foreign currencies, or indirectly through monetary policy (e.g. by changing interest rates on foreign currency bank accounts).
- Most of the countries have shifted to this system of exchange rate determination.

Important Terms

Nominal Effective Exchange Rate (NEER)

- The nominal effective exchange rate (NEER) is an unadjusted weighted average rate at which one country's currency exchanges for a basket of multiple foreign currencies. NEER is an indicator of a country's international competitiveness in terms of the foreign exchange market.
- NEER = Domestic currency exchange rate in terms of SDR/Foreign currency exchange rate in terms of SDR.

Real Effective Exchange Rate (REER)

- The real effective exchange rate (REER) is the weighted average of a country's currency relative to an index or basket of other major currencies, adjusted for the effects of inflation.
- REER is determined from NEER after correcting it for price change.
- REER = NEER × (Domestic Price Index/Foreign Price Index).

Balance of Payment

- Balance of Payment is a statistical statement that comprises all economic transactions between residents and non-residents in a given year. The term "all transactions" refers to the government as well as private transactions.
- The statistical statement is a double entry book keeping. Double entry book keeping records each transaction twice consisting of two opposite entries with equal values (credit and debit). Credit entry signifies the inflow while debit entry signifies outflow. For any transaction, both entries are recorded.
- Balance of Payment mainly comprises current account and capital account.
    - Current Account transactions are like revenue receipts and revenue expenditure in the budget document.
    - Capital account transactions are like capital receipts and capital expenditure in the budget document.

Current Account

- The current account includes flows of goods, services, primary income, and secondary income between residents and non-residents.
- Current account transactions are single time and one-way transactions. It means that the transaction happens once and ends there. For example, if a person exports a service, he gives the service and receives money and the transaction comes to an end.
- It comprises trade balance and invisibles balance.

Balance of Trade

- It is the difference between export receipts and import payments in transaction of merchandise goods.
- If the balance of trade is positive, it is called favourable balance of trade and if it is negative, it is called the unfavourable balance of trade.

Invisibles

Invisibles comprise the receipts and payments of the following items:

- **Services:** Under this head, export and import of services is accounted. The services include transportation, travel, insurance, Government not included elsewhere (GNIE) and miscellaneous services. The miscellaneous services include financial services, software services, management services, business services, etc.
- **Transfers:** Transfers include gifts, grants to governments which need not be repaid in future.
- **Income:** This head includes dividends, profits from investments; interest from loans; rent from the property; income through employment.

Balance of Payments

(US$ million)

Sl. No.	Item	2012-13	2014-15	2015-16	2016-17	2016-17 H1	2017-18 H1(P)
I. Current Account							
1.	Exports	3,06,581	3,16,545	2,66,365	2,80,138	1,34,029	1,49,211
2.	Imports	5,02,237	4,61,484	3,96,444	3,92,580	1,83,476	2,24,003
3.	Trade Balance (1 – 2)	–1,95,656	–1,44,940	–1,30,079	–1,12,442	–49,448	–74,792
4.	Invisibles (net)	1,07,493	1,18,081	1,07,928	97,147	45,580	52,548
	A. Services	64,915	76,529	69,676	67,455	32,040	36,706
	B. Income	–21,455	–24,140	–24,375	–26,291	–14,363	–14,257
	C. Transfers	64,034	65,692	62,627	55,983	27,903	30,098
5.	Goods and Services Balance	–1,30,741	–68,411	–60,402	–44,987	–17,408	–38,086
6.	Current Account Balance (3+4)	–88,163	–26,859	–22,151	–15,296	–3,868	–22,244
II. Capital Account							
	Capital Account Balance	89,300	89,286	41,128	36,482	20,016	42,141

	(i) External Assistance (net)	982	1,725	1,505	2,013	605	691
	(ii) External Commercial Borrowings (net)	8,485	1,570	–4,529	–6,102	–3,402	–1,514
	(iii) Short-term credit	21,657	–111	–1,610	6,467	–493	4,575
	(iv) Banking Capital(net) of which:	16,570	11,618	10,630	-16,616	–6,754	6,340
	Non-Resident Deposits (net)	14,842	14,057	16,052	–12,367	3,465	1,948
	(v) Foreign Investment (net) of which	46,711	73,456	31,891	43,224	29,035	34,088
	A. FDI (net)	19,819	31,251	36,021	35,612	20,881	19,570
	B. Portfolio (net)	26,891	42,205	–4,130	7,612	8,154	14,518
	(vi) Other Flows (net)	–5,105	1,028	3,242	7,495	1,026	–2,038
	III. Errors and Omission	2,689	–1,021	–1,073	364	–668	1007
IV. Overall Balance		3,826	61,406	17,905	21,550	15,481	20,903
V. Reserves change [increase (–)/decrease (+)]		–3,826	–61,406	–17,905	–21,550	–15,481	–20,903

Source: Reserve Bank of India
P: Preliminary

- Remittances are directly earned by labour and are income through employment abroad.
- The factors through which income is earned is labour; and dividend, interest, profit are earned though capital. Labour and capital are both factors of production, hence income from this head is called factor income services.
- Invisibles balance is the difference between net receipts and payments of services, transfer and income.

Current Account Balance

- It is the sum of Balance of Trade and Invisibles (net).
- Current Account Balance = Balance of Trade+ Invisibles (net)
- If the current account balance is positive, it is called surplus while if the current account balance is negative, it is said to be a deficit.

Capital Account

- The capital account comprises credit and debit transactions under non-produced non-financial assets and capital transfers between residents and non-residents.
- Capital account transactions are two way and multiple transactions. It means paid money can be recovered through periodical income and/or disposal of asset created.

For example, consider a loan given to a foreigner. The interest on the loan is received periodically and the principal amount can be recovered from the debtor at the same time.

- It comprises of External assistance, External Commercial Borrowings, short term debt, banking capital, foreign investment and other flows.

External Assistance

- It is the transaction of official bilateral and multilateral loans.
- Bilateral loan is given by one country to another while multilateral loan is given by international institutions like the World Bank to member countries.

External Commercial Borrowings

- External Commercial Borrowings (ECBs) are loans availed by an Indian commercial entity from a nonresident lender. Most of these loans are provided by foreign commercial banks and other institutions.
- It is a loan availed of from non-resident lenders with a minimum average maturity of 3 years.
- In the post reform period, ECBs have emerged as a major form of foreign capital like FDI and FII.
- ECBs can be raised as:
  - Loans, eg., bank loans, loans from equity holder, etc.
  - Capital market instruments, e.g.
    - floating rate notes/fixed rate bonds/securitised instruments
    - non-convertible, optionally convertible or partially convertible preference shares
    - FCCB
    - FCEB
  - Buyers' credit/suppliers' credit
  - Financial lease

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FCCB and FCEB

A foreign currency convertible bond (FCCB) is a type of corporate bond issued by an Indian company in an overseas market in a currency different from that of the issuer. Investors have the option of redeeming their investment on maturity or converting the bonds into equity any time during the currency of the bond. The repayment of the principal is in the currency in which the money is raised.

In case of a foreign currency exchangeable bond (FCEB), investors have the option of converting the bonds into equity of the offered company. The company issuing FCEB shall be part of the promoter group of the offered company and shall hold the equity shares being offered at the time of issuance of FCEB.

- The government follows well designed ECB policy-putting restrictions on the amount of loan that can be obtained by a company, end user restrictions, interest rate ceiling for ECBs, maturity period, the total amount of ECBs that can be obtained during a year, etc.
- ECBs can be used only for specific purposes like import of capital goods, implementation of new projects, etc. ECBs cannot be used for investment in the stock market or speculation in real estate.