Current account

6.6 Current account deficit (CAD) mirrors the saving-investment gap in the national income accounts and thus constitutes foreign savings. The challenge before the emerging market economies is to leverage foreign savings to promote domestic growth without having the long-term consequences of external payment imbalances. However, current account deficits, per se, need not necessarily enhance the productive capacity and thus overall GDP growth. This would depend on underlying component factors leading to the current account deficit. The distinction between gross capital inflow and net inflow is useful. As the latter must equal the CAD, there is no way in which net use of foreign savings can increase without an increase in the CAD. The gross inflow can, however, increase to the extent that it is offset by gross outflow in the form of build-up of foreign exchange reserves, reduction in government external debt or outward investment by entrepreneurs. Higher gross inflows have value even if net flows do not increase to the same extent, as they can improve competition in the financial sector, improve the quality of intermediation and the average productivity of investment, and thus raise the growth rate of the economy. The challenge before the Government is to maximize these benefits while minimizing the costs of exchange rate management.

6.7 Figure 6.3 shows that the rise and fall of the current account balance during the period 2000-01 to 2006-07 has been driven largely by the goods and services (G&S) balance, with the two having virtually the same pattern as a proportion of GDP. The surplus from factor income including remittances which fluctuated between 2 per cent and 3 per cent of GDP has helped moderate the

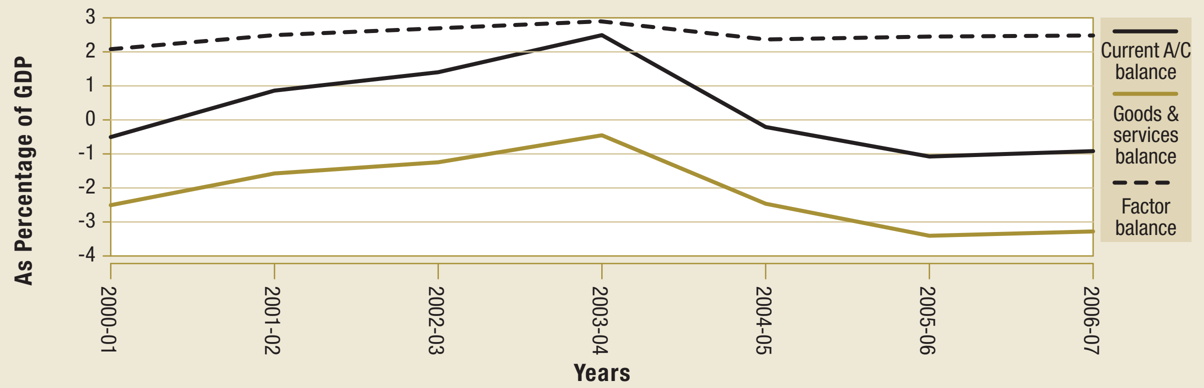
Table 6.3 Selected indicators of external sector

Items/Years	1990-91	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	(Apr.-Sept) 2006-07	(Apr.-Sept) 2007-08
1. Growth of exports - BoP (%)	9.0	21.1	-1.6	20.3	23.3	28.5	23.4	21.8	24.8	19.9
2. Growth of imports - BoP (%)	14.4	4.6	-2.8	14.5	24.1	48.6	32.1	21.8	24.7	21.9
3. Growth of non-factor services (credit)	7.2	3.6	5.4	21.1	29.4	61.0	33.3	32.1	36.9	8.6
4. Growth of non-factor services (debit)	1.4	25.2	-5.2	23.9	-2.3	66.4	24.0	28.7	26.4	14.3
5. Exports/imports - BoP (%)	66.2	78.5	79.4	83.4	82.9	71.7	67.0	67.0	64.5	63.5
6. Exports/imports goods & services (%)	73.1	85.1	88.2	91.4	96.3	87.5	85.0	86.7	83.1	79.8
7. Import cover of FER (No. of months)	2.5	8.8	11.5	14.2	16.9	14.3	11.6	12.5	10.4	12.8
8. External assistance (net)/TC (%)	26.2	4.8	13.4	-29.4	-16.5	6.7	6.8	3.8	2.0	1.4
9. ECB (net)/TC (%)	26.8	50.6	-19.0	-15.9	-16.9	18.1	10.1	34.8	30.2	20.6
10. NR deposits/TC (%)	18.3	27.2	33.0	28.0	21.0	-3.4	11.2	9.3	11.6	-0.2
	(As per cent of GDPmp)									
11. Exports	5.8	9.9	9.4	10.6	11.1	12.2	13.0	14.0		
12. Imports	8.8	12.6	11.8	12.7	13.3	17.1	19.4	20.9		
13. Trade balance	-3.0	-2.7	-2.4	-2.1	-2.3	-4.8	-6.4	-6.9		
14. Invisibles balance	-0.1	2.1	3.1	3.4	4.6	4.5	5.2	5.8		
15. Goods & services balance	-2.7	-2.7	-1.7	-1.4	-0.6	-2.6	-3.6	-3.4		
16. Current account balance	-3.1	-0.6	0.7	1.3	2.3	-0.4	-1.2	-1.1		
17. ECB	0.7	1.1	-0.3	-0.3	-0.5	0.7	0.3	1.8		
18. Foreign direct investment (net)	0.0	0.8	1.0	0.6	0.4	0.5	0.4	0.9		
19. Portfolio investment	0.0	0.6	0.4	0.2	1.9	1.3	1.5	0.8		
20. Total capital account (net)	2.7	2.1	1.7	2.1	2.9	4.1	3.1	5.1		
21. External Debt	28.7	23.3	21.2	20.3	17.8	18.5	17.2	17.9		

Source: RBI.

Notes:
- **(i) TC: Total capital flows (net).**
- **(ii) ECB: External commercial borrowing.**
- **(iii) FER: Foreign exchange reserves, including gold, SDRs and IMF reserve tranche.**
- **(iv) GDPmp: Gross domestic product at current market prices.**
- **(v) As total capital flows are netted after taking into account some capital outflows, the ratios against item No. 5, 6 and 7 may, in some years, add up to more than hundred per cent.**
- **(vi) Rupee equivalents of BOP components are used to arrive at GDP ratios. All other percentages shown in the upper panel of the table are based on US dollar values.**

Figure 6.3 Current a/c balance, goods & services balance and factor balance



substantial deficit on the trade account. Both the trade (goods & services) balance and the factor surplus improved between 2000-01 and 2003-04 leading to an improvement of the current account and both reversed direction thereafter resulting in a declining trend in the current account. In the past two years the current account deficit, trade (G&S) deficit and factor surplus have averaged 1.2, 3.5 and 2.0 per cent of GDP, respectively (Table 6.3).

6.8 The trends in the goods and services trade deficit have, in turn, been largely driven by the merchandise trade deficit since 2004-05. During 2000-01 to 2003-04, the merchandise trade deficit was around 2 per cent of GDP and the rising non-factor services surplus resulted in an improving trend in the overall trade balance (Figure 6.3). From 2004-05 the merchandise trade balance has been deteriorating and despite the continual rise in the non-factor services surplus, the overall G&S balance has followed the deteriorating trend of the former (Figure 6.3).

6.9 A widening of merchandise trade was one way in which foreign savings could be absorbed and growth in exports and imports was a key component of the growth process. As a proportion of GDP, on balance of payments (BoP) basis, exports rose from a level of 5.8 per cent in 1990-91 to reach a level of 14.0 per cent of GDP in 2006-07 (Table 6.3). The average annual growth rate in the last five years has been placed at a high of 23.5 per cent. However, imports have grown even faster in the last five years at an annual average of 28.2 per cent. As a proportion of GDP, on BoP basis, imports in 2006-07 were placed at 20.9 per cent of GDP. Thus, trade deficit widened to 6.9 per cent of GDP in 2006-07.

6.10 The higher trade deficit could be attributed to a rise in petroleum, oil and lubricants (POL) as well as non-POL components in imports. Continued uptrend in prices in the international markets and rise in the price of gold were the major contributors to this process.

6.11 Of the seven major components of non-factor services in the invisibles account of the BoP, six components — travel, transportation, insurance, financial services, communication services and business services — contributed on a net basis only 9 per cent of the surplus on account of services trade in 2006-07. Thus, the seventh component viz., software services, comprising information technology (IT) and IT-enabled services (ITES), was the main driver of the surpluses generated from non-factor services.

6.12 The net surplus from travel grew modestly in 2006-07. Travel receipts grew by 22.1 per cent on an annual average basis for the last three years reflecting in part the attractiveness of India as a tourist destination; travel payments were also catching up with corresponding average annual growth at 24.3 per cent. Transportation payments exceeded receipts, resulting in a modest deficit. The classification in BoP accounting system of software, business, financial and communication under the head "miscellaneous" allude to the recent nature of their importance. Growth in software services receipts (both IT and ITES) was phenomenal at an annual average of 32.9 per cent in the last five years. As per revised data of the RBI, growth in business services on a net basis as made available by RBI was higher at 39.4 per cent in 2006-07; the other services, albeit posting lower growth rates, have nevertheless helped catalyze the growth process through appropriate technology transfer from the rest of the world. Thus, higher levels of surplus arising from services helped moderate the overall goods and services balance. As a proportion of GDP, goods and services deficit was placed at 3.4 per cent of GDP in 2006-07, which was lower than the level of 3.6 per cent of GDP in 2005-06.

6.13 Private transfers continued its traditional role of being a major source for the invisibles account surplus with annual average growth at 13.5 per cent in the five-year period 2002-03 to 2006-07. According to a report published by the World Bank containing estimates of cross-country data on migration and remittances, India topped the list of countries that received remittances. Investment income (net) which reflects the servicing costs on the payment side and return on Foreign Currency Assets (FCA) on the receipts side, has remained negative over the years indicating higher interest outgo. Investment income (net) was placed at US$ (-) 3.5 billion in 2002-03. With the rapid build up of foreign currency assets the credit side of investment income also grew as rapidly as the debit side. Given the latter's higher base, net investment income deteriorated to US$ (-) 6 billion in 2006-07.

6.14 Current receipts in 2006-07 amounted to US$ 243.2 billion and current payments were placed at US$ 252.9 billion. Current receipts covered 96.1 per cent of the current payments in 2006-07. Consequently, current account deficit was placed at US$ 9.8 billion in 2006-07 (US$ 9.9 billion in 2005-06).

6.15 The nature of the current account deficit is indicated by the contribution of the oil trade deficit and non-oil trade deficit in conjunction with the surpluses on factor and non-factor services (Table 6.4).

6.16 Based on sharp upward movements in exchange rates and foreign exchange reserves, there is a general apprehension about the developments on the BoP front and its consequences in terms of competitive losses and thereby on the growth prospects of exports. BoP data for the first half of the current financial year shows some deceleration in growth in exports from a level of 24.8 per cent in 2006-07 (April-September) to 19.9 per cent in 2007-08 (April-September). Simultaneously, growth in imports in the first half of 2007-08 fell to 21.9 per cent from 24.7 per cent in 2006-07 (April-September). On BoP basis, merchandise trade deficit rose to US$ 42.4 billion in 2007-08 (April-September), equivalent of 8.1 per cent of GDP from a level of US$ 33.8 billion in 2006-07 (April-September), equivalent of 8.3 per cent of GDP. In the same reference period, a deceleration in software services exports to 15.2 per cent from 37.2 per cent led to a lower growth in net invisibles surplus (17.5 per cent from 35.2 per cent). Receipts from business services actually declined from US$ 8 billion in 2006-07 (April-September) to US$ 6.4 billion in 2007-08 (April-September) and, with payments rising marginally, there was a decline of 91 per cent in 2007-08 in net receipts. Thus, as a proportion of GDP, goods and services deficit rose to 5.3 per cent in 2007-

Table 6.4 Decomposition of current account deficit

Items\Years	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
	(As per cent of GDPmp)						
1. Oil balance in trade account	-3.0	-2.5	-3.0	-2.8	-3.3	-4.0	-4.2
2. Non-oil balance in trade account	1.8	0.9	1.2	0.4	-0.7	-1.7	-2.3
3. Trade balance (1+2)[1]	-2.7	-2.4	-2.1	-2.3	-4.9	-6.4	-6.9
4. Non-factor services balance	0.4	0.7	0.7	1.7	2.2	2.9	3.4
5. Goods & services balance	-2.3	-1.7	-1.4	-0.6	-2.6	-3.6	-3.4
6. Factor balance	1.7	2.3	2.5	2.8	2.2	2.3	2.3
7. Invisibles balance	2.1	3.1	3.4	4.6	4.5	5.2	5.8
8. Current account balance (3+7)	-0.6	0.7	1.2	2.3	-0.4	-1.2	-1.1

Compiled from RBI (BoP data) and the Directorate General of Commercial Intelligence and Statistics (DGCI&S) (trade data)

Note: [1]Due to trade data divergence between BoP basis and DGCI&S, the totals may not add up.

08 (April-September) from a level of 4.7 per cent in 2006-07 (April-September).

6.17 Private transfers receipts (mainly remittances) shot up, year-on-year, by 49.2 per cent as against 19.2 per cent in the corresponding period of the previous year. Investment income (net) grew by 60.0 per cent in 2007-08 (April-September) reflecting the burgeoning foreign exchange reserves. Net invisible surplus grew by 35.2 per cent to reach US$ 31.7 billion in 2007-08 (April-September), equivalent of 6.1 per cent of GDP. Thus, higher invisible surplus was able to moderate somewhat the rising deficits on trade account and current account deficit was placed at US$ 10.7 billion in 2007-08 (April-September), equivalent of 2.0 per cent of GDP.