

Study of Factors Influencing Current Account Deficit of India (2007-12) with Special Emphasis on Gold Imports



Commerce

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ABSTRACT

The period 2007-12 witnessed major developments in terms of the current account deficit of the country. During 2008-09 to 2010-11, CAD averaging at 2.7 per cent of GDP, however, didn't cause any stress as capital inflows have been more than adequate. Subsequently, during 2011-12, CAD exceeded the level of 4.0 per cent of GDP and there has been net drawdown of reserves to the extent of about USD 13 billion. Keeping the above under consideration, the present study tries to analyse the factors influencing current account deficit of India from the year 2007 to 2012. The rising gold import is the most important factor influencing current account deficit.

INTRODUCTION

A sustainable level of current account deficit is considered inevitable in a growing economy. But if this is too high, it becomes a cause of worry for the external sector of the economy. India has been witnessing a high CAD during the past few years. POL imports have always remained a major cause of the CAD due to the heavy dependence of the country on imports to meet its huge need for fuel. But lately gold and silver imports have also emerged as the major factor influencing CAD. The latest balance of payments data show that the current account was in small deficit in 2006-07, as it was in the previous two years. However, if gold and silver imports are excluded, then the deficit turns into a surplus over the past three years. The huge domestic demand of gold is being met by imports. Such hoarding of gold is causing large amount of country's savings to be blocked in the form of an unproductive asset. Thus it becomes imperative to study the factors responsible for the rising CAD and how it can be tackled.

FACTORS AFFECTING THE CURRENT ACCOUNT DEFICIT IN INDIA

India trades in both goods and services. It is the negative merchandise trade balance of India which is responsible for the current account deficit.

Merchandise trade deficit = Export receipts obtained from goods exported abroad - Import payments given abroad for goods imported

A negative merchandise trade deficit implies an excess of import payments over export receipts. Hence rising imports and declining exports put upward pressure on merchandise trade deficit and hence on CAD. As per the data available from DGCI & S's Annual Report, the major components of merchandise exports are engineering goods, petroleum products, gems & jewellery and textiles. Together these items form more than 50% of the total export volume.

Reasons for low growth in engineering exports -

Some reasons for the slow growth in exports of engineering products based on the summary of the strategy paper 2010-14 by EEPC India are as follows-

- i) India has benefited less than its export competitors from bilateral and regional trade agreements - narrow focus on regional integration - most of India's trade agreements that become operationalised till as recently as 2007 mere with SAARC countries.
- ii) Most of India's agreements have been preferential trade agreements which cover only a small cross-section of goods.
- iii) Most small and medium enterprises have not achieved economies of scale or the requisite technological capabilities required to be competitive in the global export mar-

ket.

- iv) Infrastructural and procedural bottlenecks lead to competitive disadvantage in terms of costs and timelines for Indian exports.
- v) Complicated custom duties

Petroleum products exports

India has been the exporter of petroleum products since 2001-02. Major hindrances to export growth of Indian petroleum products are -

- Volatility of crude oil prices
- Supply disruptions
- Imparting capital intensive technology
- Improvement in quality of petroleum products to enhance its competitiveness

Gems and jewellery exports - India is a processing, cutting and polishing country in this sector. The country has an 80% share in the world market. The main hindrances to the potential growth in this sector are as follows -

- i) Fragmented and unorganized market - hence uses largely labour intensive and indigenous technology
- ii) Inadequate financial capital and high labour cost per unit.
- iii) Threat from China which is the second largest diamond processor in the world.
- iv) Predominance of the US market
- v) Exchange rate/currency risk - the gems and jewellery sector is affected by the rupee/dollar exchange rate because it is export oriented. Any volatility in the exchange rate affects the margins of the players. For example - rupee appreciation makes export less competitive.

Factors affecting trade in services in India

According to a research paper by Prabir De on "Barriers to trade in services in India", India has seen a gradual shift towards the service sector in the past decades, with services comprising a growing share of GDP and employment. India's service exports currently constitute about 36.68% of the country's total exports. Yet, a large part of India's service sector is untapped and rarely explored in the international market. In 2008, India's share in world service export was around 2.67% compared with a 1.11% share in world merchandise trade.

The following dimensions of service trade in India has been studied in the research paper mentioned above -

- The strong demand for Indian computer and information related services in developed economies has led to a rapid growth in exports from India.
- India's import of transportation services outweighs its export heavily.

- Service trade facilitation can help unlock unrealized trade potential.
- Improving trade infrastructure (both hardware and software).
- Availability of human resources which is educated and English speaking.
- Cost effective workforce (almost 1/10th of cost overseas)

Merchandise imports

The most important item group imported by India is 'Petroleum, crude & products'. As per the annual report of DGCI & S on 'Foreign Trade Performance of India', it is the imports of this item and the increasing price of petroleum products globally that has changed the scenario of imports but countries such as UAE, Saudi Arabia etc into top five countries. POL group had a share of 30.19% in India's total imports during 2009-10 with Rs. 4,11,649 crores of import values.

Table 1: Percentage share in total imports

	2007-08	2008-09	2009-10
POL	31.68	30.55	30.19
Non-POL	68.32	69.45	69.81

Source: RBI "Database on Indian Economy" (2007-12)

"Gold & Silver" is the second most important item (10.30% share in 2009-10). Electrical and non electrical machinery comes third (7.93%), electric goods (7.29%), pearls and precious stones (5.62%).

Factors affecting imports of merchandise

- Petroleum prices globally
- Non-oil imports are also affected by growth of import of export related items (pearls, semi-precious stones & chemicals)
- Economic upheavals abroad (US & EU)

In a nutshell major factors which influenced the CAD during 2007-12 which fuelled the CAD to record high levels are as follows –

- Crude oil prices which effect the imports (comprising of 30% of POL products)
- Global economic slowdown which effected the CAD through two below mentioned channels –
 - Shrinkage in external demand
 - Decline in invisible receipts due to fall in travel, transportation and insurance receipts and insurance receipts, private transfers and remittances

Both the above mentioned factors have led to decline in exports thus increasing the CAD during the global recession.

- Robust import demand (oil, pearls and semi precious stones) in domestic markets.
- Growth asymmetry between India and rest of the world.
- Uncertainty in the global economy (EU crisis which weakened the external demand, reducing exports and thus CAD)
- Government policies to support exports

The current account deficit of any country is influenced by either the demand side factors or supply side factors or both. These factors can be defined as below –

Demand side factors – these refer those factors which are affecting the demand of imports in the domestic economy and domestic exports abroad. Factors which decrease the demand

for imports in the domestic economy would reduce the CAD while factors which would increase the demand for domestic exports abroad would also reduce the CAD. During the period under consideration to conduct the study, Indian economy was facing the problem of high current account deficit. This was because the export demand of Indian goods abroad declined during 2007-12 as the world economy faced the most severe financial crisis after the Great Depression of 1929, starting 2007-08. The slow growth in exports widened the current account deficit by influencing the merchandise trade component of current account.

The rising per capita income in India has increased the consumerism culture here. Further, festivals like Diwali and marriage seasons give significant boost to the demand of gold. This increase in demand for gold is invariably inelastic during these times. The government tries to reduce this gold imports by increasing import duty on gold. The rising gold imports increases the total import bill as gold imports form the second largest imports to India after POL (petroleum, oil and lubricants) products.

The huge demand of POL products in the country is due to the need to fulfil the energy requirement of the second highly populated country of the world. India is largely dependent on imports to cater to its oil needs. This is because the country is not well endowed with sufficient oil reserves and is not equipped enough for efficient exploitation of these resources. The high imports have always been a major reason for a heavy import bill.

Supply side factors – refer to those factors which affect the supply of imports and exports of the country. The supply of imports depends largely on factors external to the domestic economy. The supply of exports depends on the quantity and quality of production in the domestic economy. The Indian economy faces several infrastructural bottlenecks which prevents the production to reach its optimum level. The goods manufactured for export purpose must meet those qualitative standards which are required to face the competition of the international markets.

Besides these demand and supply side factors affecting current account deficit, there is one another very important factor influencing the CAD. It is the value of the domestic currency in the currency market. For example, a depreciation of rupee would decrease the price of Indian exports abroad thus increasing the export volume and increases the price of imports from abroad to India thus reducing the import volume. This makes the Indian exports more attractive in the international market and imports to India less attractive in the domestic economy. Exports increase and imports decrease thus reducing the CAD. The variation in price of domestic currency in terms of dollar or the exchange rate fluctuation has a very limited effect on CAD in case of the Indian economy due to the unique import and export composition. The imports include POL products which the country will import no matter what the price is. Even if the export price reduces it will not increase the export competitiveness unless the quality of exports meets international standards.

From the above, we can conclude that there are four important factors influencing CAD in India –

- POL imports
- Gold imports
- Export volume
- Rupee depreciation

The relation between volume of gold imports and current account deficit of India during the period 2007-12 is studied in

detail using correlation and regression analysis.

Table 2: Volume of gold imports and volume of current account deficit (2007-12)

YEAR	VOLUME OF GOLD IMPORTS IN CRORES (X)	VOLUME OF CURRENT ACCOUNT DEFICIT IN CRORES (Y)	dx=X-A	dy=Y-B	dx*dy	x	y
2007-08	7193	68914	-133247	-110786	1.48x	1.78x	1.23x
2008-09	100467	127631	-39973	-52069	0.21x	0.16x	0.27x
2009-10	(A) 140440	(B) 179700	0	0	0	0	0
2010-11	184728	210100	44288	30400	0.13x	0.20x	0.09x
2011-12	341000	376000	200560	196300	3.94x	4.02x	3.85x
			71628	63845	5.76x	6.16x	5.44x

Source: RBI "Database on Indian Economy" (2007-12)

$$r = \frac{\sum dx dy}{\sqrt{\sum dx^2 \sum dy^2}}$$

$$= \frac{5.76 \times 10^{10}}{\sqrt{6.16 \times 10^{10} \times 5.44 \times 10^{10}}}$$

$$= \frac{5.76 \times 10^{10}}{5.78 \times 10^{10}}$$

$$= 0.996$$

$$byx = \frac{(\sum dx dy \cdot N - \sum dx \cdot \sum dy)}{(\sum dx^2 \cdot N - (\sum dx)^2)}$$

$$= \frac{(5.76 \times 10^{10} \cdot 5 - 71628 \cdot 63845)}{(6.16 \times 10^{10} \cdot 5 - 71628^2)}$$

$$= \frac{2.83 \times 10^{11}}{3.02 \times 10^{11}}$$

$$= 0.9370$$

CONCLUSIONS AND SUGGESTIONS

- The relation between volume of gold imports and current account deficit was studied in detail using the statistical tools of correlation and regression. Using the above model, the correlation coefficient was calculated to be **0.996** which shows that there is a positive relation between gold imports and current account deficit. This implies that if there is an increase in gold imports the current account deficit will also increase and vice-versa. In other words both gold imports and current account deficit move in the same direction. The value of correlation coefficient varies between -1 and +1. Thus a high value of the coefficient depicts that there is a strong correlation between the two.
- The regression coefficient is also high, i.e., 0.937. It implies that for a unit change in the value of gold imports the current account deficit changes by 0.937.

Here are some suggestions to control rising gold imports in order to curb the rising CAD-

- Controlling import of gold by restoring the faith of Indians in other financial instruments.
- Imposition of high gold import duty (the government is already resorting to this measure and has been quiet successful in curtailing the deficit). But this can ultimately lead to smuggling of the precious metal.

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