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How Current Account Deficit Affects Indian Economy

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ABSTRACT:

The largest component of a current account deficit is the trade deficit, when the country imports more goods and services than it exports and also when foreign investment income exceeds the savings of the country's residents however this foreign investment can help a country's economy grow. The largest component of a deficit is a trade deficit. This simply means the country imports more goods and services than it exports. A substantial current account deficit is not necessarily a bad thing for certain countries. Developing counties like India may run a current account deficit in the short term to increase local productivity and exports in the future. The current account balance is one of two major measures of a country's foreign trade (the other being the net capital outflow). A current account surplus indicates that the value of a country's net foreign assets (i.e. assets less liabilities) grew over the period in question, and a current account deficit indicates that it shrank. Both government and private payments are included in the calculation. The current account consists of the balance of trade, net primary income or factor income (earnings on foreign investments minus payments made to foreign investors) and net cash transfers that have taken place over a given period of time. The current account is an important indicator about an economy's health. It is defined as the sum of the balance of trade (goods and services exports less imports), net income from abroad and net current transfers. A positive current account balance indicates that the nation is a net lender to the rest of the world, while a negative current account balance indicates that it is a net borrower from the rest of the world. A current account surplus increases a nation's net foreign assets by the amount of the surplus, and a current account deficit decreases it by that amount. India's current account deficit (CAD) narrowed during last fiscal due to a contraction in the country's trade deficit. According to data furnished by the Reserve Bank of India (RBI), the CAD for last fiscal narrowed to 0.7 per cent of the GDP from 1.1 per cent in 2015-16 on the back of the contraction in trade deficit. The current account is the net difference between inflows and outflows of foreign currencies. India's trade deficit during the fiscal under review narrowed to $112.4 billion in 2016-17 from $130.1 billion in 2015-16. "Net invisible receipts were lower, mainly due to moderation in both software exports and net private transfer receipts, and higher outgo on account of primary income (profit, interest and dividends)," the RBI said in a statement. However, the data showed that net FDI (Foreign Direct Investment) inflows in 2016-17 marginally declined to $35.6 billion from $36 billion reported during 2015-16. India's external sector balance sheet remained in the comfort zone of less than 2% of GDP during the quarter ended March'17, despite a higher merchandise import bill and almost flat growth in services income as both software services income as well as remittances by the overseas Indians were at the same level as previous year. Strong FDI as well as portfolio flows resulted in a sharp rise in capital account flows, putting the overall balance of payments in a higher surplus. Fiscal deficit is a percentage of the nation's GDP and can be considered as an economic event in which the government expenditure exceeds its revenue. Meanwhile, current account deficit occurs when the country's imports are greater than the country's exports of goods, services and transfers. The current account deficit (CAD)- excess of country's imports of goods and services over its exports- touched nearly two percent of the GDP as oil prices rose and electronics imports surged.This could be a blow to the Rupee which is already weakening. India's current account in the balance of payments ended in a deficit of $ 13.5 billion or 2 per cent of GDP in the quarter ended December 2017, up from $ 8.0 billion or 1.4 per cent of GDP in the quarter:

ended December 2016 and $ 7.2 billion (1.1 per cent of GDP) in the preceding quarter ended September 2016, according to the preliminary data released by the Reserve Bank of India.

INTRODUCTION:

Balance of trade of the country is the net or difference between the country's exports of goods and services and its imports of goods and services, ignoring all financial transfers, investments and other components, over a given period of time. When a country is said to have a trade surplus when its exports exceed its imports and a trade deficit when its imports exceed its exports. Normally, the current account is calculated by adding up the 4 components of current account: Goods, Services, income and Current transfers. Japanese financial services major Nomura, stronger global demand and higher export prices are driving exports recovery, while the recovery in imports reflects higher commodity prices and likely improvement in domestic demand. "In 2017, we expect the CAD to widen to 1.6 per cent of GDP from 0.5 per cent in 2016 owing to higher commodity prices and an expected strong domestic recovery in the second half of 2017," Nomura said in a research note. In the CAD the difference between the value of imports of goods, services and investment incomes, and that of exports increased to USD 7.9 billion, or 1.4 per cent of GDP, in October-December quarter of 2016. According to official data, exports continued their uptrend in March with a growth of 27.6 per cent year-on-year from 17.5 per cent in February. Import growth rose even faster to 45.3 per cent in March from 21.8 per cent in February. Since the start of this year, the Indian rupee has appreciated steadily in line with other emerging market currency which is a reflection of the strength in Indian economy. The rupee is currently hovering around the 64-level mark against the dollar. The trade data suggest that stronger global demand and higher export prices are driving the exports recovery. However, there are risks to this uptrend from protectionist policies in the US, a slowdown in China and fading price effects.

KEYWORDS: Current account deficit, Fiscal Deficit, Trade balance, Export-Import Policy etc.

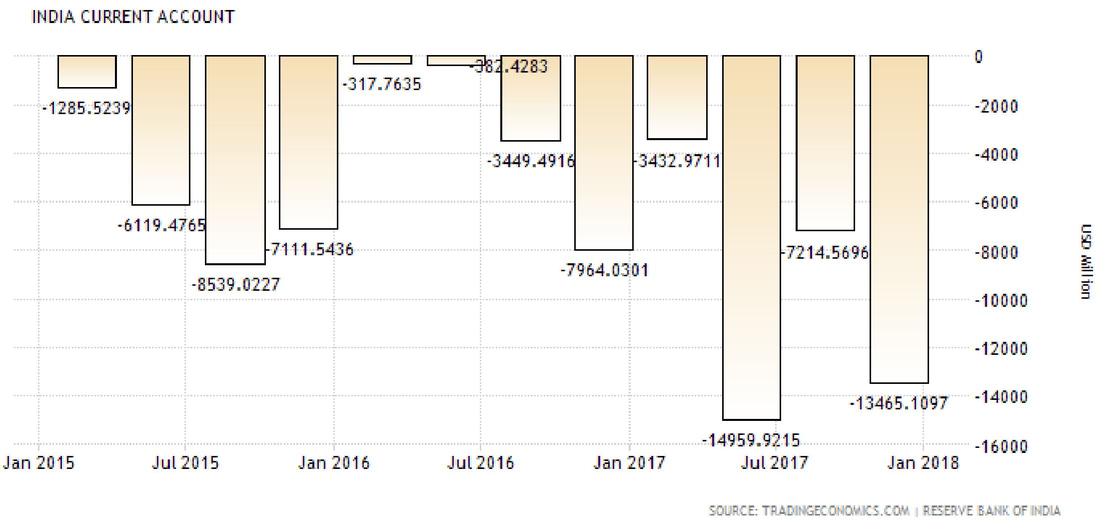
OBJECTIVES:
1. To analyze the role of current account Deficit in Economy.
2. To identify the role of Fiscal Deficit in Economy
3. To identify the role of Producers Surplus
4. To analyze the role of Export-Import Policy in Economy.

GOODS:
In calculating current account, exports are marked as credit (the inflow of money) and imports as debit (the outflow of money).Being movable and physical in nature, goods are often traded by countries all over the world. When a transaction of certain good's ownership from a local country to a foreign country takes place, this is called an "export". The other way around, when a good's owner changes to a local inhabitant from a foreigner, is defined to be an "import".
SERVICES:
If intangible service (e.g. tourism) is used by a foreigner in a local land and the local resident receives the money from a foreigner, then it will also counted as an export, thus a credit.

INCOME:
A credit of income happens when an individual or a company of domestic nationality receives money from a company or individual with foreign identity. A foreign company's investment upon a domestic company or a local government is considered as a debit.

CURRENT TRANSFERS:

Current transfers take place when a certain foreign country simply provides currency to another country with nothing received as a return. Typically, such transfers are done in the form of donations, aids, or official assistance. In the net factor income or income account, income payments are outflows, and income receipts are inflows. Incomes are receipts from investments made abroad (note: investments are recorded in the capital account but income from investments is recorded in the current account) and money sent by individuals working abroad, known as remittances, to their families back home. If the income account is negative, the country is paying more than it is taking in interest, dividends, etc. The various subcategories in the income account are linked to specific respective subcategories in the capital account, as income is often composed of factor payments from the ownership of capital (assets) or the negative capital (debts) abroad. From the capital account, economists and central banks determine implied rates of return on the different types of capital. The United States, for example, gleans a substantially larger rate of return from foreign capital than foreigners do from owning United States capital. In the traditional accounting of balance of payments, the current account equals the change in net foreign assets. A current account deficit implies a paralleled reduction of the net foreign assets.



CURRENT ACCOUNT DEFICIT OF INDIA 2017:

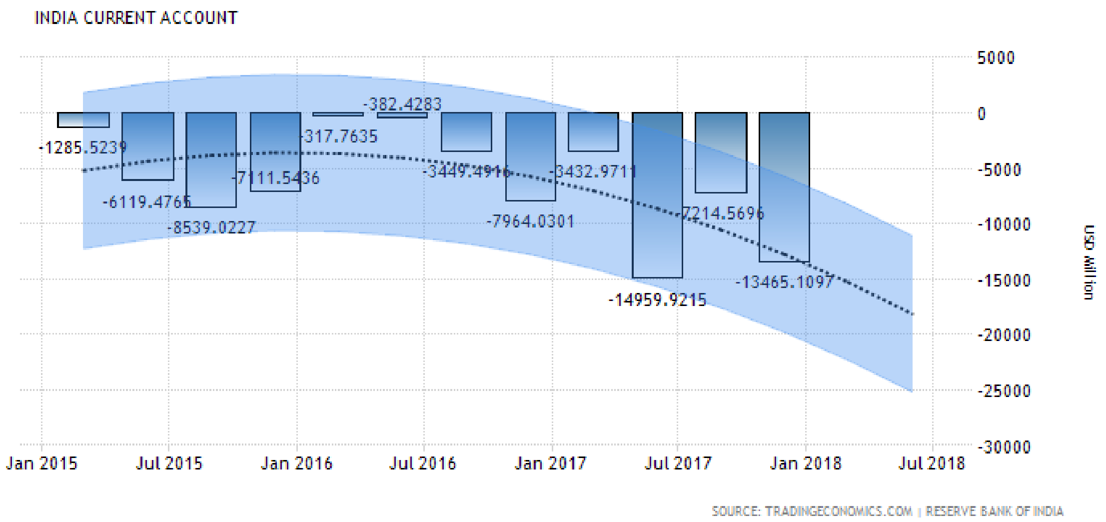
As the country's economy is open, this saving is being invested abroad and thus foreign assets are being created. India's external sector balance sheet remained in the comfort zone of less than 2% of GDP during the quarter ended March'17, despite a higher merchandise import bill and almost flat growth in services income as both software services income as well as remittances by the overseas Indians were at the same level as previous year. Strong FDI as well as portfolio flows resulted in a sharp rise in capital account flows, putting the overall balance of payments in a higher surplus. Current account deficit (CAD), excess of countries imports over exports expanded marginally to $ 3.4 billion (0.6 per cent of GDP) in the fourth quarter of FY'17, according to the preliminary figures released by the Reserve Bank of India. It was higher than $ 0.3 billion (0.1 per cent of GDP) in Q4, FY'16 but narrowed from $ 8.0 billion (1.4 per cent of GDP) in the preceding quarter. The CAD was higher primarily due to higher trade deficit of $ 29.7 billion. "The y-o-y widening of the merchandise trade deficit in Q4 FY2017 was led by a sharp expansion in net oil imports and gold imports, which ate into the improved services trade surplus". The CAD number for the quarter ended up being lower than economists' expectations. "The size of the current account deficit in Q4, FY'17 was somewhat smaller than our expectation of $4.0-5.0 billion, benefitting from a smaller outflow of primary income" said Nayar. Private transfer receipts, mainly representing remittances by Indians employed overseas, at $ 15.7 billion remained almost at the same level as in the preceding year. Capital flows comprising foreign direct investment, foreign portfolio investments, overseas borrowings and NRI deposits recorded strong flows during the quarter. Capital account surplus more than doubled to $ 10.3 billion from $ 3.9 billion in the same period a year ago on account of strong portfolio flows during the quarter. The overall balance of payments which is the sum of current and capital account ended in a higher surplus of \$7.3 billion compared to \$3.3 billion surplus in the same period a year ago. For the financial year as a whole, the CAD narrowed to 0.7 per cent of GDP in 2016-17 from 1.1 per cent in 2015-16 on the back of the contraction in the trade deficit. Going forward, ICRA expects merchandise exports to rise by 5-7% to ~US\$295-300 billion and merchandise imports to expand by 6-8% to ~US\$418-423 billion in FY2018. Notably, volatility in commodity prices could significantly influence the pace of growth of import and export values. Current account = changes in net foreign assets. If an economy is running a current account deficit, it is absorbing (absorption = domestic consumption + investment + government spending) more than that it is producing. This can only happen if some other economies are lending their savings to it (in the form of debt to or direct/ portfolio investment in the economy) or the economy is running down its foreign assets such as official foreign currency reserve. On the other hand, if an economy is running a current account surplus it is absorbing less than that it is producing. This means it is saving. According to official data, exports continued their uptrend in March with a growth of 27.6 per cent year-on-year from 17.5 per cent in February. Import growth rose even faster to 45.3 per cent in March from 21.8 per cent in February. Since the start of this year, the Indian rupee has appreciated steadily in line with other emerging market currency which is a reflection of the strength in Indian economy.

CURRENT ACCOUNT DEFICIT OF INDIA 2018:

India's current account deficit (CAD) for this financial year is expected to be around USD 40 billion, or 1.5 per cent of GDP, says a Nomura report. India's current account deficit (CAD) rose sharply to USD 14.3 billion -- 2.4 per cent of GDP -- at the end of first quarter of 2017-18.In general terms, CAD refers to the difference between inflow and outflow of foreign exchange that has a bearing on the exchange rate.

According to the Japanese financial services major, July-September CAD is expected at about 1.6 per cent of GDP and accordingly, CAD for the first half of this fiscal (April- September) is likely to be around 2 per cent of GDP."For the full year, we expect the current account deficit to remain elevated at USD 40 billion, or 1.5 per cent of GDP, up from 0.7 per cent of GDP in FY17," Nomura said in a research note. According to Nomura, the widening of the trade balance in April-September was due to transitory factors, which is expected to reverse in the second half (October-March).

The global brokerage firm laid down four reasons for "narrow" CAD numbers in the second half of this fiscal. First, a reversal of import substitution that was triggered by domestic supply disruptions and second, gains in price competitiveness. Other factors include normalisation of gold imports and fading GST-related disruptions that are pushing exports to catch up with the global cycle. "Overall, our analysis shows that the worsening of India's current account deficit is largely due to transitory factors and thus, external imbalances should correct in the second half of 2017-18 as these effects faded.



TRADE DEFICIT.

Trade deficit occurs when a country is not producing enough goods for its requirements; it means country's consumers are wealthy enough to purchase more goods than the country produces.
Imports from other nations increase when production cannot meet demand. It is not necessarily detrimental because it often corrects itself over time. An increase in imported goods from Other country decreases the price of consumer goods in the nation as foreign competition increases. The lower prices help to reduce the threat of inflation in the local economy. In the fastest growing economy country may import more to meet the demand of its consumer but prices will go down, and domestic companies may be unable to produce and compete at the lower prices, these are produced in the economy which, in turn, could lead to even more imports and a greater deficit. The current account deficit (CAD)- excess of country's imports of goods and services over its exports- touched nearly two percent of the GDP as oil prices rose and electronics imports surged. This could be a blow to the Rupee which is already weakening. India's current account in the balance of payments ended in a deficit of $ 13.5 billion or 2 per cent of GDP in the quarter ended December 2017, up from $ 8.0 billion or 1.4 per cent of GDP in the quarter: ended December 2016 and $ 7.2 billion (1.1 per cent of GDP) in the preceding quarter ended September 2016, according to the preliminary data released by the Reserve Bank of India.

TRADE BALANCE

Trade balance is the largest section of the current account and measures the income that a country receives from its exports and the cost of imports. Country that exports more than it imports will have a trade surplus since the inflow of currency is greater than the outflow of currency. Countries attempt to export more goods and services than they import to obtain greater currency inflows.
However, it is not uncommon to see trade deficits in a country's current account.

FISCAL DEFICIT

Fiscal deficit occurs when a government's total expenditures exceed the revenue that it generates, excluding money from borrowings. Deficit differs from debt, which is an accumulation of yearly deficits. Fiscal deficit is regarded by some as a positive economic event, economist John Maynard Keynes believed that deficits help countries climb out of economic recession. On the other hand, fiscal conservatives feel that governments should avoid deficits in favour of a balanced budget policy. Fiscal deficit is a percentage of the nation's GDP and can be considered as an economic event in which the government expenditure exceeds its revenue. Meanwhile, current account deficit occurs when the country's imports are greater than the country's exports of goods, services and transfers.

IMPACT ON PRODUCER SURPLUS

Producer surplus is a difference between how much of a good the producer is willing to supply versus how much he receives in the trade. The difference or surplus amount is the benefit the producer receives for selling the good in the market, producer surplus is generated by market prices in excess of the lowest price producers would otherwise be willing to accept for their goods. Producers would not sell products if they could not get at least the marginal cost to produce those products. The supply curve as depicted in the graph above represents the marginal cost curve for the producer. As such, the producer surplus is the difference between the price received for a product and the marginal cost to produce it. From an economics standpoint, marginal cost includes opportunity cost. In essence, an opportunity cost is a cost of not doing something different such as producing a separate item. The existence of producer surplus does not mean there is an absence of a consumer surplus. The idea behind a free market that sets a price for a good is that both consumers and producers can benefit, with consumer surplus and producer surplus generating greater overall economic welfare. Market prices can change materially due to consumers, producers, a combination of the two or other outside forces. As a result, profits and producer surplus may change materially due to market prices. The current account deficit (CAD) - excess of country's imports of goods and services over its exports- touched nearly two percent of the GDP as oil prices rose and electronics imports surged. This could be a blow to the Rupee which is already weakening. India's current account in the balance of payments ended in a deficit of $ 13.5 billion or 2 per cent of GDP in the quarter ended December 2017, up from $ 8.0 billion or 1.4 per cent of GDP in the quarter: ended December 2016 and $ 7.2 billion (1.1 per cent of GDP) in the preceding quarter ended September 2016, according to the preliminary data released by the Reserve Bank of India.

EXPORT- IMPORT POLICY OF INDIA:

India's trade policy has been undergoing rapid and drastic changes since 1991. Some of these changes are the result of economic reforms initiated by the Government while some others are also influenced by the requirements of the World Bank and the IMF from whom India has received structural adjustment loans. The most important element of the new policy is the increasing use of exchange rate. Rupee was adjusted downwards by 18 per cent in July 1991 to make the rupee's external value more realistic. Simultaneously, the system of cash compensatory support which has so far been the most important instrument of export promotion was abolished. These steps were supposed to improve export incentives and make them uniform. Few months later, in March, 1992, Rupee was made partly convertible, under a system known as Liberalised exchange Rate Management System (LERMS). In March 1993, the rupee was made fully convertible on trade account. The Government of India outlined the policy framework for a broad-based, rapid and sustained growth of exports in the next four years.

1. Reduction in domestic excess demand: The balance of payments deficit represents the excess of domestic demand for goods and services over domestic supply. In order to correct it domestic demand will have to be restrained and supply increased. It will be necessary to restrain the degree of excess spending by the Government to correct the balance of payments.
2. Enhanced Competitiveness: By mid-1991, domestic prices had become seriously misaligned with international prices. This required two changes. A change in the exchange rate of the Rupee was made by means of a downward adjustment of about 18 per cent in the external value of the Rupee in July 1991. The second step would require a phasing down of import restrictions and a reduction in this high level of protection which characterize Indian industries. Progress in this regard is at present constrained by the grave balances of payments position as well as by the importance of import duties as a source of government revenue.
3. Deregulation: One of the obstacles to exports lies in the cumbersome administrative procedures involved, arising from controls over imports (and on inputs required for exports) and exports, exchange control and also customs procedures.
4. Capability for self-improvement: World markets are more competitive than some hitherto sheltered domestic markets. If agricultural and industrial products are to compete internationally,

their producers will have to improve their own competitive position continuously through technological and managerial improvements and adapt themselves rapidly to changes in international market conditions. This capacity for unceasing adaptation and innovation would need to be developed.

5. Export-Import policy 2015-20 provides a framework for increasing exports of goods and services as well as generation of employment and increasing value addition in the country, in line with the 'Make in India' programme. Export-Import policy 2015-20 introduces two new schemes, namely 'Merchandise Exports from India Scheme (MEIS)' for export of specified goods to specified markets and 'Services Exports from India Scheme (SEIS)' for increasing exports of notified services. Duty credit scrips issued under MEIS and SEIS and the goods imported against these scrips are fully transferable. For grant of rewards under MEIS, the countries have been categorized into 3 Groups, whereas the rates of rewards under MEIS range from 2 per cent to 5 per cent. Under SEIS the selected Services would be rewarded at the rates of 3 per cent and 5 per cent. Measures have been adopted to nudge procurement of capital goods from indigenous manufacturers under the EPCG scheme by reducing specific export obligation to 75per cent of the normal export obligation. Measures have been taken to give a boost to exports of defence and hi-tech items-Commerce exports of handloom products, books/periodicals, leather footwear, toys and customised fashion garments through courier or foreign post office would also be able to get benefit of MEIS (for values up to INR 25,000).Manufacturers, who are also status holders, will now be able to self-certify their manufactured goods in phases, as originating from India with a view to qualifying for preferential treatment under various forms of bilateral and regional trade agreements.

6.Exports during March 2017 were valued at US$ 14179 Million (Rs. 93406.57 Crore) registering a positive growth of 8.57 per cent in dollar terms as compared to negative growth of 3.76 per cent during February 2017 (as per RBI's Press Release for the respective months).Imports during April 2017 were valued at US$ 37884.28 million (Rs. 244380.52crore) which was 49.07 per cent higher in Dollar terms and 44.67 per cent higher in Rupee terms over the level of imports valued at US$ 25413.72 million (Rs. 168923.71 crore) in April, 2016.

CONCLUSION

The current account deficit is helpful to the debtor nation, which led to attract foreign investors who are willing to pump capital into it. This drives economic growth beyond what then country could manage on its own. Foreign investors question whether economic growth will provide enough return on their investment. Demand weakens for the country's assets, including the country's government bonds. As foreign investors withdraw funds, bond yields rise. The national currency loses value relative to other currencies. That lowers the value of the assets in the foreign investors' strengthening currency, which further depresses investor demand for the country's assets. This can lead to a tipping point where investors will dump the assets at any price. The only saving grace is that the country's holdings of foreign assets are denominated in foreign currency. The value of its currency declines, the value of the foreign assets rise. That further reduces the current account deficit. The lower currency value increases exports as they become more competitively priced. The demand for imports falls once prices rise as inflation sets in. These trends stabilize any current account deficit. Whether the current account deficit unwound via a disastrous currency crash or a slow, controlled decline, the consequences would be the same, which led a lower standard of living for the country's residents.

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