THE CURRENT ACCOUNT DEFICIT IN INDIA-SOME FACTS, IMPLICATIONS AND SUGGESTIONS TO CURTAIL THE DEFICIT

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Abstract:

This article starts with the definition of capital account deficit and attempts to clarify the method of calculating it. It then proceeds to examine how current account deficit arises, while highlighting the past and recent trends. It also spells out the implication of a large current account deficit and tries to provide recommendations for curtailing the deficit.

Key words: Current Account, Deficit, FII (Foreign Institutional Investor), FDI (Foreign Direct investor), Risks

Introduction:

The logical starting point is to define the current account. Current Account is the sum of the balance of trade which is export minus import of goods and services, net factor income such as interest and dividends and net transfer payments such as foreign aid. The most important part of the current account is the balance of trade. A deficit in the current account is therefore associated with a trade deficit. For countries which have substantial overseas assets or liabilities, net factor payments may be significant. Negative net sales to foreign countries generally contribute to a current account deficit as the value interest or dividends generated abroad is lower than the value of interest or dividends generated from foreign capital in the country. For poor and developing countries the net transfer payments form a very important part of the current account. This is because workers' remittances, donations, aids and grants & official assistance may balance high trade deficits

Calculation of the Current Account Deficit:

Balance of Payment is made up of two components- a) Current Account and b) Capital Account.

Let us look at the current account which this article primarily deals with. It is made up of three parts

1. Balance of Trade
2. Earning from Investment
3. Cash Transfers

Balance of Trade

The money which comes in is taken as positive (+) and the money that is going out is taken as negative (-). Let us look at the data for 2010-11, presented in Table 1

Table 1: Balance of trade for 2010-11

Goods and Services	Worth (Million dollars)
Export	+ 299284
Import	- 381061
Total	- 81777

The total is a negative number. Hence India has a trade "deficit" of $ 81777 million for the year 2010-11. Had we got a positive number, we would have said India had a "surplus". But ironically getting a surplus is a far-fetched dream as every year India has to import crude oil and gold worth billions of dollars which upsets the balance. The deficit or surplus between exports and imports is called as the 'net difference'

Earnings on Investment:

Foreigners invest their money in India through FDI and FII. Similarly Indians also invest their money abroad. The investors earn an income in the form of interest rates and dividends. The amount of money that is actually invested is put under capital account while the interest earned is included in the current account. Let us look at an example. An FII makes an investment of $100 on 8% bonds. He earns an interest of $8 at the end of the first year. The $100 is included in the capital account and interest earned is included in the current account.

Cash Transfer:

Cash transfer is the money that is transferred without any exchange of goods or services. The example of a worker in Dubai sending money to his family in Tamilnadu is a case of such a remittance. The money is transferred without exchanging any goods or services. Donations also fall under cash transfers. The remittances were positive in the year 2010-11 at +52140 Million US $.

The question that arises here is why it was positive. This is because many Indians work abroad and send money to their families in India. This remittance is very high that the balance has been made positive. But there are only very few foreigners working in India and sending money back home.

Origin of Capital Account Deficit

As already mentioned, India is a large importer of crude oil and gold. This is the biggest driver of the trade gap. Large fuel subsidy given by the government is a disturbing cause. In addition, Indians have a craze for gold which spurs the government to import more gold. The enormity of the import of crude oil can be seen from the Table: 2 below.

The Table: 2 shows very high import of oil in 2010 after a progressive increase over the years. The imports were at its highest in the year 2008. The import bill leapt by 40% and reached a record high of US $ 140 billion in the year 2011-12. This surge occurred because of the depreciation of the rupee and high rates of crude oil & petroleum products in the international market. Looking at the current trends the oil imports in January were valued at $ 15.89 billion which is higher than the import bill of $ 14.87 billion by 6.91 per cent during the corresponding month of the last year. The total value of oil imports in April-January (10 months) increased to $ 140.42 billion which is higher than $ 125.87 billion in the first 10 months of 2011-12.

We now can look at the value of gold imports and see how it is contributing to a high current account deficit. As can be seen from Table: 3 below, the value of gold imports has been consistently rising. The import of gold as a percent of the total imports increased from 11.0% in 2010-11 to 11.5% in 2011 - 12. It was as high as 8.6% for half year between April and September 2012.

Table: 2- Value of Import of Oil between 2000- 2010

Year	Value of oil imports	Percent Change
2000	**15.11**	**77.18 %**
2001	**13.956**	**-7.64 %**
2002	**16.46**	**17.94 %**
2003	**19.599**	**19.07 %**
2004	**27.281**	**39.20 %**
2005	**39.928**	**46.36 %**
2006	**56.284**	**40.96 %**
2007	**67.564**	**20.04 %**
2008	**90.182**	**33.48 %**
2009	**88.762**	**-1.57 %**
2010	**76.812**	**-13.46 %**

Sources: 1. Office of Coal Controller, Ministry of Coal, 2. Ministry of Petroleum & Natural Gas

Table: 3 - Gold Imports as a Per Cent of Total Import in India between 2000-01 to April –September 2012-13

Year	Total Imports (USD billion)	Gold Imports (USD billion)	Gold Imports as % of Ttl Imports
2000-01	50.5	4.2	8.2
2001-02	51.4	4.2	8.1
2002-03	61.4	3.8	6.3
2003-04	78.1	6.5	8.3
2004-05	111.5	10.5	9.4
2005-06	149.2	10.8	7.3
2006-07	185.7	14.5	7.8
2007-08	251.7	16.6	6.6
2008-09	303.7	21.3	7.0
2009-10	288.4	28.8	10.0
2010-11	369.8	40.7	11.0
2011-12	489.3	56.5	11.5
April - Sep 2012	**234.8**	**20.3**	**8.6**

Source: Ministry of Commerce, Govt of India

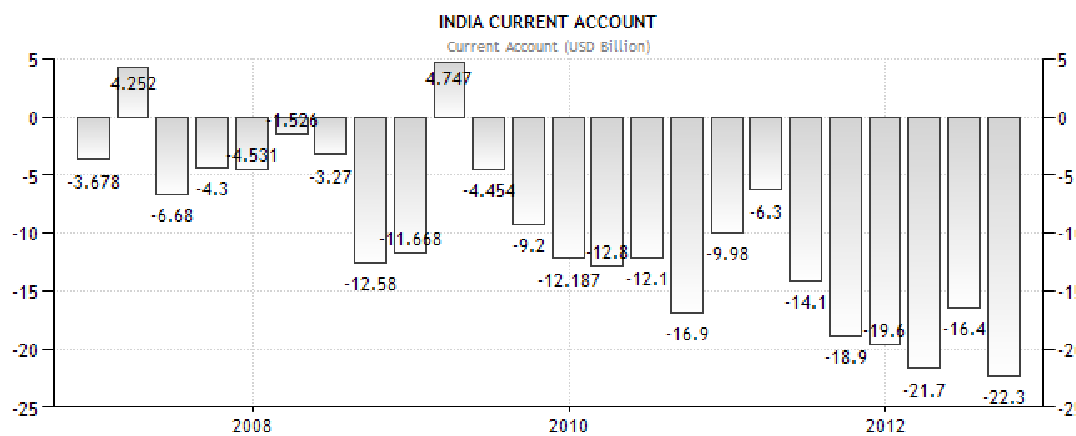
In addition to oil and gold which we examined in detail above, the deficit has also increased by the following direct transfers.

- Wages sent back to a foreigner's home country.
- Government grants made to foreigners.
- Direct investments made abroad by a country's residents.
- Bank loans to foreigners

Past Movements and Recent Trends

From 1949 until 2012, India's Current Account averaged $ -1.32 Billion. It reached an all-time high of $7.36 Billion in March of 2004. It hit a record low of $ -22.30 Billion in September of 2012 The Graph 1 shows the current account deficit between 2008 to 2012.[1]

Graph: I *India's Current Account Deficit 2008- 2012*



Source : www.tradeeconomics.com , Reserve Bank of India

The graph above shows the highest deficits in 2012, the same period where the value of crude imports and gold was also was very high. The Reserve Bank of India (RBI) in 2012 published data to show that India's current account deficit increased to $ 22.3 billion or 5.4% of the GDP in July- September quarter from $16.4 billion in the April-June period in the year 2012. Analysts at that time said that the current account deficit would continue to grow in October and November of 2012.[2]

The following table (Table-4) shows the current account deficit as a per cent of the GDP. The CAD/GDP ratio reached its highest ever peak of 5.4 % of GDP in Q2 of 2012-13. Early indications are that it may increase further in Q3 of 2012-13 as trade deficit worsens, according to the central bank.

India's current account deficit for financial year 2013 is likely to rise to $87.9 billion or 4.7 per cent of GDP as against $ 76 billion or 4 per cent of the Gross Domestic Product estimated earlier, Citigroup said in a research note, "going forward for FY14 we expect the CAD to remain elevated at 4.3 per cent of GDP as exports are more sensitive to global demand rather than the rupee, while oil and gold are likely to keep imports high," [3]

According to the data released by the Ministry of Commerce and Industry, India's trade deficit widened to $20 billion in January 2013. This put pressure on the current account deficit. This gap is the result of weak exports and high imports. After contracting for eight months, the exports increased marginally by 0.82% to $ 25.58 billion in January India's imports was at $ 45.58 billion an increase of 6.12 per cent. This left a trade of $20 Billion.[4]

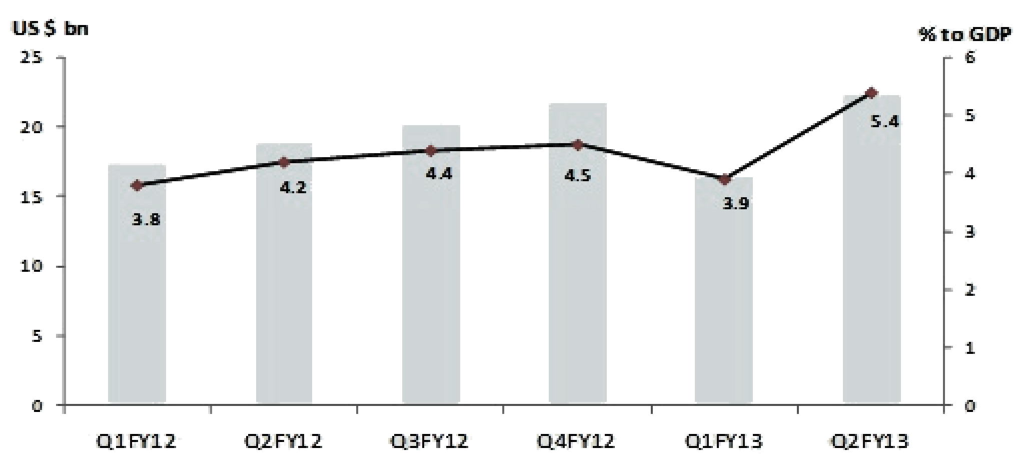
Table: 4 Current Account Deficit as per cent of GDP

Quarter	Year	Value
1	2007-08	2.5
2	2007-08	1.9
3	2007-08	1.7
4	2007-08	0.3
1	2008-09	3.1
2	2008-09	4.4
3	2008-09	4.6
4	2008-09	1.7
1	2009-`10	1.7
2	2009-`10	3.1
3	2009-`10	3.6
4	2009-`10	3.7
1	2011-12	3.9

Source : Reserve Bank of India

The same trend is reiterated by the Graph 2 below.

Graph: 2 Quarterly Movement of CAD-GDP Ratio



Source : Reserve Bank of India

Implications of Current Account Deficit

A large current account deficit, which is fuelled by a trade gap, is the biggest drag on the Indian rupee. The rupee weakened by more than 3% against the dollar in 2012. This was followed by a 16% fall last year.

When a country has a current account deficit, it becomes a 'debtor' to the whole world. It 'owes' foreign exchange to the tune of the deficit. To nullify this debt, the Government, has to attract overseas investors who bring capital to invest in India. This can be in the form of investment in real assets like factories, airports, roads etc. They can also give financial assets like equity, debt, treasury bills, bank deposits etc. The inflows are part of the capital account which complement the current account by financing its deficit. Depending on foreign resources can be extremely dangerous, as the flight of the resources out of the country can ruin the economy's fundamentals. This occurs because of a systemic risk which is brought about by the reversal of capital. If unchecked, the economy can head for another crisis.

The Finance Ministry in January 2013 said that a current account deficit could mean a net outflow of dollars. This can drain the foreign exchange reserves. Thus a country with a current account deficit has to attract capital inflows like FDI. If the capital inflows are insufficient to meet the deficit, the currency starts to depreciate.[5]

Recommendations to Curtail the Deficit

The simplest solution to a high current account deficit is to increase exports and reduce imports. But as of now the Government is focused on reducing imports as there is a export slowdown due to weak global demand. Gold imports have sought to be reduced by imposing import duty. In an attempt to lower the deficit, the Finance Minister increased the import duty on gold from 4% to 6% in order to decrease the demand for the same.

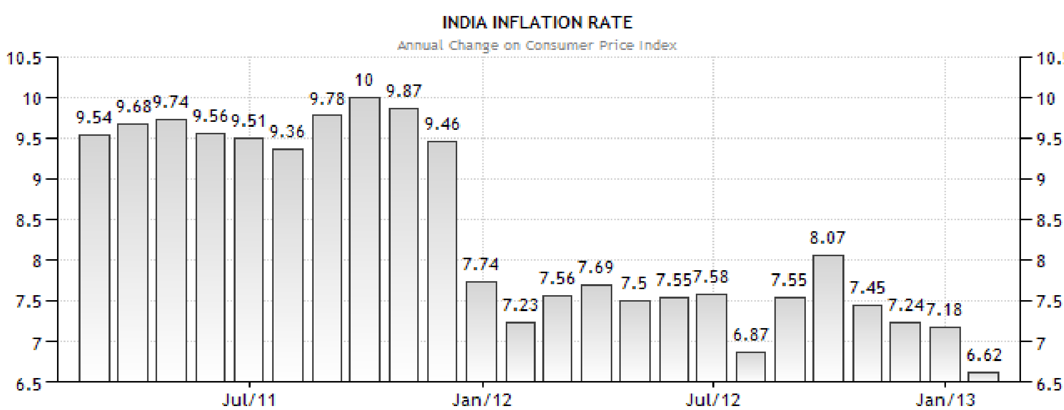
Gold today has crossed 10 % of the total import bill. Schemes are being put in place to channelize retail gold holdings into institutions so that more gold could be released and circulated. This will reduce gold imports.

One strong step that needs to be taken is to peg the Indian rupee against the US dollar atleast for a year. One of the important reasons is that India's foreign exchange reserves have dropped from a peak of $ 320 bn in September 2011 to $290 bn in 2012. This is a drop of $30 billion which should alert the policy makers. This means increased supply of rupees against the dollar in the foreign exchange market. This will therefore reduce the value of the rupee. Exporting firms in India are expecting the rupee to further fall thereby affecting their export potential. Foreign investors are also converting their rupee asset into dollars and taking them out. This spells out a clear case for rupee devaluation. Banks can help to overcome the situation. By increasing the interest on the rupee deposits of their customers. Given the situation as outlined above, the Government can think of a devaluation and peg it for a year. Rs. 60/- to $1/ might be ideal. The same move has been recently suggested by Bimal Jalan, former Governor of Reserve Bank of India. According to him "Your imports are much higher than your exports and part of that can be a monetary issue. So, the exchange rate certainly has to be flexible and we should manage it in that way,"[6]

As we have already seen, oil bill forms a substantial part of our import bill. The Government can bring a clear cut policy on promoting renewable sources of energy and also take bold initiatives towards Bio-CNG, Bio butanol, Bio diesel, Solar power, Wind power etc. The Government could further give efficiency rewards for industry. The Government can also encourage the production of electric vehicles which are costly to make but which are very energy efficient. Some successful public private partnerships have proven to be useful and the same could be tried for energy renewables also.

Inflationary pressures should be curbed. From the graph below it can be seen that inflation rates are quite high. Between January 2011 and 2012 the rates were hovering around 9.5%. From there on, till January 2013, it has been at an average of 7.5%. It January 2013, it decreased to 6.62%. The rates are still very high making the exports non-competitive.

Graph: 3 *Inflation in India 2011-2013*



Source: www.tradingeconimics.com/ Ministry of Commerce and Industry

The Government, since mid September 2012 has sharply increased the price of diesel to reduce fuel subsidies. Currently the Government plans to increase the price of diesel by 50 paise every month. The subsidies on LPG cylinders have also been reduced.

The Government has allowed for more foreign investment in retail, broadcasting and aviation. Changes have been approved by lawmakers in the banking laws. This move is expected to pave the way for new bank licenses from the central bank

India in the pre-reform period managed its deficits by worker remittances and by export of services in the post-reform period.

The risks

Let us have a look at the table below (Table-5). A point of concern is the composition of the current account. It has shifted away from the more stable FDI towards volatile components like NRI deposits and debt creating ECBs. This increases the economy's vulnerability to external crisis as in any crisis the volatile components will dry up first.

Secondly, as already mentioned current account deficits will lead to currency depreciation. This could propel inflation through higher import prices. This will lead to a further worsening of the current account deficit, more so as in the case of India where exports are poor. Further if doubts arise in the minds of the foreign lender about India's capacity to repay its foreign debt, the lenders might withdraw their money leaving the country with a full blown currency.

Table: 5 *Major Items of Capital Account*

US$ billion	Q1FY12	Q2FY12	Q3FY12	Q4FY12	Q1FY13	Q2FY13
Net FDI	9.3	6.5	5	1.4	3.9	8.9
Net Portfolio investment	2.3	-1.4	1.8	13.9	-2	7.6
Other equity (ADRs/GDRs)	0.3	0.2	0.1	0.03	0.1	0.1
Currency and NRI deposits	1.2	3.1	3.2	4.6	6.4	3.5
Loans	14.9	9.5	-7.7	-0.03	3.5	3.3
Trade credit and advances	3.1	2.9	0.6	0.2	5.4	4.1
Other accounts receivable/payable	-6.8	-1.5	4.8	-3.3	-0.6	-3

Source: Reserve Bank of India

Conclusion:

In conclusion it can be said that the situation is indeed very grave. The government has to go all out and implement the measures spelt above to curtail the deficit and ensure strong fundamentals in the economy which will propel real growth.

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