**JNTUA SCHOOL OF MANAGEMENT STUDIES**

**JAWAHARLAL NEHRU TECHNOLOGICAL UNIVERSITY ANANTAPUR**

ANANTAPURAMU – 515 002, ANDHRA PRADESH, INDIA

2020 – 2022

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**EFFECT OF TWIN DEFICIT PROBLEM IN INDIA**

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**SUBMITTED BY**

**NAME : NIKHILESWAR. R**

**REG.NO :  200A1E0308**

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**EFFECT OF TWIN DEFICIT PROBLEM IN INDIA**

**INTRODUCTION:**

Current account imbalances have in recent years become a concern of policy makers and public opinion in a number of countries. While it is possible to argue from a theoretical point of view that this concern is misguided, it appears to be a fact of life that governments are being pressured to "do something" to correct external imbalances. Increasingly the conduct of fiscal policy has become the focus of such pressures. It is often argued that budget imbalances of the public sector are at the root of the current account imbalances. The so-called twin-deficit hypothesis goes so far as to assert that an improvement on the fiscal front will bring about a one-for-one improvement in the current account.

Unfortunately, the relationship between the two deficits does not appear to be as close as this hypothesis claims. The experience of countries, including Australia, that have taken measures to achieve budget consolidation suggests a significantly looser connection and one that is not invariant across countries or over time. The aim of the following analysis is to provide a suitable framework for investigating the determinants of the current account and to use this framework to study the relationship between budget imbalances and current account imbalances) A major conclusion that will emerge is that reactions of the private sector to government policies may partially, fully, or even more than fully offset the effects on the current account of budget consolidation efforts depending on the way in which fiscal policy is altered to achieve a reduction in the public sector's borrowing requirement. Careful empirical analysis is therefore necessary in order to ascertain the impact of changes in fiscal policy on a country's external position.

Fiscal imbalance is an important topic among the economist regarding its causes and effects on the economy of a country. The difference between the revenues and expenditure of the government is the fiscal imbalance. Government of a country generally has two type of revenue in its budgetary plan, one is tax and another is non-tax revenue (like, duties, fees and other duties).

On the other hand, government expenditures of a country may include material consumption of the public sector, salaries of government employees, depreciation of fixed national capital, as well as various types of transfer to the population. The total revenue and expenditure of the government seldom coincides.

The difference between the two is the negative fiscal imbalance or the positive fiscal imbalance, which is called the budget deficit or surplus, respectively. When the fiscal imbalance is positive, it means that government revenue exceeds the costs that seem to benefit the economy. On the other hand, severe negative financial imbalances can pose a serious problem for the economy. It is because the expenditure or costs of the government is more than its revenue. Increasing of the expenditure means that government took loan from domestic or abroad. Fiscal deficit in this situation shows that the government does not have enough income to prepay its obligations. According to the (Rakesh, 2000), if the country continues to spend more than it earns over time, this will put increasing pressure on the country's macroeconomic stability.

High negative financial imbalance leads to an unpleasant scenario that the government provide additional expenses more than income through loans. Borrowing through its impact on interest rates in the country leads to the formation of capital. Thus, the path of sustainable long-term growth slows down the economy. Therefore, it is well established that controlling and reducing financial imbalances is essential to achieving long-term macroeconomic stability and sustaining economic growth in any country. The fiscal deficit has been much discussed in many of the literature on economic growth.

As per Bernheim, the studies based on the neoclassical school of thought argue that the financial deficit prevents economic growth by pushing interest rates to increase government borrowing, which attracts private investment. Other studies, following Keynesian approach, argue that a financial deficit can stimulate domestic production and lead to economic optimism among private investors and, as a result, greater investment - what is known as the bustling or crowding-in effect.

In India, the fiscal deficit in recent years has been a cause for concern because India's economy has been in constant deficit. Therefore, there is a fear that high fiscal or financial imbalances will negatively affect the country's economic growth. This paper is an attempt to analyse the impact of fiscal deficit on GDP growth of India to understand whether there is any impact or not. If there is any impact, how much it is. And also, to find whether there is any relationship between these two variables or not.

According to the (IMF, 2019)’s data India was ranked as the 7th biggest economy in the world in 2018, but in 2019, according to the (Press Trust of India, 2020) India has ranked as the 5th biggest world economy by $2.94 trillion in the world. According to the (Moody’s Investors Service, 2019) the GDP growth rate of India in 2018 was 7.4 percent that it decreased to 5.6 percent in 2019, but this company once a time predicted the GDP growth of India in 2020 and 2021 to 6.6 and 6.7 percent respectively, but in February 2020 it changed the prediction to the 5.4 percent and 5.8 percent respectively because the negative impacts of Corona Virus1.

Besides, according to the prediction of (Economic Survey, 2020) the GDP of India will grow at 6 to 6.5 percent in 2020-212. India’s GDP has been increased after liberalization policies. In 1995 the GDP of India was 11.92 trillion rupees that it increased to 151.84 trillion rupees, that was an increase of 1174 percent. That shows India is economy is increasing as it mentioned above too. Besides, the total GDP of India from 1995 to 2016 was around 1249.54 trillion rupees.

On the other hand, government of India as per his budgetary plan going to have expenditure in the country and the revenue of the government is generally coming from tax and non – tax. And the fiscal deficit is happening when government has more expenditure than its revenue. Government of India from 1995 to 2016 had 155.01trillion rupees revenue that among these the tax revenue total was 129.08 trillion rupees and non-tax was 25.93 trillion rupees, that the share of tax revenue and non-tax revenue totally was 83.27 percent and 16.73 percent, respectively. This shows that the most import part of revenue of Indian government is tax part.

The government revenue increased from 1995 to 2016 such that in 1995 it was 1.48 trillion rupees that increased to 20.35 trillion rupees that shows an increase of 1277.28 percent. Besides, the share of government revenue also increased in GDP growth rate of India. In 1995, the share government revenue in GDP was 12.05 percent that it is increased to 13.34 percent of 2016. On the other hand, the expenditure of the Indian government also had an ascending slope from 1995 to 2016. The total expenditure of the government from 1995 to 2016 was around 196 trillion rupees.

India’s government also increased its expenditure such that in 1995 his expenditure was 1.74 trillion rupees that increased in 2016 to 23.89 trillion rupees. Besides, the share of the government expenditure in GDP of the country is increased too. Such that, in 1995 the share was 14.19 percent that increased to 16.69 percent of 2009 and 15.66 percent of 2016. As per the above data, the government of India had more expenditure than its revenue in many of the time. This shows that India had faced fiscal deficit. In 1995, the fiscal deficit of India was -0.26 trillion rupees that it increased to -3.54 trillion rupees of 2016. This means that the fiscal deficit of India in 21 years had increased by 1244.76 percent.

The above table shows the trends of fiscal deficit and its components and the GDP growth of India since 1995. The data shows that the lowest GDP growth of India was in 1995 around 11.92 trillion rupees, and the highest GDP growth among the selected years was on 2016s that was around 151.84 trillion rupees. Besides, the table shows that the highest revenue and expenditure of the Indian government were in the 2016 around 20.35 trillion rupees and 23.89 trillion rupees, respectively. And the lowest revenue and expenditure of the Indian government were in the 1995 around 1.48 trillion rupees and 1.74 trillion rupees, respectively.

The above table also shows that the revenue of the government more coming from the tax and less coming from other or non-tax, such that; the highest Indian government tax revenue and non-tax revenue were in 2016 around 17.03 trillion rupees and 3.27 trillion rupees, respectively, and the lowest tax revenue and non-tax revenue of the government was in 1995 around 1.11 trillion rupees and 0.35 trillion rupees, respectively.

On the other hand, the table also shows that in many time the Indian economy faced of fiscal deficit. the fiscal deficit of India in 1995 had the lowest amount around -0.26 trillion rupees and the highest amount of fiscal deficit was in 2015 around -3.82 trillion rupees. From the above table, we can conclude that from 1995 to 2016 the GDP, and fiscal deficit with its parts had experienced increased growth in their amount. For better understanding that how much government revenue and government expenditure had portion in the GDP growth of the India, the below figure has been prepared.

**The impact of India’s fiscal deficit on its GDP growth:**

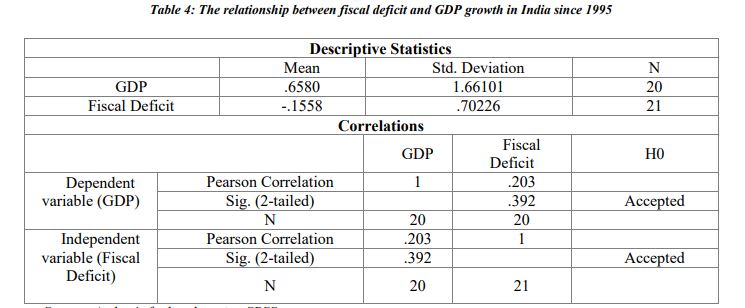
As per different papers fiscal deficit had a negative impact on the economic growth of the countries, but as per some of the papers fiscal deficit had positive impact on the GDP growth of the countries. In this study the OLS estimator simple regression model has been used to check the impact of fiscal deficit on GDP growth of India from 1995 to 2016. Before running the OLS estimator simple regression, it is required to see that the mean and median of the data equal or not, or on the other hand, to see the data are stationarity in nature or not.

For understanding the stationarity of the data, the Augmented Dickey-Fuller unit root test has been used. a. The Augmented Dickey-Fuller Unit Root Test The characteristics of stationary of the series are examined by using the ADF test for both variables. Pvalue is compared with the significant value of, and then the decision has been taken. If Pvalue is greater than 0.05, the null hypothesis (H0) would be accepted and if it is less than 0.05 then the (H0) would be rejected.

If null hypothesis is accepted, we can interpret that the data are not stationer or there is problem of unit root at 95 percent confidence interval. And if the null hypothesis is rejected, we can conclude that the data are stationer and there is no problem of unit root. So as per the above table, the results, show that fiscal deficit and GDP growth of India had problem unit root that means at the level point the data were not stationer. The first difference for fiscal deficit and the second difference for the GDP growth has been taken to make the data stationer. After solving the problem of unit root, the paper used the OLS estimator simple regression to check the impact of fiscal deficit on GDP growth of India from 1995 to 2016.

**The relationship between fiscal deficit and GDP growth in India**

The below table shows the relationship between fiscal deficit and GDP growth in India from 1995 to 2016. The Pearson’s correlation model is used to check the correlation between the variables. As per our hypothesis, we can accept or reject that there is any relationship between the variable or not. The hypotheses are as below: H0: There is no significant relationship between fiscal deficit and GDP growth of India H1: There is significant relationship between fiscal deficit and GDP growth of India.



The above table from the correlation matrix confirm a positive and direct relationship between fiscal deficit and GDP growth in India from 1995 to 2016, or in long run. From the table, it can be analysed that the relationship coefficient stands at 0.203 or 20.3 percent, that shows a moderate correlation between the variables, and the significance of 2-tailes test is 0.392 which is greater than the 0.05 significant level, thereby, establishing statistically that is no significant correlation between fiscal deficit and gross domestic product in India in that period of time. So it can be interoperated, that there is no significant relationship between the variables, (means H0 is accepted), at 95 percent confidence interval because the significant level is less than the P-vale (0.05)

**Interpretation of the data**

The above data show that the both hypotheses of the study have been accepted. This means there is no effect of fiscal deficit on GDP growth in India, and the relationship between the variables are positive but a moderate relationship. So, in this case we can bring the theory of Keynes to support the positive relationship between the fiscal deficit and GDP of a country. It is because when the government start to increase its expenditure from its revenue and from its debt of domestic and abroad then it would increase the GDP of the country. In this situation the role of the government is very much important to take the fiscal police too, if the inflation happened in the economy because of the more expenditure.

Fiscal Deficit is the situation that arises when total expenditure of the Government (this includes expenditure on account of revenue, capital, interest payments on borrowed capital and grants or aids provided by the government for creation of capital assets) are more than the aggregate of revenue receipts (Net Tax revenue to centre government and non-tax revenue), recovery of loans and other receipts of central government.

Fiscal Deficit = Total Expenditure (-) Revenue Receipts (-) Recovery of Loan (-) Other Receipts

The situation is more common when country in developing league. Deficit of government is most common symptoms for those nations looking for more investments. Country like India has witnessed longer trends of fiscal deficit. The effect of fiscal deficit needs to be targeted properly. The present concerns of India and like countries are, their fiscal deficit is rising due excessive burden of Interest payments being a part of total expenditure. The situation is anticipated as being a developing nation, country has to spend on interest expenditure because of heavy foreign borrowings. But the concern that may arise under such situation is when borrowing is intended to finance the deficit than to fund the projects or build capital expenditure (Assets). Thus, the money so will not give its productivity, rather it just adds further pressure on following years fiscal deficit makes the country in further concerns.

**CURRENT ACOUNT DEFICIT:**

The current account is one of the two primary apparatuses of the balance of payments (the two components of Bop are Capital Account and Current Account). The Current Account, an important segment of BoP, consists of flows of merchandises, services, primary income and secondary income between a country and rest of the world. While the “Goods and Services Account “are the major constituents of the current account, the primary income account replicates amount payable and receivable in return for rendering labour services, financial resources or non-produced non-financial assets (natural resources).

The secondary income of income between resident and non-residents, i.e., when resources for current purposes are swapped without economic value being exchanged in return (transfers). The net effect of all the above-mentioned transactions is known as the “current account balance”. The current account deficit is a significant indicator of competitiveness and the level of imports and exports.

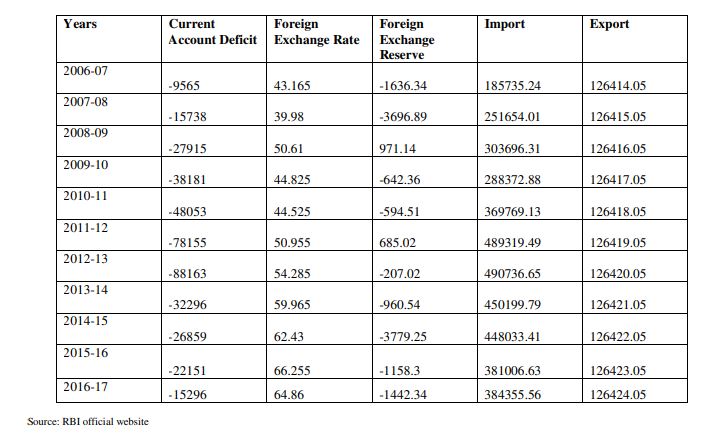
A large current account deficit typically implies some kind of disparity in the economy, which needs to be corrected. In the short-term, a current account deficit is mostly advantageous. However, in the long term, a current deficit is responsible for economic vitality. The current account deficit is also known as current account imbalance. Developing countries may run a current account deficit in the short term to increase local productivity and exports in the future. But in long run this is a not desirable situation for a domestic economy. Developed countries, such as the United States, often run current account deficits while emerging economies often run current account surpluses. Extremely poor countries tend to run current account deficits.

**Managing a Current Account Deficit:**

A country can manage its current account deficit by the way of increasing the value of its exports relative to the value of imports. A country can place restrictions on imports with application of tariffs or quotas, or it can emphasize policies that promote exports, such as import substitution, industrialization or policies that improve domestic companies' global competitiveness. The country can also apply the tools under monetary policy to improve the domestic currency’s valuation relative to other currencies through devaluation, which reduces the cost of a country’s exports.

**Data analysis and interpretation**

This tables shows the value of different determinants (of 10 years) of current account deficit taken for the current study. The selected variables have direct or indirect impact on current account deficit. Foreign exchange reserves have direct bearing on the value of rupees making exchange rate cheaper or dearer. The exchange rate will make imports and exports increased or decreased. Whenever exports and imports are decreasing or increasing because of foreign exchange rate then it will have direct impact on current account deficit. Other variables taken for the study are exports and imports which are the constituents of current account under balance of payment account. So exports and imports of the country are the direct determinants of current account deficit.



The “current account” of balance of payments comprises the transactions between residents and non-residents in terms of goods, services and incomes. A deficit in current account always reflects in an increase in net financial claims of foreigners (i.e. increase in net capital flows or depletion in foreign exchange reserves). Alternatively, CAB can be derived from national accounts by deducting total expenditure (i.e. sum of consumption (C), investments (I) and government spending (G)) from gross national production (GNP). From this equation, one can derive CAB as the difference between gross national savings (S) and investments (I)[1]. In an open economy, S hardly matches with I, and thus lead to a current account imbalance.

The debate over CAB is not new in academic or policy circles, and dates back to the sixteenth century when mercantilists criticised the drainage of precious metals implied by trade deficits. The debate is still ongoing whether a country should run a deficit or surplus to sustain its external sector balance. Countries such as Australia and New Zealand have been running CADs for decades without any problems, and countries like China have sustained persistent current account surpluses over the past two decades. However, many countries in the past have faced severe crises because of high CADs.

Therefore, the debate on CAD still remains an important issue in policymaking. The views on CAD can be broadly classified as positive or negative. This section documents the perceptions about CAD, and how they have changed from “CAD matters” to “CAD does not matter” and then to “CAD matters sometimes”. The evolution of theories analysing the behaviours of current account ranges from David Hume’s “specie-flow” mechanism, through the “elasticities”, the “monetary”, the “portfolio balance” to the recent “inter-temporal optimising” approach to the balance of payments (Pitchford, 1995).

The initial concerns about CAD are well reflected in the views of mercantilists who emphasised trade surplus. However, the specie-flow mechanism of Hume (1752) shows that attempts to sustain trade surpluses would be defeated because perpetual accumulation of external wealth itself would tend to eliminate trade imbalances in a world without international capital flows. According to him, trade imbalances would be brought to balance by an automatic mechanism implicit in the use of precious metals as an accepted means of settling international obligations.

The current account debate was even prevalent in the 1940s as it could be inferred from the Keynes’ proposal for an international Clearing Union, intended to support countries during times of large payment imbalances and thereby share burdens of adjustment between both deficit and surplus nations (Edwards, 2004). The period following the Second World War analysed the behaviour of current account based on the elasticities approach and the absorption approach. The importance of elasticities in explaining trade balance, popularly known as “elasticities pessimism”, dominated the policy debates of developing countries until the mid-1970s, when most economists focused on whether currency devaluation could improve a country’s external position, including its trade and CABs (Edwards, 2002). On the other hand, the structuralist economists during that time argued that external sector imbalances in developing countries are “structural” in nature and severely constrain their ability to grow, and, therefore need to be addressed by policies ranging from industrialisation to import substitution.

The absorption approach – considering CAB as the difference between national savings and investments – emphasised how macroeconomic factors ultimately determine international borrowing or lending patterns. Until the mid-1970s, much of the emphasis was on trade balance rather than CAD per se. Even the discussions on current account were not intense as CAB was relatively stable and countries were having strong capital controls. The debate over CAD intensified in the late 1970s after a number of countries experienced large swings in their current account due to sharp increase in oil prices, change in exchange rate regimes and with several Latin American countries entering into debt crises. Both the elasticity approach and absorption approach independently failed to explain the large swings in CAB. Of the various theories developed during that period to explain the behaviour of current account, the inter-temporal approach to current account was the most popular.

The inter-temporal dimension of current account analysis extended the absorption approach through its recognition that private saving and investment decisions, and sometimes even government decisions, emanate from life-cycle considerations and depend on expected returns on investment projects. In his influential work, Sachs (1981) argued that to the extent that a CAD is due to rise in investment, there is no cause for concern or policy action. Supporting the views of Sachs, Robisch (1981) argued that there is no reason for Chile to worry even with CAD of more than 14 per cent of GDP to the extent fiscal accounts are under control and savings are rising. In an important paper, Corden (1994) argued that “an increase in the current account deficit that results from a shift in private sector behavior – a rise in investment or a fall in savings – should not be a matter of concern at all”. Policymakers and economists having similar views argued that CAD should not be a matter of concern if it results from a change in private sector behaviour – a rise in investment or a fall in savings.

The view that current account does not matter if it resulted from saving and investment decisions of the private sector, is also popularly known as consenting adults view. This view, also known as Lawson Doctrine and Pitchford thesis, was carried forward by policymakers in their public statements during the late 1980s. In these ways, the debate over CAD changed from “CAD matters” to “CAD does not matter”. However, this “consenting adults view” came under severe criticisms when several countries faced crisis due to the accumulation of huge external debts accompanied by large CADs. Some policymakers during that time criticised this inter-temporal view of current account as it was based on a few unrealistic assumptions such as perfect capital mobility and constant world interest rate. Important flaws were found in this type of approach as many countries with large CADs faced crisis in the 1980s even in the presence of rising investments and a balanced fiscal account (Edwards, 2021)

**Trends, composition and dynamics of CAD in India**

India was considered to be one of the most open economies in the world during the eighteenth century. In the nineteenth century, after becoming an agricultural exporter, it still managed a trade surplus (Desai, 2003). During the colonial rule, India’s external sector deteriorated but the country still remained one of the top 10 exporting countries in the world. According to the data compiled by Banerji (1961), India ran current account surplus in seven years during 1921–1938. However, it experienced a decline in its share of merchandise exports in the world trade from about 2.5 per cent in 1949–1950 to a mere 0.5 per cent by the late 1980s (Singh, 2009). This decline and glitches in macroeconomic policies followed during that period landed India in an external payment crisis. Indian economic policy witnessed a marked shift thereafter with massive liberalisation measures to promote trade, capital flows and, ultimately, economic growth.

**3.1 External sector policies**

In the period following its independence, India remained insulated from the world trading system pursuing an inward-looking development strategy to achieve economic self-sufficiency. This goal displayed itself in a trade system characterised by strictly controlled imports through various exchange controls and quantitative trade restrictions, which were accompanied by a complex tariff structure with high and differentiated rates across industries (Joshi and Little, 1994). Given the apparent share of primary exports in the export basket and the hostile international environment for primary commodities, export pessimism gained ground in the post-independence period until the second Five-Year Plan (1956–1960) (Kapur, 1997). In contrast to the pessimistic and indifferent approach during the 1950s, export promotion received major attention in the 1960s, resulting in improved export earnings, albeit at a slower pace. Fall in invisibles surplus in 121 Explaining India’s CAD conjunction with high trade deficit led by rising import demand kept the CAD high during the third Plan (1960–1965). During these first three Plan periods, the CAD was financed through foreign aid and by depleting foreign exchange reserves.

The border wars with China and Pakistan and two disastrous droughts in succession also contributed to the high CAD until 1967–1968 due to defence- and food-related imports. Thereafter, the current account problem was less acute until the end of the 1970s led by higher export growth in conjunction with improvement in invisibles. Despite a comfortable balance of payment position, the oil shocks in 1973–1974 caused the policymakers to worry about imports and overall current account. The share of crude oil and petroleum products in India’s import bill jumped from 11 per cent in 1972–1973 to 26 per cent in 1974–1975 and the import bill on account of fertiliser also increased by a substantial amount (Nayyar, 1982). India had recourse to various IMF facilities in 1974–1975 to finance its CAD. During the mid-1960s through the end-1970s, India adopted several steps to promote exports, including a 36.5 per cent devaluation of rupee on June 6, 1966, and recognised invisibles as a source of foreign exchange by paying attention to the development of shipping and tourism and preventing leakages of remittances through unofficial channels.

A recognition of shortcomings in earlier policies attached to inefficiencies in import substitution and export pessimism resulted in setting up of a number of committees by the Government of India to make changes in existing policies. However, the recommendations of those committees were mostly unimplemented until the late 1980s. Steps were taken in the late 1980s to ease industrial and import licensing, replace quantitative restrictions with tariff barriers and simplify the tariff structure, which were still less comprehensive and left a lot to be desired (Rangarajan and Mishra, 2013).

The 1980s witnessed a gradual deterioration of current account position and a profound change in its financing reflecting the effect of second oil shock in 1979–1980, deterioration in export growth, significant legal restrictions, large public spending, heavy dependence on official capital flows and debt flows, a fixed exchange rate system coupled with fall in remittances inflows. As a result, India entered into a balance of payment crisis in 1990. Thereafter, a number of measures were undertaken to liberalise India’s external sector include removal of quantitative restrictions and reduction of tariff rates, reduction of capital controls and adoption of a market determined exchange rate system. Gradually, all the restrictions in current account were lifted and most of the restrictions in the capital account were removed. Among the various liberalisation measures undertaken, India has a strong preference for non-debt-creating flows, long-term and stable capital flows such as FDI.

**3.2 Trends and composition of CAD**

Until recently, the concerns about CAD are dominated by India’s foreign trade and swayed its policies and practices. India’s export basket is dominated by manufactured goods, particularly, low-value engineering products, and gems and jewellery. Although manufacturing goods remained as a major component in India’s total exports, its share in world manufacturing exports is still low at 1.6 per cent in 2012 mainly because of low value and mostly semi-skilled nature of these products. The shares of agricultural products, textiles and textile products and handicrafts in total exports have declined while the share of petroleum products are rising (the share in world’s total fuel exports is still low at 1.6 per cent). The share of India’s exports in the world, which had reduced gradually from 2.2 per cent in 1948 to about 0.5 per cent in the mid-1980s, increased to 1.6 per cent in 2012.

Therefore, India’s export performance cannot be considered as phenomenal. On the other hand, the share of petroleum and crude products and gold imports in India’s import basket are rising. While petroleum is an important input in different production processes and transportation, gold is argued to be used as a hedge against inflation by Indian households. More than used as a hedge item, gold is used for making 122 JABES 26,1 jewellery, which is unproductive. Realising this and in a view of a swelling CAD, the Reserve Bank of India (RBI) and the Government of India have imposed various restrictions on gold imports. The measures include a ban on gold selling by banks, a phased increase in gold import duty from 2 to 10 per cent, a ban on imports of coins and medallions, and the requirement for 20 per cent of gold imports being used for export purposes. These steps helped curtail gold imports in 2013 and the overall CAD as well. Given a high demand for gold in India and the alleged smuggling of the yellow metal recently after the imposition of restrictions, authorities will likely be forced to withdraw these restrictions in the long run once the current account returns to a comfortable zone. India being the sixth largest economy in the world, witnessed the highest spike in fuel import growth (up 18 per cent) followed by China (up 14 per cent) in 2012.

While the import growth exhibited some deceleration due to gold imports and a slowdown in domestic demand, the import demand is expected to increase in future with a potential revival of the economy and given the demographic structure of the Indian economy. Over past six decades, merchandised trade deficit has been the leading factor behind India’s CAD. Without any exception, India had deficits in merchandised trade account in all years, much of which was offset by surplus in invisibles, particularly, services and remittances. It may also be noted that India’s invisibles account exhibited a negative balance during 1969–1970 through 1972–1973 and in the year of 1990–1991. India faced external payment crisis in 1991 essentially due to a negative invisibles balance led by sharp increase in investment income payments (debt servicing) and reduction in remittances receipts (Table I). Since 2004, India has experienced a significant increase in merchandised trade deficit led by a significant increase in imports (particularly oil imports) as compared to exports.

Recently, gold imports have contributed significantly to the rise of trade deficit and thereby the widening of CAD. Much of the trade deficit is being financed by services receipts and stable remittances inflows. However, CAD has widened recently due to deceleration in export growth, strong growth in oil and gold imports and rise in investment income payments coupled with a slowdown in investment income receipts. As a result, CAD to GDP ratio rose from an average of 1.7 per cent in 2006–2010 to 3.4 per cent during 2008–2012, reaching its historical peak of 4.8 per cent in 2012–2013. One of the reasons for the persistent CAD is CAD itself as large payments towards servicing international liabilities keep the investment income account balance in the negative zone. Therefore, prolonged deficits in current account of any country are problematic as they either put pressure on reserves or increase debt servicing burden. A long-term view of the current account requires an understanding of the structural features of the economy, such as levels of economic development, demographic profiles and patterns of consumption and production.

These factors have a role in determining the savings and investments, hence, the CAB. In the post-global crisis period, both saving and investment rates have dropped; however, a higher fall in the saving rate as compared with the investment rate has resulted in the greater CAD. thereafter. It is also important to note that private sector deficit reduced during the post-crisis period, mainly due to a slowdown in corporate investments Household saving rates have decelerated since 2009-10 mainly reflecting high inflation, contributing to the widening of S–I gap. Therefore, the recent widening of CAD, despite a fall in private investments, is not necessarily because of rise in investments but due to fall in savings. Although, the large S–I gap for earlier years were fed by a rise in investments and therefore were of lesser concern, the continuation of the recent S–I gap on account of fall in savings rate presents a major risk to the sustainability of CADs.

**Econometric results on sustainability issues**

In the Indian context, few studies attempted to examine the sustainability issues. using an inter-temporal model found that CAB of India was inter-temporally insolvent during the pre-reforms period but has turned solvent during the post-reform period. According to them, this result is a reflection of significant liberalisation of capital account which helped in smoothening of private consumption. Goyal (2012) estimated the medium-term sustainable level of CAD for India is in the range of 2.4–2.8 per cent of GDP based on Domar’s debt sustainability model. According to the International Monetary Fund’s (IMF, 2013) external sustainability approach, the estimated threshold is marginally lower at 2.3 per cent of GDP. Holmes et al. (2011) employing a range of parametric and nonparametric tests for cointegration between exports and imports and a set of unit root tests for CAB, for the period of 1950–2003, found favourable evidence for India’s current account sustainability since the late 1990s.

Using a similar approach, Tiwari (2012) also concluded that CAD is sustainable as both non-oil exports and imports are strongly co-integrated. In this study, sustainability of India’s current account is examined using different econometrics techniques as discussed in literature. A mean-reverting or stationary CAB is considered as sustainable. This is because a sustainable current account needs to be solvent. The present discount value of a country’s future trade surplus must be equal to the present value of its foreign debt to make it inter-temporally solvent (Milesi-Ferretti and Razin, 1996). This inter-temporal solvency condition implies that all debts will be repaid in the long run, which has been examined empirically extensively through unit root and cointegration tests (e.g. Hakkio and Rush, 1991; Husted, 1992; Sawada, 1994; Wu and et al., 1996; Bodman, 1997; Fountas and Wu, 1999; Leachman and Francis, 2000; Apergis et al. 2000; Arize, 2002; Matsubayashi, 2005; Baharumshah, et al., 2005; Wei, 2011). Furthermore, the modern inter-temporal approach combines the assumptions of perfect capital mobility and consumption-smoothing behaviour (Dülger and Ozdemir, 2005).

This emphasises that the current account series should be stationary to be sustainable. Four unit root tests, namely, Elliott–Rothenberg–Stock DF-GLS test (DF–GLS), augmented Dickey–Fuller test (ADF), Phillip–Perron test (PP) and Kwiatkowski–Phillips–Schmidt–Shin test (KPSS), are used to examine the stationarity of India’s CAB to GDP ratio (CAB). These tests are also used to examine the stationary property of data used in other empirical exercises. The data on CAB, exports, imports, deposit rate, consumer price index (CPI) for industrial workers, real GDP, real effective exchange rate (REER), gross fiscal deficit and GDP at current market price are collected from RBI’s Handbook of Statistics on the Indian Economy; age dependency, i.e. the ratio of dependents – people younger than 15 or older than 64 years – to the total working-age population in the ages of 15–64 years (DEP) is taken from World Bank’s online database; and world real GDP, unit value index (UVI) of exports and imports data are taken from International Financial Statistics of the IMF.

Terms of trade (TOT) is calculated as the ratio of UVI of exports to UVI of imports multiplied with 100. For empirical exercise, CPI inflation (INF), growth in age dependency (ΔDEP), growth in TOT (ΔTOT) and ratio of India’s GDP growth to world GDP growth (RGDP) are considered. Trade openness (TOP) is defined as the sum of exports and imports of goods and services as a percentage of GDP. Gross fiscal deficit (GFD) is expressed as a percentage of GDP. Real deposit rate (RD) is calculated taking the difference between deposit rate and CPI inflation. The sample period is 1980 to 2012 except for cointegration test where the sample starts from 1950. Overall unit root test results are presented in Table V. From the results, it can be said that CAB, RD, INF, RGDP and GFD are stationary at levels whereas other variables those are non-stationary at levels but stationary at first differences by at least one of the test criteria. The CAB is found to be stationary at levels by all test criteria suggesting that India’s current account is mean-reverting. This indicates at first insight about India’s CAD, which is not unsustainable

In its latest ‘Monthly Economic Review’, the Ministry of Finance has painted an overall optimistic picture of the state of the domestic economy. “The World is looking at a distinct possibility of widespread stagflation. India, however, is at low risk of stagflation, owing to its prudent stabilization policies,” it states.

The economic growth outlook is likely to be affected by several factors owing to the trade disruptions, export bans and the resulting surge in global commodity prices —all of which will continue to stoke inflation — as long as the Russia-Ukraine conflict persists and global supply chains remain unrepaired. “However, the momentum of economic activities sustained in the first two months of the current financial year augurs well for India continuing to be the quickest growing economy among major countries in 2022-23,” states the Finance Ministry report.

The report states that “as government revenues take a hit following cuts in excise duties on diesel and petrol, an upside risk to the budgeted level of gross fiscal deficithas emerged”.

The fiscal deficit is essentially the amount of money that the government has to borrow in any year to fill the gap between its expenditures and revenues. Higher levels of fiscal deficit typically imply the government eats into the pool of investible funds in the market which could have been used by the private sector for its own investment needs. At a time when the government is trying its best to kick-start and sustain a private sector investment cycle, borrowing more than what it budgeted will be counter-productive.

The report underscores the need to trim revenue expenditure (or the money government spends just to meet its daily needs). “Rationalizing non-capex expenditure has thus become critical, not only for protecting growth supportive capex but also for avoiding fiscal slippages,” it states. “Capex” or capital expenditure essentially refers to money spent towards creating productive assets such as roads, buildings, ports etc. Capex has a much bigger multiplier effect on the overall GDP growth than revenue expenditure.

The current account essentially refers to two specific sub-parts:

\* Import and Export of goods — this is the “trade account”.

\* Import and export of services — this is called the “invisibles account”.

If a country imports more goods (everything from cars to phones to machinery to food grains etc) than it exports, it is said to have a trade account deficit. A deficit implies that more money is going out of the country than coming in via the trade of physical goods. Similarly, the same country could be earning a surplus on the invisibles account — that is, it could be exporting more services than importing.

n 1991, the government was compelled to airlift its national gold reserves to the IMF and World Bank in exchange for a loan to cover the balance of payment dues, as imports burgeoned due to the ongoing Gulf War, leaving India with a budget deficit and trade deficit at the same time. This formed a twin deficit. Rating agencies like Moody degraded India’s credit rating, and the value of the rupee depreciated sharply, which ultimately spurred the liberalisation move.

The pair of deficits has had a significant effect on the Indian economy. Because of the budget deficit, the government is restricted in its spending on development projects like infrastructure and manufacturing, which in turn leaves the supply side more brittle. As a percentage of GDP, India’s budget deficit, vis-à-vis those of other Asian countries such as Thailand, Bangladesh and Indonesia, is very high. Both inflation and trade deficit can increase because of the huge budget deficit, impeding macro- and microeconomic management.

India’s budget deficit stood at 5.07 per cent of GDP in February 2020, and is expected to shoot up to 6.2 per cent of GDP in FY21, according to a Fitch Ratings report. This is a worrying factor for the government, which needs to meet its fiscal deficit target of 3.8 per cent of GDP in FY20.

To address the budget deficit, the government has issued bonds, with public sector banks playing a significant role.

**Trade deficit challenge**

The trade deficit is the largest component of the current account deficit (CAD). It’s evident from the numbers that India is one of the developing nations that are highly dependent on foreign investments. In 2013, Morgan Stanley, one of the major global financial institutions, coined the term ‘Fragile Five’ for India, Turkey, Brazil, South Africa and Indonesia, which are highly dependent on FDI. The list, however, was revised in 2016 and India was moved out of it, thanks to significant improvement in CAD, inflation and reserves.

One factor India must focus on in the present situation is crude oil prices and imports of the same. India is a net crude oil importer — it is highly dependent on other nations for oil, and the demand has always been inelastic. Macroeconomic stability factors like CAD are highly influenced by the movement in crude oil prices. A rise in crude price leads to a rise in CAD.

As per a survey by a financial institution, with an average rise in crude oil price by $10/barrel globally, India’s CAD widens by $15 billion, which is around 0.5 per cent of GDP.

Also, if the domestic fuel prices remain unchanged, the same situation widens the budget deficit by $3 billion, which is 0.1 per cent of GDP.

Though India is progressing well in handling CAD as well as trade deficit, at the end of the day, with a negative CAD, India needs to maintain the balance of payments with its net capital inflow, which means it should focus more on FDIs rather than FPIs as a stable source of income.

Amid the pandemic, as many leading economies are on the verge of a recession, India must work to overcome the twin deficit issue. In order to do that, the government should focus more on attracting more FDI, create a better environment for businesses, relax some regulations, and build the necessary infrastructure.

**CONCLUSION**

India’s CAD has widened in last few years mainly because of the rise in gold and oil imports, and increase in investment income payments in conjunction with fall in investment income receipts, despite a large comfort provided by services sector and private remittances. Given large demand in India, it is difficult to control import growth. However, policy makers should focus on achieving phenomenal export growth so that a sustainable current account is maintained. With rising working-age and skilled population, India could focus more on high-value product exports rather than low-value manufactured items.

On the structural side, the widening CAD is contributed to a large extent by fall in household financial savings despite a fall in corporate investments, which raises concerns. Further investigation suggests that slowdown in household savings has been mainly led by acceleration in inflation. India has been financing its CAD through capital inflows and the composition of capital inflows has changed during previous few years. In particular, currently a large portion of CAD is financed through short-term volatile capital flows. The rising short-term debt mainly due to high CAD is a risk to India’s external sector. Granger non-causality test result suggests that capital inflows in the post-liberalisation period are driving CADs rather than the causality running from the opposite side.

The empirical results using unit root tests and Johansen cointegration test provide the evidence of sustainability of India’s CAD in the long run. Results from econometric analysis revealed that India’s current account is driven by fiscal deficit, term of trade, inflation, real deposit rate and age dependency factor. The results suggest that one of the important factors contributing to large CADs over the years from the structural side is fiscal deficit. Therefore, it is important to correct fiscal deficits to keep CAB at a sustainable level.

In the era of globalisation, the countries have both opportunities and threats in going global. The international trade among nations can bring trade deficit for a particular country. Export and import are the two substantial factors for trade inequities. The adverse gap between exports and imports of a country generates trade deficit. Trade deficit is directly related to current account deficit of a country.

Due to factors like exchange rate volatility, currency devaluation, economic disequilibrium, global crisis the current account deficit gets wider. The study explains different elements of current account deficit. The study also explains that in order to reduce the deficit in the current account, earnings from invisibles trade should be further increased as the trends of the invisibles trade indicate huge improvement, particularly in services and transfers, throughout the study period.

The study found adverse relationship between exchange rate and current account in the long run. It implies that despite the reduction of Indian exchange rate, its exports are not taking advantage in the market, indicating misalignment of exchange rate. Thus, in order to mitigate this misalignment, competitiveness of exports is certainly required.