Trends and Challenges of India's Balance of Payments

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Introduction

Balance of Payments (BoP), being a record of the monetary transactions over a period with the rest of the world, reflects all payments and liabilities to foreigners and all payments and obligations received from foreigners. In this sense, the balance of payments is one of the major indicators of a country's status in international trade. BoP accounting serves to highlight a country's competitive strengths and weaknesses and helps in achieving balanced economic-growth. It can significantly affect the economic policies of a government and the economy itself. Therefore, every country strives to a have a favorable balance of payments and maintains its long run sustainability. India's balance of payment position was quite unfavorable during the time of country's entry into liberalized trade regime. Two decades of economic reforms and free trade opened several opportunities that, of course, reflected in the balance of payments performance of the country. This paper, therefore, attempts to evaluate the trends and emerging challenges of India's Balance of Payments. The discussion is broadly classified into four parts viz. i) India's balance of payments picture since 1991, ii) emerging role of invisibles and software services in balance of payments iii) unhealthy trends in FDI and iv) the vulnerability and challenges ahead.

a) India's Balance of Payments picture since 1991

Independent India's external trade and performance had faced severe threats many a times. The most challenging one was that of 1991.The economic crisis of 1991 was primarily due to the large and growing fiscal imbalances over the 1980s. India's balance of payments in 1990-91 also

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suffered from capital account problems due to a loss of investor confidence. The widening current account imbalances and reserve losses contributed to low investor confidence putting the external sector in deep dilemma. During 1990-91, the current account deficit steeply hiked to $-9680 million while the capital account surplus was far below at $ 7188 million. This led to an ever time high deficit in BoP position of India.

India initiated economic reforms to find the way out of the growing crisis. Structural measures emphasized accelerating the process of industrial and import delicensing and then shifted to further trade liberalization, financial sector reform and tax reform. Prior to 1991, capital flows to India predominately consisted of aid flows, commercial borrowings, and nonresident Indian deposits. Direct investment was restricted, foreign portfolio investment was channeled almost exclusively into a small number of public sector bond issues, and foreign equity holdings in Indian companies were not permitted (Chopra and others, 1995). However, this development strategy of both inward-looking and highly interventionist, consisting of import protection, complex industrial licensing requirements etc underwent radical changes with the liberalization policies of 1991.

The post reform period really eased India's struggles with regard to external sector. This is evident from the RBI data summarizing the BOP in current account and capital account. The current account which measures all transactions including exports and imports of goods and services, income receivable and payable abroad, and current transfers from and to abroad remained almost negative throughout the post reform period except for the three financial years. Until 2000-01, the current account deficit that comprises both trade balance and the invisible balance, remained stagnant and stood around $ 5000 million. However, for the first time since 1991, the current account recorded surplus in its account during three consecutive financial years from 2001-02. The deficit in current account continued to occur from 2004-05 onwards and the growth rate was comparatively faster. Surprisingly, the current account deficit grew like anything since 2007-08, the period witnessed financial crisis. The current account balance of India during 2011-12 is recorded to be $ - 78155 million, signifying a deficit eight times that of the figures of 2007-08. Huge negative debits and comparatively low positive credits caused for this negative value in current account. Another notable feature of current account balance is that the deficit was mounting during the previous years. Two major items of current account are merchandise and the invisibles. These two items generate the value of current account balance of the country. The net merchandise has been always found to be huge negative figure. During 2011-12 it was recorded to be $ - 189759 million. During the same period, our total merchandise credit was $ 309774 million while our merchandise debit was $ 499533 million. This is a common feature of India's merchandise figures during all the years.

The recent crisis of 2008 affected the trade performance of India in a large way. Indian economy had been growing robustly at an annual average rate of 8.8 per cent for the period 2003-04 to 2007-08. Concerned by the inflationary pressures, Reserve Bank of India (RBI) increased the interest rates, which resulted in a slowdown of India's trade flows prior to the Lehman crisis (Kumar and Alex, 2009). The trade flows, which are one of the important channels through which India was affected during the recent global crisis of 2008, started to collapse from late 2008. Merchandise trade, software exports and remittances declined in absolute terms in response to the exogenous external shock.

Table 1

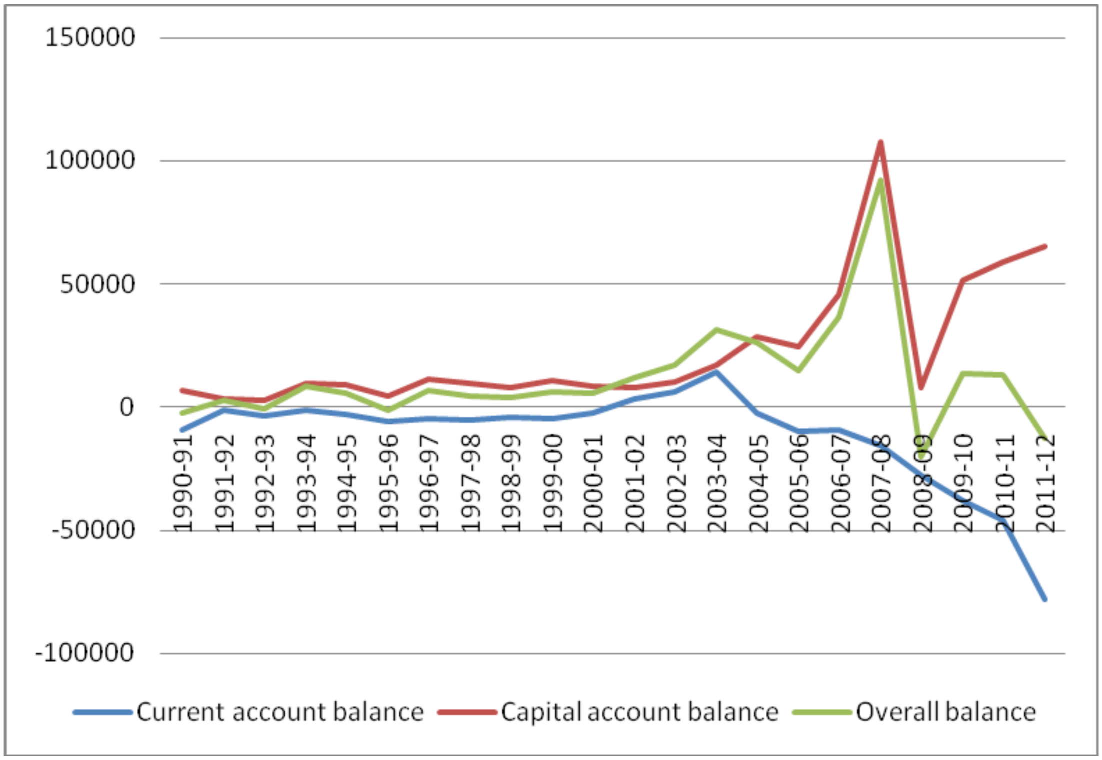
India’s BOP during 1990-91 to 2011-12 (values in US $ million)

Year	Current account balance	Capital account balance	Overall balance
1990-91	-9680	7188	-2492
1991-92	-1178	3777	2599
1992-93	-3526	2936	-590
1993-94	-1159	9694	8535
1994-95	-3369	9156	5787
1995-96	-5912	4690	-1222
1996-97	-4619	11412	6793
1997-98	-5499	10010	4511
1998-99	-4038	8260	4222
1999-00	-4698	11100	6402
2000-01	-2666	8535	5868
2001-02	3400	8357	11757
2002-03	6345	10640	16985
2003-04	14083	17338	31421
2004-05	-2470	28629	26159
2005-06	-9902	24954	15052
2006-07	-9565	46171	36606
2007-08	-15737	107901	92164
2008-09	-27915	7835	-20079
2009-10	-38180	51622	13441
2010-11	-45945	58996	13050
2011-12	-78155	65324	-12832

Source: Reserve Bank of India, www.rbi.org

Figure 1

Trend of India’s BOP during 1990-91to 2011-12



The growing trade deficit since 2008 can be attributed to destination wise collapse of India's exports. Trade with US, EU and Asia (India's most important trading partners) fell considerably during the year 2009, with the least being in case of Asia. As a result, the value of export reduced from $ 189001 million during 2008-09 to $ 189442 million during 2009-10.

During the same period of economic crisis, our import bill too declined from $ 308520 million to $ 300644 million. This fact certifies the phenomenon that Indian trade flows was hit by the global crisis, but with a lag. However, Indian economy could find way out of the crisis driven path to the recovery as a result of various measures implemented by the Reserve Bank of India.

b) Emerging role of invisibles and software services in Balance of Payments

India's balance of payments, which is built up of a large trade deficit sustained by large positive invisible inflows, is truly a miracle of the new service-oriented global economy. The liberalized environment has made India's services attractive to the new IT dependent sector of the developed countries. The trade deficit is financed largely by net invisible earnings consisting of remittances from expatriates and software. The importance of invisibles in the BoP is increasing in the post reform period.

A notable development found in the performance of India's current account is the growing contribution of the invisibles. Among the three components such as services, transfers and income, the largest surplus is generated by the services followed by transfers while income flow is greater from India adding net deficit in the BoP account. The net invisible to the current account was deficit during 1990-91 worth $ 242 million. However, the post reform period witnessed rapid growth in this category contributing a large surplus to India's BoP account. This surplus though not enough to eliminate the merchandise deficit, could contribute significantly to neutralize the magnitude of the impact of the huge deficit. From 2001-02 onwards, the growth of invisibles was at very high rate. Interestingly, it grew from $ 14974 million during 2001-02 to $ 91605 million during 2008-09. The very next two consecutive years, global crisis affected the net flow of invisibles as the surplus from it declined to $ 80022 million and $ 84648 million respectively. However, 2011-12 figures show that net invisibles in the current account is positive and very high in value i.e. $ 111604 million. It can be found that value has almost doubled within a gap of just 6 years.

The mounting share from software services shows another optimistic external sector picture. Software services include the software related services offered by Indian IT professional to foreigners including those done by the IT parks. Notable feature is that the credit from this item is very huge say for instance, during 2011-12, it stood at $ 62212 million while the debit i.e., the amount we pay out for foreign software services was only a meager figure - $ 1256 million only. The growth of India's IT sector especially during the period of globalization turned favorably.

The growth of software services earnings is a recent development in the reform period. India possesses huge manpower professionally equipped with software services potentials who find the way in earning foreign exchange by exporting the services. The NASSCOM data exhibits the growing share of software services in India's current account balance. The Total software services exports was only $754 million during 1995-96. The total software export contribution increased unbelievably in the years of economic liberalization. The earnings from software services multiplied several times within a decade of time i.e., it increased from $ 7556 million during 2001-02 to $ 60956 million during 2011-12. The growth rate was steady and above 10 percent during every year despite the global challenges put forward by the so called financial crisis. Interestingly the debit in this item is very narrow say $ 1256 million during 2011-12 that declined from $2267 million during 2006-07. United States remained the major destination for software services exports from India.

c) Unhealthy trends in Foreign Direct Investment

Foreign direct investment (FDI) has played an important role in the process of globalization during the past two decades. The rapid expansion in FDI by multinational enterprises since the mid-eighties may be attributed to significant changes in technologies, greater liberalization of trade and investment regimes, and deregulation and privatization of markets in many countries including developing countries like India.

The widening gap of deficit in India's current account is always compensated by the surplus accumulated in capital account. Major components in the capital account are foreign investment and borrowings. There are several studies revealing the relevance of FDI in the economy. Some of the literature reviews are worth mentioning at this moment. FDI plays a multidimensional role in the overall development of host economies. It is widely discussed in the literature that, besides capital flows, FDI generates considerable benefits. These include employment generation, the acquisition of new technology and knowledge, human capital development, contribution to international trade integration, creation of a more competitive business environment and enhanced local/domestic enterprise development, flows of ideas and global best practice standards and increased tax revenues from corporate profits generated by FDI (Klein et al., 2001;Tambunan, 2005) FDI in manufacturing is generally believed to have a positive and significant effect on a country's economic growth(Alfaro, 2003).

Total FDI inflows into India during 1991-92 were only $ 129 million. There was gradual increase in inflows during that decade and it reached $ 6130 million during 2001-02. Though the inflow fluctuated during first part of 2000s the year 2006-07 witnessed 154 percent hike in inflow which is treated as the highest in the last two decades. However, during the global recession the inflow was negatively affected showing negative growth during 2009-10 and 2010-11. The Indian economy regained confidence of the foreign investors during 2011-12 attracting $

49007 million. The huge sum of FDI inflow is contributing significantly in reducing the deficit in India's current account and maintaining surplus in overall balance of payment account.

Table 2

FDI inflow into India (US $ million)

Year	FDI inflow	Annual growth rate of FDI inflow	FDI outflow	Annual growth rate of FDI outflow
2000-01	4029	---	829	---
2001-02	6130	52.1	1490	80
2002-03	5035	-17.9	1892	27
2003-04	4322	-14.2	2076	10
2004-05	6051	40.0	2309	11
2005-06	8961	48.1	6083	163
2006-07	22826	154.7	15897	161
2007-08	38844	70.2	21429	35
2008-09	41903	7.8	20634	-4
2009-10	38484	-8.2	20518	-1
2010-11	35464	-7.9	26104	27
2011-12	49007	38.2	26947	3

Source: Reserve Bank of India (2012)

Along with mounting credits in foreign investment account, there is growing debits in it in the form of capital outflow. It can be noted that the total outflow of FDI from India was only $ 829 million during 2000-01. Until 2004-05, the growth rate of outflow was moderate but thereafter, the FDI outflow increased significantly. During last five years, the outflow stood above $ 20000 million which seems unhealthy for India capital account is concerned. The logic behind this trend is that Indian companies are reaching overseas destinations to tap new markets and acquire technologies. Acquisitions bring with them major benefits such as existing customers, a foothold in the destination market and the niche technologies they require. Due to the rapid growth in Indian companies' M&A activity, Indian companies are acquiring international firms in an effort to acquire new markets and maintain their growth momentum, buy cutting-edge technology, develop new product mixes, improve operating margins and efficiencies, and take worldwide competition head-on. It is noted that inflow of FDI has got very favorable impact on India's BoP balance. However, the danger alarmingly growing on the other side of the coin is in the form of outflow of FDI from India and massive withdrawal of foreign funds from the domestic economy.

d) Vulnerability and challenges ahead

Post 1991 crisis, Indian economists have managed to reduce the external debt through various strategies. They have succeeded as India withstood the global 2008 downturn well. But now, troubles are looming large over our emerging economy. After the 2008 downturn of global economy, the vulnerability of India's external sector has increased. The latest report from Reserve Bank of India about the rising external debt is a case of worry for the government. According to the data given by the Reserve Bank of India, India's external debt stood at $390 billion as of March 2013, which was up by 12.9 % from its previous year figure. External debt is a cumulative sum of External Commercial Borrowings (ECBs), Foreign Currency Convertible Bonds (FCCBs) and trade bill of the country. Any country's inability to repay the external debt may lead to a crisis situation and worsen our balance of payment sustainability in near future.

Yet another challenge to BoP emerges today in the form of rupee depreciation. The Indian Rupee has been losing its value against the US Dollar marking a new risk for Indian economy. Grim global economic outlook along with high inflation, widening current account deficit and FII outflows have contributed to this fall. Though RBI has responded with timely interventions by selling dollars intermittently, in times of global uncertainty, investors prefer USD as a safe haven. To attract investments, RBI can ease capital controls by increasing the FII limit on investment in government and corporate debt instruments and introduce higher ceilings in ECB's, which may ultimately attract BoP burden on the economy. Government can create a stable political and economic environment. The depreciation of the rupee was brought about by the adverse external trade position and the depreciation of regional currencies. It was an inevitable response to the balance of payments difficulties caused by a huge trade deficit.

The deterioration in India's current account and thereby overall BoP has led to a series of debates in the policy arena relating to sustainability, the importance of exchange rates in influencing the trade balance, and the role of high and rising inflation. Appropriate exchange rate policies, monetary policies and fiscal policies are vital to ensure economic stability and growth. The depreciation of the currency is one of the means of correcting the trade deficit to manageable proportion. Higher interest rates, containment of the fiscal deficit and control public expenditure that restrains imports are crucial to containing the trade deficit. This is especially so with respect to oil imports that is the single most import expenditure. A depreciating rupee is not the only concern that Indian economy is striving to retrieve for the moment. The bigger challenge is to reduce external sector vulnerability. Boosting investor confidence remains the key to attracting capital flows. Fiscal consolidation, reducing inflation and further careful liberalization of capital inflow could all contribute towards creating an environment conducive to domestic and foreign investors. Sustainability and strength of

Balance of Payments, being the symptoms of economy's strength and competitiveness in the global scene, need to be maintained using every tough measure possible.

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