For XAT , CMAT , SNAP , MAT , IIFT Exam

EXTERNAL SECTOR IN INDIA

- All economic activities of an economy which take place in foreign currency fall in the external sector such as export, import, foreign investment, external debt, the balance of payment, current account, capital account, etc

TRADE

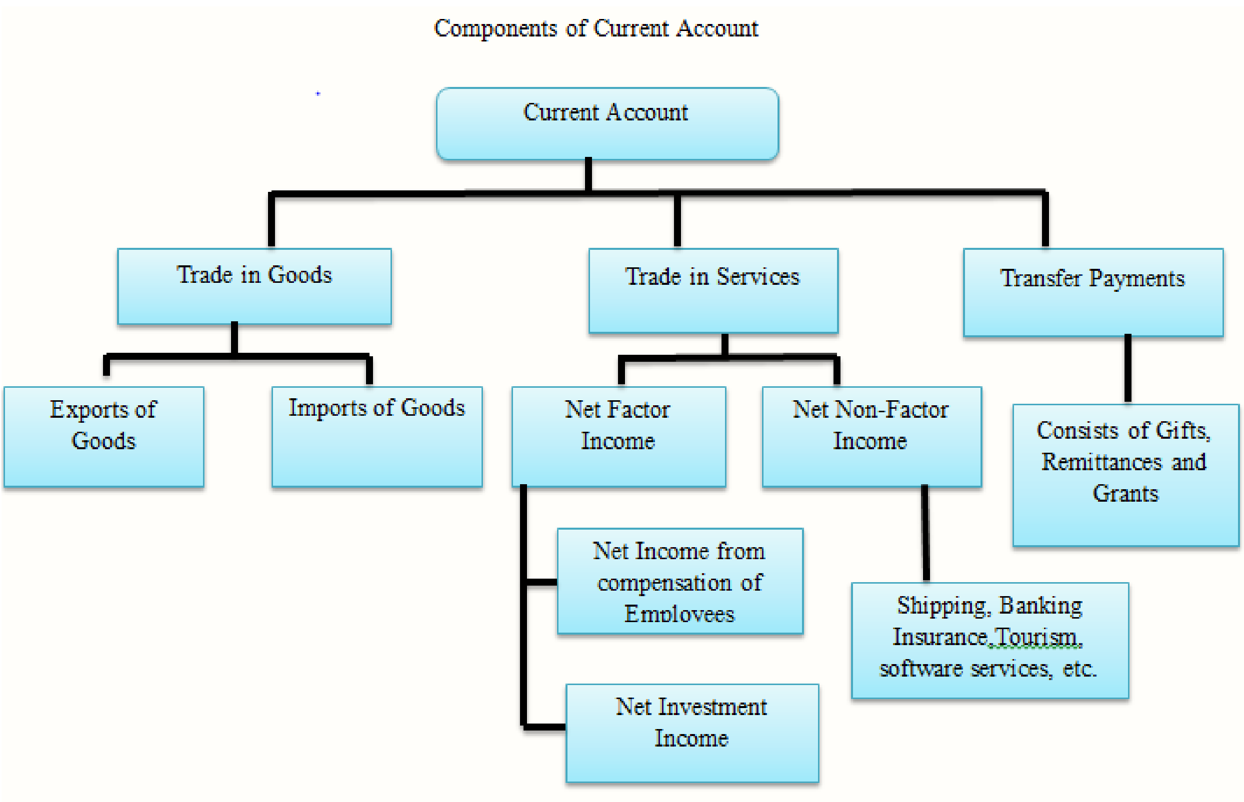
- Trade is one of the powerful forces of economic integration. The term 'trade' means exchange of goods, wares or merchandise among people.

THE BALANCE OF PAYMENTS

- The Balance Of Payments (BoP) records the transactions in goods, services and assets between residents of a country with the rest of the world for a specified time period typically a year. Basically, it is the net outcome of the current and capital accounts of an economy
- There are two main accounts in the Balance Of Payments (BoP) — **the current account** and **the capital account.**

CURRENT ACCOUNT

- Current Account is the record of trade in goods and services and transfer payments.
- It includes all international trade transactions of goods and services, international service transactions (i.e. tourism, transportation and royalty fees) and international unilateral transfers (i.e. gifts and foreign aid).



- **Trade in goods** includes exports and imports of goods

- **Trade in services** includes factor income and non-factor income transactions
- **Transfer payments** are the receipts which the residents of a country get for 'free', without having to provide any goods or services in return. They consist of gifts, remittances and grants. They could be given by the government or by private citizens living abroad.

Balance on Current Account

- Current Account is in balance when receipts on current account are equal to the payments on the current account.

  1. **Receipts = Payments (Balanced Current Account)**

- A surplus current account means that the nation is a lender to other countries and a deficit current account means that the nation is a borrower from other countries.

  1. **Receipts > Payments (Current Account Surplus)**
  2. **Receipts < Payments (Current Account Deficit)**

- Balance on Current Account has two components:

  1. Balance of Trade or Trade Balance
  2. Balance on Invisibles

Balance of Trade (BOT)

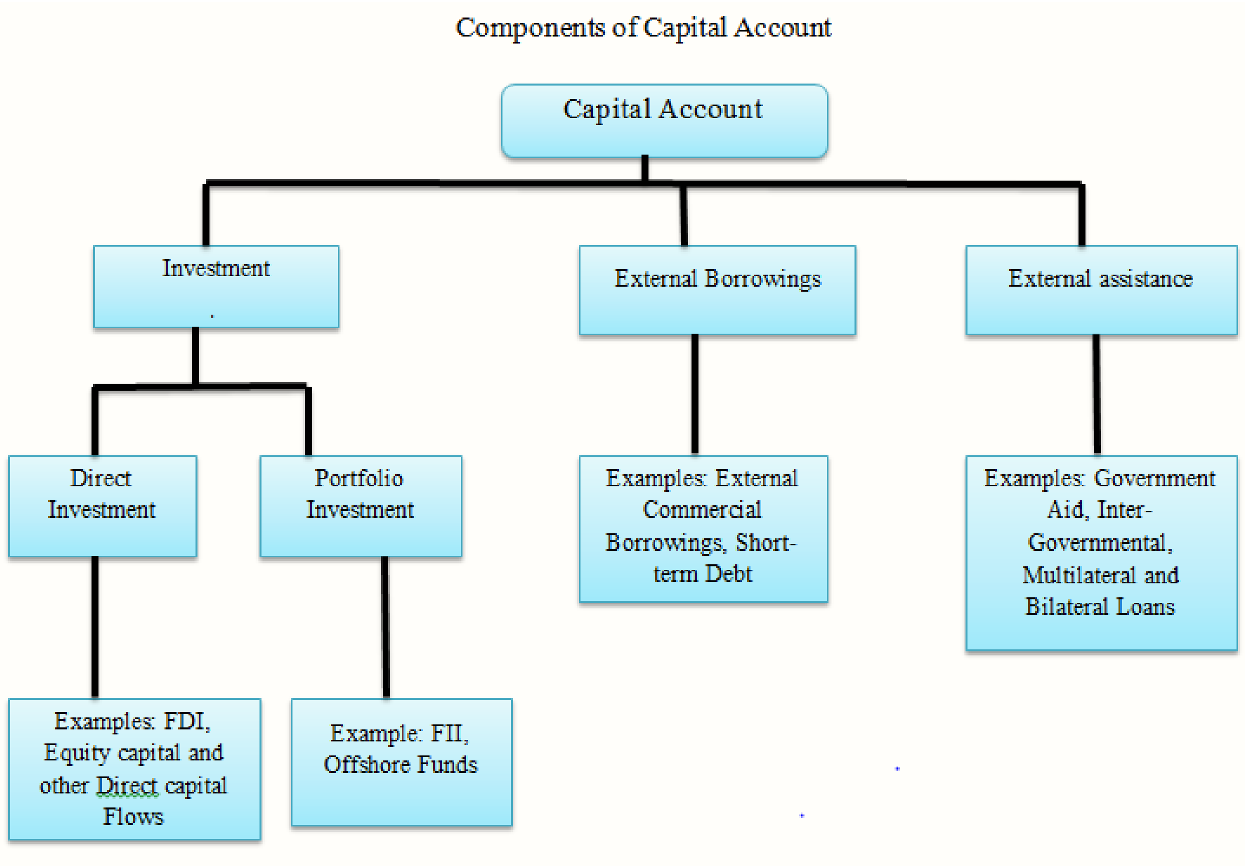
- It is the difference between the value of exports and the value of imports of goods of a country in a given period of time.
- Export of goods is entered as a credit item in Balance of Trade (BOT), whereas import of goods is entered as a debit item in Balance of Trade (BOT). It is also known as Trade Balance.
- **Balance of Trade** (BOT) is said to be in balance when exports of goods are **equal** to the imports of goods. Surplus BOT or Trade surplus will arise if country exports more goods than what it imports. Whereas, Deficit BOT or Trade deficit will arise if a country imports more goods than what it exports.

Balance on Invisibles

- Net Invisibles is the difference between the value of exports and value of imports of invisibles of a country in a given period of time.
- Invisibles include services, transfers and flows of income that take place between different countries.
- Services trade includes both factor and non-factor income. Factor income includes net international earnings on factors of production (like land, labour and capital). Non-factor income is net sale of service products like shipping, banking, tourism, software services, etc.

Capital Account

- Financial transactions consisting of direct investment and purchases of interest-bearing financial instruments, non-interest bearing demand deposits and gold fall under the capital account
- Capital Account records all international transactions of assets. An asset is any one of the forms in which wealth can be held, for example, money, stocks, bonds, Government debt, etc.



Balance on Capital Account

- Capital account is in balance when capital inflows (like receipt of loans from abroad, sale of assets or shares in foreign companies) are equal to capital outflows (like repayment of loans, purchase of assets or shares in foreign countries).
- Surplus in capital account arises when capital inflows are **greater** than capital outflows, whereas deficit in capital account arises when capital inflows are **lesser** than capital outflows.

Balance of Payments Disequilibrium

- The BoP is said to be balanced when the receipts (R) and payments (P) are just equal **R / P =1**
- Favorable BoP: When receipts exceed payments, the BoP is said to be favorable. That is,

R / P > 1

Unfavorable BOP: When receipts are less than payments, the BoP is said to be unfavorable or adverse. That is **R / P < 1**

EXCHANGE RATE

Definition of FOREX

- FOREX is the system or process of converting one national currency into another, and of transferring money from one country to another.

FOREX Reserves

- The total foreign currencies (of different countries) an economy possesses at a point of time is its ‘foreign currency assets/reserves’.
- The FOREX Reserves of an economy is its ‘foreign currency assets’ added with its gold reserves, SDRs (Special Drawing Rights) and Reserve Tranche Position (RTP) in the IMF

Foreign exchange market

- The market in which national currencies are traded for one another is known as the foreign exchange market.
- The major participants in the foreign exchange market are commercial banks, foreign exchange brokers and other authorised dealers and monetary authorities.

Rate of Exchange

- The price of one currency in terms of another currency is known as the foreign exchange rate or simply the exchange rate.
- The transactions in the exchange market are carried out at exchange rates. It is the external value of domestic currency. Thus, exchange rate may be defined as the price paid in the home currency (say ₹ 72) for a unit of foreign currency (say 1 US $).

Types of Exchange Rate Systems

- There are two major exchange rate systems, namely,

  (1) Fixed (or pegged) exchange rate system and

  (2) Flexible (or floating) exchange rate system.

- Managed Floating Exchange Rate system also prevails in some countries (Example: India)

Fixed Exchange Rates

- Countries following the fixed exchange rate (also known as stable exchange rate and pegged exchange rate) system agree to keep their currencies at a fixed rate as determined by the Government. Under the gold standard, the value of currencies was fixed in terms of gold.

Flexible Exchange Rates

- Under the flexible exchange rate (also known as floating exchange rate) system, exchange rates are freely determined in an open market by market forces of demand and supply

Determinants of Exchange Rates

1. Differentials in Inflation

- Inflation and exchange rates are inversely related. A country with a consistently lower inflation rate exhibits a rising currency value, as its purchasing power increases relative to other currencies

2. Public Debt

- Large public debts are driving out foreign investors, because it leads to inflation. As a result, exchange rate will be lower.

3. Current Account Deficits

- A deficit in the current account implies excess of payments over receipts. The country resorts to borrowing capital from foreign sources to make up the deficit. Excess demand for foreign currency lowers a country’s exchange rate

4. Recession

- Interest rates are low during the recession phase. This will decrease inflow of foreign capital. As a result, a currency will be depreciated against other currencies, thereby lowering the exchange rate.

APPRECIATION

- An appreciation means an increase in the value of a currency against other foreign currency.
- An appreciation makes exports more expensive and imports cheaper.

DEPRECIATION

- In foreign exchange market, it is a situation when domestic currency loses its value in front of a foreign currency if it is market-driven.
- It means depreciation in a currency can only take place if the economy follows the floating exchange rate system.

DEVALUATION

- In the foreign exchange market when exchange rate of a domestic currency is cut down by its government against any foreign currency, it is called devaluation. It means official depreciation is devaluation.

REVALUATION

- A term used in foreign exchange market which means a government increasing the exchange rate of its currency against any foreign currency. It is official appreciation.

Important Terms

SOFT CURRENCY

- A term used in the foreign exchange market which denotes the currency that is easily available in any economy in its FOREX market. For example, rupee is a soft currency in the Indian FOREX market.

HARD CURRENCY

- Hard currency, safe-haven currency or strong currency is any globally traded currency that serves as a reliable and stable store of value.
- The strongest currency of the world is one which has a high level of liquidity.
- Some of the best hard currencies of the world today are the US Dollar, the Euro(€), Japanese Yen (¥) and the UK Sterling Pound (£).

CHEAP CURRENCY

- The term was first used by the economist J. M. Keynes (1930s).
- If a government starts re-purchasing its bonds before their maturities (at full-maturity prices) the money which flows into the economy is known as the cheap currency, also called cheap money.
- In the banking industry, it means a period of comparatively lower/softer interest rates regime

HOT CURRENCY

- Hot currency is a term of the FOREX market and is a temporary name for any hard currency
- When any hard currency is exiting from any economy at a fast pace, at the time that hard currency is said as hot currency

HEATED CURRENCY

- A term used in the FOREX market to denote the domestic currency which is under pressure of depreciation due to a hard currency high tendency of exiting the economy. It is also known as currency under heat or under hammering.

DEAR CURRENCY

- When a government issues bonds, the money which flows from the public to the government or the money in the economy in general is called dear currency, also called as dear money.
- In the banking industry, it means a period of comparatively higher/costlier interest rates regime

Foreign Direct Investment (FDI)

- FDI is an important factor in global economy. Foreign trade and FDI are closely related.
- **FDI** means an investment in a foreign country that involves some degree of control and participation in management. It corresponds to the investment made by a multinational enterprise in a foreign country. It is different from portfolio investment, which is primarily motivated by short term profit and it does not seek management control.
- **Foreign Portfolio Investment (FPI)** means the entry of funds into a nation where foreigners deposit money in a nation's bank or make purchase in the stock and bond markets, sometimes for speculation. FPI is part of the capital account of BoP.
- **Foreign Institutional Investment (FII)** is an investment in hedge funds, insurance companies, pension funds and mutual funds. Foreign institutional investment is a common term in the financial sector of India

FDI in India

- In India, FDI has been advantageous in terms of free flow of capital, improved technology, management expertise and access to international markets.
- FDI in India is allowed under Automatic Route. does not require prior approval either by the government of India/Reserve Bank of India
- The major sectors benefited from FDI in India are financial sector (banking and non-banking), insurance, telecommunication, hospitality and tourism, pharmaceuticals and software and information technology.

- Following sectors are prohibited for FDI
  1. Lottery Business
  2. Gambling and betting
  3. **The business** of chit fund
  4. Nidhi Company
  5. Trading in transferable development rights (TDRs)
  6. Atomic Energy