How Can We Tackle The Current Account Deficit

EPGP-203 Economic Environment | Macroeconomics | 30-May-2021

Introduction

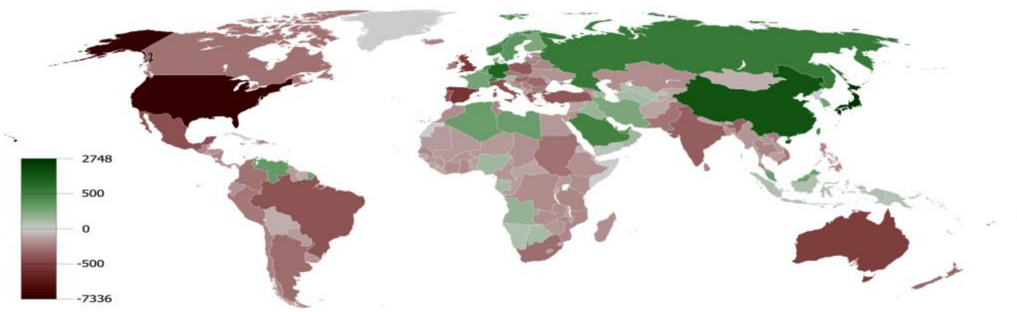
Current account deficit is measured primarily through balance of trade. CAD is measurement of a country's trade where the value of the imports (of goods, services) exceeds the value of the exports. Simply put:

Current account deficit indicates that a country is spending more on purchasing foreign goods, than earning from the sale of its domestic goods.

While running in debts, theoretically, is not a positive indication of bank balances; however, in macroeconomic terms, running an account deficit is not always a detrimental situation for a country. It could actually mean that the country could be using external debt for financing investments essential for the growth of the country's economy in the long term.

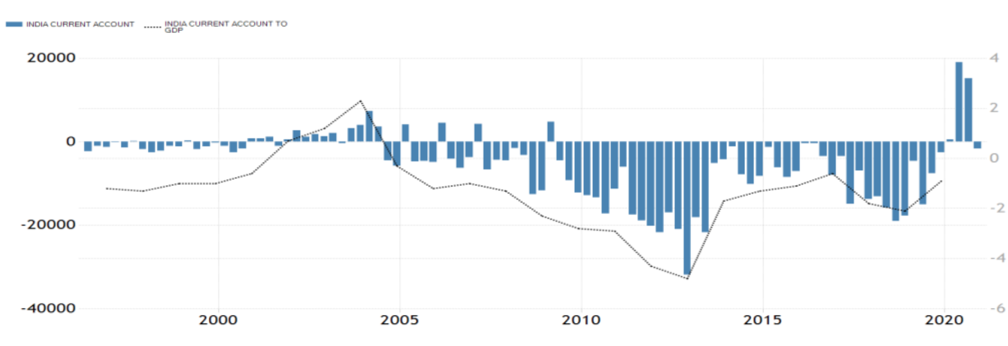
India, being a developing and emerging market economy, typically runs a deficit on current account to supplement domestic savings with foreign savings to fund higher investment. The current account deficit is usually financed by a capital account surplus to maintain BOP.

CAD being harmful or not really depends on the country in question as we can see developed economies like China and Russia are having surplus while on other hand U.S has a huge deficit.



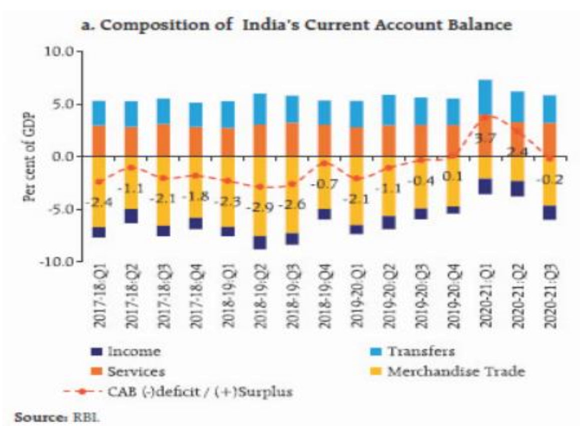
CAD as % of GDP is a key measure. A deficit of over 5% would be cause for greater concern. So, **India needs manageable current account deficit, not a surplus.**

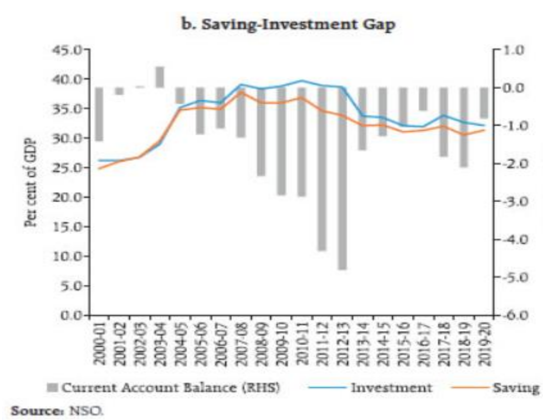
"According to C. Rangarajan, a CAD of 1.6% of GDP is at a sustainable level. However, growing degree of integration of the Indian economy with global economy would imply variability in the size of the CAD and hence, S.S Tarapore, in 1997, recommended a CAD of 2% of GDP as sustainable level. This level was further increased to 3% of GDP by him in 2006 while working with the Committee on Fuller Capital Account Convertibility."



India’s current account in Q3 2021 returned to deficit after two quarters, caused by a rise in merchandise trade deficit. The nation’s current account recorded a deficit of $1.7 billion in the Q3 against a surplus of $15.1 billion in Q2, according to the BOP data published by RBI (Table in Appendix).

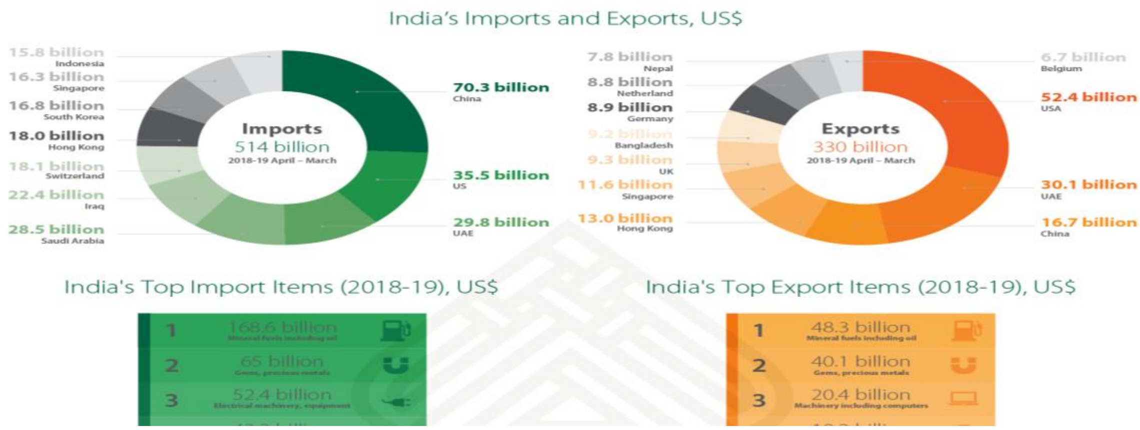
- The shift to deficit was primarily due to a merchandise trade deficit that reached $34.5 billion, up from $14.8 billion in Q2
- Foreign exchange reserves totaled $32.5 billion, up from $31.6 billion in Q2
- Worker remittances fell 7.2% in Q3 on a year-over-year basis, compared with 15.78% in Q2
- Net FDI recorded inflow of $17 billion as against outflow of $24.6 billion in Q2
- Net foreign portfolio investment increased to $21.2 billion compared to $7 billion in Q2
- External commercial borrowings contributed to a net outflow of $1.7 billion over an outflow of $4.1 billion in Q2





India’s primary reason of CAD is because of heavy dependence on foreign markets for the needs of our citizens.

- **Merchandise trade deficit -** Exports are less than imports
- **High import of crude Oil -** Oil imports constitute a third of India’s imports and half of its CAD
- **High import of gold -** People investing in gold to hedge their risk against price rise.



It is practically impossible for in current economic situation to be completely dependent on its domestic produce and earn an income via exports. India is dependent on imports for some or the other needs, which could be due to unavailability of resources, geographical demographics, availability of manpower or technical expertise. Thus, trade is inevitable between countries. It is essential for us to understand how much trade is healthy for India's economy. Imports and foreign debt help countries build domestic capacities, exports directly add to the country's coffers and push the Gross Domestic Product (GDP).

Additionally, understanding current accounts is also essential to gain insights into the performance of an economy. For instance, CAD tend to increase when the country's economy is flourishing because consumer spending increases and more expenditure being done on imported products. While during recession, CAD tend to dip, due to a decrease in imports amid reduced consumption.

In this report, we will discuss the issues which can happen if India do not maintain a sustainable level of CAD and recommendations to maintain the sustainable level of CAD.

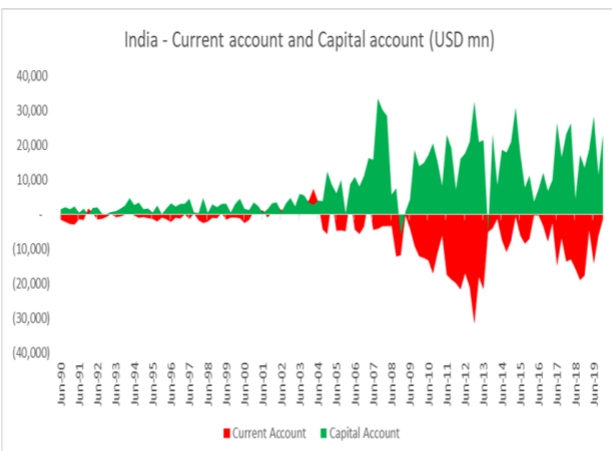
Implications of Not Maintaining Sustainable Level of CAD

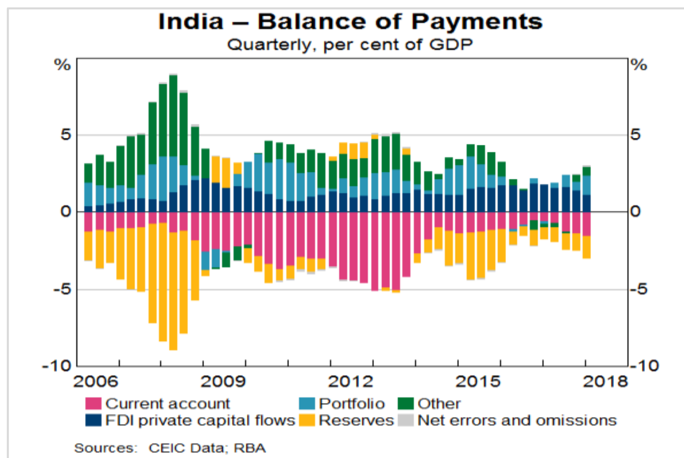
CAD becomes harmful for Indian economy and its GDP, if not maintained at sustainable level and could pose a great concern at multiple fronts:

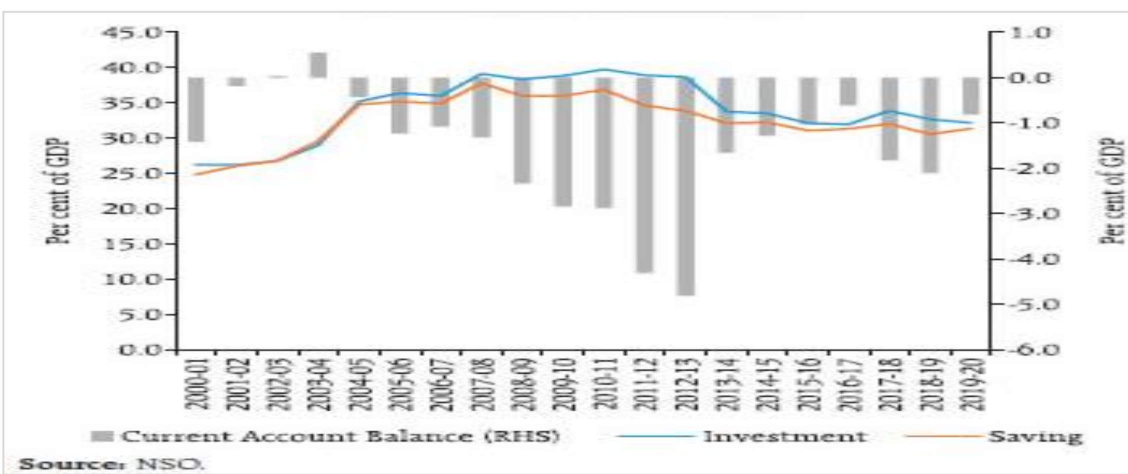
<u>Depletion of foreign reserves:</u>

India use these reserves to keep a fixed exchange rate, maintain exports price competitive, have liquidity in crisis, and to give confidence to investors.

- CAD means net outflow of foreign capital i.e. $ outflow from India for high imports.
- Without equal or more amount of $ inflow, a deficit puts strain on India's foreign reserves to fund the imports.
- In deficit, India will depend on external savers to fund part of domestic investment expenditure.



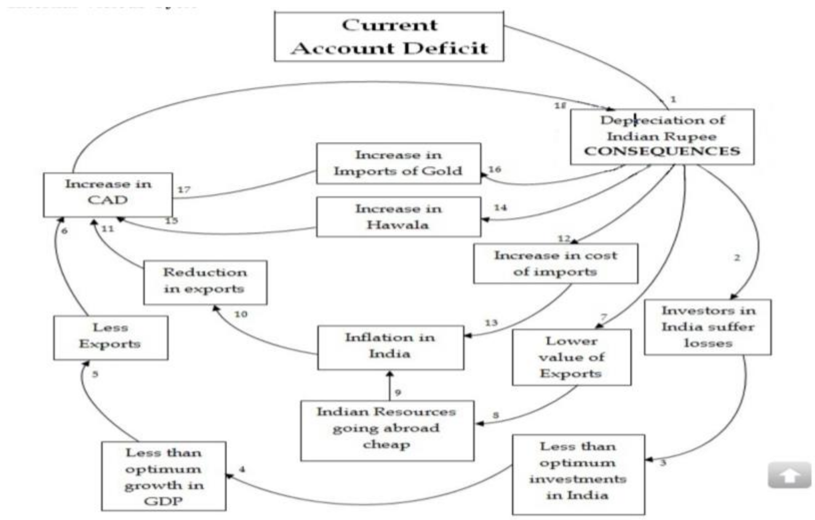




Depreciation of Indian Rupee:

In high CAD, we buy fewer foreign currency or foreigners buy more rupees due to imports. This cause rupee to depreciate and triggers an internal vicious cycle which has consequences

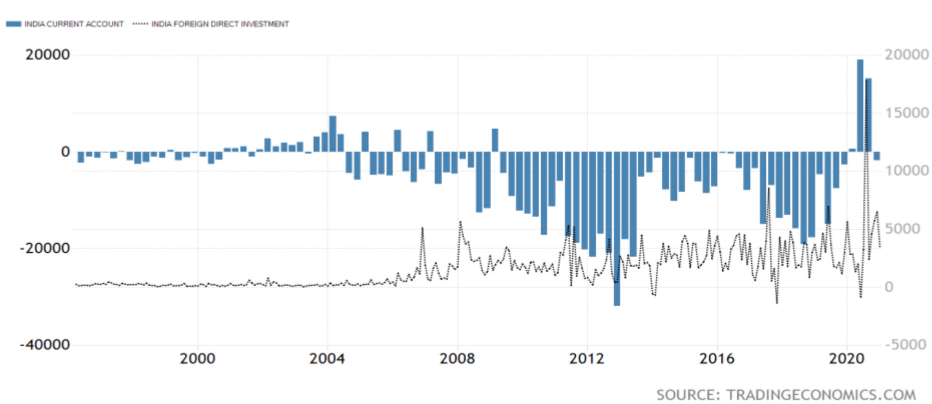
- Interest income of investors will be less and in turn they will suffer losses which in turn will lower the investment in form of FDI and FII.
- It will lead to rise in inflation.
- Imports will be expensive and country will be spending more on essential import commodities like oil etc.



Low Investments:

India, typically runs a deficit on the current account to supplement domestic savings with foreign savings to fund higher investment. If CAD becomes more than sustainable levels then

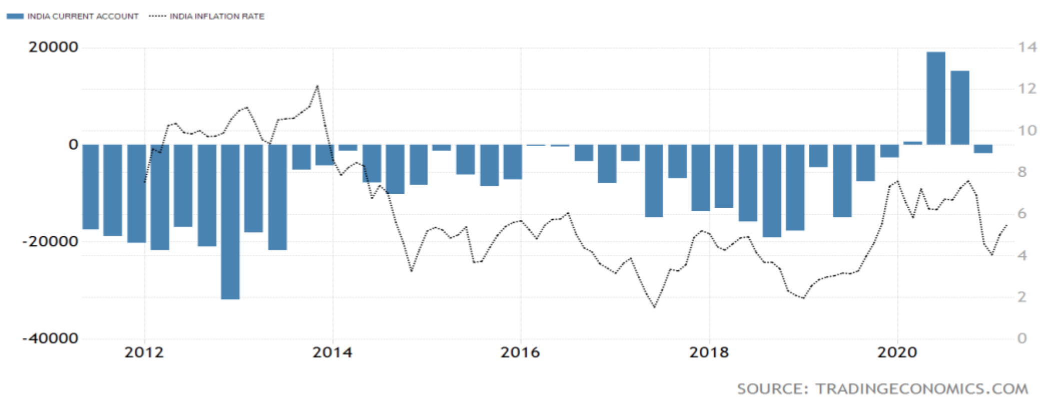
- It led to decline in India's credit rating, directly affecting FDI and FII i.e. low investment
- India needs the foreign inflows to keep its foreign reserves in check and to maintain BOP.



Rise in Inflation:

High inflation affects country's economy and GDP. CAD fuels the inflation. Thus, we need to maintain CAD at sustainable level.

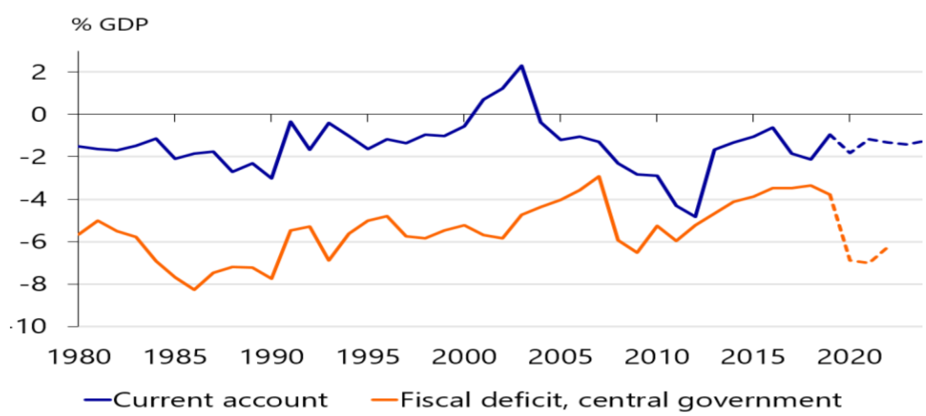
- With depreciation of rupee, value of exports will be lower, Indian resources will be bought at lower prices and Indian income will increase, which in turn will increase the consumption and thus aggregate expenditure, causing a rise in inflation.
- Imports will become expensive and will be spending more on essential import commodities like oil etc. which in turn will put economy in supply shock. Thus, increasing price level and to counter this effect Government will increase AD, which will further increase price levels.



Twin Deficit:

CAD and government budget deficit at the same time.

- High CAD will leave government with less investment and thus budget deficit, results in restriction on spending on development projects like infrastructure etc., which in turn leaves the supply shock and thus increase price level.



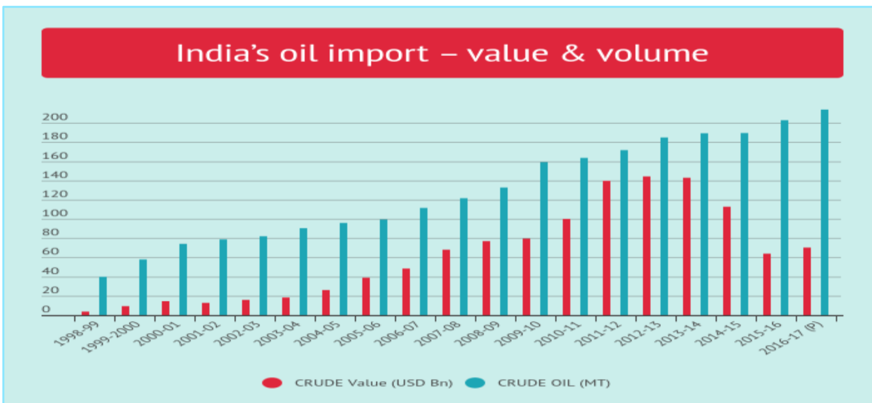
Recommendation For Maintaining Sustainable Level of CAD

After careful study of various indicators of economy, reasons for CAD and its impact on India's economy, Our recommendations is to maintain sustainable level of CAD.

Reduce Oil Imports:

Fluctuating price of oil in international market poses a threat of twin deficit and supply shock. India has already taken initiatives to promote alternate fuel. To reduce oil imports further, government should:

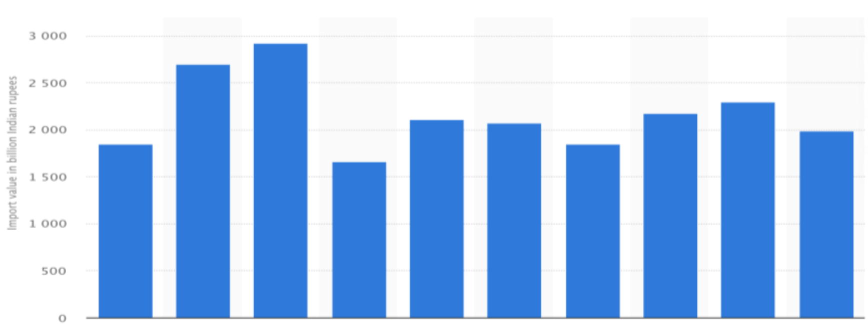
- Bring incremental pricing for large consumers, so that they opt for alternate fuel.
- Remove all subsidies slowly in order to make consumer think of using alternate fuel.
- Bring strong and effective policy on alternate fuel.



Reduce Gold Imports:

India took initiatives like gold monetization scheme, promotion of national savings etc. To reduce gold imports further, government should:

- Provide high growth alternate saving schemes.
- Regulate the gold imports through strict custom and border protections.
- Regulate jewelers and traders through strong policies.



Increase Exports:

Export plays a major role in reducing India's CAD. India introduced policies in recent past like "The Foreign Trade Policy (2015-2020) and (2021-2026)", "Ease of Doing Business 2018/19", Atmanirbhar Bharat and The Export Preparedness Index (EPI) 2020 etc. to boost exports. To further emphasize on exports, government should:

- Focus to enter those lines of production from where China had been weakened due to recent Covid scenarios.
- Bring favorable export promotion policies and create necessary infrastructure for exports.
- Exports diversification and add India to Global value chain.

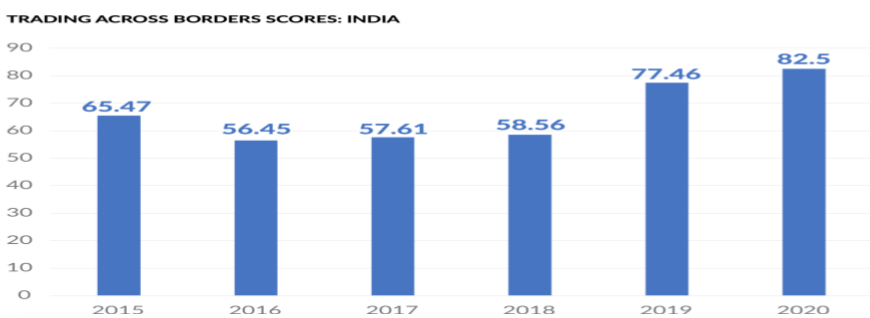
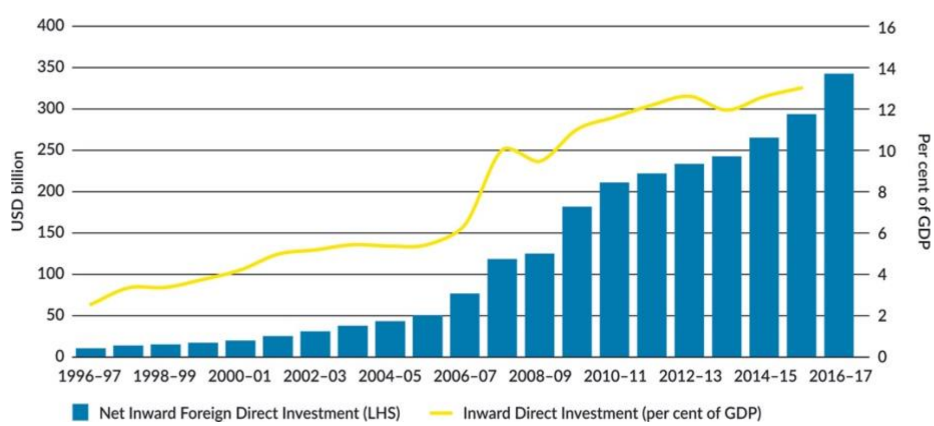


*Figure G: India's perfor-
mance in Trading across
Borders 2015-2020
(Source: World Bank Dat
2015-2020)*

Attract More FDI and FII:

FDI and FII are needed to supplement domestic savings with foreign savings and to fund higher investment. India took steps like "Make in India", opening sectors like defense, retail, insurance etc. for FDI. To further attract more FDI and FII, government should:

- Not only have FDI specific policies but broader economic policies including corporate taxes, business climate, regulatory issues and burdens etc. to make FDI more attractive.
- Structural reforms to bring drastic increase in FDI and FII.



Apart from the recommendations mentioned above, government can use its policies to tackle CAD

Regulate Through Devaluation of Indian Rupee:

It can be use as extreme measure where government can reduce value of currency against foreign currency. It will help maintain CAD but it depends on elasticity of demand for exports and imports. If there is a devaluation of the currency, the price of imported goods increases and therefore the quantity demanded of imports falls.

Regulate Through Monetary Policy:

Government can increase interest rates.

- Increases the cost of debt and loan repayments. Thus, leave people with less money to spend. Therefore, this will reduce their consumption of imports.
- Cause a fall in AD and therefore reduce economic growth. This will reduce inflation and help to make exports more competitive.
- Put pressure on manufacturers to reduce costs, and this will lead to more competitive exports and exports may increase in the long run.
- The issue with this is that it will tend to cause hot money flows and an appreciation in the exchange rate. This appreciation makes exports less competitive, and imports more attractive. Assuming demand is relatively elastic, this appreciation will worsen the current account.

Regulate Through Fiscal Policy:

Government can increase income tax

- Reduce consumer discretionary income and reduce spending on imports.
- Advantage is that it would not have an adverse effect on the exchange rate. Higher tax would also improve government finances.
- This will conflict with other macroeconomic objectives – with lower aggregate demand (AD), growth is likely to fall causing higher unemployment. A government is unlikely to want to risk higher unemployment just to reduce a current account deficit.

Government Protection Measures:

Some measures which government can take from time to time

- Ease the rules for manufacturing industries to increase growth and reduce imports.
- Increase tariffs on imports or even impose quotas. Both these measures would have the impact of reducing imports and therefore improve the current account.
- Mandatory currency hedging for some sectors
- To reduce wages. Lower wages will reduce costs of production and improve competitiveness.

References

During our analysis, we took help from various sources to analyze the issue and also to gather data on latest trends. We used google.com to search images and content.

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Appendix

Project Log:

RBI Data:

India's balance of payments (BOP) for the third quarter (Q3), i.e., Oct-Dec 2020-21

Statement II: Standard Presentation of India's Balance of Payments

(INR Crore)

Item	Apr-Jun 2020 PR			Jul-Sep 2020 PR			Oct-Dec 2020 P			Apr-Dec 2020 P		
	Credit	Debit	Net	Credit	Debit	Net	Credit	Debit	Net	Credit	Debit	Net
A. CURRENT ACCOUNT												
I. MERCHANDISE	**3,97,215**	**4,79,522**	**-82,308**	**5,62,264**	**6,72,449**	**-1,10,186**	**5,69,637**	**8,24,411**	**-2,54,774**	**15,29,115**	**19,76,382**	**-4,47,267**
II. INVISIBLES (a+b+c)	**5,32,039**	**3,05,590**	**2,26,448**	**5,58,702**	**3,36,206**	**2,22,496**	**5,91,612**	**3,49,715**	**2,41,897**	**16,82,353**	**9,91,512**	**6,90,841**
a) Services	3,55,159	1,99,598	1,55,560	3,69,259	2,13,920	1,55,339	3,96,378	2,22,240	1,74,138	11,20,796	6,35,759	4,85,037
i) Travel	14,176	20,984	-6,808	15,903	20,559	-4,657	16,002	20,896	-4,894	46,080	62,439	-16,359
ii) Transportation	36,497	31,992	4,505	39,926	35,397	4,528	41,322	37,963	3,359	1,17,745	1,05,353	12,392
iii) Insurance	4,288	2,872	1,416	4,385	3,994	391	4,238	4,254	-16	12,911	11,120	1,791
iv) G.n.i.e.	1,123	2,504	-1,381	1,074	1,414	-339	1,317	1,918	-601	3,514	5,836	-2,322
v) Miscellaneous	2,99,076	1,41,247	1,57,829	3,07,972	1,52,556	1,55,416	3,33,498	1,57,208	1,76,290	9,40,545	4,51,010	4,89,535
Of which :												
Software Services	1,71,650	14,027	1,57,623	1,84,399	20,598	1,63,801	1,89,459	17,051	1,72,408	5,45,508	51,675	4,93,832
Business Services	85,604	87,365	-1,762	86,464	91,890	-5,426	92,447	94,400	-1,953	2,64,514	2,73,656	-9,141
Financial Services	7,659	8,056	-396	7,462	8,233	-771	7,879	8,793	-914	23,000	25,081	-2,081
Communication Services	5,364	2,309	3,055	4,914	2,638	2,275	5,440	2,809	2,632	15,718	7,756	7,962
b) Transfers	1,38,268	9,477	1,28,792	1,51,896	15,140	1,36,756	1,53,095	11,051	1,42,044	4,43,259	35,668	4,07,592
i) Official	205	2,049	-1,844	269	2,006	-1,737	457	2,199	-1,742	931	6,253	-5,322
ii) Private	1,38,063	7,428	1,30,635	1,51,627	13,134	1,38,492	1,52,638	8,852	1,43,786	4,42,328	29,414	4,12,914
c) Income	38,611	96,515	-57,904	37,547	1,07,146	-69,599	42,139	1,16,425	-74,285	1,18,298	3,20,086	-2,01,788
i) Investment Income	28,265	91,438	-63,174	26,797	1,01,968	-75,171	30,824	1,11,150	-80,326	85,886	3,04,556	-2,18,670
ii) Compensation of Employees	10,347	5,077	5,270	10,750	5,178	5,572	11,315	5,274	6,041	32,412	15,530	16,882
Total Current Account (I+II)	**9,29,253**	**7,85,113**	**1,44,141**	**11,20,966**	**10,08,656**	**1,12,310**	**11,61,249**	**11,74,126**	**-12,877**	**32,11,468**	**29,67,894**	**2,43,573**
B. CAPITAL ACCOUNT												
1. Foreign Investment (a+b)	**5,65,271**	**5,66,475**	**-1,204**	**7,23,754**	**4,88,374**	**2,35,380**	**8,85,030**	**6,03,352**	**2,81,678**	**21,74,055**	**16,58,201**	**5,15,854**
a) Foreign Direct Investment (i+ii)	90,953	97,025	-6,072	2,26,923	43,594	1,83,330	2,09,376	84,190	1,25,186	5,27,252	2,24,809	3,02,443
i. In India	89,859	73,864	15,995	2,19,679	18,223	2,01,456	1,98,458	51,132	1,47,326	5,07,996	1,43,218	3,64,777
Equity	52,352	73,787	-21,435	1,77,009	18,184	1,58,825	1,61,128	51,035	1,10,092	3,90,488	1,43,006	2,47,482
Reinvested Earnings	29,715	0	29,715	30,721	0	30,721	32,436	0	32,436	92,872	0	92,872
Other Capital	7,792	77	7,715	11,949	39	11,910	4,894	96	4,797	24,635	212	24,423
ii. Abroad	1,094	23,162	-22,068	7,245	25,371	-18,126	10,918	33,058	-22,140	19,257	81,591	-62,334
Equity	1,094	9,230	-8,137	7,245	10,017	-2,772	10,918	14,479	-3,561	19,257	33,726	-14,469
Reinvested Earnings	0	6,183	-6,183	0	6,061	-6,061	0	6,010	-6,010	0	18,253	-18,253
Other Capital	0	7,749	-7,749	0	9,293	-9,293	0	12,570	-12,570	0	29,612	-29,612
b) Portfolio Investment	4,74,318	4,69,449	4,869	4,96,831	4,44,780	52,050	6,75,655	5,19,162	1,56,492	16,46,803	14,33,392	2,13,411
In India	4,69,430	4,61,102	8,328	4,94,044	4,36,504	57,540	6,72,784	5,12,712	1,60,072	16,36,258	14,10,318	2,25,940
FIIs	4,69,430	4,61,102	8,328	4,94,044	4,36,504	57,540	6,72,784	5,12,712	1,60,072	16,36,258	14,10,318	2,25,940
of which:												
Equity	4,00,227	3,66,734	33,493	4,09,153	3,58,396	50,757	5,94,234	4,48,009	1,46,225	14,03,614	11,73,139	2,30,475
Debt	69,203	94,368	-25,165	84,891	78,108	6,783	78,550	64,703	13,847	2,32,644	2,37,180	-4,535
ADRs/GDRs	0	0	0	0	0	0	0	0	0	0	0	0
Abroad	4,888	8,347	-3,459	2,786	8,276	-5,490	2,871	6,450	-3,580	10,545	23,074	-12,529
2.Loans (a+b+c)	**1,42,675**	**1,22,098**	**20,578**	**1,53,744**	**1,82,359**	**-28,615**	**1,43,955**	**1,42,748**	**1,207**	**4,40,374**	**4,47,205**	**-6,831**
a) External Assistance	43,572	12,426	31,146	23,866	9,840	14,026	18,933	10,202	8,731	86,371	32,468	53,902
i) By India	71	153	-82	71	153	-82	71	153	-82	213	459	-247
ii) To India	43,501	12,273	31,228	23,795	9,687	14,108	18,862	10,049	8,813	86,158	32,009	54,149
b) Commercial Borrowings(MT&LT)	30,687	39,768	-9,080	65,448	94,575	-29,127	47,922	57,137	-9,214	1,44,058	1,91,479	-47,421
i) By India	3,350	7,612	-4,262	5,722	7,473	-1,751	7,153	3,567	3,586	16,225	18,652	-2,427
ii) To India	27,338	32,156	-4,818	59,726	87,102	-27,376	40,770	53,570	-12,800	1,27,833	1,72,827	-44,994
c) Short Term To India	68,416	69,904	-1,488	64,430	77,945	-13,515	77,100	75,409	1,690	2,09,946	2,23,258	-13,312
i) Buyers' credit & Suppliers' Credit >180 days	68,416	63,825	4,591	64,430	72,671	-8,241	70,350	75,409	-5,059	2,03,196	2,11,905	-8,709
ii) Suppliers' credit up to 180 days	0	6,079	-6,079	0	5,273	-5,273	6,749	0	6,749	6,749	11,353	-4,603
3. Banking Capital (a+b)	**1,34,263**	**1,17,303**	**16,960**	**1,39,558**	**2,23,336**	**-83,778**	**1,55,574**	**2,11,734**	**-56,160**	**4,29,394**	**5,52,373**	**-1,22,978**
a) Commercial Banks	1,34,263	1,11,481	22,782	1,39,459	2,23,336	-83,877	1,52,674	2,11,734	-59,060	4,26,395	5,46,550	-1,20,155
i) Assets	52,131	33,257	18,874	53,611	1,24,564	-70,953	39,708	1,17,071	-77,362	1,45,450	2,74,893	-1,29,442
ii) Liabilities	82,132	78,223	3,908	85,848	98,771	-12,923	1,12,966	94,663	18,303	2,80,945	2,71,657	9,288
of which: Non-Resident Deposits	80,826	58,063	22,763	76,699	62,311	14,387	1,04,375	82,480	21,896	2,61,901	2,02,855	59,046
b) Others	0	5,823	-5,823	99	0	99	2,900	0	2,900	2,999	5,823	-2,824
4. Rupee Debt Service	**0**	**419**	**-419**	**0**	**15**	**-15**	**0**	**0**	**0**	**0**	**434**	**-434**
5. Other Capital	**1,28,424**	**1,54,974**	**-26,549**	**1,23,573**	**1,26,721**	**-3,148**	**1,39,650**	**1,19,208**	**20,442**	**3,91,647**	**4,00,902**	**-9,255**
Total Capital Account (1 to 5)	**9,70,633**	**9,61,268**	**9,365**	**11,40,629**	**10,20,805**	**1,19,824**	**13,24,209**	**10,77,042**	**2,47,167**	**34,35,471**	**30,59,115**	**3,76,356**
C. Errors & Omissions	**0**	**2,923**	**-2,923**	**2,679**	**0**	**2,679**	**5,293**	**0**	**5,293**	**7,973**	**2,923**	**5,049**
D. Overall Balance (A+B+C)	**18,99,886**	**17,49,304**	**1,50,582**	**22,64,274**	**20,29,460**	**2,34,814**	**24,90,751**	**22,51,168**	**2,39,583**	**66,54,911**	**60,29,933**	**6,24,979**
E. Monetary Movements (i+ii)	0	1,50,582	-1,50,582	0	2,34,814	-2,34,814	0	2,39,583	-2,39,583	0	6,24,979	-6,24,979
i) I.M.F.												
ii) Foreign Exchange Reserves	0	1,50,582	-1,50,582	0	2,34,814	-2,34,814	0	2,39,583	-2,39,583	0	6,24,979	-6,24,979
(Increase - / Decrease +)												

P: Preliminary. PR: Partially Revised.