Current Account Deficit with Foreign Exchange Reserves - An Analysis

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Abstract

This paper attempts to study the nature of the principle of valuation at the market price is generally adopted for recording BoP transactions. Recording of non-merchandise transactions is at the price reported by transactors to banks while putting through the financial transactions. Exports are valued on f.o.b. basis while imports are invoiced on c.i.f. basis. Investment transactions are recorded at actual market prices. Unilateral receipts and payments are also called 'Unrequited Transfers'. They are called so because the flow of transfer is unidirectional or in one direction. There is no liability for an automatic reverse flow or repayment obligation in other direction since they are not lending's and borrowings. These items are simply gifts, and grants exchanged between governments and people of one country with that of others. For the most part, transactions are recorded on a payments (cash) basis. Reinvested earnings, interest income on reserves and interest payments are recorded on an accrual basis. Exports are recorded when they leave India (drawn from the data from the DGCI&S), after allowing for certain timing and valuation adjustments. Grossing/netting procedures are broadly in accordance with the fifth edition of the IMF's *"**Balance of Payments Manual**"*. Most transactions in the current account are recorded on a gross basis and on a net basis in the financial account, separately for assets and liabilities. Data for India's BALANCE OF PAYMENTS are obtained primarily as a by-product of ITRS i.e. the system of reporting of foreign exchange transactions undertaken by banks in fortnightly returns to RBI. These are supplemented by collection of information from other sources *viz.,* Ministry of Finance, Ministry of Commerce, Directorate General of Commercial Intelligence & Statistics and financial institutions.

Key words: capital account, current account, liberalization, capital flow, India, Balance of Payments

Introduction

- **Capital and financial accounts:**

Money is also exchanged between countries through investments or other kinds of financial transactions. This is calculated in the capital and financial accounts. After the 1990 crisis when India did not have enough money left to fund its deficit, it opened markets partially to foreign investors. Today, India runs a net surplus of $33.3 billion in its capital and financial accounts. This money is used to fund the current account deficit. An increase in borrowings from outside the country has a negative impact on the capital account, while an increase in foreign investment inflows has a positive impact.

- **Rupee impact:**

India's capital and current accounts have a strong bearing on the rupee value. This is because, when you owe the world money, you have to sell rupee and buy dollars or other foreign currencies. Similarly, when a foreigner invests in India, rupee is bought while dollars are sold. An increase in demand for the rupee leads to an appreciation in its value and vice-versa. This was the reason why the rupee fell 20% to Rs 69-to-a-dollar levels between May and August 2013. Foreign investors exited the Indian capital market in droves, while the country's current account deficit stood at a lifetime high.

- **Credit ratings:**

Every country's sovereign bond - issued by the government - is analyzed by credit ratings agencies. Depending on the risks involved, a credit rating is given from time to time. Greater the risks, poorer is the credit rating. For this reason, an increase in deficit is detrimental to credit rating. This is because a high deficit is a liability. When a country owes more to the world, the risks of a default of interest payments to bond holders increase. This is the reason credit ratings agencies like Moody's and S&P issued warnings to India about its high current account and fiscal deficits.

Economic Transactions include all the foreign receipts and payments made by a country during a given financial year. Item-wise details are as under:

The Foreign receipts include all the earnings and borrowings by a country from the other countries.

Source of Earnings (Inflows)

- Merchandise Exports
- Services Exports
- Interest, Profits, Dividends and Royalties received from Foreign countries.
- Gifts, Grants and Aids received from Foreign Countries.
- Private Transfers such as Remittances.

Source of Borrowings (Inflows)

- Foreign Direct Investments
- Foreign Portfolio Investments
- Government Loans from Foreign Governments.
- Short Term deposits by NRIs and Foreigners.

The accumulation of foreign receipts (net of payments) over the years becomes Foreign Exchange Reserves of a Country.

The Payments include all the spending and lending by a country from the countries of the rest of the World.

Spending's (Outflows)

- Merchandise Imports
- Services Imports
- Interests, Profits, Dividends and Royalties paid to foreign countries
- Gifts, Grants and Aids given to foreign countries
- Remittances paid.

Lending's (Outflows)

- Outward Foreign Direct Investment by Indian Firms
- Outward Foreign Portfolio Investment by Indian Citizens
- Indian Governments Lending's/Loans to Foreign Governments
- Short Term Deposits by country residents into foreign countries.

All the foreign receipts are financial inflows, and all the foreign payments are financial outflows in a given year.

Objective:

This paper intends to explore and analyze India's **balance of payments,** its components **current account** that includes a country's key economic activities such as capital markets and services. Along with **capital account** that keeps track of the net change in a nation's assets and liabilities during a year**.** Also, its implications in world income and in non-interest domestic government expenditure

Filling Current Account Deficit with Foreign Exchange Reserves

A country could also engage in official reserve transactions, running down its reserves of foreign exchange, in the case of a deficit by selling foreign currency in the foreign exchange market. But, official reserve transactions are more relevant under a regime of pegged exchange rates than when exchange rates are floating.

A country is said to be in **balance of payments equilibrium** when the sum of its current account and its non-reserve capital account equals zero so that the current account balance is financed **entirely by** international lending without reserve movements.

Note: A BOP surplus is accompanied by an accumulation of foreign exchange reserves by the central bank.

Ideally, BoP should be Zero! How?

From a balance of international payments point of view, a surplus on the current account would allow a deficit to be run on the capital account. For example, surplus foreign currency can be used to fund investment in assets located overseas. Also, if a country has a current account deficit (trade deficit), it will borrow from abroad.

In reality, the accounts do not exactly offset each other, because of statistical discrepancies, accounting conventions and exchange rate movements that change the recorded value of transactions.

1. Exports	250.5
2. Imports	-381.1
3. Trade balance (2 – 1)	**-130.6**
4. Invisibles (net)	84.6
(a)Non-factor income	48.8
(b)Income	-17.3
(c)Pvt. Transfers	53.1
5. Current account balance (3 + 4)	**-45.9**
6. External assistance (net)	4.9
7. Commercial borrowing (net)	12.5
8. Short-term debt	11.0
9. Banking Capital of which NR deposits (net)	4.9 3.2
10. Foreign investment (net)	39.7
Of which: (i) FDI (net)	9.4
(ii)Portfolio	30.3
11. Other flows (net)	-11.0
12. Capital account total (net)	**62.0**
13. Errors and Omissions	-3.0
14. Balance of payments [5 + 12+13]	**13.1**
15. Reserve use (- increase)	-13.1

An example of Balance of Internatinal Payments with respect to India

BoP Deficit or Surplus

- The decrease (increase) in official reserves is called the overall balance of payments deficit (surplus).
- The balance of payments deficit or surplus is obtained after adding the current and capital account balances.
- The balance of payments surplus will be considered as an addition to official reserves (reserve use).

BoP Crisis

- Countries with current account deficits can run into difficulties. If the deficit is large and the economy is not able to attract enough inflows of foreign investment, then their currency reserves will dwindle.
- There may come a point when the country needs to seek emergency borrowing from institutions such as the International Monetary Fund, that may lead to external debt.
- Countries with deficits in their current accounts will build up increasing debt and/or see increased foreign ownership of their assets.
- BoP crisis is also known as the currency crisis.

Autonomous Transactions vs Accommodating Transactions

- International economic transactions are called autonomous when transactions are made independently of the state of the BoP (for instance due to profit motive).
- These items are called 'above the line' items in the BoP.
- The balance of payments is said to be in surplus (deficit) if autonomous receipts are greater (less) than autonomous payments.
- Accommodating transactions (termed 'below the line' items), on the other hand, are determined by the net consequences of the autonomous items, that is, whether the BoP is in surplus or deficit.
- The **official reserve transactions** are seen as the accommodating item in the BoP (all others being autonomous).

Errors and Omissions

Errors and Omissions constitute the third element in the BoP (apart from the current and capital accounts) which is the 'balancing item' reflecting our inability to record all international transactions accurately.

BoT vs BoP

- The balance of Trade (BoT) or Trade Balance is a part of the Balance of Payments (BoP). BoT just includes the balance between export and import of goods.
- BoP not only adds the service-trade but also many other components in the current account (Eg: Transfer payments) and capital account (FDI, loans etc).

Indian rupee is fully convertible only in the current account and not in the capital account.

Conclusion

In a globalized world, no country is self-sufficient. Every country purchases and sells goods and services to another. This includes both public and private transactions. The balance of payments calculates the value of these transactions. Usually, the value of the outflows should be equal to the total inflow of money into the country. However, this is not so because payments are sometimes delayed or paid over a longer term. For this reason, countries can have a deficit or surplus of BoP in the short-term. A deficit is when you owe money to the world, while a surplus is when your cash inflows exceed your outflows.

In the **current account**, receipts from export of goods, services and unilateral receipts are entered as credit or positive items and payments for import of goods, services and unilateral payments are entered as debit or negative items. The net value of credit and debit balances is the balance on current account.

1. Surplus in current account arises when credit items are more than debit items. It indicates net inflow of foreign exchange.

2. Deficit in current account arises when debit items are more than credit items. It indicates net outflow of foreign exchange.

Capital account of BOP records all those transactions, between the residents of a country and the rest of the world, which cause a change in the assets or liabilities of the residents of the country or its government. It is related to claims and liabilities of financial nature. India's balance of payments position improved to $ 433.7 billion by September 2015 from $ 412.9 billion of forex reserves in March 2015 -2015. India's merchandise trade balance improved from 2009-14 to 2014-19 on the back of the decline in crude prices. The merchandise Exports-to-GDP ratio declined to 11.3 percent, due to weakened global demand and heightened trade tensions over 2015-19 to H1 of 2015-20.

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