



UNDERSTANDING THE BALANCE OF PAYMENTS: CURRENT AND CAPITAL ACCOUNT DYNAMICS IN INDIA: ECONOMIC: GS III



The balance of payments (BoP) serves as a comprehensive record of all economic transactions between a country and the rest of the world over a specific period. It reflects the financial and trade flows of goods, services, and capital and offers insights into the health and direction of an economy. India's BoP reveals fascinating trends and challenges, shaped by the dynamics of its current and capital accounts. This article explores the foundational role of the BoP, the implications of deficits in its components, and two pivotal features recently impacting the



Indian economy: the shift in focus from a current account deficit to a capital account deficit and the structural nature of India's merchandise trade deficits. We also delve into how these factors influence the economy and outline the way forward.

The Balance of Payments: Basis in the National Economy

The BoP consists of two primary components: the **current account** and the **capital account**.

1. **Current Account:** This includes the trade of goods and services, income receipts, and transfer payments. It essentially measures a country's net earnings and expenditures on foreign trade. A deficit in the current account indicates that a nation is spending more on imports than it earns from exports, while a surplus suggests the opposite.
2. **Capital Account:** This records capital flows such as foreign investments, loans, and deposits. It reflects the net change in ownership of national assets. A surplus here signals significant foreign investments and borrowing, while a deficit might imply capital outflows or repayments.

The interplay of these accounts determines whether a country runs an overall BoP surplus or deficit. Managing these flows is crucial for maintaining currency stability, fostering economic growth, and ensuring resilience against global financial uncertainties.

Current Account and Capital Account Deficits: Impacts on the Economy

1. **Current Account Deficit (CAD):**
A CAD arises when a nation imports more goods, services, and capital than it exports. Persistent CADs can strain forex reserves, weaken the currency, and heighten dependency on foreign capital to finance the deficit. However, a manageable CAD, especially when driven by productive imports (e.g., capital goods), can support economic growth.
2. **Capital Account Deficit:**
A deficit here reflects capital outflows exceeding inflows, often due to reduced foreign direct investment (FDI) or portfolio investment (FPI) and repayment of external debt. Unlike a CAD, a capital account deficit can directly reduce forex reserves and exert significant pressure on currency stability. It can also signal eroding investor confidence in the country's economic prospects.

India's economic narrative has shifted from a CAD-dominated challenge to growing vulnerabilities in the capital account. This evolving landscape demands careful assessment.



Key Features of the Indian Economy: Recent Trends

1. Transition from Current Account Deficit to Capital Account Deficit

Traditionally, India's economic concerns revolved around the CAD. While the CAD has moderated in recent years—thanks to robust surpluses in the services and remittance segments—the capital account now presents significant risks. Two major trends underpin this transition:

- **Reduced FDI Inflows:** FDI, considered a stable and long-term source of capital, has seen a steady decline from \$56 billion in 2019-20 to \$26.47 billion in 2023-24. This drop raises concerns about India's ability to attract sustained foreign investment in productive sectors.
- **Volatile FPI Flows:** Unlike FDI, FPIs are short-term and highly sensitive to global economic conditions. In 2023-24, FPIs contributed a record \$44.08 billion to the capital account. However, this volatility is evident in October and November 2024, when FPIs pulled out \$14 billion, exerting pressure on the rupee and forex reserves.

The shift from CAD concerns to capital account vulnerabilities highlights India's growing reliance on fickle capital flows, which are subject to external shocks like changes in US Federal Reserve policies or geopolitical risks.

2. Structural Features of Merchandise Trade Deficits

India's merchandise trade deficits have been a persistent challenge, stemming from the country's dependence on imports for critical goods like crude oil, electronics, and machinery. In 2023-24, the merchandise trade deficit stood at \$242.07 billion, with imports outpacing exports by a significant margin.

Key reasons for the structural deficit include:

- **High Energy Import Dependency:** India imports over 80% of its crude oil needs, contributing significantly to the trade deficit. Despite efforts to diversify energy sources, this dependency remains a structural weakness.
- **Lagging Manufacturing Competitiveness:** While India has made strides in services exports, its manufacturing sector has struggled to achieve global competitiveness. Factors such as inadequate infrastructure, high logistics costs, and complex regulations hinder the growth of exports in goods.
- **Limited Export Diversification:** India's export basket remains concentrated in a few sectors like textiles, gems and jewelry, and pharmaceuticals. The lack of diversification reduces resilience against global demand fluctuations.



Despite these challenges, the services trade surplus has been a bright spot. Software exports and remittances have consistently contributed to India's BoP, offsetting the impact of merchandise trade deficits.

Impacts on the Indian Economy

The combined effects of current and capital account dynamics influence India's economic trajectory in several ways:

1. Rupee Stability:

The pressure on forex reserves from capital outflows and merchandise trade deficits has weakened the rupee, which depreciated from 83.67 to 84.66 per US dollar between September and November 2024. A weak rupee raises import costs, fueling inflation and widening the trade deficit further.

2. Reserves Depletion:

The Reserve Bank of India (RBI) has intervened in currency markets to stabilize the rupee, leading to a \$46.79 billion decline in forex reserves since September 2024. While reserves remain substantial at \$658.09 billion, sustained drawdowns could limit India's ability to absorb future shocks.

3. Investor Confidence:

The decline in FDI and increased reliance on FPI flows signal potential vulnerabilities in India's investment climate. Addressing structural bottlenecks and ensuring policy stability will be critical to attracting long-term capital.

Way Forward

To address the challenges posed by BoP dynamics, India needs a multi-pronged strategy:

1. Boosting Manufacturing and Export Competitiveness:

Policies like "Make in India" must focus on improving infrastructure, reducing logistics costs, and enhancing ease of doing business. Diversifying exports beyond traditional sectors is essential to reduce trade imbalances.

2. Energy Transition:

Accelerating the shift to renewable energy and promoting domestic energy production can mitigate the impact of crude oil imports on the trade deficit.

3. Encouraging Stable Capital Flows:

Reviving FDI inflows through investor-friendly policies, coupled with efforts to reduce the dependence on volatile FPIs, is crucial. Initiatives like setting up production-linked incentive (PLI) schemes can attract long-term investments.



4. Forex Reserve Management:

The RBI must strike a balance between supporting the rupee and conserving reserves. Enhancing reserve adequacy through sovereign bonds or bilateral currency swap agreements can strengthen resilience.

5. Strengthening Services and Remittance Inflows:

Building on the success of software and IT exports, India can explore opportunities in emerging services sectors like fintech and green technologies. Encouraging diaspora engagement can sustain the growth in remittances.

Conclusion

India's balance of payments reflects a complex interplay of global and domestic forces. While the current account has stabilized due to robust services surpluses, vulnerabilities in the capital account and structural trade deficits remain significant challenges.

By fostering competitiveness, diversifying exports, and attracting stable capital flows, India can chart a sustainable path forward. Managing these transitions effectively will be critical to ensuring economic resilience and positioning India as a global economic powerhouse in the coming decades.

Main Practice Question

Descriptive Question

"Discuss the recent dynamics in India's Balance of Payments (BoP), with a specific focus on the shift from the Current Account Deficit (CAD) to vulnerabilities in the Capital Account Deficit. Highlight the structural factors contributing to India's merchandise trade deficit and suggest measures to address these challenges. (250 words)"

Answer Guidelines

To evaluate the aspirants effectively, the answer should focus on three major areas:

1. Introduction to Balance of Payments (BoP) and Recent Trends (50 words):

- Define BoP as the record of all economic transactions between a country and the rest of the world.
- Highlight the recent trend: India's shift from CAD challenges to growing capital account vulnerabilities.

2. Key Dynamics: CAD vs. Capital Account Deficit (100 words):



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- **CAD moderation:**
 - Services trade surplus and remittances have helped stabilize the current account.
- **Capital account vulnerabilities:**
 - Decline in stable FDI inflows (from \$56 billion to \$26.47 billion).
 - Volatility in FPI flows (e.g., \$44 billion inflow in 2023-24 but \$14 billion outflow in Oct-Nov 2024).
- This shift makes India more reliant on fickle short-term capital, increasing forex reserve pressure.
- 3. **Structural Factors of Merchandise Trade Deficit (75 words):**
 - **High energy import dependency:** Over 80% of crude oil is imported.
 - **Lagging manufacturing competitiveness:** Inadequate infrastructure, high logistics costs, and complex regulations.
 - **Export concentration:** Limited diversification in goods exports (textiles, gems, pharmaceuticals).
- 4. **Way Forward (25 words):**
 - Boost manufacturing competitiveness (Make in India, PLI schemes).
 - Reduce energy dependency (renewables).
 - Attract stable FDI flows with investor-friendly policies.





Mind Map

