Basic Information:

Countries trade with one another to buy goods not produced in domestic economy. With the advent of globalization, investment to and fro have also increased many fold. A countryâ€™s trade and other economic exchanges with the world are recorded on its external account in the form of balance of payment (BoP) transactions.

There are two components of BoP

Current Account

Capital Account

Current Account â€“ It deals with current, ongoing, short term transactions like trade in goods, services (invisible) etc. It reflects the nationâ€™s net income. For instance, if you a buy a laptop from US, it will be a current account transaction and it will be debit on current account as you have to pay to US. There are 4 components of Current Account-

Goods â€“ trade in goods

Services (invisible) â€“ trade in services eg. tourism

Income â€“ investment income

Current unilateral transfers â€“ donations, gifts, grants, remittances Note that grants might appear as component of capital account but are included in current account as they are unilateral, create no liability. Recipient does not have to give anything back in return.

Capital Account â€“ It deal with capital transactions i.e. those transactions which create assets or liabilities. It reflects the net changes in the ownership of national assets.

For instance, if you buy a stocks or property in US, it will be a capital account transaction and it will be debit on capital account as you have to pay to US to buy the asset.

Components of Capital Account

Foreign Direct Investment (FDI)

Foreign Portfolio Investment (FPI)

External Borrowings such as ECB

Reserve Account with the Central Bank

Note here that foreign investment is under capital account but dividends and income from investment comes under current account in the category income from abroad as dividend is transferred periodically, does not result in creation of asset or liability.

Balance of Payment (BoP) = Current Account + Capital Account = 0

Why?

Current Account and Capital Account always balance each other because a country always has to pay for its imports. It does so by exports or other two components of current account. If it cannot, it runs deficit on current account and has to pay off by drawing off on its assets i.e. running capital account surplus.

What is Current Account Deficit?

Itâ€™s simply deficit on all 4 components of current account.

(Export â€“ Import) + Net income from abroad + Net Transfers

(Export â€“ Import) is trade deficit

CAD = Trade Deficit + Net Income From Abroad + Net transfers

Note that Trade Deficit and CAD are not one and the same. Trade deficit is only a component of CAD.

What does deficit on Current Account imply?

If we forget income and transfers for a moment, what it means is that we import more than what we export.

How do we pay for that extra import?

Either we get more foreign investment (FDI & FII) and pay via that or we borrow from foreign banks (ECB) or we will have to dip into our external reserves to pay for that amount and in the process our forex reserves come down. When forex reserves come down below a critical level, country appears on the brink of BoP crisis.

So, is CAD such a bad thing?

Depends on what you do with those extra imports and how you finance the deficit!

CAD is bad because â€“

If a CAD is financed through borrowing, it is unsustainable because borrowing lead to high interest payments in the future.

Attracting capital flows (hot money, FII) to finance the deficit is risky as when confidence falls, hot money flows dry up, leading to a rapid devaluation and crisis of confidence. Eg. East Asian Crisis.

Run a CAD necessarily means running a surplus on the capital account. This means foreigners have an increasing claim on your assets, which they could redeem any time.

However a current account deficit is not necessarily harmful

CAD during a period of inward investment particularly stable long term FDI may not be a bad things as investment can create jobs. Investments will lead to higher growth will be able to pay debts back.

Developing countries may use CAD to buy Capital goods and later export consumer goods and thus repay the debt.

Moderate current account deficit (2% of GDP) financed mainly by stable foreign investments which creates jobs and infrastructure in the economy can be helpful in the long run as it improves productivity.

What is this twin deficit?

Current Account Deficit and Fiscal Deficit together are knows as twin deficits and often both reinforce each other i.e. High fiscal deficit leads to higher CAD and vice versa.