

Dealing with Current Account Deficit

What is the issue?

- The key issue facing India is to sustain high growth with low inflation, and dealing with its Current Account Deficit (CAD).
- In this context, if supply-side policies successfully reduce costs and inflation, macroeconomic policy can sufficiently stimulate growth.

What is the concern?

- Indian output is below its potential as large numbers enter the labour force.
- Bottlenecks in specific sectors limit the production and exports and so there is unutilised labour capacity.
- The demand remains greater than what the country can produce domestically.
- So India is still running a current account deficit (CAD) in the balance of payments i.e. value of the goods and services of imports exceeds that of exports.

How did China deal with a similar situation?

- China too was a large economy with surplus labour.
- **Under-valuation** of its currency aided an expansion in production of traded goods and of exports.
- This, in turn, absorbed a large portion of the underemployed labour.
- The challenge in depreciation (to increase exports) is that it would raise the import bill and inflation.
- But in populous countries where food has a large share in the consumption basket, low relative food prices would ensure sustained low-inflation growth.
- So a big advantage for China was that it took this approach (devaluation) in growth in 1978 with reforms that raised **agricultural productivity**.
- Major intermediate commodity imports, such as oil, also contribute to inflation.
- But again China started its reforms process with a very **low share of oil imports**.
- China used to export oil but became a net oil importer in 1993.
- By 2006 it imported 47% of its consumption, and by 2013 became the largest oil importing country.

- But by then its exports had grown enough to finance imports without substantially reducing its current account surplus.

What are the challenges for India?

- Challenges of both, increase in import bill and rise in inflation, remain for India.
- Moreover, India is dependent on primary energy imports and is the third largest oil importer.
- In India's case, only limiting the depreciation (rather than going for it) would help contain inflation.
- This is because of India's dependence on commodity imports. In other words, devaluation is disadvantageous given the need for high imports.
- So better utilisation of resources and expansion of capacity in export sectors may eliminate CAD without having to reduce aggregate demand.

What are the other factors driving CAD?

- **Savings pattern** - A CAD also implies that investment exceeds domestic savings.
- Financial savings largely fund investments involving goods that are tradeable, while physical savings are invested more in non-traded goods, such as in real estate.
- In recent years, overall savings-GDP ratio has fallen to about 30 as growth slowed.
- However, it is fall in household physical savings that is driving this, as household financial savings have recovered from a low of 8% in 2011-12.
- Savings of non-financial corporations that are held in financial assets have risen.
- Estimates of physical savings in the household sector are identical to those of investment in the unorganised sector.
- So, in effect, if organised sector investment exceeds financial savings, it will have to be financed by foreign savings i.e. by running a CAD.
- Thus better financial intermediation of domestic savings also reduces the CAD and dependence on volatile foreign capital inflows.
- **Constraints in agriculture** have been a major factor limiting India's growth.
- E.g. high food inflation triggered macroeconomic tightening and reduced growth after 2011
- A large number of subsidies and price distortions were not able to adequately improve food production.

How does the future look?

- By 2018 India seems to have entered a period of structural agricultural surpluses.
- World political economy also seems to be working to keep oil prices in the \$60-70 range, which suits both oil importing and exporting countries.
- Moreover, with changes in oil prices, India's oil intensity (the ratio of oil consumed per unit of GDP) has been falling since 2005, which all indicate the removal of constraints.
- However, specific competitive sectors must be encouraged for the export expansion required to cover the oil import bill which remains large.

What lies ahead for India?

- **Supply side policies** - A constant or mildly appreciating real exchange rate has to be accompanied by focused sectoral and general supply-side measures to improve exports.
- Supply-side measures focus on building capacity to participate in higher growth and on reducing costs.
- India's support to traded goods sectors needs to be delivered in ways that do not distort prices.
- [India in 2017 crossed the WTO threshold of per capita incomes of \$1000 in 2017 that allows exemptions for industry specific subsidies. Click [here](#) to know more]
- Targeted and limited direct benefit transfers to farmers, along with measures to improve productivity and marketing are all steps in the right direction.
- The government, in consultation with exporters, should shift to supporting policies which can specially benefit textiles and other export intensive sectors.
- These include export infrastructure, logistics, skilling, technology development and ease of doing business.
- **Demand side policies** - In a populous country with underemployed labour, sectoral bottlenecks and price shocks can cause inflation even without aggregate excess demand.
- So in Indian context, as long as supply-side measures improve exports and reduce costs, macroeconomic policies have space to stimulate growth and absorb under-employed labour.

Source: Business Line



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