Challenges in current account deficit

Why in news?

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IMF recently forecasted India’s current account deficit (CAD) to widen to 2.6 percent of GDP in 2018/19 from 1.9 percent in the previous year.

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What are the recent developments that affected CAD?

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- Value of oil imports has risen, even though these have been offset by increases in net factor incomes from abroad.
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- This lead to a balance between balance of trade and balance of invisibles in the current account.
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- Stronger dollar growth and the negative events in Argentina and Turkey impacted many such emerging markets due to **deteriorating emerging-market sentiment** among investors.
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What are the structural factors surrounding CAD in India?

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- India’s GDP growth is largely driven by consumption that are largely import-intensive.
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- A depreciating rupee should result in a fall in import demand and a rise in export demand through the price effect.
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- The situation gets different altogether in India, wherein exports respond mainly to improvements in productivity and to changes in global demand.
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- This made our exports highly **inelastic to exchange rate depreciation**.
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- Since 1991, import intensity of the Indian economy has risen steadily.
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- It has been fuelled by increased elite prosperity and their luxury consumption needs instead of importing food and other items of mass consumption.
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- Key growing sectors like defence, aviation, and electronics have failed to secure significant import substitution in recent times.
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- New import-intensive sectors have emerged as in cheap clothing from Bangladesh and Vietnam and solar panels from Japan and China.
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- India also raised its **import of non-tradeables** wherein forex spent on education and recreational travel abroad raised from $176 million in 2013 to $5.4 billion in 2017.
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What does the recent Nomura Damocles Index say?

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- It assesses the risk of exchange rate crisis for 30 emerging market economies.
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- A score above 100 suggests a country is vulnerable to an exchange rate crisis in the next 12 months.
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- With moderation in CPI inflation and the CAD, alongside sufficient forex reserve buffer, **India scored 25** and was well **within the safety threshold**.
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- Yet, higher oil prices, portfolio outflows and a sharper-than-expected domestic growth slowdown still remains as its key vulnerabilities.
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How should India proceed?

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- Encouraging FDI and FPI inflows could be the immediate strategy to arrest the rising CAD.
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- That would make CAD to stabilise at levels which our growing mega-economy would easily finance by attracting **stable capital inflows**.
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- But in the long term, India should moderate the CAD by orienting her **domestically driven growth** to foster substitution in imports.
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- Hence, India’s external account challenge is structural and it requires a **continuing, orderly depreciation of the rupee**, which would eventually reduce the pace of import growth and encourage export growth.
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Source: Business Standard

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