



CURRENT ACCOUNT DEFICIT IN INDIA: EXPLORING THE TRENDS AND CAUSES

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ABSTRACT

Current Account Deficit(CAD) has become a major threat to India's external economic stability. One of the major causes of 1991 economic crisis was the huge CAD and the inability of the country to finance that deficit. Economy had to go through the painful process of macroeconomic policy adjustments as a consequence of 1991 crisis. After attaining stability during post reform period, the deficits started to increase again from 2012-13 onwards. These changing trends in the pattern of CAD in India makes it interesting to analyze the trends in CAD in the post reform period and also to identify the factors causing CAD in the Indian context. Analysis of secondary data used in this study reveals that commodity imports cause swings in the current account balance substantially. On the basis of these findings this study also recommends few policy options to manage current account deficit efficiently.

1.Introduction

Current Account is a part of the Balance of Payments(BOP) statement of a country. Current account records the volume of trade in the goods and service between a country and the rest of the world. It also includes private and official transfers and investment income and compensation of employees. When the import of goods, services and capital exceeds exports a country is said to be in Current Account Deficit(CAD). Current account deficit management is a crucial part of

macroeconomic policy decisions in a country. India has been experiencing current account deficit since 1970s. But CAD became a serious threat to the economy during the 1991 crisis when it was 2.2% of GDP. One of the main reasons for the BOP crisis was the high current account deficit and the lack of capital flows to finance the deficit. The Liberalization, Privatization and Globalization (LPG) model implemented during the 1990s focused on attracting foreign investment through the opening up of the economy. Before 1991, current account deficit was mainly financed through debt.

During 2011-12 and 2012-13 Current Account Deficit started becoming a threat to macroeconomic stability. In the financial year 2012-13 India witnessed a Current Account Deficit of Rs.4796.10 Billion (4.8% of GDP) which was the highest since independence. From 2013-14 onwards CAD as percentage of GDP showed a declining trend. In 2013-14 the CAD as percentage of GDP fell to 2.65% reaching a level which is very close to RBI's comfort zone of 2.5% of GDP. CAD as percentage of GDP went below the RBI's 2.5% threshold by recording 1.34%, 1.07% and 0.53% in financial years 2014-15, 2015-16 and 2016-17 respectively. Beating this decline trend, CAD surged to 2.4% of GDP in Q1 of financial years 2017-18 mainly due to increasing imports. The purpose of this paper is to analyze the current account balance trends in India and identify the factors responsible for the occurrence of current account deficit in India.

This paper is divided into 4 Sections. Section 1 deals with the introduction to the concept of current account deficit. Section 2 summarizes the review of existing literature on current account deficit along with identification of the research gaps and the objectives of the study. Research methodology along with detailed analysis of data are included in Section 3. Section 4 includes summary of findings and conclusion.

2. Review of Literature

Banday, U. J., & Aneja, R. (2016) in their paper attempts to test the twin deficit hypothesis in the Indian context. Cointegration and granger causality tests are used for testing the hypothesis. Budget and current account deficit data for the period 1990 to 2013 have been used for the analysis. Cointegration test identifies a long run co-movement of both the variables and Granger causality test reveals a bi-directional relationship between fiscal and current account deficits. Results of both these tests confirm that the twin deficits hypothesis holds good for the Indian economy.

Tastan, S., & Aric, K. H. (2016) in their paper checks whether current account deficit is sustainable in Brazil, India and South Africa. Quarterly data on current account balance as percentage of GDP have been used in this study. Sustainability has been checked using intertemporal budget constraint approached developed by Trehan and Walsh (1991) and Hakkio and Rush (1991). The study finds that it is difficult to achieve sustainability in India and South Africa. The main reasons for unsustainability in India is the high budget deficit, inadequate government policy reforms and huge merchandise trade deficit.

Thomas, M. P. (2016) in her paper investigates the impact of service trade on economic growth and current account deficit in India. Balance of Payments Constrained Growth Model of Thirwall Section has been used to measure the impacts. This paper compares the growth rate of goods sector and service sector with the balance of payments equilibrium growth rate. The paper identifies that growth rate of service sector is at par with BOP equilibrium growth rate, but the goods sector growth rate is higher than the BOP equilibrium growth rate and thereby causing a deficit in BOP.

Huntington, H. G. (2015).in this paper investigates the relationship between crude oil trade and current account deficit. This study is based on data collected from 91 countries for the time period from 1984-2009.Pooled Generalized Least Square Regression(GLS) in the study. The dependent variable used in the study was current account balance as a percentage of GDP and the independent variables were age dependency ratio, government budget balance as percentage of GDP, trade openness, real GDP per capita and net oil export balance as percentage of GDP.The study finds that oil exports are significant in explaining current account surpluses while oil imports are not significant in explaining current account deficits in importing countries.

Tiwari, A. K. (2015) in his paper discusses about the sustainability of India's current account deficit by specifically looking at impact of oil and non-oil commodity exports and imports. The data used in the study covers time period 1970 to 2007.Cointegration analysis along with unit root test with structural breaks used in the study reveals sustaining current account deficit is possible in the case of non-oil exports and non-oil imports while the same is not possible in the case of oil exports and imports. This study recommends suitable policy measures to regulate oil exports and oil import to make current account deficits sustainable in the long run.

Mathew, D. J. (2013) in his paper analyses the trends and challenges to India's BOP. Trends analysis was done for data covering the period 1990-91 to 2011-12. This paper analyses the trends in current and capital accounts during the study period. It identifies the positive impact of invisibles balance and software services on India's BOP. Major concern raised by the paper was the volatility of FDI inflows occurred during and after the 2007-08 financial crisis. The paper identifies increase in external debt and rupee depreciation as the major challenges in the external sector and urges policy maker to implement suitable monetary, fiscal and exchange rate policies to maintain macroeconomic stability.

Ramphul, O. (2013) in his paper attempts to identify the factors affecting current account deficit in India and the possibility of sustaining current account deficit in the long run. The paper covers an extensive time period from 1950 to 2010. Cointegration between variable was checked using Auto Regressive Distributed Lagged (ARDL) approach. The results of the study confirm cointegrating relationship between India's current account inflows and outflows in the long run. Granger causality test through vector error correction models also identifies a bi directional causal long term relationship between India's current account inflows and outflows. Fiscal deficit, real effective exchange rate and interest rate were identified as significant determinants of current account deficit in India.

Rangarajan, C.(2013), explores the trends in gold demand in India and its impact on CAD. The paper is written during the 2012-13 period when the current account deficits and gold imports were at the peak. This paper offers certain policy prescriptions to reduce the import of gold. According to Rangarajan by ensuring a good real return on other financial investments, investors appetite for gold can be curtailed. Maintaining real return on assets is only possible if inflation is under control. Increasing the import duty on gold and promoting transparent policies for buying and selling of gold are the other measures suggested by the paper to reduce gold imports.

U.J Srikumar(2013) in her paper discusses about the causes, implications and suggestive measures to reduce current account deficit in India. Data used in the study is quarterly in frequency and cover time period 2007-08 to 2011-12. This paper looks at the impact of import of Gold and oil on current account deficit. The main consequences of CAD according to this paper is the depreciation of rupee and the excessive dependence on volatile capital flows to

finance CAD. The corrective measures suggested in this article includes reducing gold import by increasing the import duty and encouraging the consumption of renewable energy resources instead of oil.

Callen, M. T., &Cashin, M. P. (1999) in their working paper explores the possibility of sustaining India's external instability. The initial part of this paper looks at the trends in India's current account deficit by dividing the period into three different time frames; independence to 1970,1980s to 1991 and then 1991 to 1999.India's external instability sustainability was assessed using solvency, sustainability and optimality of capital flows. The study identifies that India's current account deficit up to the period 1991 was not sustainable whereas post 1991 CAD became sustainable mainly because of the policy changes adopted during the 1991 crisis.

Most of the existing studies cover time period up to 2011-12. But the trends in current account balance underwent substantial changes after that time period. CAD was the highest in 2012-13 and from 2015-16 onwards CAD reduced substantially. Existing studies do not look at these recent changes in the current account balance trends. A study covering time period from 1990-91 to 2016-17 will help in creating a comprehensive understanding the trends in CAD.

Objectives of the study

1. To analyze the trends in Current Account Balance in India
2. To identify the causes of Current Account Deficit in India

3.Research methodology and Data Analysis

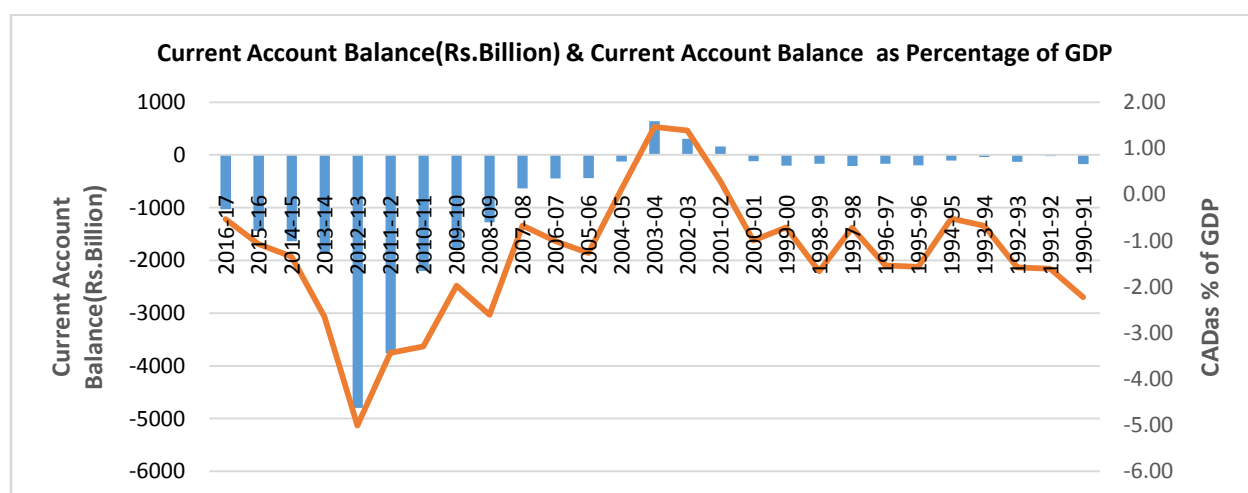
The methodology used in this study is analysis of secondary data of different macroeconomic variables. The data have been collected from secondary sources like Websites of RBI, Planning commission, World Bank etc. Annual data have been used and time period from 1990-91 to 2016-17 have been covered. Bloomberg terminal data also have been used for analysis.

Data Analysis section includes the trend analysis of current account deficit.Trend analysis comprises of identifying the patterns in the movements of variables and also the factors responsible for such movements.

Current Account Balance Trends

To understand current account balance trends, two variables have been used; Current Account balance (absolute amount) and Current Account Balance as percentage of GDP. Out of the 67 years from 1950-51 to 2016-17, India recorded current account surplus in 11 years. Five out of these 11 years current account surplus was less than Rs.0.07 Billion. This leads to the conclusion that for most of the time in the post-independence period, India witnessed current account deficits. Substantial increase in current account deficit started emerging since 1988-89. During the 45-year period between 1950-51 to 1994-95, highest current account deficit was recorded in 1990-91 which was Rs.173.67 Billion (2.2% of GDP). From 1991-92 to 2000-01, current account deficit as percentage of GDP remained below 2%. During 2001-02, 2002-03 and 2003-04 India's current account witnessed a transition from deficit to surplus. After recording surplus for three consecutive years, Current account moved back into the deficit territory in 2004-05 and ever since then the country has been witnessing deficit in the current account. As far as the magnitude deficit has been concerned current deficit remained above the RBI comfort zone of 2.5% of GDP from 2008-09 to 2013-14 except for the year 2009-10. In 2012-13 Indian economy witnessed the highest current account deficit in the history amounted to Rs.4796 Billion (4.8% of GDP). A declining trends can be seen in CAD from 2013-14 onwards both in absolute terms and as percentage of GDP.

Figure 3.1.1: Current Account Balance Trends:1990-91 to 2016-17

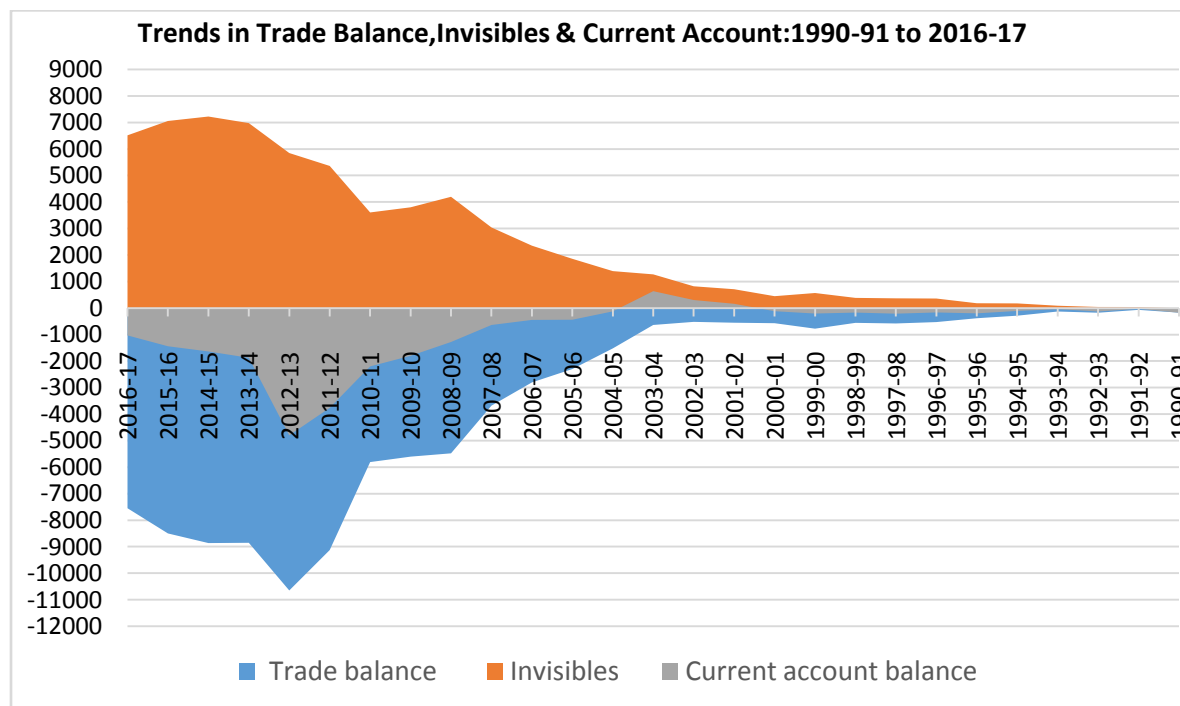


Source: Handbook of Statistics on Indian Economy, RBI

Composition of Current Account

The current account of country comprises of two sub accounts; trade balance account and invisibles account. Trade balance account shows the difference between merchandise export and import. This account could be in surplus or deficit depending on whether merchandise export is greater than merchandise import and vice versa. Invisible account comprises of trade in services, transfers and investment income.

Figure 3.1.2: Composition of Current Account



Source: *Handbook of Statistics on Indian Economy, RBI*

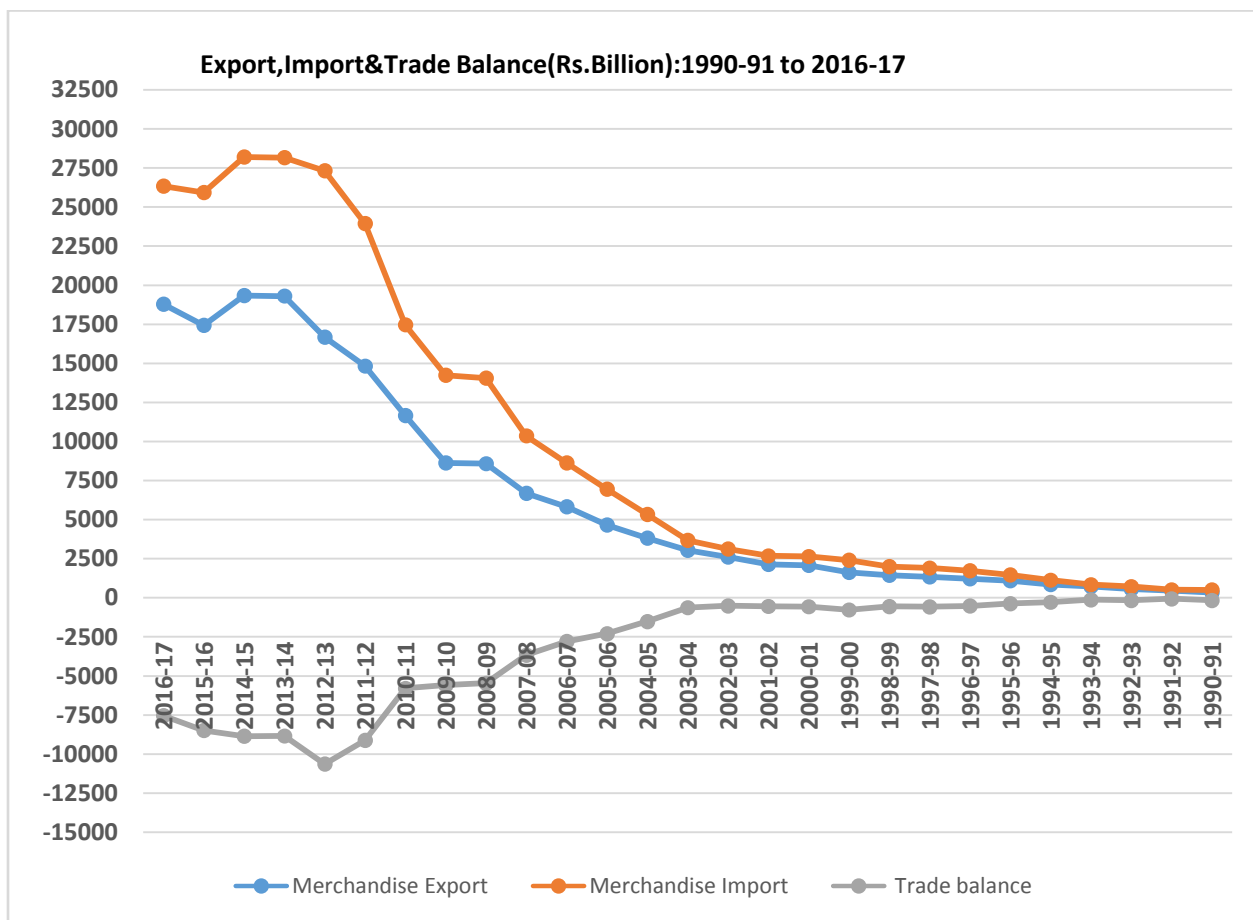
India's trade balance has been in deficit throughout the study period. The highest trade balance of Rs. -10644.56 Billion was recorded in 2012-13 and the lowest deficit of Rs.-64.94 Billion was in 1991-92. Substantial increase in trade deficit started from 2008-09 onwards. Trade deficit almost doubled between 2008-09 and 2012-13. Trade deficit has been exhibiting a declining trend since 2012-13.

Invisibles account generally shows an increasing trend during the study period. Decline in invisibles balance was observed only during five years (2000-01,2009-10,2010-11,2015-16,2016-17). Year 2014-15 witnessed the highest balance in the invisibles account.

Composition of Trade Balance

Trade balance is the major factor which influences current account balance. Understanding the trends in trade balance would provide deeper insights to structural changes happening in current account balance. Indian economy has always shown merchandise trade deficit. Merchandise imports showed a year on year upward trend throughout the study period except in 2015-16 and 2016-17. Merchandise exports also showed a continuously increasing trend except in in 2015-16 and 2016-17.

Figure 3.1.3: Composition of Trade Balance



Source: Handbook of Statistics on Indian Economy, RBI

Composition of Imports

Since imports have always been higher than exports for India, a deeper exploration of the composition of imports is helpful in understanding the impact of Imports on trade balance and current account balance. RBI classifies imports into oil and non-oil for the purpose of tracking the changes in value and volume of these two types of imports.

Table 3.1.1: Composition of Imports

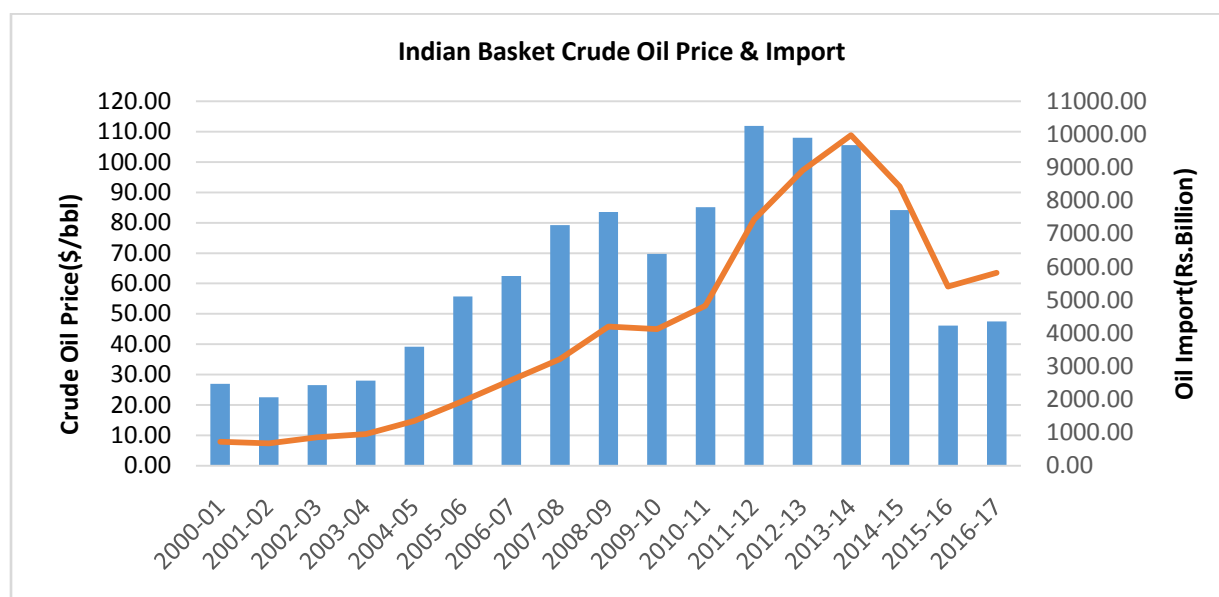
Year	Oil Import as % of Total Imports	Non-Oil Import as % of Total Imports
1990-91	25.04	74.96
1991-92	27.43	72.57
1992-93	27.05	72.95
1993-94	24.69	75.31
1994-95	20.69	79.31
1995-96	20.52	79.48
1996-97	25.65	74.35
1997-98	19.68	80.32
1998-99	15.10	84.90
1999-00	25.39	74.61
2000-01	30.97	69.03
2001-02	27.23	72.77
2002-03	28.72	71.28
2003-04	26.32	73.68
2004-05	26.76	73.24
2005-06	29.47	70.53
2006-07	30.76	69.24
2007-08	31.68	68.32
2008-09	30.56	69.44
2009-10	30.19	69.81
2010-11	28.65	71.35
2011-12	31.68	68.32
2012-13	33.41	66.59
2013-14	36.75	63.25
2014-15	30.79	69.21
2015-16	21.70	78.30
2016-17	22.70	77.30

Source: Handbook of Statistics on Indian Economy, RBI

Trends in Crude Oil Price and Crude Oil Import

The proportion of oil import in total imports became substantial since 2000-01. From 2000-01 to 2014-15 oil imports accounted for more than one fourth of total imports. In 2012-13 and 2013-14, the ratio of oil imports crossed 33% of total imports. It is interesting to note that Indian economy recorded the highest trade and current account deficits in 2012-13. India witnessed fourth highest trade deficit and second highest merchandise imports in its history in the year 2013-14.

Figure 3.1.4: Indian Basket Crude Oil Price and Imports



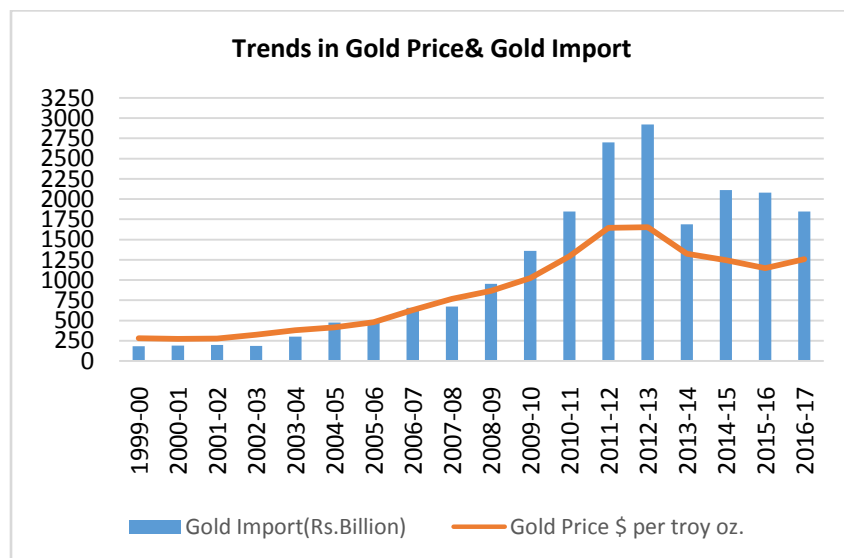
Source: Handbook of Statistics on Indian Economy, RBI

Oil prices remained above \$80/bbl from 2010-11 to 2014-15. Oil import value also started increasing substantially during this period. The proportion of oil imports in total imports also remained above 30% during this period except for year 2010-11. During the period 2011-12 to 2014-15, trade deficit was also very high. The fall in oil prices started since 2013-14 has led to a substantial fall in the oil import value. Oil prices fell from \$84.16/bbl in 2014-15 to less than \$50/bbl in 2015-16 and 2016-17. From its peak in 2013-14 Oil import value fell by more than 40% by 2016-17.

Trends in Gold Prices and Gold Imports

A peculiar component which has been creating swings in India's import and trade deficit is gold. India is one of the largest importers of gold in the world. Gold imports are contributing to the large current account deficit. During periods of volatile and uncertain capital flows, large gold imports lead to depletion of forex reserves and thereby threatens external Stability of the economy (RBI, 2013)

Figure 3.1.5: Gold Price and Import



Source: Handbook of Statistics on Indian Economy, RBI

The increase in global gold prices during and after the financial crisis led to increase in value of gold imports to India during 2008-09 to 2012-13. During 2011-12 and 2012-13 when the trade deficits were very high, the contribution of gold imports to trade deficit was greater than 25%. During these two years the current deficits were also the highest in the history of Indian economy. Due to fall in global oil prices along with various measures taken by the government, gold imports came down substantially compared to the peak in 2012-13.

Combined Impact of Gold and Oil Imports

The combined impact of gold and oil on total imports was the highest in 2012-13. Trade and current account deficits were also the highest in this year. The proportion of gold in total imports remained high in 2010-11, 2011-12 and 2012-13. Oil imports as proportion of total imports was

the highest in 2013-14 followed by 2012-13. The reduction in the proportions of gold and oil imports led to a declining trend in trade deficit in 2015-16 and 2016-17.

Table 3.1.2: Oil and Gold Imports as percentage of Total Imports

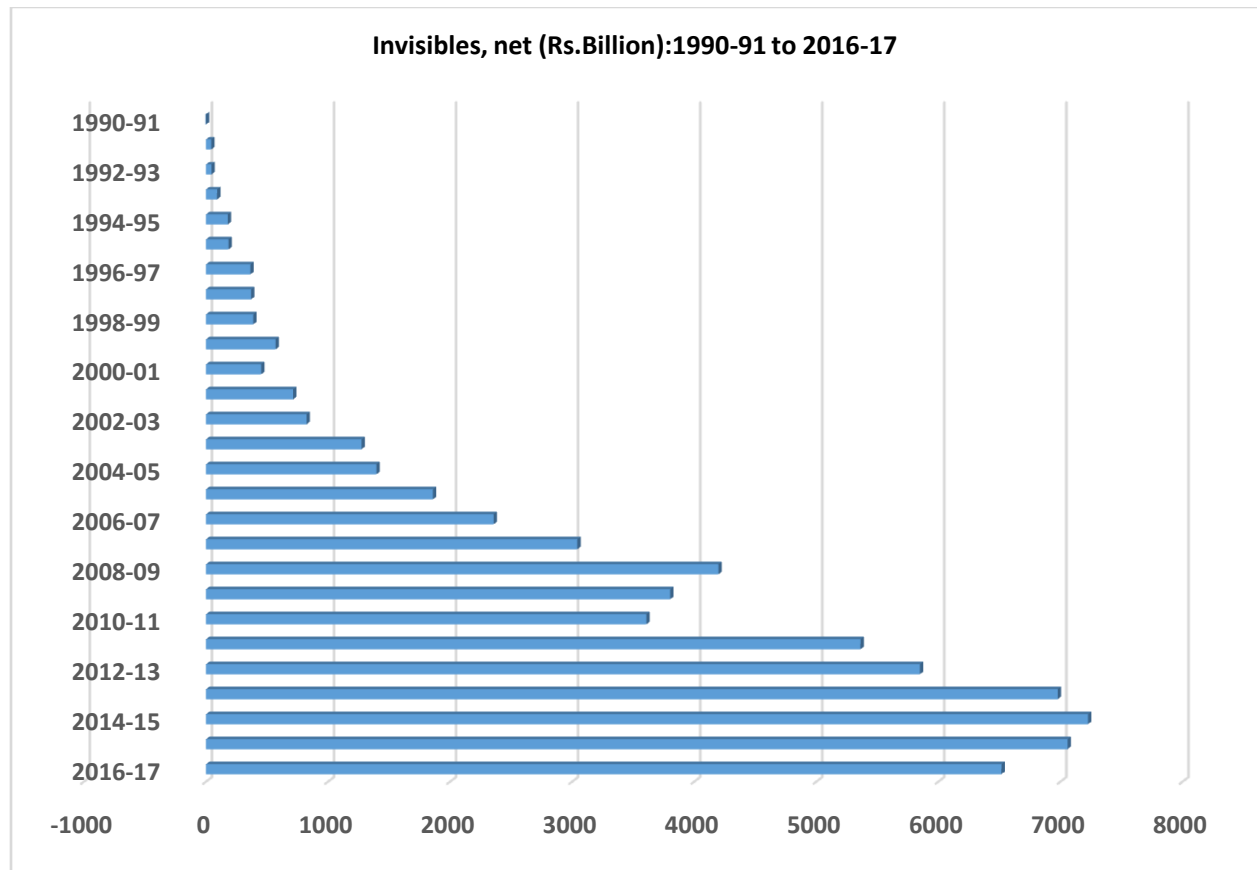
Year	Gold Import as % of Total Imports	Oil Import as % of Total Imports	Gold+ Oil Import as % of Total Imports	Trade Balance (Rs.Billion)
1999-00	8.36	25.39	33.75	-773.59
2000-01	8.16	30.97	39.12	-567.37
2001-02	8.11	27.23	35.34	-549.55
2002-03	6.26	28.72	34.98	-516.97
2003-04	8.34	26.32	34.66	-633.86
2004-05	9.45	26.76	36.21	-1517.65
2005-06	7.26	29.47	36.73	-2296.64
2006-07	7.79	30.76	38.55	-2799.62
2007-08	6.65	31.68	38.33	-3676.64
2008-09	6.94	30.56	37.49	-5474.49
2009-10	9.96	30.19	40.15	-5599.65
2010-11	10.97	28.65	39.62	-5804.70
2011-12	11.51	31.68	43.19	-9121.29
2012-13	10.95	33.41	44.36	-10644.56
2013-14	6.22	36.75	42.97	-8848.45
2014-15	7.71	30.79	38.50	-8858.62
2015-16	8.34	21.70	30.05	-8495.31
2016-17	7.19	22.70	29.89	-7544.52

Source: Handbook of Statistics on Indian Economy, RBI

Invisibles Account

Since the opening up of the economy, invisibles accounts' contribution to the current account has been increasing. From a deficit of Rs. -4.33 billion in 1990-91 invisibles accounts value hit an all-time high of Rs.7225 billion in 2014-15. The current account surplus from 2001-02 to 2003-04 was mainly propelled by the invisibles' contribution. During these three years the value of Invisibles Account was greater than the trade deficit which resulted in current account surpluses. Though there was a decline in value of invisibles during 2009-10 and 2010-11, it picked up afterwards. During the last two financial years invisibles value came down mainly because of reduction in services trade and transfers.

Figure 3.1.6: Invisibles Account



Source: *Handbook of Statistics on Indian Economy*, RBI

Composition of Invisibles

A further decomposition of the invisibles account would help us in understanding the contribution of each of the sub components. Invisibles account has been mainly divided into three subaccounts- services trade account, transfers comprising of private and official transfers and income earned by various factors of production. Services account includes trade in services related to travel, transportation, insurance, Governments Not Included Elsewhere(GNIE), software, business, communication and finance. Transfers account includes private and official transfers. Income account is the sum of investment income and compensation of employees.

Table 3.1.3: Composition of Invisibles (In Rs. Billion)

Year	Invisibles	Services	Transfers	Income
2016-17	6516.46	4524.90	3754.86	-1763.30
2015-16	7057.69	4558.28	4097.20	-1597.79
2014-15	7225.49	4683.16	4016.63	-1474.30
2013-14	6977.09	4428.68	3947.25	-1398.84
2012-13	5848.46	3532.17	3483.93	-1167.64
2010-11	3608.17	2005.60	2420.63	-818.06
2009-10	3802.66	1711.94	2470.65	-379.93
2008-09	4198.20	2484.06	2043.38	-329.24
2007-08	3041.86	1562.45	1684.52	-205.09
2006-07	2355.79	1330.64	1357.49	-332.34
2005-06	1859.27	1026.11	1094.32	-261.16
2004-05	1395.91	688.31	931.35	-223.75
2003-04	1273.69	463.81	1016.96	-207.08
2002-03	823.57	176.44	814.03	-166.90
2001-02	713.81	158.89	755.60	-200.68
2000-01	451.39	79.05	599.67	-227.33
1999-00	570.28	176.70	547.89	-154.31
1998-99	386.89	91.14	445.42	-149.67
1997-98	369.22	49.43	451.83	-132.04
1996-97	362.79	26.21	454.25	-117.67
1995-96	184.15	-7.02	298.33	-107.16
1994-95	178.36	18.83	267.26	-107.73
1993-94	90.89	16.77	176.70	-102.58
1992-93	44.75	26.98	122.80	-105.03
1991-92	42.59	31.33	105.22	-93.96
1990-91	-4.33	17.61	45.39	-67.33

Source: Handbook of Statistics on Indian Economy, RBI

Growth in the services trade balance is consistent since 1990-91 except for 1995-96 when services trade recorded deficit. Global slow down along with appreciation of real exchange rate was the major cause of the decline. From 2005-06 to 2008-09 service trade balance improved. Though the trade balance reduced in 2009-10, it again recovered and continued the upward trend till 2014-15. There has been a decline in the service trade balance during the last two financial years. On an average transfers (government+ private) show an upward trend. The consistent surpluses in service and transfers accounts maintains healthy growth of the invisible account balances.

4. Summary of findings and Conclusion

Analysis of data done in this paper clearly tracks the trends in current account deficit in the post reform period. It can be observed that most of the time in economic history Indian economy witnessed current account deficits. The BOP crisis of 1991 was mainly due to extremely high current account deficit. India's current account recorded surpluses for three years in the early 2000 period. The magnitude of current account deficit has been high since 2008-09 and in 2012-13 it reached record levels. Due the decline in commodity prices and increase in invisibles account, current account deficits started coming down since 2014-15. As far as the causes of CAD is concerned, oil imports top the list. Increase in proportion of oil imports in total imports coincided with increase in current deficit during most of the years. Gold imports also create significant deficits in the current account especially during the period 2011-12 and 2012-13. Policy changes at the government level are required to discourage the consumption of oil and gold is essential in managing the current account deficits within the sustainable limits. Policies to increase services exports also will be helpful in providing a cushion to the current account during periods of high trade deficit.

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