Current Account Deficit of the Indian Economy

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[GS Paper 3 – Indian Economy]

Context – The data for the country's current account balance for the fourth quarter of FY 2021-22 shows a decrease in the deficit to 1.5% of gross domestic product (GDP) from 2.6% of GDP in Q3 FY 2021-22.

About CAD

- A current account is a key component of balance of payments, which is the account of transactions or exchanges made between entities in a country and the rest of the world.

- This includes a nation's net trade in products and services, its net earnings on cross border investments including interest and dividends, and its net transfer payments such as remittances and foreign aid.

- A CAD arises when the value of goods and services imported exceeds the value of exports, while the trade balance refers to the net balance of export and import of goods or merchandise trade.

Components of Current Account

Current Account Deficit (CAD) = Trade Deficit + Net Income + Net Transfers

- **Trade Deficit**

- Trade Deficit = Imports – Exports
- A Country is said to have a trade deficit when it imports more goods and services than it exports.
- Trade deficit is an economic measure of a negative balance of trade in which a country's imports exceed its exports.
- A trade deficit represents an outflow of domestic currency to foreign markets.

- **Net Income**

- Net Income = Income Earned by MNCs from their investments in India.
- When foreign investment income exceeds the savings of the country's residents, then the country has a net income deficit.
- This foreign investment can help a country's economy grow. But if foreign investors worry they won't get a return in a reasonable amount of time, they will cut off funding.
- Net income is measured by the following things:

1. Payments made to foreigners in the form of dividends of domestic stocks.
2. Interest payments on bonds.
3. Wages paid to foreigners working in the country.

- **Net Transfers**

- In Net Transfers, foreign residents send back money to their home countries. It also includes government grants to foreigners.
- It Includes Remittances, Gifts, Donation etc

Process of CAD Transactions

- While understanding the Current Account Deficit in detail, it is important to understand what the current account transactions are.
- Current account transactions are transactions that require foreign currency.
- Following transactions with from which component these transactions belong to:

1. Component 1 : Payments connection with Foreign trade – Import & Export
2. Component 2 : Interest on loans to other countries and Net income from investments in other countries
3. Component 3 : Remittances for living expenses of parents, spouse and children residing abroad, and Expenses in connection with Foreign travel, Education and Medical care of parents, spouse and children

Recent Trends

- In Q4 FY 2021-22, CAD improved to 1.5% of GDP or $13.4 billion from 2.6% of GDP in Q3 FY 2021-22 ($22.2 billion).
- The difference between the value of goods imported and exported fell to $54.48 million in Q4FY 2021-22 from $59.75 million in Q3 FY2021-22.
- However, based on robust performance by computer and business services, net service receipts rose both sequentially and on a year-on-year basis. Remittances by Indians abroad also rose.

Reasons behind CAD

- Intensifying geopolitical tensions and supply chain disruptions leading to crude oil and commodity prices soaring globally have been exerting upward pressure on the import bill.
- A rise in prices of coal, natural gas, fertilizers, and edible oils have added to the pressure on the trade deficit.
- However, with global demand picking up, merchandise exports have also been rising.

Effect of CAD on Economy

- A large CAD will result in demand for foreign currency rising, thus leading to depreciation of the home currency.
- Nation's balance CAD by attracting capital inflows and running a surplus in capital accounts through increased foreign direct investments (FDI).
- However, worsening CAD will put pressure on inflow under the capital account.

- Nevertheless, if an increase in the import bill is because of imports for technological upgradation it would help in long-term development.

- Data shows the trade deficit widened to $24.29 billion in May 2022 from $6.53 billion a year ago.
  Merchandise exports in May 2022 rose by 20.55% over May 2021, while merchandise imports rose by 62.83%.

- However, if increasing imports is accompanied by an expansion in industrial production, it is a sign of economic development.

- Immediately after the covid-19 lockdown, after a long time, the country experienced a current account surplus.