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