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Distance Learning Programme (DLP)

INDIAN ECONOMY - II

(UPSC PRELIMS)

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INDIAN ECONOMY-II

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EXTERNAL SECTOR

Foreign Exchange Reserves (Forex)

- Foreign exchange reserves are the foreign currencies or any other financial assets 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.
- Countries generally maintain forex reserves for meeting their international payment obligations both short and long terms, including sovereign and commercial debts, financing of imports, for intervention in the foreign currency markets during periods of volatility, besides helping to boost the confidence of the market in the ability of a country to meet its external obligations and to absorb any unforeseen external shocks, contingencies or unexpected capital movements.
- Foreign exchange reserves are held and managed by the Reserve Bank of India. Some countries use external managers to handle their reserves. The foreign exchange reserves consists of:
  - Foreign Currency Assets
  - Gold
  - Special Drawing Rights (SDR) holdings of the government
  - Reserve Tranche
- By Aug, 2019 India's foreign exchange reserves surged by USD 1.620 billion to USD 430.572 billion. Foreign currency assets is the major component of the overall reserves, USD 398.739 billion.
- The country's gold reserves stood at USD 26.754 billion. Special drawing rights with the International Monetary Fund were up by USD 6.7 million to USD 1.441 billion.

Foreign Currency Assets (FCAs)

- The currencies of various countries held in foreign exchange reserves 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 are also a part of FCAs, and are readily available to meet a BOP financing need.

Gold

The RBI uses its gold stock as a backup 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 to 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.
- For any member country, out of the total quota, 25% should be paid in the form of foreign currency or gold. Hence this is called as reserve tranche or gold tranche. The remaining 75% can be in domestic currencies and it is called credit tranche.
- 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 Resources 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 three extremes, namely fixed and floating and managed exchange rate.

- **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 ₹71, this means that ₹71 is required to purchase 1 Dollar or 71 units of Indian rupees is required to purchase one unit of United States dollar.

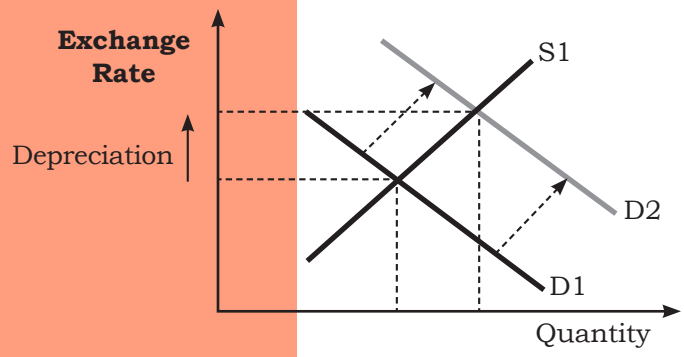
Fixed Exchange Rate Regime

- In a fixed exchange rate regime, the domestic currency is tied to another foreign currency such as the U.S. dollar, Euro, 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 is 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.

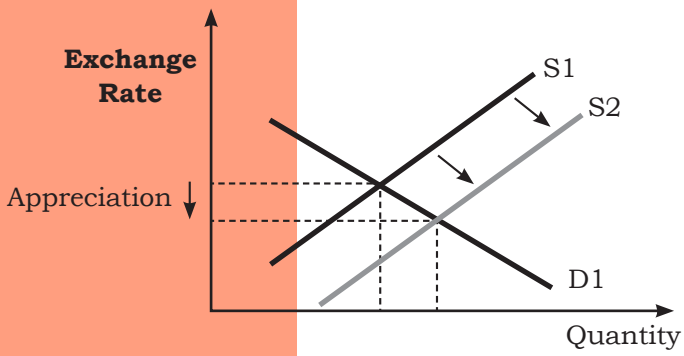
Floating Exchange Rate System

- It is an exchange rate system in which market's supply and demand of currencies determines the exchange rate.
- There is no predetermined 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.



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.



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 a 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 is the 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).
- **Liberalised Exchange Rate Mechanism System (LERMS)**
  - Under the LERMS proposed in the Union Budget 1992-1993, India delinked its currency from the fixed exchange rate regime and moved into the floating exchange rate system.
  - Indian form of exchange rate is known as 'dual exchange rate', one exchange rate of the rupee is official and the other is market-driven. It is also known as the managed exchange rate.

Types of Currency

Hard Currency

- A hard currency is one which is unlikely to lose its value and so is considered to be a good one to have or to invest in. It is the international currency in which the highest faith is shown and is needed by every economy.
- Basically, the economy with the highest as well as highly diversified exports that are compulsive imports for other countries will also create high demand for its currency in the world and become the hard currency.
- Some of the best hard currencies of the world are United States Dollar, British Pound Sterling, Chinese Renminbi, Japanese Yen and the Euro. These currencies are used worldwide for international payment obligations.
- IMF's Special Drawing Rights (SDR) is also considered as Hard Currency.

Soft Currency

- Soft currency is a currency which is hyper sensitive and fluctuates frequently. It is also known as weak currency due to its unstable nature. Such currencies mostly exist in developing countries with relatively unstable governments.
- Soft currencies cause high volatility in exchange rates as well, making them undesirable by foreign exchange dealers. These currencies are the least preferred for international trade or holding reserves.

Hot Currency

- Hot currency is the currency which is easily available in the market and can be converted into another currency. And it flows easily in and out of the market in terms of investment.
- Hot Currency is a term of the forex market and is a temporary name for any hard currency. Due to certain market vulnerabilities, if a hard currency is exiting an economy at a fast pace for the time, the hard currency is known to be hot.

Heated Currency

This term is used to denote the domestic currency, which is under pressure (heat) of depreciation due to a hard currency's high tendency of exiting the economy. Also known as currency under heat or under hammering.

Cheap Currency

This term was first used by J.M. Keynes. When a government starts re-purchasing its bonds before their maturities, the flow of money in the money will increase, as the supply of money will increase by this action of government, the money will become cheaper, and hence it will be called Cheap Money or Cheap currency.

Dear Currency

This is nothing but just opposite of Cheap money. In this, the government issues bonds, the flow of money increases from public to the government, supply of money in the market decreases, and hence the money become dear to the people, that's why it is called Dear Money or Dear currency.

Balance of Payments

- BoP is a statement of all transactions made between entities in one country and the rest of the world over a defined period of time, such as a quarter or a year.
- It is the net outcome of the current account and the capital account of an economy.
- BoP for 2017-18 show current account deficit (CAD) at $48.72 bn, the highest since the record $88.16 bn of 2012-13.
- BOP summarizes all payments and receipts by firms, individuals, and the government. It tells us whether a county saves enough to pay for its imports. Also reveals whether the country produces enough economic output to pay for its growth.
- The BOP comprises of two accounts, Current account and Capital account:

Current Account

- Current account records all transactions involving goods, services, investment income and current transfer payment.
- The four major components of current account are as follows:
  - **Trade in Goods or Visible Trade:** This is the net of exports and imports of goods (visible items). The balance of this visible trade is known as the trade balance. There is a trade deficit when imports are higher than exports and a trade surplus when exports are higher than imports.
  - **Trade in Services or Invisible Trade:** This is the net of exports and imports of services (invisible items). Transactions mainly constitute of shipping, IT, banking and insurance services, hotels, tourism, etc.
  - **Unilateral Transfers to and from Abroad:** Unilateral transfers are the current transfers which refer to payments that are not factor payments. These are 'one-way' transactions. For example, remittances, gifts or donations sent to the resident of a country by a non-resident relative.
  - **Income Receipts and Payments:** These include factor payments and receipts. These are generally rent on the property, salaries, interest on capital and profits on investments, etc.

Current Account Balance (CAB)

CAB = Balance of Trade + Balance of Invisible + Unilateral transfers + Income Receipts and payments or Investment Income.

- The CAB will be positive only when the value of exports is more than the value of imports and this is called the Current Account Surplus.
- The CAB will be negative only when the value of exports is less than the value of imports and this is called the Current Account Deficit.

Current Account Deficit

- A current account deficit is a trade measurement that says a country imported more goods, services, and capital than it exported. It encompasses the trade deficit plus capital like net income and transfer payments.
- Current Account Deficit (or Surplus) measures the gap between the money received into and sent out of the country on the trade of goods and services and also the transfer of money from domestically-owned factors of production abroad.

- India's Current Account Balance is in deficit due to the deficit in the Balance of Trade and it is a result of more imports than exports.

Capital Account

- It is a long term account which measures the net flow of financial claims
- It deals with the long term investment, FDI flows, Loans (Borrowings or lendings) and it also gives a summary of the capital expenditure and income for a country.
- The capital account is used to finance the deficit in the current account or absorb the surplus in the current account. The three major components of capital account are:
  - **Loans to and Borrowings from Abroad:** These consist of all loans and borrowings given to or received from abroad. It includes both private sector loans as well as the public sector loans.
  - **Investments to/from Abroad:** These are investments made by non-residents in shares in the home country or investment in real estate in any other country.
  - **Changes in Foreign Exchange Reserves:** Foreign exchange reserves are maintained by the central bank to control the exchange rate and ultimately balance the BOP.
- The current account deficit is financed by a surplus in the capital account and vice versa. This can be done by borrowing more money from abroad or lending more money to non-residents.
- Capital Account Balance = External Assistance (net) + External Commercial Borrowings (net) + Short term debt (net) + Banking Capital (net) + Foreign Investments (net) + Other Flows (net)
- Positive capital account balance is called surplus, which is favourable for the economy.
- Negative capital account balance is called deficit, which is unfavourable for the economy. Capital account balance is calculated with and without errors and omissions.

External Commercial Borrowings (ECBs)

- ECBs are loans availed by an Indian commercial entity from a non-resident lender. Most of these loans are provided by foreign commercial banks and other institutions.
- It is a loan availed 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.