It’s not the current account

If the fiscal deficit remains out of control, a burgeoning current account deficit can pose a threat to growth

Kaushik Das, Business Standard, March 15 2006

The current account deficit (CAD) has reached a record high of $13 billion in the first half of 2005-06, higher than 1991’s levels of $9 billion for the entire year. The recent projection by the Economic Advisory Council pegs the CAD to 2.9 per cent of GDP in 2005-06, and 3.1 per cent of GDP in 2006-07. This has raised some concern and debate among economists whether it is advisable to run a CAD in the first place and second, whether such a deficit can be sustained over a long period of time. However, most of the debates have focused around a myopic view of the balance of payment (BoP) without trying to link it to the current savings-investment situation in the domestic economy.

An open macro-economy equilibrium is reached when national savings equal domestic investment plus net exports of the country. When a country falls short of domestic savings, it has to borrow the savings of foreign countries, which is reflected in the BoP as capital account surplus or a CAD.

Between 2002-2004, the Indian economy ran a current account surplus, which essentially meant that India’s domestic savings exceeded its investments, and that India was lending those savings to other developed countries in return of low yielding bonds. Despite running a high fiscal deficit of close to 10 per cent in these years, domestic savings exceeded investments not because the growth in savings rate was high, but because private investments were sluggish.

This situation reversed in 2004-05 on the back of a robust industrial recovery and high international oil prices, which reversed the current account surplus of $10.6 billion in 2003-04, into a deficit of $6.4 billion in 2004-05. The CAD has widened further in 2005-06 on the back of high oil and non-oil imports growth, which resulted in a record CAD of $13 billion in the first half of 2005-06 itself. On the back of a large fiscal deficit and a lacklustre domestic savings growth rate, there is no other option for the Indian economy but to run a CAD to finance the upsurge in the investment cycle.

Untill now the CAD is being financed by strong foreign portfolio investments, reflected in the bullish stock market sentiments. The capital account surplus has, in fact, more than offset the CAD resulting in further accretion of forex reserves. Currently, forex reserves stands at $140.4 billion, which is more than sufficient to take care of the liquidity risk if the situation warrants.

The current account surplus between 2002-04 has actually adversely affected the GDP growth in this period. Therefore, running a small CAD of 2-3 per cent of GDP is growth-inducing for the Indian economy except for an important caveat that fiscal deficit should be under control.

Unfortunately, fiscal profligacy till today is rampant. The FRBM targets of reducing fiscal and revenue deficits have taken a backseat under pressures of catering to populist policies such as the National Rural Employment Guarantee programme.