A COMPREHENSIVE STUDY OF INDIA’S CURRENT ACCOUNT DEFICIT AND THE NEED TO REDUCE IT

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Abstract

The study illuminates the issue of India’s Current Account Deficit (CAD). The study analyses the trend of India’s CAD over the recent years as compared with the deficit of other economies. It was observed that the CADs of all of these economies has been under stress, but for reasons different from our own. Since burgeoning Gold and Petroleum Products are the root causes for the worsening India’s CAD and the external demand for our imports continue to be weak since the economic crisis of 2008, we believe that import substitution is the only credible way for tackling the current situation. Hence our recommendations are rooted in reducing Gold and Petroleum imports.

Introduction

India’s fiscal imbalance since 1980 has been widening when during that period, India started to have balance of payments problems. As a result of the Gulf War, India’s oil import bill grew, exports went down, credit dried completely, and investors took their cash out. Large fiscal deficits, consequently, had a snowballing effect on the trade deficit culminating in an external payments crisis. High imports and plummeting exports widened the Current Account Deficit (CAD) and led to serious repercussions.

Current Account Deficit (CAD) has been a major concern for the Indian Economy for the past 3 years. In Q2-2013, CAD increased and reached 4.4% of GDP. Our project was aimed at studying CAD of India since 1980 in a comprehensive manner.

Current Account (CA) of is the record of net of all exports, imports, services, dividend/interest and transfer payments between a country and the world that have occurred during a year. Current Account can be divided into 3 major components

a) Exports
b) Imports
c) Invisibles

It is important to understand that the above classification is very superficial and each of the above components can be split further. CA can also be interpreted as the difference between National Savings and Investment. Given this nature of interpretation, CAD is seen as a necessary feature of a developing economy, such as India, as there is higher need for investments compared to mature economies. At the same time, CAD is known for systematically undermining the macroeconomic stability, as experienced by India during early 1990s. Hence maintaining CAD at a sustainable level has been a topic of international concern and India, has made its own attempts in maintaining this balance.

Sustainable Optimal Level of CAD

According to C. Rangarajan, a CAD of 1.6% of GDP is at a sustainable level. However, growing degree of integration of the Indian economy with the global economy would imply variability in the size of the CAD and hence, S.S Tarapore, in 1997, recommended a CAD of 2% of GDP as the sustainable level. This level was further increased to 3% of GDP by him in 2006 while working with the Committee on Fuller Capital Account Convertibility.

Based on above recommendations, we can understand that CAD of India has clearly been at an unsustainable level since the past three years and has been deteriorating ever since. We next tried to anlayse the reasons behind this increasing CAD.

Analysis of India's CAD

In our work, we have adopted time-series analysis of various components of CA in a top-down approach. Starting 1978, all the components of CA have been considered.

Trends in Imports

The imports of India can be divided broadly into 2 categories, Bulk Imports and Non-Bulk Imports

Bulk Imports: The import items like Petroleum& crude oil, Pulses, sugar, edible oil, pulp & paper, iron & steel, rubber, fertilizers etc., are clubbed under the Bulk imports. Historically, Bulk imports have accounted for nearly 40.2% of the total imports since 1987. Petroleum and crude oil are the major contributing commodity of bulk imports, accounting for nearly 25% in the 40.2% of bulk imports.

Bulk Imports	Historical Contribution to Imports from 1987-88	Average annual Contribution to Imports from 2007-08	Historical Average Annual Growth (Since 1987-88)	Average Annual Growth in the past 5 years (2007-08)
Petroleum, Crudeand products	25.1	30.7	19.7	23.7
Consumption Goods	3.2	2.3	21.4	25.2
Other bulk items	11.9	10.9	16.3	19.0
Total Bulk Imports	40.2	43.9	16.8	22.0

Exhibit 1: Comparison of contribution and Growth of components of Bulk Imports since 1987-88 and 2007-08[i]

From exhibit 1, we can observe that the composition of Bulk imports has been changing since the past 5 years. The proportion of Petroleum products in bulk imports has been increasing. The growth rate of the bulk imports has been 16.8% on an average since 1987-88, which increase to 22% in the past 5 years. This can be attributed to the high annual growth percentage of Petroleum, crude and products as they have grown at an average of 23.7%, 4 percentage points above their historical annual growth of 19%. **So, this conclusive evidence shows that Petroleum crude and products have been driving the bulk imports, which accounts for nearly 40% of Total annual imports, because of their dominant contribution to the bulk imports and increasing annual growth rate every year.**

Non-bulk Imports: The non-bulk items historically have accounted for nearly 58% of total imports. The category of non-bulk goods has been divided further into 3 categories:

- Capital Goods (Transport Equip. , Machine Tools, Computer Goods etc.,)
- Export Relate items (Pearls, Precious Metals, Cotton Yarn etc.,)
- Others (Gold, Silver, Non-ferrous Metals, Chemical Materials etc.,)

From '87-'88 to '99-'00, the value of non-bulk imports have nearly **tripled** whereas the capital goods and export related items only doubled. From 1987-88 to 2011-12, we can see that the non-bulk goods have increased by nearly 27 fold but capital goods, the major contributor to have only increased by 20 fold and Other imports, the second major contributor to Non-bulk imports has increased nearly 48 times. Also the growth in Capital goods import can be attributed to the industrialization of the country since 1987-88 and it is deemed as a good sign as these capital goods will used in generating future exports whereas the "other imports", which are not of this capital nature, have been leading the pack of Non-bulk imports.

Non-Bulk Imports	Average Contribution to Imports 1987-2012	Average Contribution to Imports 2007-12	Average Annual Growth 1987-2012	Average Annual Growth 2007-12
Capital Goods	23.2	23.3	11.8	14.6
Mainly Export Related Items	14.9	11.1	39.2	18.9
Other Non-bulk items	20.0	21.8	27.4	19.8
Total Non-Bulk Imports	58.1	56.1	22.7	15.5

Exhibit 2: Comparison of Contribution and Growth of components of Imports since 1987-88 and 2007-08[i]

Following the observations from Exhibit 2, it is clear that other non-bulk items and export related items have been growing at a high pace. Growth of export related items is deemed as a good sign for the economy as they increase the future exports. Hence we focus on "Other non-bulk items" in the following section.

Commodity Name	Average annual Contribution to Imports (1987-2012)	Average annual Contribution to Imports (2007-12)	Average Annual growth (1987-2012)	Average Annual growth (2007-12)
Total "Others Non-Bulk " Imports	20.0	21.8	19.8	27.4
Gold and Silver	9.1	9.8	36.9	37.8
Gold	8.4	9.2	27.7	36.8
Silver	0.6	0.6	66.8	78.4
Artificial Resins and Plastic Materials, etc.	1.8	1.6	16.3	23.7
Professional, Scientific Controlling Instruments	1.7	1.3	15.2	10.7
Coal, Coke etc.	2.3	3.0	26.3	28.3
Medicinal and Pharmaceutical Products	0.8	0.7	14.6	15.9
Chemical Materials	0.7	0.7	15.0	22.3
Non-Metallic Mineral Manufactures	0.4	0.4	19.3	24.4
Others	6.5	4.2	14.4	18.2

Exhibit 3: Comparison of annual contribution and growth of commodities in Imports from 1987-88 and 2007-08[i]

From exhibit 3, we can observe that gold and silver imports have been increasing rapidly since the past 5 years with the average annual growth being 38.4% compared with the growth of total "other non-bulk imports" being 27.4% .

Hence with this conclusive evidence we can infer that Gold and silver have been contributing to the rapid growth of Non-bulk imports and thereby the overall imports, therefore are a matter of concern from the perspective of Current Account.

Comparison of India's CAD with Other economies

In an attempt to understand the situation of other emerging economies, we have studied the CA performance of these economies. Comparison has been drawn between India and other BRICS countries (Brazil, Russia, China, South Africa,) on the basis of their trade deficit. Among these BRICS nations, it has been found that within the timeline from 1987 to till date, China has always had a Current Account Surplus which is increasing with time unlike India or other BRICS nations. Hence, there seemed to be a vast structural difference in India and China. So, in our study we didn't go much deeper into the components of China's current account. For all other nations, which have had a Current Account Deficit was analysed in detail. The conclusion of our analysis for these nations is as follows:

Russia: Strong CA to the strong oil backed export sector. The current account has never been in deficit in the past 2 decades but the surplus has been decreasing gradually and it is expected to be in deficit by 2015. Our analysis has shown that Slowdown of Oil exports and increasing pace of Invisibles is the root cause of the decreasing surplus.

South Africa: Starting from 2003, it has experienced the longest and most-pronounced deficits. The breakdown of the current account into its major components indicates that from a trade perspective, the main contributor to the current account deficit has been the decline in the trade balance, whereas, the deficit on the services and income balance has not helped in neutralizing this effect as it has been negative throughout the sample period.

Brazil: CA performance of Brazil has been mixed when viewed from 1980. On an average, the economy had a deficit of nearly one Billion dollars since then. The CA reached surplus briefly prior to the financial crisis but has been in deficit ever since. We have observed that falling exports are the main reason for increasing CAD.

So, summarizing the cross country comparison, we can take it that other emerging nations also have been under CA stress, like India, but for many varying reasons. Hence it appears that there is no across the board solution for the current problems of India and the only way forward is to forge its own way.

Recommendations

Our analysis so far has shown that increasing POL, Gold & Silver are the root causes for deteriorating CAD. Decreasing demand for exports has been a common trend through the world since the financial crisis of 2008. This slowdown is evident from slowing growth of export based economies like China and commodity based economies like Brazil, Turkey etc. Hence export expansion is not a reliable option for reducing the CAD. Hence, we believe that import substitution is the only credible way for tackling CAD. Consecutively, our recommendations aim at reducing the imports of the major contributors for CAD, POL and Gold & Silver.

Tackling Gold

Setting up of a Bullion Corporation: The idea of a Gold Bank was mooted by the then Finance Minister, Dr. Manmohan Singh, in his budget speech in 1992. However, the proposal was not implemented. The RBI Working group recently suggested that the gold bank could be given powers to import, export, trade, lend and borrow gold and deal in gold derivatives. Its role would be that of intermediary in gold transactions, providing liquidity to holders of gold and gold loan providers

Tackling POL Imports

Transportation accounts for nearly 7% of annual petroleum consumption which is even higher than the consumption for industrial purposes. So, in order to tackling POL imports, it is inevitable that one deals with the excess demand from consumption due to transportation. This can be achieved by manipulating 2 levers that control the overall consumption. They are

Per capita Kilometers travelled (Subsidising Electric & Hybrid Vehicles): The biggest contributor for increasing demand from transportation is personal transport, mainly cars. So, in order to decrease the POL imports, alternatives for petroleum products should be encouraged. We believe that India should incentivize usage of electric vehicles in the country by providing subsidies/tax cuts etc.

Fuel consumed per Kilometer (Introduction of CAFE norms in India) : Corporate Average Fuel Economy (CAFÉ) is an internationally followed measure to ensure that the automobile manufacturers strive to improve the fuel efficiency of their vehicles. The Obama administration has been pushing aggressively for improving the CAFÉ standards in the U.S. CAFÉ regulation in U.S stands at 36 Miles Per Gallon (MPG). In India, no such norms have been established. Given that many of counter parts automobile manufacturers in the U.S are striving towards improving the fuel efficiency, India should push the domestic manufacturers and all other entities present in India to adopt the CAFÉ Norms.

Conclusion

In our work we tried to identify the root causes for burgeoning CAD of India. Our analysis has shown that increasing POL and Gold & Silver are the reasons behind the deficit. Consecutively, we came up with recommendations for tackling these issues.

The Balance of Payments (BOP) crisis of 1990 has been a turning point in Indian economy leading to opening up for external players. Since then the nation's economy has progressed so much that the concerns of BOP crisis have disappeared. Now India has Forex reserves worth nearly 280 Billion USD, which can fund the imports for the next six months. IMF reports peg Indian CAD for 2012 at 2.7% of GDP after cyclical adjustments. This year the CAD is expected to be around 3% of GDP, significantly lower than last year's. Does this means that the CAD is not a persistent issue for India? What to make of the rapid depreciation of India rupee after announcement of QE3 tapering by Federal Reserve which gave a reminiscence of the BOP crisis? How effective are the Inflation indexed bonds going to be in reducing Gold imports? Only time will tell. If there is something that many nations have learned the hard way, when dealing with external sector, is that it is better to be safe than sorry. Let's hope that we have had our dose of lessons when it comes to this.

Keywords

Economics, India, BRICS, Current Account Deficit

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[i] *Handbook of Statistics on Indian Economy, 2012*