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INDIA'S CURRENT ACCOUNT DEFICIT SINCE 90S: THE WAY OUT

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ABSTRACT

Despite no consensus among economists on the threshold limit of the current account deficit, an ever-widening current account deficit has always been an issue of concern for policymakers. An imbalance in merchandise trade that is not covered by invisible earnings leads to current account deficits. With the exception of a few years, the Indian economy has faced deficits in its current account since the 1980s due to excessive imports accompanied by sluggish growth in exports. A large current account deficit was a key reason among many for the severe balance of payments crisis in 1991. Having no other options in sight, the country resorted to economic reforms on a massive scale in subsequent years. With economic reforms and judicious external sector policies, the country became resilient on the external front in the late 1990s. Moreover, the government realized a current account surplus for three consecutive years, i.e., from 2001-02 to 2003-04 and the current account deficit was not a cause of concern for policymakers until the advent of the global financial crisis in 2008-09. The present paper discusses the trend and composition of India's current account since the 1990s, the reasons for expanding the current account deficit, and policy responses by the government to make the current account sustainable.

KEYWORDS: Capital Inflows, Exports, Imports, Invisible Earnings, Remittances, Trade Balance

1. INTRODUCTION

The current account deficit (CAD) simply means that a country's total payments to other countries are more than the total receipts from those countries in a given period of time, generally a year. CAD may be good or bad for an economy depending on the underlying component factors that give rise to it. All receipts and payments in India's current account are broadly classified into two heads: merchandise and invisibles. Invisibles are further classified into services, transfers and income. Travel, Transport and insurance are major components of services. Transfer includes official and private transfers and income is composed of investment income and compensation of employees. The significant role played by invisible earnings in narrowing down India's current account deficit has been unquestionable. Economic Survey 2007-08 mentions that "current account deficit mirrors the savinginvestment gap in the national income accounts and thus constitutes foreign savings. The challenge before the emerging market economies is to leverage foreign savings to promote domestic growth without having the long-term consequences of external payment imbalances. However, current account deficits, per se, need not necessarily enhance the productivity capacity and thus overall GDP growth. This would depend on underlying component factors leading to the current account deficit."

When income received from export of merchandise goods and services fall short of payments made for import of goods and services, the country runs a trade deficit. Being the largest component of India's CAD, trade deficit has had always been in the limelight and has drawn undue attention of the policy makers. The reason behind India's trade deficit has been large volume of imports relative to exports. The Indian government periodically constituted various committees to develop strategies for promoting exports and substituting imports. But until the late 1980s, the recommendations made by these committees were hardly ever put into practice. India's external sector policies have been liberalized comprehensively after realizing balance of payment crisis in 1990-91.

Keeping CAD at a sustainable level is undoubtedly a prerequisite for achieving external sector balance. Rising current account deficit creates challenges for the economy as it may lead to depreciation of national currency, loss of foreign investors' confidence in domestic economy and inflation. Besides, the countries that are not able to finance their large CAD through foreign investments resort to foreign borrowings that may lead to debt accumulation and excessive external debt can further adversely affect the economy. Thus, keeping CAD at a manageable level requires policies concerning promotion of exports, substitution of imports, attracting foreign investments and gaining foreign investors' confidence in the economy. India's current account deficit has always been lower than the trade deficits as a large component of the merchandise trade deficit is offset by invisible earnings, particularly from the export of services and remittances. Furthermore, the country experiences a surplus in its current account when the invisible earnings are more than enough to cover the trade deficit.

Crude oil prices play an important role in India's current account balance through imports and remittances. Higher oil prices increase import bill and put strain on balance of trade but at the same time it augments remittance inflows. However, due to restrictions on immigrant workers by Gulf Cooperation Council (GCC) countries in recent years, an increase in oil prices may not culminate into higher remittances. And consequently, may not shield CAB against trade deficit.

2. Explaining Trade Deficit

India's balance of trade (BoT) has always been in deficit in the post-reform period (Figure 1). The merchandise trade deficit increased from US$ 5.9 billion in 1990-91 to US$ 12.8 billion in 1999-00 before reaching to US$ 190.3 billion in 2012-13. Merchandise trade deficit fluctuated between US$ 108.5 billion to US$ 184.0 billion during 2013-14 to 2020-21 and then increased to US$ 191.0 billion in 2021-22. Thus, data depicts that despite fluctuations in the trade deficit it has been showing an upward trend since 1990-91. The Figure 1 exhibits that both imports as well as exports have increased since 1990-91 but except for a few years, growth of imports has always been higher than the growth of exports leading to trade deficit. India's trade deficit widened during 1990-91 as a consequence of deceleration in growth of exports and surge in import bill. Despite poor export performance caused by severe trade disruption with the erstwhile Soviet Union and ongoing recession in industrialized countries, the trade deficit narrowed down in 1991-92 as import tightening policies pursued in the past resulted in drastic fall in imports. The sharp decline in trade deficit in 1993-94 is attributed to the extraordinary performance of exports accompanied with modest increase of imports.

Trade deficit as percent of GDP increased from 3.4 in 1995-96 to 4.0 in 1996-97 despite sharp decline in import growth, because growth of exports also fell abruptly. Weak domestic demand and slowdown in industrial activity, among other factors, were the cause for sharp decline in growth of imports in 1996-97. The deficit in the trade account narrowed in 2000-01 as a consequence of increase in growth of export. Export growth accelerated in 2000-01 with a growth rate of 21.0 per cent after showing a sharp turnaround in 1999-00. Export growth in 2000-01 almost doubled as compared with the previous year. A major part of this increase was contributed by an increase in volume of exports. The government's concerted efforts for providing a favorable environment for international trade tripled exports between 2001-02 and 2006-07. Export grew continuously at more than 20 per cent in the period from 2002-03 to 2007-08. The merchandise trade deficit was around 2 percent of GDP during 2000-01 to 2003-04.

With a rise in petroleum, oil and lubricants (POL) as well as non-POL components in imports during 2006-07, imports reached at 20.9 per cent of GDP as compared to exports which reached at a level of 14.0 per cent of GDP thus widening trade deficit to 6.9 per cent of GDP. India was not significantly affected by the global financial crisis in the beginning but as the crisis intensified there was slowdown in exports in the second half of 2008-09 and both export as well as import growth became negative in 2009-10. The situation improved in succeeding two years but the negative growth of exports worsened the situation and trade deficit reached its highest level in 2012-13 since 1990-91. The merchandise trade balances showed an improvement in successive years and with robust export growth and sluggish import growth it plummeted to US $10.9 billion in 2016-17. Since then, India's trade deficit has had widened except in year 2020-21. India's merchandise export reached an all-time high at US$ 422 billion in 2021-22 but high growth of imports relative to imports raised trade deficit to US$ 191.0 billion in 2021-22.

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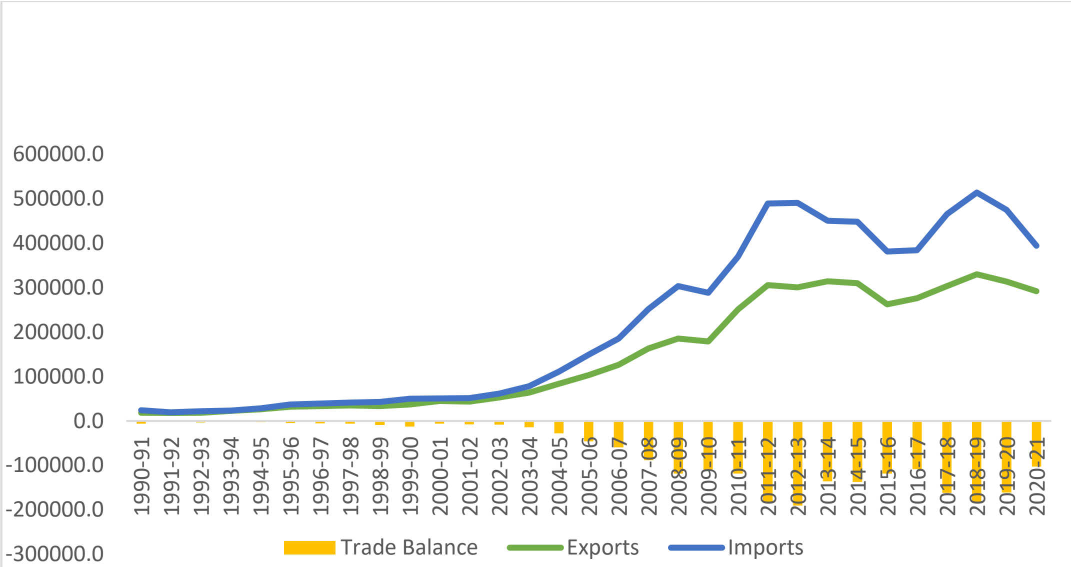

Figure 1: India's Exports, Imports & Trade Balance (US$ million)

Table 1: Growth in Exports, Imports and Merchandise Trade Balance

Year	Exports (US $billion)	Growth (%)	Imports (US $billion)	Growth (%)	Merchandise Trade Balance (US$ billion)	Growth (%)
1990-91	18.14	9.2	24.1	13.5	-5.9	28.7
1995-96	31.8	20.8	36.7	28.0	-4.9	110.0
1997-98	35.0	4.6	41.5	6.0	-6.5	14.4
2001-02	43.8	-0.6	51.4	2.9	-7.6	28.6
2002-03	52.7	20.3	61.4	19.4	-8.7	14.6
2003-04	63.8	21.1	78.1	27.3	-14.3	64.6
2009-10	178.8	-3.5	288.4	-5.0	-109.6	-7.4
2012-13	300.4	-1.8	490.7	0.3	-190.3	3.8
2015-16	262.2	-15.5	381.0	-15.0	-118.7	-13.8
2020-21	291.8	-6.9	394.4	-16.9	-102.6	-36.4
2021-22	422.0	44.6	613.0	55.4	-191.0	86.2

Source: Handbook of Statistics on the Indian Economy, 2021-22, Reserve Bank of India, Mumbai.

3. Explaining Invisibles

Invisibles has had always acted as a cushion against India's merchandise trade deficit and has made current account deficit manageable. However, the net invisibles turned negative in 1990-91 as payments on account of invisibles were more than the invisible receipts (Table 2). There was a radical fall in invisible receipts in the form of transportation, travel and tourism earnings, private remittances etc. However, a remarkable turnaround was realized in the invisibles account after 1990-91. The invisibles account which suffered from deficit in 1990-91 was converted into a surplus in 1991-92 and the surplus was maintained in subsequent years also as the private transfers shifted away from illegal channels (Hawala) to banking channels. Private transfers and tourist earnings were more than offsetting large outflows on account of investment income payments and non-factor services apart from travel.

From 1992-93 to 1997-98 invisible receipts, in US dollar terms, recorded a growth rate of around 20.0 per cent with the support of buoyant private transfer receipts and increased tourism earnings. Private transfers were encouraged as market determined exchange rate motivated for channeling remittances through formal sources. About 82 per cent of the deficit on the trade account was covered by net inflow of invisibles in 1997-98. Private transfers, with an annual average growth at 13.5 per cent during 2002-03 to 2006-07 played its traditional role of being a major source for the invisibles account surplus. Prior to global economic slowdown, increases in trade deficit were weakened by surplus invisibles which was majorly contributed by private transfers particularly workers' remittances and services exports. Since 2005-06, software services have remained the most significant component of India's services exports. However, investment income account has had always remained negative since 1990-91 as outflows were more than the inflows (Figure 2).

With an increase of 40.7 per cent, India's net invisible balances registered significant improvement in 2011-12 as invisible receipts increased while invisible payments declined. The reason for decline in invisible payments was lower imports of software and business services and investment income payments. Net invisibles increased from US $107.5 billion to US$150.7 billion during 2012-13 to 2021-22. In spite of a sharp contraction in travel receipts (due to imposition of international mobility restrictions) along with fall in remittances in the COVID-19 pandemic period, net invisibles declined by US$ 6.8 billion in 2020-21. However, net invisibles showed a significant improvement in 2021-22.

Table 2: Components of Invisibles Account (US $million)

Year	Non-Factor Services (Net) I	Income (Net) II	Private Transfers (Net) III	Official Transfers (Net) IV	Invisibles (Net) (I to IV)
1990-91	980	-3752	2069	461	-242
1995-96	-200	-3205	8507	345	5447
1997-98	1319	-3520	11830	379	10008
2001-02	3324	-4206	15398	458	14974
2002-03	3643	-3446	16387	451	17035
2003-04	10144	-4505	21608	554	27801
2009-10	36015	-8038	51791	254	80022
2012-13	64915	-21455	64342	-309	107493

2015-16	64915	-24375	63139	-512	107928
2020-21	88565	-35960	74439	-979	126065
2021-22	107516	-37269	81230	-783	150694

Source: Handbook of Statistics on the Indian Economy, various issues, Reserve Bank of India, Mumbai.

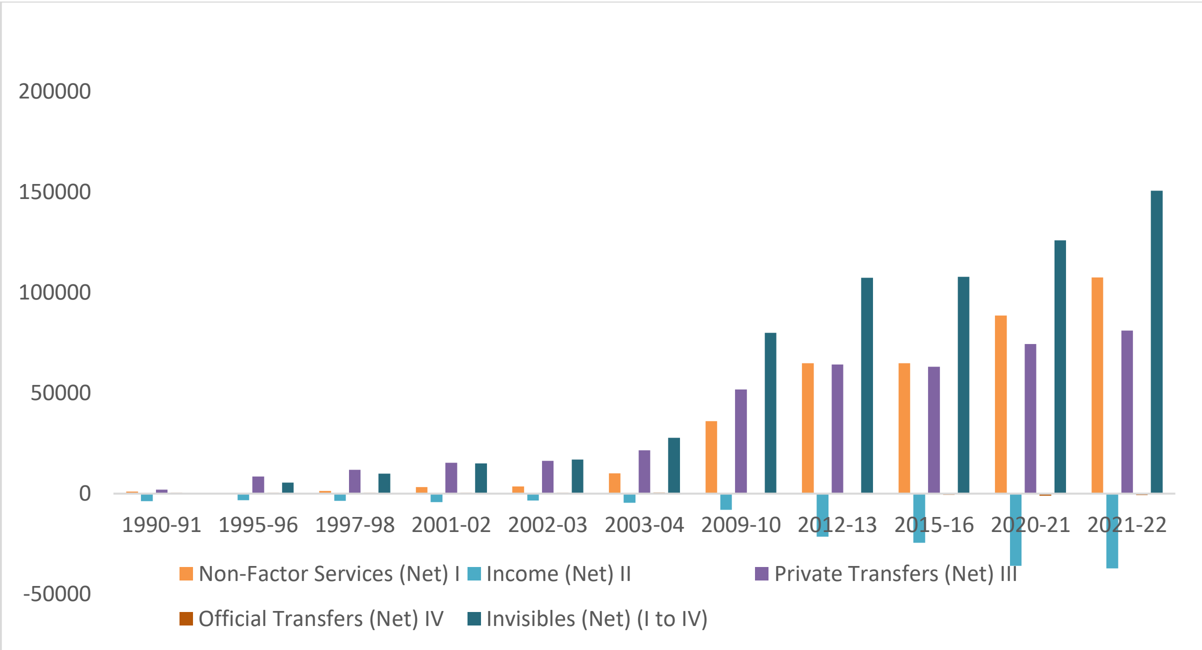

Figure 2: Components of Invisibles (US$ billion)

4. India's Current Account Balance: Trends & Composition

India adopted an inward-looking development strategy and remained insulated from the world trading system after independence. Restrictions on imports were imposed and exports were dominated by primary commodities. The country experienced high growth in imports during Second Plan due to heavy investments in capital goods industries required for industrialization. The high volume of imports accompanied by the sluggish performance of exports resulted in a widened trade deficit. This trend continued in the Third Plan also.

CAD was met by external assistance and through the depletion of foreign exchange reserves during the first three Plan periods. The deficit in the current account was further aggravated in 1967-68 on account of rising defense and food-related imports due to two successive wars with China and Pakistan along with severe droughts. Thereafter, the current account was relatively in a comfortable position till the end of the 1970s. However, the country had to resort to IMF in 1974-75 owing to high import bills due to oil shocks in 1973-74. The doubling of world oil prices during 1979-81 turned India's current account into a deficit of 2 percent of GDP in 1981 which was almost in balance in 1978. This deficit continued during 1982-85 as a consequence of the stagnation of exports. The CAD became unsustainable at the end of the 1980s and reached a level of 3 percent of GDP in 1990-91 when invisible as the percent of GDP turned negative to the tune of 0.08 (Figure 3). Thereafter, India's current account deficit as a percent of GDP hovered in the range of 0.4 to 2.0 till 2000-01. There was a surplus in India's current account for three consecutive years from 2001-02 to 2003-04 as receipts on the current account were more than that of payments. This was the period when there was surplus in both the current as well as capital account which resulted in larger overall surpluses and led to accumulation in the foreign exchange reserves of the country. The country took 24 years to experience a surplus in its current account and it lasted merely three years when the country again started experiencing a deficit in its current account. Despite a robust growth in net invisibles account, current account reverted to a deficit in 2004-05 and thereafter it increased in subsequent years.

One of the significant achievements of economic reforms has been India's comfortable position concerning the balance of payments on the current account. The country made an effort and succeeded in maintaining a sustainable current account deficit in the post-reform period. Before the occurrence of the global financial crisis in 2008-09, CAD continued to remain at moderate levels and was easily financed by normal capital inflows. However, CAD shot up to 2.3 per cent of GDP in 2008-09 which was the highest level of CAD since 1990-91. In the post-2008 crisis period, CAD increased continuously and reached its highest level of 4.8 percent of GDP in 2012-13. The widening of CAD during this time was ascribed to sluggish growth in exports, a rising share of petroleum and crude products and gold imports in India's import basket, and negative net investment income.

There was a sharp increase in import of gold in 2012-13 which constituted about 11 per cent of total import bill. The RBI and the Government of India then put several restrictions on the import of gold to curtail CAD and prevent speculation in the domestic market. Import duty on gold was increased in a phased manner from 2 percent to 10 percent, the selling of gold by banks and import of coins and medallions was banned, and a requirement that 20 percent of gold import be used for export purposes was made. Following these steps, the share of gold in India's import declined to 6.4 per cent and CAD came down to 1.7 per cent of GDP in 2013-14 and further to 0.6 per cent in 2016-17. However, CAD increased in the subsequent two years and reached 2.1 percent of GDP in 2018-19. Thereafter, CAD as a per cent of GDP improved and the country experienced a surplus in its current account to the tune of 0.90 per cent of GDP in 2020-21 after a gap of 17 years owing to a lower trade deficit and a sharp rise in net invisible receipts. The situation reversed in 2021-22 as there was again a deficit in India's current account.

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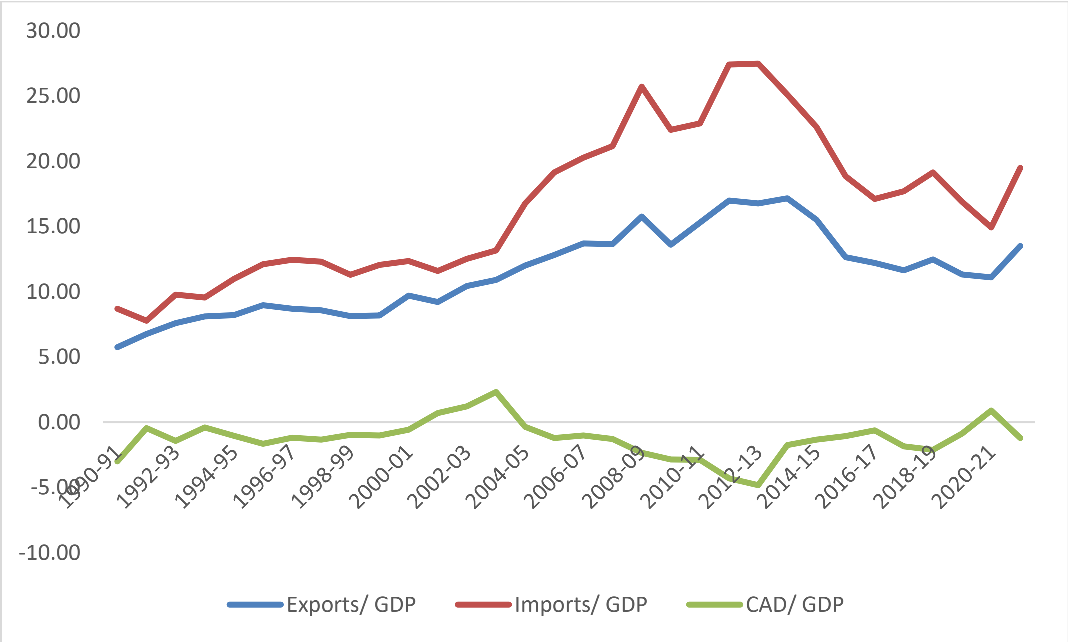

Figure 3: India's Exports, Imports and CAD as a per cent of GDP

4. Capital Inflows to India

India adopted the policy of strict capital controls till the reform of 'nineties. The process of liberalization of capital flows across borders started and most of the controls on capital account were lifted after experiencing Balance of Payments crisis. Opening of capital account was one of the objectives of the New Economic Policy initiated in 1990-91. India's external financing need was met by official capital flows particularly concessional bilateral and multilateral external assistance till the early 'eighties. However, growing external financing need and decline in availability of concessional official flows in 'eighties together with the burden of repayments to IMF for loans received under Extended Fund Facility in late 'eighties made the country to resort to external commercial borrowings, syndicated loans and bonds and short-term NRI deposits. As the commercial sources of finance dried up in the early 'nineties due to Gulf crisis, the country faced severe liquidity crisis. The country made an adjustment programme to overcome the Gulf crisis and launched a massive program of structural reforms.

Several reforms in the external sector were implemented as per the recommendations of a High-Level Committee on Balance of Payments under the chairmanship of Dr. C. Rangarajan. Current account was made convertible in 1994. The Reserve Bank of India constituted Tarapore Committee to make a roadmap for fuller convertibility on capital account. As per recommendations of the committee in

1997, India adopted gradual approach towards liberalization of capital account and it was made partially convertible. Various liberalization measures related to foreign investment inflows (FDI & FPI), opening of Indian corporate offices abroad, investment in Joint Ventures/wholly owned subsidiaries abroad etc. were undertaken. For capital account management, certain restrictions were placed on capital inflows and outflows keeping in view financing need as well as cost involved with such flows. Quantitative and end-use restrictions have been made for external commercial borrowings. There are severe quantitative restrictions on short-term borrowings also, excepting those strictly related to trade.

Prior to East Asian crisis, many policy makers worldwide appreciated the policy of complete liberalization of capital account and frowned upon any kind of restrictions on it. However, unlike many emerging economies when India could insulate its economy from adverse consequences of East Asian crisis in 1997, it forced many policy makers to revisit the policy of capital account liberalization. Those who were earlier in favor of complete liberalization of capital account changed their view. When India's CAD was at moderate level it was financed by normal capital flows. In pre-reform period, capital flows to India were dominated by debt-creating flows. However, excessive external indebtedness in the early nineties and resultant BoP crisis led shift in focus of policy from debt to non-debt creating and from short-term to long-term capital inflows in post-reform period. Also, debt creating flows like external commercial borrowings (ECB), short term trade credit and banking capital are now closely monitored. To attract foreign investments particularly foreign direct investments the government has gradually increased the sector-wise ceilings for foreign equity holdings. India has become one of the top recipients of foreign capital inflows among emerging economies.

5. The Way Out

Trade is essential for developing countries to take the advantage of increased globalisation of products and financial markets in present globalised era. International trade has been one of the significant pillars of resilience of India's external sector. India's trade as a percent of GDP has been continuously increasing since 1980. In globalized era, policy of restrictions, regulations and control is not desirable. Keeping in mind the dangers of opening up the economy the country needs to follow some precautionary measures to insulate the external sector of the economy from economic crisis.

Firstly, the country should keep its current account deficit manageable by making its exports competitive and substituting imports by indigenous products and services. Diversification of exports in terms of product as well as well as potential markets is imperative to increase India's exports. The government of India has been consistently adopting measures to diversify its exports. India has diversified its export destinations in last 25 years, yet more than 40 per cent of India's exports is still accounted by only seven countries (Economic Survey 2021-22). Thus, diversification of exports holds an immense potential and opportunity for its growth. Also, the government has been making free trade agreements (FTAs) - both bilateral as well as regional - over the past several years which would help the country in diversifying both products and destinations.

Secondly, theoretical and empirical studies appreciate that debt liabilities are more burdensome as compared to equity liabilities at the time of economic crisis. Therefore, debt-equity composition of external liabilities should always be monitored and taken care of. Thirdly, the proportion of short-term debt to total debt should not be high because it becomes difficult to rollover short-term capital flows under unfavourable market conditions. Fourthly, the country should have sufficient amount of foreign exchange reserves for the import of goods and services. However, high level of foreign exchange reserves also needs to be carefully analysed. Fifthly, large capital inflows require investor friendly policy in the host country. Therefore, the initiatives taken by the government to make investor friendly environment in the country should continue in the future also.

Lastly, trade disrupted in post-Covid-19 period word-wide regained its momentum in the first half of 2021-22 and global trade volume increased by 4.8 per cent. India's merchandise export reached an all-time high in 2021-22. Services export also recorded a growth of 23.5 per cent in 2021-22 despite fall in tourism revenues. However, the likelihood of a recession in major economies, adverse consequences of Russia-Ukraine conflict, disrupted supply-chain, tightening of monetary policy by many central banks etc. seem to put constraint on the global trade in subsequent periods. India needs to safeguard itself from the ripple effects of expected slowdown of global trade in coming years.

6. Findings & Concluding Remarks

India's current account since 90's has been appreciated by perseverance of high trade deficit and resilient invisibles surplus which have provided shield to current account position. There have been fluctuations in CAD as a percent of GDP throughout this period and it remained at a moderate level till 2008-09 and then gradually increased after the global economic crisis and became unsustainable in the year 2011-12 and 2012-13. However, since 2013-14 declining trend has begun and CAD as a percent of GDP reached a minimum level in 2016-17. But it again increased in subsequent years. However, a surplus in the current account was recorded in 2020-21 as a consequence of a sharp reduction in the trade deficit.

Since India's current account deficit originates from merchandise trade deficit, therefore reduction of CAD necessitates reduction of merchandise trade deficit which occurs due to higher growth of imports relative to exports. The government has taken various measures for promoting exports and curbing imports but much success has not been achieved yet. There is need to contain import of gold and petroleum products which constitute a major part of the import bill. Moreover, exports should be made competitive. One of the major reasons for high growth of imports in post-reform period was that Indian government had been removing quantitative restrictions on imports as a part of import liberalization policy since 1990-91. Invisible flows have always been a source of enormous strength to current account. Private transfers and services exports particularly software services export have been the major contributors to the invisibles account. The outflows on account of investment income have always been higher than inflows turning (net) income negative over the years.

To conclude, experience of many countries has shown that large current account deficit poses macroeconomic challenges for the economy and adversely affects the economic growth of the respective country. India’s performance on the external sector has improved in the post-reform period and except few years, CAD has always remained in comfortable position during the entire period. There is need to maintain sustainable CAD in future also. The country should make efforts to minimize CAD so that it can be covered by normal capital flows.

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