Current Account Deficit V/S Capital Account Deficit

The Two Components of the Balance of Payments

The balance of payments records a country’s economic transactions with the rest of the world within a given period of time (one year). A nation’s balance of payments is bifurcated into the current account and the capital account. The current account is a log of a nation’s exports of goods, services and transfers, and its imports of the same. It also includes net factor income, which is the income received from interest and dividend payments, and net transfer payment in the form of loans and grants. The current account runs a deficit when the imports exceed exports; hence, there is a net outflow of foreign exchange.

The capital account is the summation of foreign direct investment, portfolio investment, other investment (trade credit, loans and deposits), and reserve accounts. A capital account deficit implies that financial outflows exceed inflows.

A current account deficit is financed through a surplus on the capital account, showing that the additional investment funds support the imports that are in excess of exports. Most sovereign states run a current account deficit which is backed by a positive capital account. Developing nations typically run very large current account deficits in proportion to their GDP, which are financed by loans and grants on the capital account.

Is Current Account Deficit a problem?

In deciding whether a deficit on the current account is good or bad, one must look at the underlying factors that give rise to it. A deficit reflects prevalent economic trends in that nation, which may be favourable or unfavourable.

In the short run, a current account deficit is favourable, especially for developing nations, which have more investment opportunities than they can undertake due to a low domestic savings. A deficit has the potential to quicken the pace of economic growth and development. It shows that investment in the nation is high, as a current account deficit is backed by a capital account surplus.

However, a worsening current account deficit signals trouble, and the economy must act quickly to curtail it and prevent a debt spiral. In the long run, demand for domestic assets will weaken. Foreign investors may pull out of the country as persistent deficit reflects borrowing to
finance current consumption rather than future investment. This will cause the currency to depreciate, and will prompt more investors to pull out as the value of their investment reduces further. If the deficit is not curbed, there will be a long term impact on employment, economic growth and the standard of living.

**Why is India’s Current Account Deficit a problem?**

India’s current account deficit became something to worry about when our growth rate halved to 5%. In the final quarter of 2012, it reached a historic high of 6.7%. This is primarily due to gold imports, hefty crude oil imports and a reduction in exports due to the global slowdown. Petroleum products are the biggest contributor to India’s import bill. Gold is the second largest import item after oil, and contributes roughly 10% to the import bill. Furthermore, India’s trade deficit stood at $59.6 billion in December 2012. The country’s external debt also rose, due to a high dependence on short term borrowing and External Commercial Borrowings (ECB’s). At the end of March 2013, India’s external debt stood at US $376.3 billion, roughly twenty percent of the GDP.

While strong investment into the Indian equity market has helped to bridge the gap, low FDI inflows and high debt are a growing concern. As the capital inflows are not sufficient to cover the deficit, the rupee has begun to depreciate over growing concerns that India will find it difficult to fund its current purchases and meet its international debt obligations, given the slower rate of growth.

The current account deficit represents a major outflow of dollars and will exhaust our foreign reserves if inflows to counter the deficit do not materialise. India must look at measures to increase exports. This will improve the foreign reserves and lower the current account deficit.

**Capital Account Deficit: A Rare Phenomenon**

A capital account deficit is a very infrequent occurrence. It implies that there is a net outflow of investment capital, as domestic institutions and individuals increase their holdings of assets valued in foreign exchange. China, the world’s largest export, experienced a temporary capital
account deficit of US $71.4 billion in the first quarter of 2012-13. This is largely because of investors pulling out short-term funds amid the global economic downturn.

Earlier, China ran massive surpluses on both accounts. This was possible due to a high level of government intervention. The influx of foreign funds put pressure on the yuan to appreciate. To combat this pressure, the People’s Bank of China bought up most of the foreign currency that entered the country, leading to a swelling of the nation’s foreign exchange reserves. This allowed it to maintain a surplus in its capital account.