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STUDENTS' ECONOMIC FORUM

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To empower the student community…

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CURRENT ACCOUNT BALANCE

MEANING, CAUSES & CONSEQUENCES OF DEFICIT/SURPLUS

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Theme No: 344: **CURRENT ACCOUNT BALANCE**

"When learning is purposeful, creativity blossoms. When creativity blossoms, thinking emanates. When thinking emanates, knowledge is fully lit. When knowledge is lit, economy flourishes."
- Dr. A.P.J. Abdul Kalam

The "SIB Students' Economic forum" is designed to kindle interest in the minds of younger generation. We highlight one theme in every monthly publication. Topic of discussion for this month is **"Current Account Balance".**

What is Current Account Balance (CAB)?

The current account balance (CAB) of a country's Balance of Payments (record of monetary transactions of a country with the rest of the world) provides a good idea of its economic activity. It includes activity around the country's industries, capital market, services, and the money entering the country from other governments or through remittances. A country's current account balance (CAB) is either a deficit or a surplus. If there is a deficit, does that mean the economy is weak? Does a surplus automatically mean that the economy is strong? Not necessarily.

When looking at a country's current account, it's important to understand the four basic components that factor into it-goods, services, income, and current transfers.

The Current Account Components

a) Trade in Goods (Exports and imports of goods or in other words Visible Trade)

When we export goods, money gets credited to the current account. When we import goods, money gets debited from the current account. The difference between exports and imports is called **merchandise Trade Balance.** If exports are more than imports there will be **trade surplus** and if imports are more than exports there will be **trade deficit.**

b) Trade in Services (Export and Import of Services or in other words Invisible Trade)

When we export services, money gets credited to the current account. When we import services, we debit money from the current account. Export of services happens in two ways. We either provide service to the foreign nationals in their own land or we provide service to foreigners when they visit our country. Outsourcing Service from overseas is an import of service which would create a debit entry in the current account. The trade in services is also called **invisible trade.**

Following are examples of trade in services

- Money spent on travel by tourists
- Tuition paid to universities by international students
- Banking, Insurance, Consulting services in foreign land
- Royalties and license fee paid for use of copyright or patent

c) Investment Income

Investment income includes any income made from investing abroad, profits from business activities of subsidiaries located abroad, interest received from investment and loans abroad, and dividends from shares in overseas companies. Receipt of interest, dividends and other income from abroad will be a credit entry in the current account. Similarly, payment of interest, dividends and other expenditures abroad will be a debit entry from the current account.

d) Unilateral transfers

Unilateral transfers include foreign aid, personal gifts sent to friends and relatives abroad, donations, international remittances, withdrawal/redemption of NRE deposits locally etc. Whenever there is inward remittance, credit to the current account happens and outward remittances will be debited from the current account. The same is valid for pension also. If a person living in India receives pension from another country, it would be a credit to current account and vice versa.

When we look at the overall money flow in the current account, the aggregate of these four sections will either be net positive or net negative. Aggregate negative indicates a **current account deficit** and an aggregate positive figure indicates a **current account surplus.**

CURRENT ACCOUNT DEFICIT

Current Account Deficit or CAD is the shortfall between the money flowing in, and the money flowing out. Current Account Deficit is slightly different from Balance of Trade, which measures only the gap in earnings and expenditure on exports and imports of goods and services. Whereas, the current account also factors in the payments from domestic capital deployed overseas.

Causes of Current Account Deficit

We can sort the causes under two sides, Demand and Supply.

A. Demand Side

- **a) Strong Domestic Growth**

  Incomes are high ⟶ living standards are high ⟶ high purchasing power ⟶ more import purchases ⟶ more expenditure on imports

- **b) Recession Overseas**

  Income abroad fallen ⟶ reduced demand for our export products ⟶ reduced revenue from exports

- **c) Strong Exchange Rate**

  Strong currency makes imports cheap and exports expensive.

  Imports are cheap ⟶ more demand for imports ⟶ more expenditure on imports.

  Exports are expensive ⟶ less demand for exports ⟶ less revenue from exports.

B. Supply Side Causes

- a) Low Investment
- b) Low Productivity
- c) High Relative Inflation
- d) High Unit Labour Cost
- e) Poor Quality of Resources
- f) Depletion of Resources

The above reasons lead to decline in competitiveness of exports. This results in lesser demand overseas for domestic products and hence lesser revenue from exports. Supply-side reasons create more impact than demand side because these reasons last for longer term.

Consequences of Current Account Deficit

- a) Reduction in growth, increase in unemployment due to less need for labour and less demand for laborers.
- b) Current account deficit might be an indicator of a strong growing economy if it is caused by the demand-side.

Is it true that the demand-side or the supply side factors alone can cause current account deficit? What if it is the income or transfers that are pushing the current account deficit and not trading goods or trading services. Usually the impact on the economy depends on the size of the deficit.

How to reduce a Current Account Deficit

There are three main policies:

a) **Devalue the exchange rate:** Cheaper exports and more expensive imports should improve the current account balance.

b) **Reduce consumer spending:** Tight fiscal/monetary policy will lead to a slowdown in consumer spending, reducing imports and improving the current account. Export demand will be unaffected by domestic monetary policy. Also, lower domestic demand should reduce inflation. Lower inflation should improve the competitiveness of exports. But reduction in consumer spending will conflict with objectives of higher economic growth.

c) **Supply-side policies:** In the long term, efforts to improve productivity can improve the competitiveness of exports.

While an existing deficit can imply that a country is spending beyond its means, it is not inherently disadvantageous. If a country uses external debt to finance investments that have higher returns than the interest rate on the debt, the country can remain solvent while running a current account deficit.

CURRENT ACCOUNT SURPLUS

A current account surplus increases a nation's net assets by the amount of the surplus. The trade balance generally has the largest impact on the current account balance and hence nations with large and consistent current account surpluses tend to be exporters of manufactured products or energy.

Causes of Current Account Surplus

A. Demand Side

a) High income abroad

A boom in the economy of a major trading partner ⟶ increased purchasing power of people ⟶ increased demand for imported products ⟶ increase in the demand of our exports ⟶ increase in revenuefrom our exports.

b) Low income at home

Low purchasing power ⟶ low demand for imports ⟶ fall in expenditure on imports

c) Weak exchange rate

Imports are expensive ⟶ less demand for imports ⟶ less expenditure on imports.
Exports are cheaper ⟶ more demand for exports ⟶ more revenue from exports.

B. Supply Side

a) Low relative inflation

If inflation is lower in our country than a major trading partner's economy, it means our exports are more competitive.

b) Low Unit Labour Cost

High productivity, weak trade unions and low minimum wages result in higher exports competitiveness.

c) Strong Investment

Latest technology, good investment and strong capital base can help lower the cost of production for businesses and thus they can be more competitive.

d) Discovery of new local resources will offer a competitive edge.

Consequences of Current Account Surplus

a) Current Account Surplus due to trade surplus may be an indication of increased growth, reduced unemployment and increased inflation (high demand induced inflation).

b) There will be more demand and supply of the currency and this could bring about an upward pressure on the exchange rate. An appreciation of the exchange rate or a stronger exchange rate will result in the current account surplus not being long lasting.

c) A country that runs a large current account surplus might be using excessive protectionism, they might be using other tactics like managing their exchange rates and the end result is that, countries that have current account deficit might retaliate and harming international relations and there could be a trade war being triggered as a result. So large current account surplus could trigger an attack by countries that are running current account deficit.

d) Could large current account surplus be a sign of an unbalanced economy? It could be. If a country is so reliant on exports or if they are exporting all /majority of their produce overseas, then what about meeting the needs of domestic consumers? It could be that there isn't enough consumer spending. What if for some reason the demand for exports reduces? Is there an alternate avenue of growth in that case? If the answer is no, then the economy could be in trouble.

Consequences of current account surplus may not be necessarily positive. The macro objective of trade is to maintain a balanced trade because excessive trade surplus or current accounts surplus could create issues as well.

India's Current Account Balance – In News

In June, India recorded a trade surplus of $793 mn for the first time in more than 18 years as the domestic demand slump following the coronavirus outbreak hit imports harder than exports. India returned to a trade deficit of $4.8 billion in July. Data released by commerce ministry showed that, merchandise exports fell for the fifth consecutive month by 10.2%, while imports dipped 28.4% in July 2020 compared to same month last year. India's current account balance is expected to turn surplus in FY21.

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