Desirable and Undesirable Components of India's CAD

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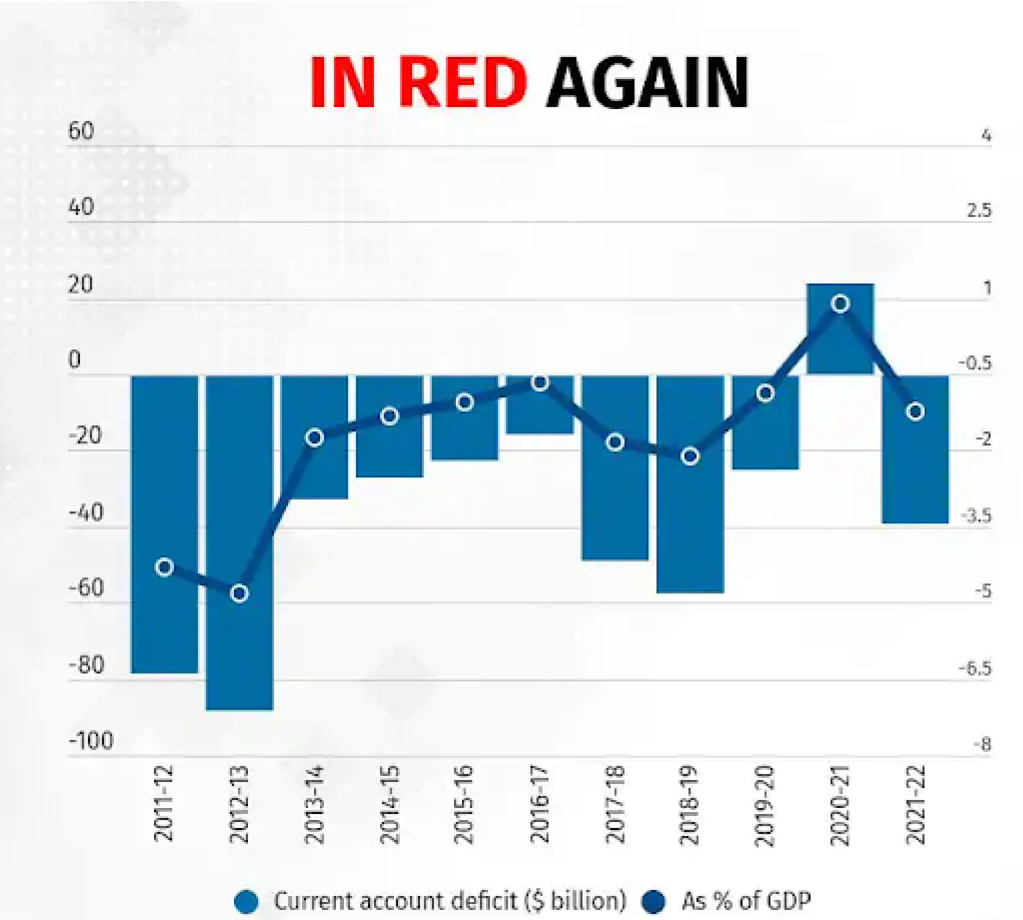
Context – According to the RBI's quarterly statistics, the **Current Account Deficit** (CAD) has increased to 4.4% of the **GDP** in the second quarter of 2022-23. This marks a reversal from an unusual surplus of 0.9% of GDP in 2020-21. In the third quarter of this financial year, while the merchandise trade deficit has widened, the CAD may witness a fall.

What is CAD?

- The Current Account Deficit is determined by:

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

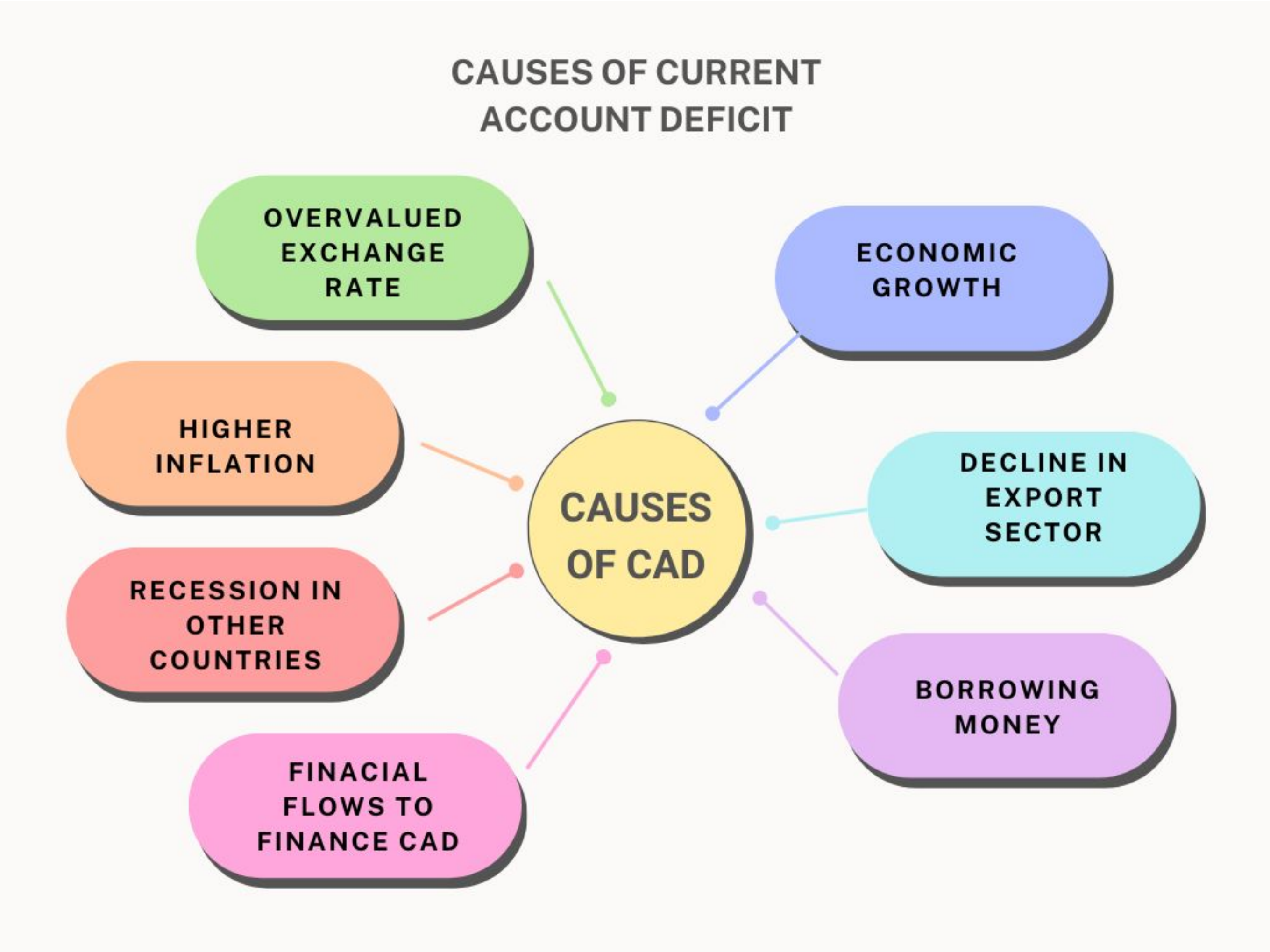
- A current account is a key component of **balance of payments**, which is the account of transactions or exchanges made between entities in a country and the rest of the world.
- This includes a nation's net trade in products and services, its net earnings on cross border investments including interest 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

- **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.
- Net income is measured by Payments made to foreigners in the form of dividends of domestic stocks, Interest payments on bonds and 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 also Includes Remittances, Gifts, Donation etc.

A Deficit on the Current Account is balanced by a surplus on the financial account.



Desirable and Undesirable Components of India’s CAD

Desirable Components

- A desirable deficit is a natural reflection of rising investment, portfolio choices and the demographics of the country.
- If CADs can be financed by stable capital inflows, such as FDI inflows, they are desirable as they are less prone to capital flight.
- Stable capital flows are desirable as they allow debtor countries, such as India, to utilize and allocate them into sectors that may yield long-term productive gains and foster higher economic growth.

Undesirable Components

- Large and persistent CADs can be undesirable if they reflect bigger problems such as poor export competitiveness and are financed by unstable financing.
- If deficits are financed by volatile capital flows such as portfolio flows, there may be a cause of concern. Portfolio flows are capricious and more susceptible to reversals in case of any global financial shock.

Countercyclical Nature of India’s CAD

Dominance of external shocks: Research suggests that the country’s CAD rises when output falls rather than when demand rises, indicating the dominance of external shocks.
For instance: If oil prices rise, and as oil is an input in the production process, it raises the cost of production and leads to a fall in economic growth. In this case, CADs rise with falling growth due to both the inelasticity of oil import demand as well as its major share in India’s total imports.

Challenges and Way Forward

- The composition of financing is crucial. While FDI inflows were enough to finance the deficit in 2021-22, these inflows have been weak in the current fiscal year.
- Over the medium term, policymakers need to arrest the negative spillovers from the slowdown in global trade on merchandise exports.
- Further rate hikes by the US Fed may lead to capital outflows leading to additional exchange rate market pressures. This could be challenging in the current situation as a weaker currency, coupled with a sticky import basket will lead to imported inflation.
- Policy measures thus must facilitate exports by focusing on structural reforms to improve trade competitiveness, alongside which the government must sign free trade agreements.

Conclusion

India is currently facing the twin-deficit problem of high fiscal and CADs. While aggressive fiscal consolidation may be undesirable in the face of rising fears about a global slowdown, a comfortable external environment can be maintained by ensuring stable financing, along with using exchange rates as a shock absorber to weather the adverse global economic situation.