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Anil Kumar Nagar
PhD Scholar, M.S.J College,
Bharatpur, Rajasthan, India

Sarita Singh
PhD Scholar, M.S.J College,
Bharatpur, Rajasthan, India

Dr. Reeta Gupta
Associate Professor, M.S.J
College, Bharatpur,
Rajasthan, India

India's current account deficit since 2001: A review of literature

Anil Kumar Nagar, Sarita Singh and Dr. Reeta Gupta

Abstract

Current account deficit is a result of current account imbalance. CAD occurs when a country's total imports of goods, services and transfers are greater than countries total exports of goods, services and transfers. India encountered a big balance-of- payment crisis in 1991. After 1991 economic turmoil many studies had been done. After economic reforms and structural adjustment India led to a major boost for the external sector as current account surplus condition during 2001-02 to 2003-04. This review aims to analyze India's current account deficit since 2001.

Keywords: Current account deficit, India

Introduction

In a global world a well-connected economy is described as an open economy. Since the end of World War II, World Trade has grown much faster than world output. One way to show this is to estimate the ratio of exports by all countries to total production by all countries. In 1950 total world Exports -which are the same as world imports- are estimated to have been 5.5% of world Gross Domestic Product. Fifty years later, in 2005, they were 20.5 percent of world GDP. One measure of the importance of international trade in a Nation's economy is the sum of exports and imports divided by the GDP especially it is the value of all final goods and services produced inside a nation during some period usually one year^[1].

The level of interaction with other economies shows the degree of openness of an economy. Export, Import and trade balance are the main variables which are related to openness of an economy. There are two ways for an economy to interact with rest of the world: It trades goods and services in the world market and buys and sells capital assets in world capital market. The balance of payment is a summary statement in which all the transactions of the residents of a nation with the residents of all other nations are recorded during a year. The balance -of -payment account is a composition of current account and capital account. The Current account is one of the two primary components of the balance of payments. The balance of payments (BOP) is the place where countries record their monetary transactions with rest of the world. Current account deficit is a result of current account imbalance. CAD occurs when a country's total imports of goods, services and transfers are greater than country's total exports of goods, services and transfers. This situation makes a country a net debtor to the rest of the world. The current account includes the flow of goods and services into and out of the country. It also includes investment income flows and unilateral transfers. Current account includes merchandise trade, invisibles in which primary things are services, transfers and income. In services category it includes account of travel, transportation, insurance etc. In transfer category there are official and private transfers. In income category there is investment income and compensation of employees are the part of current account.

Current account deficit is not necessarily a bad thing for certain countries. It could be a positive for growth for some time whereas sometime it may be a negative sign, indicating countries credit risk. Developing countries may run a current account deficit situation in the short term to increase the local productivity and exports in the future. But in the long run this is not a desirable situation for the domestic economy. Exports and imports include both goods and services so that trade balance can be decomposed into the balance on goods and balance on services. In every segment of current account the net surplus or deficit has a policy effect while the overall current account balance is an important indicator to determine economy's strength.

Corresponding Author:
Anil Kumar Nagar
PhD Scholar, M.S.J College,
Bharatpur, Rajasthan, India

A nation's trade policy effects its relations with rest of the world. These policies include taxes on some international transactions, subsidies for other transactions, legal limits on the value or volume of particular imports and many other measures. A tariff, the simplest of trade policies, is a tax levied when a good is imported. Ad valorem tariff are taxes that are levied as a fraction of the value of the imported goods. There are some non-tariff barriers also present in international trade, such as import quotas and export restraints. An understanding of the effects of a tariff remains a vital basis for understanding other trade policies. These trade policies of any country can tame its trade deficits with rest of the world when needed ^[2].

India has very less share in world trade and its development needs are much higher. India's rank in global export of services was at tenth place with 2.7 per cent share in 2006. India ranked at twenty eight place in merchandise export with a one per cent share in world export in same year. India's rank in global import of services was at thirteenth place with 2.4 per cent share in 2006. India ranked at seventeenth place in merchandise imports with 1.4 per cent share in same year. Taming imports is not desirable while exports can be easily hurdled in sluggish world trade. So a close look on current account is always needed. Despite a developing country India has emerged as good trader in world market. World trade data suggest that in 2017 India was at 20th place in merchandise export while at 8th place in export of services. India stood at 11th place in merchandise import and at 10th position in services import. China's share in India's total trade deficit increased from 20.3 per cent in 2012-13 to 47.1 per cent in 2016-17. Thus India's current account deficit study has a lot of scope for research purpose with many objectives to achieve. The widening trend of current account deficit can be noticed from 2016-17. According to RBI data It's ratio with GDP was 0.7 percent in 2016-17 and increased to 1.8 percent in 2017-18. Japanese financial services major Nomura has expected India's CAD to GDP ratio to be 2.8 per cent in 2018-19. The State Bank of India also expected the same level of CAD in 2018-19 in its report of August 2018. In same line Moody's investors service also suggest that India's CAD to GDP ratio for 2018-19 is likely to widen at the level of 2.5 per cent which is slight lower than other expectations. According to RBI the current account deficit for 2018-19 finally settled down at the level at 2.1 per cent of GDP.

Review of Literature

India encountered a big balance –of- payment crisis in 1991. After 1991 economic turmoil many studies had been done. After economic reforms and structural adjustment India led to a major boost for the external sector as current account surplus condition during 2001-02 to 2003-04. Peak tariff rates had come down from 150% in the early 1990's to just 10% by 2007. The quantitative restrictions on imports were phased out and bulk of the tariff lines over 70% have been found under the World Trade Organization (WTO) ^[3].

The share of merchandise trade in GDP became more than doubled between 2001-02 from 20.8 to 43.35 percent in 2011-12. It is quite interesting that this ratio become at significant down level of 29.23 in 2017-18 ^[4].

India is known for an impressive turnaround of the external sector from foreign exchange crisis faced in 1991, when the current account deficit was just 3% of GDP, to a current account surplus during 2001-4 and the buildup of large

fforeign exchange reserves. However the economy had once again entered a period of balance of payment stress in the wake of global financial crisis of 2008-09 which continues to rattle the world economy for next many years. India's export structure has moved from the export of primary and conventional products, such as textiles, clothing, leather products, gems and Jewellery towards products with greater value added, such as transport equipment, generic pharmaceuticals, and refined petroleum products. However the share of technology intensive products India's exports is still very low compared to that of East Asian countries. The emergence of the Invisibles as the most dynamic sector driving India's growth has been accompanied by its growing importance. The ratio of Invisibles and GDP of India become much higher from 12.05% to 18.02% between 2001-2 and 2018-19. India's CAD was 1.0 per cent of GDP in 2007-08 but in next five years it was near five per cent of GDP. This figure was twice the level that Reserve Bank of India considered as the safe threshold ^[5].

Francis Cherunilam also found from government data that in services export category travel industry, transportation and softwares stood at 36.9, 27.4 and 10.2 percent in 1995-96. In 2006-07 this trend got a different shape as travel industry, transportation and softwares stood at 11.6, 9.9 and 38.5 percent. Thus software export services become important in recent years ^[6].

India's deficit on current account was alarming not because of its high ratio to GDP but its rapidity with which it reached the unsustainable point. The CAD crossed the three percent bench mark its ratio with GDP in 1990-91. After 1991 it became down at 1.02 in 2006-07. In 2012-13 the CAD to GDP ratio was 4.82 but India had sizeable foreign exchange reserves and this time it could cover upto seven month imports while in 1989-90 it was an 1.90 month imports cover with 1.99 CAD to GDP ratio. C. Rangarajan found that the year 1991 was a great divide in India's post-independence economic history. The country faced an acute economic crisis triggered by a severe balance- of- payments (BOP) problem. The crisis was converted into an opportunity to bring about fundamental changes in India's economic policy. The new regime allowed foreign direct investment (FDI) over a wide range of sectors with even majority ownership except in certain areas. Portfolio investment in Indian stocks was of course permitted to financial institutional investors. C. Rangarajan also emphasises on the same argument that after 1991 the financing of CAD is changed at significant level. In present scenario India has attained proper resilience to handling the fluctuations. On the financing side of the CAD, there is a sea change in 1990 – 91, there was neither FDI nor portfolio investment. The three elements that dominated the sources of financing were net external assistance, net commercial borrowings and non-resident Indian deposits, each equivalent to 0.7% of GDP. In contrast in 2014-15 the dominant flows were FDI, which was equivalent to 1.5% of GDP, and portfolio investment, which was equal to 2.1% of GDP. The net effect of the capital flows and the CAD is the change in Fforeign Exchange Reserves. At the height of the 1991 crisis our reserves were hardly a few billion dollars. Ttoday these reserves stand at \$413 billion ^[7].

It is imperative that India should keep the Current account deficit at a level that can be financed by normal capital flows. The structure of merchandise trade, trade of services and flow of remittances is also a point of concern for a

better understanding of government initiatives to handle the inappropriate situations. In 2003-04 the Current Account was in surplus and it was 2.3 per cent of GDP while in 2013-14 it dipped to a minus 4.8 per cent of GDP. The negative trajectory within a decade is a cause of concern for a developing country like India. In last five years many reports, working papers of different research institutions and government agencies provided vital information and data on the subject. Arvind Pangaria also considered large and persistent current account deficit often give rise to macroeconomic instability and crisis and that the appreciation of the exchange rate accompanying capital inflows can undercut exports, to date the RBI has chosen to turn a substantial part of the capital inflows into reserves. The maximum current account deficit India ran between 1994-95 and 2003-04 was 1.64% of the GDP in 2002-03 and 2003-04 the current account was actually in surplus, implying that India invested a part of its savings abroad during these years. He also suggested that it was a mistake to expect capital inflows to contribute more than two percent of GDP on a sustained basis ^[8].

C. Rangarajan has also argued for an appropriate level of current account deficit that can be financed without any setback for Indian economy's macroeconomic stability. CAD to GDP ratio of 2.0 to 2.5 per cent would mean an absolute 45 billion \$ to 56 billion \$. This will require merely 4 percent to 5 per cent of total capital inflows to emerging markets and according to C. Rangarajan it would not be a big Problem. The focus of every government policy leads on attracting larger inflows of foreign capital to finance the growing current account deficits. This is based on presuppositions and judgments that can be called misguided. The policy strengthens the probability of the emergence of a vicious circle of ever larger capital inflows financing ever larger current account deficits till an external shock or a confidence crisis brings about sudden stops and outflows and thus economic collapse. The focus of policy should instead be on reducing the current account deficit through a mix of measures: restrictions of imports particularly of gold but also of petroleum products and restoration of competitiveness of manufacturing through a combination of measures (essentially improvements in physical infrastructure) to promote efficiency of production, export and measures to promote depreciation of the real exchange rate.

Conclusion and Suggestions

As Dr. Raghuram Rajan has said that when global growth is uncertain we should make sure that our domestic environment promotes strong, sustainable and stable growth. This requires a firm platform of macroeconomic stability. Fiscal consolidation combined with lower commodity prices has also led to a lower current account deficit. Government has been encouraging foreign investors to "make in India". One offshoot of this campaign has been sizable rise in foreign direct investment, the most stable source of investment. Thus we can reach in the area of comfortable higher than the current account deficit area ^[9].

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