

Why India's Trade Deficit Is Not a Weakness: Understanding Its Economic Strengths

November 26, 2024 • vajiramandravi.com



What's in today's article?

- Why in News?
- Link Between Capital Inflows and Current Account Deficit
- India's approach
- India's deficit – not a sign of weakness

Why in News?

India's persistent trade deficit, where imports exceed exports, does not signify weak manufacturing but **highlights its relative strengths in services and its appeal as an investment destination.**

Given these strengths, the goods trade deficit is likely to persist. To accelerate the growth of Indian manufacturing, the focus should be on **domestic demand** rather than relying on exports.

Link Between Capital Inflows and Current Account Deficit

- **Current account deficit (CAD)**

- A current account deficit occurs when a country imports more goods and services than it exports, making it a net importer overall.
- India's CAD widened marginally to \$ 9.7 billion (1.1% of GDP) in Q1:2024-25 from \$8.9 billion (1.0% of GDP) in Q1:2023-24.

- **Foreign investment and current account deficit are two sides of the same coin**

- Countries attracting investment through net capital account inflows must either run a current account deficit (net outflow) or accumulate foreign exchange reserves.
- This happens because, in economic terms, **the total amount of money flowing in and out of the country must balance out.**
- If money is coming in through foreign investment, there needs to be an equivalent outflow to maintain the balance.
- If not through reserves, the outflow happens through buying goods and services from other countries (imports).
 - This relationship is a mathematical certainty, where: $\text{Capital Inflows} = \text{Current Account Deficit} + \text{Increase in Reserves}.$

India's approach

- **India's Approach to Capital Inflows**

- India aims to attract foreign investment to supplement domestic savings, enabling higher investments and fostering faster economic growth.
- This strategic inflow on the capital account aligns with India's developmental goals.

- **Role and Cost of Foreign Exchange Reserves**

- Foreign exchange reserves act as a buffer against economic shocks, like oil price spikes, allowing flexibility in addressing current account deficits.
- However, holding reserves incurs costs, as India pays higher returns to foreign investors than it earns on its reserves.

- **Capital Inflows and Current Account Deficits**

- Capital inflows must match the sum of the current account deficit and reserve accumulation.
- Since India doesn't need significant reserve accumulation, inflows correspond directly to the current account deficit.
- This means attracting foreign investment implies accepting a net import of goods and services.

- **India's Balanced Policy**

- India maintains a prudent policy of running a current account deficit of ~2% of GDP, balanced by equivalent capital inflows, showcasing its status as an attractive investment destination.

India's deficit - not a sign of weakness

• Composition of India's Current Account Deficit: Goods and Services

- India's current account deficit arises because it imports more than it exports in total.
- However, this deficit is influenced by the country's comparative advantage in different sectors.
- **India excels in services**, making it a net exporter of services. This includes sectors like IT, pharmaceuticals, and automobiles, where India holds a significant edge globally.
- As a result, India is able to offset the higher import bills by exporting services.
- Since India is a net exporter of services, it must inevitably be a net importer of goods to maintain the overall current account deficit.
- This means India imports manufactured goods, but its export strength in services helps to keep the deficit within manageable levels.

• Manufacturing and Comparative Advantage

- India's manufacturing exports, especially in pharmaceuticals and auto components, are sufficient to maintain the current account deficit.
- This success is tied to India's comparative advantage in these sectors, not necessarily a lack of productivity in manufacturing compared to countries like Vietnam or Bangladesh.
- India's advantage in services simply outweighs its advantage in manufacturing.

• Scope for Faster Manufacturing Growth

- While India's manufacturing sector is performing well, there is room for faster growth.
- However, achieving this requires stronger domestic demand.
- If domestic consumption rises and the current account deficit remains stable, this increased demand would drive greater domestic production, leading to faster manufacturing growth.
- This highlights that the expansion of India's manufacturing sector is closely tied to internal market dynamics rather than solely relying on export markets.

Q.1. Why does India run a trade deficit despite its strong economic sectors?

India's trade deficit arises from importing more goods than it exports, but it offsets this through strong service exports like IT, pharmaceuticals, and automobiles, where it has a global edge, keeping the overall deficit manageable.

Q.2. How can India boost its manufacturing sector despite a trade deficit?

Faster growth in manufacturing depends on increasing domestic demand. By improving internal consumption while maintaining a stable current account deficit, India can drive greater production in manufacturing, beyond just relying on exports.

News: Expert Explains: Why India's trade deficit is not necessarily a weakness

Source: <https://vajiramandravi.com/current-affairs/why-indias-trade-deficit-is-not-a-weakness/>

© Vajiram & Ravi. For personal use only.