



**INDIA'S CURRENT ACCOUNT DEFICIT : EXTERNAL AND
INTERNAL IMPLICATION**



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ABSTRACT

Current Account Deficit shows the difference between the nation's exports and imports. Current Account Deficit (CAD) in Balance of payment is more or less a common phenomenon amongst the countries. It does not matter, whether a country is rich or poor. India is no exception to that. India has been persistently running deficit in its current account for many years like USA , Australia, Newzealand, UK etc. But this cannot be a certificate for a huge gap of CAD. How long a country will allow its current account deficit to be widened ? This paper intends to study the implications of CAD in both the external implications as well as the internal implications in India's economy.

KEYWORDS

current account deficit, balance of payment, intra-temporal trade , inter-temporal trade export, import, implication.

RESEARCH PAPER

Introduction

Theoretically the Current Account Balance should be equal to the Capital Account. Current account deficit shows the difference between the nation's exports and imports. A CAD occurs when a country's government, businesses and individuals imports more goods, services—such as banking and insurance and capital than it exports. That's because the current account measures trade, as well as international income, direct transfers of capital, and investment income made on asset. CAD is usually measured as a percentage of GDP (gross domestic product). GDP refers to the total market value of the goods and services manufactured within the country in a financial year. The U.S. dollar is the major currency for international trade. Most countries use it to pay for their imports and also peg the dollar for exporting products and services.

The balance of trade (net import or export) would determine if a country is a net payer or a receiver of dollars. Trade, along with other dollar inflows (portfolio/FII, FDI, inward remittances), determines the overall availability of the international currency for a country to engage itself in the global economy. This also has a bearing on determining the exchange rate of a country's own currency with that of the dollar.

The current account can also be expressed as the difference between national (both public and private) savings and investment. A current account deficit may therefore reflect a low level of national savings relative to investment or a high rate of investment—or both. For capital-poor developing countries, which have more investment opportunities than they can afford to undertake because of low levels of domestic savings, a current account deficit may be natural. A deficit potentially spurs faster output growth and economic development. The advanced economies, such as the United States run current account deficits, whereas developing countries and emerging market economies often run surpluses or near surpluses.

Another way to look at the current account is in terms of the timing of trade. We are used to intratemporal trade—exchanging cloth for wine today. But we can also think of intertemporal trade—importing goods today (running a current account deficit) and, in return, exporting goods in the future (running a current account surplus then). Just as a country may import one good

and export another under intra-temporal trade, there is no reason why a country should not import goods of today and export goods of tomorrow.

Intertemporal theories of the current account also stress the consumption-smoothing role that current account deficits and surpluses can play. For instance, if a country is struck by a shock—perhaps a natural disaster—that temporarily depresses its ability to access productive capacity, rather than take the full brunt of the shock immediately, the country can spread out the pain over time by running a current account deficit.

1. Conceptual Framework

Current Deficit Account has three components. The largest component of a deficit usually a **trade deficit**. This simply means the country imports more goods and services than it exports.

The second largest component is usually a deficit in the **net income**. This occurs when the country exports dividends on stocks, interest payments made on financial assets, and wages paid to foreigners working in the country. If all payments made to foreigners are greater than the interest, dividends and wages made by foreigners to the country's residents, the deficit will rise.

The last component of the deficit is the smallest, but often the most hotly contested. These are **direct transfers**, which includes government grants to foreigners. It also includes any money sent back to their home countries by foreigners. It can be presented in the following way.

X = Exports of goods and services

M = Imports of goods and services

NY = Net income abroad

NCT = Net current transfers

Current Account Balance (CAB) = X - M + NY + NCT

2. Review of Literature

The present review of literature looks into the different dimensions of current account deficit. It traces the different approaches to deal with the problem.

According to the intertemporal approach, the current account deficit is the outcome of forward-looking dynamic saving and investment decisions driven by expectations of productivity growth, government spending, interest rates, and several other factors. Within this framework, it has been stressed the role of the current account balance as a buffer against transitory shocks in

productivity or demand (Sachs, 1981; Obstfeld and Rogoff, 1995, 1996; Ghosh, 1995; Razin, 1995).

One of the main lessons learned from this literature is that the impact of policy changes may vary according to the nature, persistence and timing of such changes. With respect to their nature, shocks may be country-specific or global. This is important since the literature finds that the latter tends to have a smaller impact on current account deficits than the former (Milesi-Ferretti, G.M. and Razin, A. (1996), Similarly, the persistence of the shocks, whether transitory or permanent, may produce a different response of the current account balance. For instance, a permanent productivity shock may widen the current account deficit as it may generate a surge in investment and a decline in savings (given that it causes consumption to rise by more than gross output).

On the other hand, transitory productivity shocks may move the current account into surplus as there may be no investment response to a purely temporary shock (Glick and Rogoff, 1995; Obstfeld and Rogoff, 1995).

Finally, the timing of shocks, that is, the extent to which they are expected or unexpected by agents in the economy, may also matter in current account outcomes. In the context of a real business cycle model, the intertemporal approach has been widely used to evaluate the impact on the current account balance of fiscal policy (Leiderman and Razin, 1991; Frenkel and Razin, 1996), real exchange rate, terms of trade fluctuations (Obstfeld, 1982; Svensson and Razin, 1983; Greenwood, 1983; Mendoza, 1995; Tornell and Lane, 1998; Mansoorian, 1998), capital controls (Mendoza, 1991) and global productivity shocks (Glick and Rogoff, 1995; Razin, 1995)

In this regard, the literature on current account sustainability (Milesi-Ferretti and Razin, 1996) has proved to be a useful complement.

However, there are still unsolved issues regarding the factors that could trigger a policy reversal in situations of unsustainability. Events that might generate policy shifts are different across countries, and might reflect different degrees of vulnerability of external shocks, or differences in the ability to undertake policy adjustments

3. Objective:

This paper intends to study India's current account deficit with the following objectives.

- a) To find out the causes and present situation of CAD in India.
- b) To find out the possible external and internal effects of CAD in India.
- c) To study the question of sustainability with CAD.

4. Data source and Methodology

The study is based on Secondary data from RBI bulletin and articles etc. and so far the methodology is concerned it is exploratory in nature.

5. India's current account situation.

India has a current account deficit; that is, its imports exceed exports. India recorded a Current Account deficit of 18.10 USD Billion in the first quarter of 2013. Current Account in India is reported by the Reserve Bank of India. **India Current Account averaged a deficit equivalent to 1.51 USD Billion from 1949 until 2013, reaching the best surplus at 7.36 USD Billion in March of 2004 and the worst deficit at 32.63 USD Billion in December of 2012, that is ,a record high of 6.7 per cent in the December quarter of last fiscal year (2012).** The CAD in 2012-13 fiscal is likely to be around 5 per cent of the gross domestic product (GDP). The current account deficit for the full financial year ended March 2013 was at 4.8 percent of GDP.

India's CAD for the second quarter ended September 2012 rose sharply to \$22.3 billion from \$18.9 billion in second quarter of a year ago higher pace of imports and moderating exports growth. Every year India imports crude oil and gold worth billions of dollar and that disturbs the whole balance. India's current account deficit has increased due to weak exports, heavy gold and crude oil imports.

More foreigners invest in India compared to Indians investing abroad. **Rajiv Gandhi Equity saving scheme** was an initiative of the finance ministry, to make Indians reduce gold-purchase and use that money to invest in capital market. The CAD increased to 5.4% of gross domestic product for second quarter of Financial Year 2012-13 from 4.2% for second quarter Financial Year 11-12.

The earlier research on the 1991 crisis said it was basically a result of high current account deficit and inability to finance it via capital inflows. The capital inflows mainly constituted commercial borrowings, external assistance and NRI deposits. As the economy was closed, there was hardly any inflow in form of foreign investment (it started from 1986-87 onwards). So as long as debt flows were available, it was all considered safe. However, concerns grew as

current account deficit increased and finally a situation came in 1990-91 when the current account deficit was higher than capital inflows. Moreover, India's import cover declined to touch just 1.9 months in 1989-90 and 2.5 months in 1990-91. The situation came to limelight after Gulf war broke in 1991 resulting into a balance of payments crisis.

India's current account deficit improved to 3.6% of the country's gross domestic product in the first quarter of 2013 at \$18.2 billion against a historic high of 6.7 percent of the GDP in the fourth quarter of 2012, but totalled a record 4.8 percent for the full 2012-13 fiscal. This is because of the moderation in CAD was due to non-oil and non-gold imports falling due to slowing economic growth. (RBI bulletin)

The deficit has widened in recent years as a percentage of GDP and has become a concern for policymakers, economists and global investors. Describing high Current Account Deficit (CAD) as the biggest risk to Indian economy, the Reserve Bank of India (RBI) said any further deterioration of CAD could result in its policy reversal stance. In this context, the Reserve Bank of India, **Ex governor, D Subbarao** said in last month that the sustainable CAD for India is 2.5% of GDP. Finance minister, P Chidambaram also has said that such a high current deficit was 'worrying'. This has raised concerns over the impact on the economy.

6. Probable causes of CAD in India:

6.a. Quality of India's imports is worrying: An economy that is growing at a faster clip than other nations has high imports and usually runs a current account deficit. The RBI governor, D Subbarao has expressed concern about the quality of imports. He argued in a speech last month that if a country imports more capital goods, it means there is an increase in the economic activity. However, India's imports primarily include oil and gold. These two commodities do not help any manufacturing and export growth. India's oil imports rose despite an overall economic slowdown. India also continued to import gold as demand stayed high. This was despite the additional duties imposed on import of gold.

6.b. Economic growth: There is increase in income and demand; people are ready to consume more goods. The domestic production has not met that demand.

6.c. No signs of exports growth: India's overall trade deficit stood at \$ 59.6 bn during the quarter to December 2012. This is the excess value of imports over exports. The economy becomes less competitive leading to decrease in exports, hence an increased CAD.

6. d. Recession in other countries: Major trading countries such as US & EU have experienced recession leading to a reduction in import of our goods adding to CAD.

6.e. Debt: To finance deficit and current account the government has incurred high debt while CAD has exacerbated

6.f. Depreciation of Exchange Rate: Depreciated currency has been attracting less foreign investment leading to decrease in capital investment.

7. Implications

Current Account Deficit in India's balance of payments has impacts on the internal as well as in its external economy. Generally deficit in current account in BOP does not put pressure on the economy. CAD helps to expand the business activities but with a huge gap of CAD will create lot of problems in the economy.

Economic theory tells us that whether a deficit is good or bad depends on the factors giving rise to that deficit, but economic theory also tells us what to look for in assessing the desirability of a deficit. If the deficit reflects an excess of imports over exports, it may be indicative of competitiveness problems, but because the current account deficit also implies an excess of investment over savings, it could equally be pointing to a highly productive, growing economy. If the deficit reflects low savings rather than high investment, it could be caused by reckless fiscal policy or a consumption binge. Or it could reflect perfectly sensible intertemporal trade, perhaps because of a temporary shock or shifting demographics. Without knowing which of these is at play, it makes little sense to talk of a deficit being "good" or "bad." Deficits reflect underlying economic trends, which may be desirable or undesirable for a country at a particular point in time.

7.a. Internal implication

A deficit of current account of an economy will lead to a loss of aggregate demand and as a result of that the country will experience a slower growth. This is happening in case of India. India's GDP comes down from around 8 - 9 % to 5% at present. In the long run, persistent trade deficit undermines the standard of living. This trade deficit can lead to a loss of jobs in home based industries. There is a possibility of currency weakness due to consistent deficit in current account in India and this deficit can lead to higher inflation in its internal economy.

Another problem that may arise is that a higher inflation creates a situation to rise in market interest rates as a consequence of that there will be a cut of consumers demand and business investment in the economy. A higher current account deficit will decrease spending and in turn it will cost jobs opportunity. Moreover, with a huge CAD, Indian economy will experience a shortfall in savings and investment because of the reluctance of the foreign investors to invest their capital. Current account deficit has positive effects in an economy. It helps economic growth by inviting foreign capital to the concerned country but at present situation in India it cannot be expected as CAD is too high to have positive effects but export sector can improve as the Indian rupee has become cheaper in the foreign market due to devaluation.

7.b. External implication

A higher current account deficit will lead to currency weakness at international market and there will be loss of confidence among the foreign investors. As a result, there will be outflow of Capital and out flow of capital from India will indicate a shortfall of vital foreign exchange reserves. This is already started happening in India. India will have to depend on more inflow of short term capital loan to bridge the gap which means India have to take more burden in future. The country with a big gap of current account deficit in its balance of payment does not have alternative but to face depreciation in its currency. At present India is facing the problem of this crisis. Indian rupee is falling rapidly against the US dollar. **The rupee historically falls to Rs 62/ per US dollar on 16th August, 2013.** Seeing the fall of the rupee to new lows, traders booked profits by massively selling shares across all industries. Furthermore, to make worse the fall in equity markets has prompted banks and importers to buy dollars, further lowering the value of rupee. Another crisis which may arise is that the loss of confidence in the minds of the foreign investors will isolate India from the global capital market.

8. Sustainability

A natural question comes in our mind that is how long a country runs a current account deficit? When a country runs a current account deficit, it is building up liabilities to the rest of the world that are financed by flows in the financial account. Eventually, these need to be paid back. Common sense suggests that if a country making expenditure in its borrowed foreign funds on spending that yields no long-term productive gains, then its ability to repay—its basic solvency—might come into question. This is because solvency requires that the country be

willing and able to generate (eventually) sufficient current account surpluses to repay what it has borrowed to finance the current account deficits. Therefore, whether a country should run a current account deficit (borrow more) depends on the extent of its foreign liabilities (its external debt) and on whether the borrowing will finance investment with a higher marginal product than the interest rate (or rate of return) the country has to pay on its foreign liabilities.

But even if the country is intertemporally solvent—meaning that current liabilities will be covered by future revenues—its current account deficit may become unsustainable if it is unable to secure the necessary financing. While some countries (such as Australia and New Zealand) have been able to maintain current account deficits averaging about 4.5 to 5 percent of GDP for several decades, others (such as Mexico in 1995, Thailand in 1997, and several economies during the recent global crisis) experienced sharp reversals of their current account deficits after private financing withdrew during the financial crisis.

Such reversals can be highly disruptive because private consumption, investment, and government expenditure must be curtailed abruptly when foreign financing is no longer available and, indeed, a country is forced to run large surpluses to repay in short order what it borrowed in the past. This suggests that—regardless of why a country has a current account deficit (and even if the deficit reflects desirable underlying trends)—large and persistent deficits call for caution, otherwise the country experiences an abrupt and painful reversal of financing.

What determines whether a country experiences such a reversal? Empirical research suggests that an overvalued real exchange rate, inadequate foreign exchange reserves, excessively fast domestic credit growth, unfavorable terms of trade shocks, low growth in partner countries, and higher interest rates in industrial countries influence the occurrence of reversals. More recent literature has also focused on the importance of balance sheet vulnerabilities in the run-up to a crisis—such as the extent to which companies have large liabilities in foreign currencies such as dollars or maturity mismatches that occur when companies have more short-term liabilities than short-term assets and more medium- and long-term assets relative to their liabilities. Recent research has also underscored the importance of the composition of capital inflows—for example, the relative stability of foreign direct investment compared with more volatile short-term investment flows, such as in equities and bonds. Moreover, weak financial sectors can often increase a country's vulnerability to a reversal of investment flows as banks borrow

money from abroad and make risky domestic loans. Conversely, a more flexible policy framework—such as a flexible exchange rate regime, a higher degree of openness, export diversification, and coherent fiscal and monetary policies—combined with financial sector development could help a country with persistent deficits be less vulnerable to a reversal by allowing greater room for better shock absorption. At present India's current account deficit is 4.8% of GDP. India enjoys a permissible level as well as a sustainable level of CAD is at 2.5% of GDP.

From the above discussion, it will be judicious on the part of India to minimize the gap of deficit in current account of BOP. Failing to maintain the sustainable level will invite a threat to Indian economy.

9. Suggestion and Conclusion

From the above discussion and observation of India's current account deficits in the balance of payments, it can be brought to possible solutions in the following way.

India's growth engine has been predominantly driven by oil (over two-thirds of which is imported). This situation may not change much over the next few decades. The government is considering exploration of shale gas but that will take a long time. Thus the oil import bill will remain a function of both quantity imported and the international price of crude. Despite price increase and volatility, oil imports are a necessity. Further, shortfall in domestic coal production has resulted in increased dependence on imports. Hence reducing CAD through lowering oil imports is not a feasible option.

The second major cause of widening CAD is being attributed to gold imports. India and China together account for more than half of global gold consumption. Indians, irrespective of economic position, are positively inclined towards gold purchase. It is largely driven by custom, marriage, safety concerns, tradability, and as a hedge against the rupee.

The government in the near term has tried to suppress domestic gold demand by imposing higher taxes. But with increasing affluence and affordability due to rising disposable income, gold demand will continue to grow. Hence addressing CAD by trying to restrict gold imports may not have a long-term impact. At present, government of India imposes 10% tax on gold import to restrict the import of gold.

Other imports like capital goods and machinery, transport equipment and electronics are necessary for India's infrastructure growth. Indigenization has reduced dependence on imports, but in areas like telecom and mining, imports have played a crucial role in lowering input cost. Reducing CAD by limiting imports is therefore not a judicious option. And to depend on short-term capital flows to address dollar needs makes India's economic position quite vulnerable. Therefore, the probable solution lies in expanding the export sector and other measures of restrictions which may come into the way.

Over the years India has made progress in both information technology and generic pharmaceutical exports, apart from its traditional gems and jewellery, natural fibers and garment sectors.

But its competitiveness in areas like manufactured goods and readymade garments is being challenged. India's share of merchandise export in global trade is still below 2 percent and hence a lot needs to be achieved in this area.

Export of auto and auto components is on the rise and with supportive policy initiatives, India could emerge as a regional hub for sourcing components for global automakers. The country's vast engineering talent pool could be put to better use in manufacturing than in the financial sector.

Government policy towards enhancing trade with existing partner countries and establishing new relationships with developing countries in Asia, Africa and Latin America would also help promote exports to these regions.

Improving the infrastructure of existing Export Processing Zones, enhancing trade finance, simplifying procedures for interacting with government agencies, facilitating small and medium enterprises (SMEs) to access global markets etc, are other areas which need immediate attention.

The Reserve bank of India announced a series of measures in the last two months to curb volatility in foreign exchange market. The continuous widening CAD continues to be a serious concern. RBI announced restrictions on foreign exchange spending by individuals and also on overseas investment by Indian companies. This attempt to impose partial control on capital outflow but failed miserably. It seems government is running out of option on how to control

the downward rupee. Government hopes only that this problem will be brought under control by first quarter of 2014 year.

Finally, it can be concluded by saying that it is high time for the government to come out with a clear and concise trade policy with a roadmap for strengthening India's global trade.

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