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EXTERNAL SECTOR OF ECONOMY

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1. Balance of Payments (BoP)

Components of BoP: Capital Account (FDI, FII, External Borrowings, NRI Deposits)

- Balance of Payments (BoP) records all international economic transactions, encompassing both current and capital accounts.
- Balance of Trade (BoT) specifically records only visible (merchandise) goods transactions.
- An Indian businessperson buying shares in a foreign company is an international financial transaction (capital outflow), recorded in the Capital Account of BoP, not in the Balance of Trade.
- The Capital Account includes Foreign Direct Investment (FDI), Foreign Portfolio Investment (FPI, formerly FII), External Borrowings (e.g., External Commercial Borrowings - ECB), and Non-Resident Indian (NRI) Deposits.
- India's external debt is predominantly owed by non-governmental (corporate) entities, not primarily by governmental entities.
- India's external debt is denominated in multiple currencies, not exclusively in US dollars.
- Regarding India's external debt currency composition (as of December 2021 context), the US Dollar is the largest component, followed by the Indian Rupee as the second largest.

Components of BoP: Current Account (Goods, Services, Income, Transfers)

- **Balance of Payments (BoP)**

  A systematic record of all economic transactions between residents of a country and the rest of the world during a specific period.
- **Current Account**

  Records transactions that do not create future claims (i.e., do not affect assets/liabilities).
- **Components of Current Account**
  - **1. Goods (Visible Trade / Merchandise)**
    - Exports and imports of physical goods.
    - **Debit**

      Imports of goods (outflow of foreign exchange).
    - **Credit**

      Exports of goods (inflow of foreign exchange).

- Terms like 'Agreement on Agriculture', 'Agreement on the Application of Sanitary and Phytosanitary Measures', and 'Peace Clause' are associated with the

  World Trade Organization (WTO), which governs trade in goods.

- **India is a member of the** International Grains Council (IGC)**, but membership is not required for exporting or importing rice and wheat.**
- Local Currency Agreements India and UAE signed a Memorandum of Understanding (MoU) for a framework for trade settlements in their respective national currencies (INR and AED). This agreement was signed by the RBI Governor and the Governor of the Central Bank of UAE.

◦ **2. Services (Invisible Trade)**

- Exports and imports of non-factor services (e.g., tourism, transportation, software, financial services, insurance).
- **Debit**

  Payment for services received from non-residents (e.g., Indian paying for foreign tour).
- **Credit**

  Receipts for services provided to non-residents (e.g., earnings from software exports, foreign tourist spending in India).
- **Technical Assistance**

  Often provided by international agencies, falls under services.

◦ **3. Income (Factor Income)**

- Investment income (e.g., interest, dividends, profits) and compensation of employees.
- **Credit**

  Income earned by residents from investments abroad (e.g., dividends from foreign stocks) or wages/salaries earned abroad.
- **Debit**

  Income paid to non-residents for their investments in the domestic economy or wages/salaries paid to non-residents.

◦ **4. Transfers (Unilateral Transfers)**

- Receipts and payments for which there is no economic value exchanged (no quid pro quo).
- **Credit (Receipts)**

  Remittances from non-resident Indians (NRIs), grants received from foreign governments/ agencies, gifts.
- **Debit (Payments)**

  Grants given to foreign countries (e.g., India's $5 million grant to Tajikistan in 2001 to tackle drought), gifts to non-residents.
- **Remittances**

  India was the world's largest recipient of remittances in 2021 ($87 billion); the USA was the biggest source (20% of India's remittances). India is followed by China, Mexico, Philippines, and Egypt.
- **Non-Resident External (NRE) Accounts**

  Can be opened by NRIs and Overseas Corporate Bodies (OCBs) with authorized dealers and banks in all forms of demand and term deposits. NRE accounts are Rupee-denominated; foreign currency remitted from abroad is converted to INR upon deposit.

- **General BoP Principles**
    - **Debit Entry**

      Represents an outflow of foreign exchange. (e.g., Imports of goods by India).
    - **Credit Entry**

      Represents an inflow of foreign exchange. (e.g., Income from Indian investments abroad, Receipts of transfer payments, Exports of services by India).
    - **Foreign Exchange Regulation Act (FERA) was replaced by the Foreign Exchange Management Act (FEMA).**
    - **International agencies funding development programs in India often provide Technical assistance, Soft loans (Capital Account), Grants, and Food assistance.**
    - Visa Waiver Agreements Such as the one signed between India and Moldova for diplomatic passports in May 2024, facilitate travel and can indirectly influence services trade.

Components of BoP: Financial Account (Official Reserve Account)

- **Official Reserve Account (ORA)**: Part of the Financial Account in the Balance of Payments (BoP); records transactions in reserve assets held by the central bank.
- **Foreign Exchange Reserves (Forex Reserves)**: External assets in foreign currencies, gold, Special Drawing Rights (SDRs), and the Reserve Tranche Position with the IMF, held by a country's central bank (RBI in India).
- **Components of India's Forex Reserves**:
    - **Foreign Currency Assets (FCA)**: The largest component of India's reserves; held in major currencies (e.g., US Dollar, Euro, Japanese Yen, Pound Sterling). Most of India's total reserves are held in the form of foreign currency.
    - **Gold Reserves**: Physical gold held by the Reserve Bank of India (RBI). India's rank in terms of gold reserves is typically around 9th globally (as per World Gold Council data, subject to dynamic changes).
    - **Special Drawing Rights (SDRs)**:
        - An international reserve asset created by the International Monetary Fund (IMF).
        - Often referred to as an 'artificial currency' or 'paper gold'.
        - It exists solely as a book-keeping entry (not paper currency, gold, or silver).
        - Its value is based on a basket of five major international currencies: US Dollar, Euro, Chinese Renminbi (added in October 2016), Japanese Yen, and British Pound.
        - SDRs aim to supplement official reserves of member countries, thereby addressing the problem of international liquidity (related to the non-availability of dollars and other hard currencies).
    - **Reserve Tranche Position (RTP) / Gold Tranche**:
        - Refers to a portion of a member country's quota in the IMF that can be drawn without conditions.
        - Represents the difference between a country's quota and the IMF's holdings of its currency.
        - This is a credit system granted by the IMF to its members.
- **Custody of India's Forex Reserves**: The Foreign Exchange Reserves of India are kept in the custody of the Reserve Bank of India (RBI).
- **Cost of Holding Reserves**: Holding foreign currency as reserves incurs an opportunity cost (the return that could have been earned by investing these funds elsewhere) and exposure to exchange rate fluctuations. Thus, there is a cost associated with holding foreign currency as reserves.
- **International Liquidity**: Refers to the availability of widely accepted international

means of payment. The problem of international liquidity is related to the non-availability of dollars and other hard currencies.

- **Import Cover**: Describes the number of months of imports that a country's international reserves could finance. It is calculated as the ratio of total forex reserves to average monthly imports.
- **General Share Order in India's Forex Reserves (Descending)**: Foreign Currency Assets (FCA) > Gold Reserves > Special Drawing Rights (SDRs) > Reserve Tranche Position (RTP). (This order is generally consistent, though specific proportions can fluctuate).
- **Illustrative/Exam-Specific Value for India's Forex Reserves**: India's foreign exchange reserves were approximately USD 640.3 Billion towards the end of December 2024 (value typically referenced in MCQ scenarios; actual figures are dynamic).
- **Items NOT included in Official Forex Reserves**: Foreign credits not yet received, loans from foreign countries, loans from the World Bank, and foreign assets held by Indian individuals or businesses are not components of official foreign exchange reserves.

Current Account Convertibility (CAC) and Capital Account Convertibility (CAC)

- **Convertibility**

  Ability to exchange domestic currency for foreign currency and vice versa, without restrictions, for international transactions.

- **Current Account Convertibility (CAC)**

  Freedom to convert domestic currency into foreign currency (and vice versa) for all legitimate current account transactions (e.g., trade, services, remittances, interest/dividend payments).

- India achieved

  full Current Account Convertibility in August 1994.

- Foreign Exchange Management Act (FEMA), 1999 **replaced FERA, 1973.**
- FEMA, 1999 aims at facilitating external trade and payments and promoting the orderly development and maintenance of the foreign exchange market in India.
- Capital Account Convertibility (CAC) Freedom to convert domestic currency into foreign currency (and vice versa) for all capital account transactions (e.g., investments, loans, cross-border purchase/sale of assets).
- India currently has

  partial (or limited) Capital Account Convertibility, meaning certain restrictions apply to capital flows.

- Tarapore Committee (1997) Recommended a phased approach to full CAC, outlining preconditions.

- **Second Tarapore Committee (2006)**

  Re-examined the roadmap for full CAC, reaffirming the need for preconditions.

- **Prerequisites for full CAC (as per Tarapore Committees)**

  Sound fiscal policy (reduced fiscal deficit), low inflation, robust financial sector (strong banks, effective regulation), adequate foreign exchange reserves.

Definition and Significance of Balance of Payments (BoP)

- **Balance of Payments (BoP)**:
  - Systematic record of all economic transactions between residents of a country and the rest of the world over a specific period (normally a year).
  - Includes all import and export transactions (goods, services, income, transfers) and capital movements.
  - Comprises:
    - **Current Account**: Records transactions related to goods, services, income (e.g., remittances, interest, dividends), and unilateral transfers.
    - **Capital Account**: Records transactions related to financial assets and liabilities (e.g., foreign investments, loans, banking capital).
  - BoP, in an accounting sense, always balances. A deficit/surplus typically refers to the current account or the

combined current and capital accounts excluding official reserves.
- Significance: Indicates a country's economic relations, external financial health, and informs policy decisions.

• **International Monetary Fund (IMF)**:
- Established: 1945, resulting from 1944 Bretton Woods Conference (a "Bretton Woods Twin" with World Bank).
- Headquarters: Washington D.C.
- Mandate: Promote international monetary cooperation, exchange stability, facilitate balanced growth of international trade, eliminate foreign exchange restrictions, provide short-term/medium-term financial assistance for Balance of Payments (BoP) problems.
- Loan Eligibility: Grants loans *only to member countries*. Not for long-term project loans.
- Quota & Voting: Quota determines financial contribution, voting power, and access to finance. China has emerged as a significant member post-2019 but not the largest in quota/vote share.
- India's Status: Founding member (1947). Special Drawing Rights (SDR) percentage: ~2.75%, Vote percentage: ~2.63%.
- Reports: Prepares 'Global Financial Stability Report'.
- IMFC (International Monetary and Financial Committee): Advises IMF Board of Governors on global economy, mirrors Executive Board, operates by consensus. World Bank participates as an observer.
- Triffin Dilemma: The conflict between short-term domestic objectives and long-term international objectives when a national currency serves as the international reserve currency.

• **World Bank Group**:
- Established: 1945, resulting from 1944 Bretton Woods Conference (a "Bretton Woods Twin" with IMF).
- Headquarters: Washington D.C.
- Purpose: Provide financial and technical assistance to developing countries for development projects and poverty reduction.
- Constituent Institutions (5):
  - **IBRD (International Bank for Reconstruction and Development)**: Provides loans to middle-income and creditworthy low-income countries.
  - **IDA (International Development Association)**: Provides "soft loans" (low or no interest, long repayment) to the poorest developing countries.
  - **IFC (International Finance Corporation)**: Promotes private sector development in developing countries.
  - **MIGA (Multilateral Investment Guarantee Agency)**: Offers political risk insurance and credit enhancement.
  - **ICSID (International Centre for Settlement of Investment Disputes)**: Resolves investment disputes between investors and host countries.
- Not part of World Bank Group: Investment Policy Framework for Sustainable Development (IPFSD) (framework by UNCTAD).
- Role: Acted as a third party in the Indo-Pak River Water Agreement.
- India's Debt: Classified by World Bank (e.g., as a moderately indebted country).

• **World Trade Organization (WTO)**:
- Purpose: The only global international organization dealing with the rules of trade between nations.
- Establishment: Officially commenced operations on 1 January 1995, under the Marrakesh Agreement, concluding the Uruguay Round negotiations.
- Predecessor: General Agreement on Tariffs and Trade (GATT), which ceased to exist upon WTO's formation.
- Headquarters: Geneva.
- Membership: India is a founder member. A WTO member must be a cus-