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CAD in focus

What is the issue?

The current account deficit which has started to rapidly expand, needs to be watched closely.

What is Current Account?

- External transactions are classified as
 - Current account and
 - Capital account
- The current account measures
 - Current account balance = Trade Balance + Net of Invisibles.
 - Trade Balance = Export - Import
 - Net of Invisibles which includes
 - Remittances from labour abroad.
 - Income received from investments abroad
 - Payments to foreign holders of a country's investments
 - Transfers such as foreign aid.
- The current account may be positive (a surplus) or negative (a deficit)
- A positive current account balance
 - Indicates that the nation is a net lender to the rest of world.
 - Increases a nation's net foreign assets by the amount of the surplus
- A negative current account balance
 - Indicates that it is a net borrower
 - Decreases a nation's net foreign assets by the amount of the deficit.
- A country's current account balance, whether positive or negative, will be equal but opposite to its capital account balance.
- India has been recording a current account deficit over the past two decade.

What is the present situation?

- With economic activity slowly moving towards pre-pandemic levels and central banks beginning to withdraw their easy monetary policies, India's external account could come under pressure in the coming quarters.
- Signs of stress have already emerged in the balance of payments statement for the September quarter of 2021
- CAD moved up to 1.3% of GDP or \$9.6 billion.
- Trade deficit in the December 2021 quarter was at a 25-year high

What are the Reasons for increase in CAD?

- **Trade deficit** - Increase in CAD was mainly due to trade deficit expanding quite sharply.
- This is because of
 - Increase in crude oil prices.
 - Increase in consumption
 - Commodity prices too ruling high.
- The cushion provided by decline in commodity prices as well as low demand in 2020 will no longer be available.
- Low commodity price decreases the cost of import. Low demand reduces the quantity of imports.
- **Uncertainty in capital inflows** - Though India records CAD over the past two decades, the difference now is that there is growing uncertainty in capital flows.
- This could induce stress on balance of payments.
- **FPI** - Increase in demand for gold imports along with copious foreign portfolio outflows will also weigh on external account.
- FPIs have already pulled out over ₹50,000 crore from equity and debt in the December 2021 quarter.

What is the concern?

- Most economists expect CAD to widen beyond 3% of GDP in the Q4 of this fiscal due to increase in demand and inflation
- Trade deficit could remain elevated in the next fiscal year too with supply chain disruptions due to the Omicron variant keeping commodity prices high.
- Despite the mounting pressure rupee has been reasonably resilient in December mainly due to Forex reserve that RBI has accumulated in last two years.
- But central bank intervention to support the rupee has its limitations. Forex reserves have begun shrinking since November.

What needs to be done?

- The RBI should speed up the process of inclusion of government securities in global bond index. Due to this annual inflows of \$40 billion in 2022 are estimated.
- As a result the rupee as well as the external account will get some support.
- Besides this, structural moves to address the trade imbalance such as initiating production linked incentives for more sectors and improving domestic availability of gold should receive more attention.

Reference

1. <https://www.thehindubusinessline.com/opinion/editorial/the-current-account-deficit-which-has-started-to-rapidly-expand-needs-to-be-watched-closely/article38175411.ece>



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