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Current Account Deficit (Cad) on Inflation, Commercial Debt, and Foreign Direct Investment in India

Mr. Kapil Dev Pandey*

INTRODUCTION

The fiscal balance of payment deficit refers to the situation where a country's government expenditures exceed its revenues in the international trade and financial transactions. In the context of India, the fiscal balance of payment deficit reflects the imbalance between the government's spending on imports and foreign debt servicing compared to its earnings from exports and foreign investments. It is an important economic indicator that reflects the financial health and sustainability of a country's external sector.

India, as one of the world's largest emerging economies, has experienced a significant fiscal balance of payment deficit in recent years. This deficit has been influenced by a complex interplay of factors, including trade imbalances, capital flows, exchange rates, and government policies. Understanding the trend, pattern, and implications of India's fiscal balance of payment deficit is crucial for policymakers, economists, and investors to assess the country's economic performance, external vulnerabilities, and policy implications.

The fiscal balance of payment deficit has implications for various aspects of the Indian economy. Firstly, it affects the country's foreign exchange reserves, which are crucial for maintaining stability in the currency market and meeting external obligations. A sustained deficit can put pressure on reserves, leading to currency depreciation and potential risks to financial stability.

Secondly, the fiscal balance of payment deficit influences the overall balance of payments, which is a comprehensive measure of a country's economic transactions with the rest of the world. A persistent deficit can widen the current account deficit, indicating an imbalance between imports and

* Research Scholar, Amity Business School, Amity University, Noida

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exports of goods, services, and income. This can have implications for the competitiveness of domestic industries, employment levels, and the overall economic growth rate.

Furthermore, the fiscal balance of payment deficit impacts India's external debt levels. When the deficit is financed by borrowing from abroad, It raises the nation's external debt load, raising questions about the sustainability of the debt and the nation's capacity to pay off its debts in the future. Additionally, higher amounts of foreign debt might put the economy at risk from fluctuating interest rates and currency exchange rates.

Addressing and managing the fiscal balance of payment deficit is a significant challenge for the Indian government. It requires a careful balancing act between promoting economic growth, managing import-export dynamics, attracting foreign investments, and implementing appropriate fiscal and monetary policies. Policy interventions aimed at improving export competitiveness, promoting domestic industries, attracting foreign direct investment, and diversifying the export basket can help reduce the fiscal balance of payment deficit and enhance the country's external sector stability.

The current account deficit (CAD) is a critical macroeconomic indicator that reflects a country's net transactions in goods, services, income, and current transfers. A persistent CAD can have varying implications for different macroeconomic variables, such as inflation, commercial debt, and foreign direct investment (FDI). This research study aims to investigate the effects of the current account deficit on inflation, commercial debt, and foreign direct investment in India, providing a comprehensive understanding of the interplay between these variables in the Indian economy.

India has experienced persistent current account deficits over the past few decades, primarily driven by high oil prices, gold imports, and sluggish export growth (Rajeshwari & Radhakrishnan, 2012; Gopinath, 2012). As a result, policymakers and researchers have been increasingly interested in understanding the consequences of the CAD on various macroeconomic variables, which may have implications for the country's economic growth and stability.

The relationship between the CAD and inflation has been widely debated in the literature. Some studies have suggested that a persistent CAD may lead to inflationary pressures in the economy (Kılınç, Tunç, and Yörükoğlu (2016)). However, empirical evidence on this relationship in the Indian context has been mixed (Muraleedharan, V. R., Sundararaman, T., & Vaidyanathan, G. (2020).

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Commercial debt is another variable affected by the CAD. A higher CAD may lead to an increased reliance on external borrowing to finance the deficit (Eichengreen, B., Gupta, P., & Masetti, O. (2018). This can result in higher commercial debt levels and raise concerns about debt sustainability (Mohan & Kapur, 2013).

Lastly, the impact of the CAD on FDI has been a subject of interest for researchers and policymakers alike. Empirical studies examining the relationship between the CAD and FDI in India have produced mixed findings (Akbas, Y. E., Senturk, M., & Sancar, C. (2013). Understanding the role of FDI in financing the CAD and its implications for macroeconomic stability is essential for formulating effective policy responses.

Trends and composition of CAD

India's foreign trade has undergone significant changes since 2000. Here is a brief overview of the composition of India's foreign trade over the years:

Financial Year	Exports (in USD billions)	Imports (in USD billions)	Top Exported Items	Top Imported Items
2000	44.6	54.7	Gems and jewelry, textiles,engineering goods	Crude oil, electronic goods, pearls, and precious stones
2001	42.1	46.3	Gems and jewelry, textiles,engineering goods	Crude oil, electronic goods, pearls, and precious stones
2002	43.3	51.6	Gems and jewelry, textiles,engineering goods	Crude oil, electronic goods, pearls, and precious stones
2003	51.1	65.2	Gems and jewelry, textiles,engineering goods	Crude oil, electronic goods, pearls, and precious stones
2004	63.8	89.4	Gems and jewelry, textiles,engineering goods	Crude oil, electronic goods, pearls, and precious stones
2005	80.5	116.4	Gems and jewelry, textiles,engineering goods	Crude oil, electronic goods, pearls, and precious stones
2006	126.1	185.7	Gems and jewelry, textiles,engineering goods	Crude oil, electronic goods, pearls, and precious stones
2007	163.0	266.2	Gems and jewelry, textiles,engineering goods	Crude oil, electronic goods, pearls, and precious stones

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Financial Year	Exports(in USDbillions)	Imports(in USDbillions)	Top Exported Items	Top Imported Items
2008	185.3	303.7	Gems and jewelry, textiles, engineering goods	Crude oil, electronic goods, pearls, and precious stones
2009	168.7	267.6	Gems and jewelry, textiles, engineering goods	Crude oil, electronic goods, pearls, and precious stones
2010	246.9	369.5	Gems and jewelry, textiles, engineering goods	Crude oil, electronic goods, pearls, and precious stones
2011	305.1	489.3	Gems and jewelry, textiles, engineering goods	Crude oil, electronic goods, pearls, and precious stones
2012	300.4	490.6	Gems and jewelry, textiles, engineering goods	Crude oil, electronic goods, pearls, and precious stones
2013	314.4	450.9	Gems and jewelry, textiles, engineering goods	Crude oil, electronic goods, pearls, and precious stones
2014	310.3	448.4	Gems and jewelry, textiles, engineering goods	Crude oil, electronic goods, pearls, and precious stones
2015	262.3	379.6	Gems and jewelry, textiles, engineering goods	Crude oil, electronic goods, pearls, and precious stones
2016	275.9	384.3	Gems and jewelry, textiles, engineering goods	Crude oil, electronic goods, pearls, and precious stones
2017	303.5	465.6	Gems and jewelry, textiles, engineering goods	Crude oil, electronic goods, pearls, and precious stones
2018	330.1	514.0	Gems and jewelry, textiles, engineering goods	Crude oil, electronic goods, pearls, and precious stones
2019	314.3	476.9	Gems and jewelry, textiles, engineering goods	Crude oil, electronic goods, pearls, and precious stones
2020	291.9	368.9	Gems and jewelry, pharmaceuticals, engineering goods	Crude oil, electronic goods, pearls, and precious stones

RBI Official Website

The table shows the composition of India's foreign trade from 2000 to 2020 in terms of exports and imports. The data is presented in US dollars (in billions) and includes the top exported and imported items. From 2000 to 2020, India's exports grew from $44.6 billion to $291.9 billion, while imports grew from $54.7 billion to $368.9 billion. India's top exported items during this

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period were gems and jewelry, textiles, and engineering goods, while its top imported items were crude oil, electronic goods, and pearls and precious stones.

In 2006, there was a significant increase in India's exports, reaching $126.1 billion, and continued to rise in subsequent years, reaching its peak at $330.1 billion in 2018. However, in 2020, there was a decrease in both exports and imports due to the COVID-19 pandemic and the global economic slowdown.

Throughout the period, India's trade deficit remained high, with imports consistently exceeding exports. This can be attributed to various factors, such as high demand for imported crude oil, increasing domestic consumption, and a lack of competitiveness in certain sectors of the economy. However, the government has implemented various measures to reduce the trade deficit, such as increasing exports, attracting foreign investments, and promoting domestic manufacturing.

India's international commerce was the primary driver of worries around CAD, which in turn influenced India's policies and practices. The majority of India's exports consist of manufactured items, in particular low-value engineering products and gems and jewelry. Even though manufactured goods continue to make up a significant portion of India's overall exports, the country's percentage of the world's total manufacturing exports was only 1.6% in 2012. This is primarily due to the low-value and largely semi-skilled nature of the majority of the products that India exports in this sector. The percentage of overall exports that are comprised of agricultural goods, textiles, and textile products, and handicrafts has decreased, while the percentage that is comprised of petroleum products has increased (although it still only accounts for 1.6% of the total fuel sent throughout the globe). The percentage of the world's total market that is comprised of India's exports climbed to 1.6 percent in 2012 after having steadily declined from 2.2 percent in 1948 to about 0.5 percent in the middle of the 1980s. Because of this, India's success in terms of exports cannot be deemed to be remarkable.

It would be inaccurate to describe the success of exports as amazing. On the other hand, the proportion of India's total imports, which are comprised of petroleum and crude products as well as gold is steadily increasing. It has been suggested that Indian families utilise gold as a hedge against inflation, in contrast to the widespread usage of petroleum, which is an essential component in a variety of manufacturing processes as well as transportation. Gold is not only utilised as a hedged item, but it is also used for producing jewelry, which is a wasteful use of gold. In response to this fact, the RBI and the Indian government have imposed a variety of restrictions on the importation of gold.

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The growing current account imbalance in India was the impetus for these actions. Some of the restrictions include preventing banks from selling gold, gradually raising the import tariff on gold from 2% to 10%, banning the import of coins and medallions, and mandating that 20% of gold imports be utilised for export. These steps helped to lower the CAD as a whole and the imports of goldin 2013. Given the high demand for gold in India and the recent accusations of smuggling the yellow metal following the imposition of limitations, the authorities will be forced to remove these restrictions in the long run if the current account stabilises. This is a result of India's huge demand for gold. In 2012, the nation of India, which has the world's sixth biggest economy, had the greatest increase in the rise of fuel imports, which was 18 percent, followed by China, which saw an increase of 14 percent. Even though there was a slight slowdown in the growth of imports because of an increase in gold imports and adecrease in domestic demand, it is anticipated that the demand for imports will increase in the future because of the demographic make-up of the Indian economy as well as the possibility of a revival of the economy.

The merchandised trade deficit has been the primary contributor to India's current account deficit over the last six decades. The merchandised trade account for India always showed a deficit, but this was more than compensated for by a surplus in "invisible," mainly services and remittances. India's trade deficits occurred every year without fail. It should also be brought to your attention that India's invisible account had a negative balance from the fiscal years 1969–1970 through 1972–1973 and in the year 1990–1991. In 1991, India was confronted with a problem related to its foreign payments, which was primarily caused by a negative invisible balance brought on by a steep rise in investment income payments (debt servicing), as well as a fall in remittance collections.

Since 2004, India has seen a large rise in the amount of its goods trade imbalance, which has been caused by huge growth in the country's imports (especially its imports of oil) as opposed to its exports. Recent gold imports have been a substantial contributor to the rising trade imbalance and, as a result, the worsening of the current account deficit. The earnings from services and consistent remittance inflows are financing a significant portion of the country's trade imbalance. However, the current account deficit (CAD) has lately worsened as a result of a downturn in the growth of exports, high growth in imports of oil and gold, and an increase in payments related to investment income combined with a slowdown in receipts related to investment income. As a result, from an average of 1.7 percent in the years 2006–2010 to 3.4 percent during the years 2008–2012, and finally reaching an all-time high of 4.8 percent in the years 2012–2013, the ratio of the CAD to the GDP rose. Since considerable payments needed to service foreign debt keep the investment

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income account balance in the negative, the current account deficit itself is one of the elements behind the continuous CAD. Therefore, ongoing current account deficits in any country are problematic because they either strain reserves or drive up debt repayment costs. Any nation may be considered to have this.

Understanding the structural features of the economy, such as the various phases of economic development, demographic profiles, and consumption and production patterns, is crucial to have a good view of the current account over the long term. These factors have a role in determining the CAB and, therefore, the amount of savings and investments. Since the conclusion of the global financial crisis, both the rates of saving and investment have declined; however, the saving rate reduction has been greater than the investment rate decline, which has increased the current account deficit. A deeper look shows that both the public (PUB) and private (PVT) sectors have deficits, which together account for the majority of India's current account deficit (CAD), which is the exact opposite of the economy's absorptive capacity as assessed by the savings-investment (S-I) gap. This is true since India's CAD is the exact opposite of the economy's absorptive ability. Due to the fact that households save more money than they invest, the household sector (HH) is always in the black. On the other hand, the public sector deficits, which have been consistently high throughout the years, have contributed more to the S-I gap. Additionally, the public sector's S-I gap, which had been decreasing since 2002–2003 as a consequence of the FRBM Act's effects, increased during 2008–2010, mostly as a result of a significant fiscal stimulus, and is largely to blame for the current increase in S-I gap as shown in expanding CAD. This is as a result of a significant fiscal stimulus that increased government expenditure. However, a major amount of these deficits were offset by a reduction in the business sector's deficit and a sizable surplus in the home sector, preventing the CAD from growing much between 2008 and 2010. Following that, the CAD has significantly increased. It is also crucial to be aware that throughout the years after the financial crisis, the deficit in the private sector decreased. This was principally brought on by a slowdown in business investment.

Household saving rates have been falling since 2009–2010, mostly as a result of growing inflation, which has widened the S-I gap. Therefore, despite the fact that private investments have been declining, the recent widening of the current account deficit is more related to a drop in savings than it is to an increase in investments. The previous years' big S-I gap was fueled by increased investments; thus, it was less concerning; nevertheless, the current S-I gap's persistence due to a decline in savings rate poses a serious threat to the sustainability of CADs. As a consequence of the declining savings rate, this danger is now apparent.

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CAD Financing

Recent research has given a significant amount of emphasis to the investigation of the current account's viability by centering their attention on the account's composition and the methods by which the deficit is funded (Beim and Calomiris, 2001). An attempt has been taken throughout the course of this study to look into the financing trends for CAD in the context of India. Despite having a fairly low CAD, India's trade deficits remain significant and have been steadily growing since 2004–2005. Despite having a relatively small current account deficit, this is the case for India. India's current account deficit is low thanks to a surplus in invisibles, which includes a net surplus in the services account as well as sizeable inflows of remittances from workers. The primary risk in this scenario is that any layoffs in unrelated job markets or a visa ban by the US, EU, or other nations may have a negative impact on the CAB. This is because the majority of remittances to India come from the Gulf region (37 percent), followed by North America (34 percent), and then Europe (12 percent) (Lane, 2004, 2005); Lessons from the past suggest that a few crises in Dubai, the US, and Europe had an impact on remittance inflows, albeit a minor one. The viability of CAD is also contingent on the manner in which it is financed, namely whether it is funded via debt capital or equity capital, as well as whether it is funded through short-term or long-term capital flows. A nation is deemed to be susceptible if the majority of the capital inflow it uses to fund its deficits comes from either short-term or debt sources.

The amount of a country's foreign currency reserves is another factor that determines whether or not its current account and external debt can be maintained sustainably. However, it is essential to have an understanding of the processes that led to the accumulation of these reserves throughout the course of time. The building of $267.6 billion in reserves was the outcome of capital movements that occurred following the financing of $331.0 billion CADs. This took place between 1990–1991 and 2012–2013. When the reserves position at the end of March 1991 and the valuation effect are added to the $267.6 billion, the total amount of foreign exchange reserves at the end of March 2013 was $292.0 billion. Short-term capital flows are responsible for a significant part (92.6% of the total amount), which is $292.0 billion. In addition, the fact that India's net foreign liabilities are more than the country's overall reserves assets—that is, 205.9 percent of the total reserves—is something that should cause the country's external sector some anxiety (Lane and Milesi-Ferretti, 2005a, b; Tang, 2006).

It is a well-held belief that an economy faces significant risks if it finances its CAD with money with a short-term investment horizon. Two of the most significant factors in the early 1990s payments crises were a very high

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level of short-term debt and problems with short-term commitments' rollovers. India has continued to have a strict policy on short-term financial flows as a result. The lessons that were discovered as a result of the 1991 payments crisis have largely influenced this approach. The most recent pattern, however, indicates a considerable increase in short-term capital flows to India. The carrying trade operations brought on by better returns on assets denominated in rupees and the quicker liberalisation of India's capital account are to be to blame for this increase. These two elements have both influenced the current pattern. This trend also reflects India's desire to draw short-term capital inflows in a situation when long-term inflows have slowed in order to fund the growing deficit during the post-global crisis era. In this context, long-term capital inflows have slowed down.

A study of the makeup of India's capital inflows is presented here so that readers may better comprehend the dangers connected with CAD. Non-debt-creating capital inflows, which include equity flows under FDI and foreign portfolio investments, have been dominating capital inflows to India during most of the course of the past two decades. This trend can be seen throughout most of the period covered by the table. It is important to highlight that during the pre-reform era, the majority of the capital flows into India consisted of debt-creating flows, which accounted for around 98% of the total capital inflows during the decade 1990–1992. And one of the reasons why there was difficulty with the balance of payments was that India had a large amount of debt owed to other countries. Over the course of the previous several years, a pattern of the comparable growing trend in foreign debt, especially short-debt, has been seen. At the same time, a decrease in the amount of FDI being invested is adding gasoline to the fire. During the year 2012–2013, the total capital that came in was comprised of outflows due to short-term trade credit and net investments by FIIs. This accounted for 46.6% of all inflows. It is necessary to reverse this trend in order to fix India's current account deficit (CAD), which has been funded for the most part during the last several years by short-term and debt capital inflows.

Sen (2013) stated that a greater current account deficit in India is the outcome of substantial capital inflows, which cause a real appreciation of the currency rate. The link between capital mobility and the current account was investigated by Yan (2007), who came to the conclusion that capital mobility is demand-induced and consequently contributes to the financing of the current account in developed nations. On the other hand, he discovered that a financial account contributes to an imbalance in a country's current account when it is an emerging market economy.

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India's Composition of Foreign Trade with Countries

While the mix of India's international commerce with other nations changes over time, certain broad tendencies may be seen. China, the United States of America, and the United Arab Emirates have recently been India's top commercial partners.

The United States ($52.4 billion), China ($18.7 billion), and the United Arab Emirates ($16.2 billion) were India's main export destinations in 2020. China ($66.8 billion), the United States ($24.5 billion), and the United Arab Emirates ($20.8 billion) were India's top three import suppliers.

India has grown its commerce throughout time with nations in the Asia-Pacific area including Japan, South Korea, and Singapore. India has also improved its trade relations with the European Union and the United Kingdom, notably in the fields of engineering, pharmaceuticals, and information technology.

Overall, India's foreign trade composition with countries is dynamic and subject to change based on various economic and political factors. However, India continues to pursue policies and initiatives to promote trade and investment with its major partners and diversify its trade relations with other countries.

Factors Responsible for the Current Account Deficit of India

The current account deficit of India can be attributed to several factors. Here are some key factors, along with relevant in-text citations to support the information:

- **Trade Imbalance:** India's current account deficit is significantly influenced by its trade imbalance, where the value of imports exceeds the value of exports. In recent years, India has experienced a widening trade deficit due to increased imports of crude oil, gold, electronic goods, and machinery. (Source: Reserve Bank of India, "Macroeconomic and Monetary Developments," October 2021).

- **Oil Imports:** India is heavily dependent on oil imports to meet its energy needs. Fluctuations in global oil prices impact India's import bill, leading to a higher current account deficit. Rising oil prices can exert pressure on India's trade balance and contribute to a wider deficit. (Source: Ministry of Finance, Government of India, "Economic Survey," 2020-21).

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- **Services Trade:** Although India has a significant services sector, including information technology and business process outsourcing, the services trade surplus has not been sufficient to offset the merchandise trade deficit. This imbalance in services trade contributes to the current account deficit. (Source: Reserve Bank of India, "Macroeconomic and Monetary Developments," October 2021)

- **Remittances:** While India receives substantial remittances from its diaspora abroad, these inflows have not been able to fully compensate for the trade imbalance. Remittances contribute positively to the current account, but they are not sufficient to offset the deficit caused by trade imbalances. (Source: Reserve Bank of India, "Macroeconomic and Monetary Developments," October 2021)

- **Capital Goods Imports:** Capital goods must be imported for India's expanding infrastructure and industrial growth. Capital goods imports increase the value of imports without increasing exports by an equal amount, which results in a current account deficit. (Source: Ministry of Finance, Government of India, "Economic Survey," 2020-21)

- **Global Economic Conditions:** The global economic environment, including fluctuations in global demand and trade tensions, also influences India's current account deficit. Weaker global demand or protectionist measures in major trading partners can impact India's export performance and contribute to a wider deficit. (Source: International Monetary Fund, "India: Selected Issues," March 2021)

These factors demonstrate the complex dynamics contributing to India's current account deficit, encompassing trade imbalances, import patterns, remittances, capital goods imports, and global economic conditions.

Persistent current account deficit: are they good or bad for Indian economy

The issue of whether a persistent current account deficit (CAD) is beneficial or detrimental to the Indian economy is a topic of considerable debate. A current account deficit occurs when a country's total imports of goods, services, and investments exceed its total exports and foreign investments. This essay aims to provide an in-depth analysis of the implications of a persistent CAD on the Indian economy, considering various factors and perspectives.

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Positive Aspects of a Persistent CAD

- A persistent CAD can attract foreign capital inflows, including foreign direct investment (FDI) and portfolio investment, which can contribute toeconomic growth. These inflows can help finance investments in critical sectors, such as infrastructure, manufacturing, and technology, facilitating productivity improvements and job creation.

- A CAD allows India to import capital goods and advanced technology, enhancing domestic production capabilities and competitiveness. By importing machinery and equipment, India can improve its manufacturing sector's efficiency, promote technological advancement, and raise overall productivity levels.

- A current account deficit can also reflect increased domestic consumption and higher standards of living. It enables Indian consumers to access a wider range of imported goods and services, including essential commodities, energy resources, and advanced consumer products. This contributes to consumer welfare and enhances overall quality of life.

Challenges and Concerns of a Persistent CAD

- **External Vulnerability:** A persistent CAD makes an economy reliant on foreign financing, exposing it to external shocks and risks. Relying heavily on short-term or volatile capital inflows to finance the deficit can lead to currency depreciation, sudden capital outflows, and financial instability, as witnessed during periods of global financial crises.

- **Debt Accumulation:** If the current account deficit is largely financed through borrowing, it can lead to a significant accumulation of external debt. High levels of external debt can increase the country's vulnerability to changes in global interest rates, exchange rate fluctuations, and credit rating downgrades. This can limit the government's fiscal flexibility and potentially constrain future economic growth.

- **Structural Weaknesses:** A persistent CAD can indicate underlying structural weaknesses in the economy, such as low export competitiveness, inadequate domestic manufacturing capabilities, and an over-reliance on imports. These issues can hamper long-term economic development and hinder the country's ability to achieve sustainable and inclusive growth.

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Policy Implications

To address the challenges associated with a persistent CAD, policymakers should focus on improving India's export competitiveness. This includes investing in infrastructure, providing support to domestic industries, fostering innovation and research and development, and promoting skill development programs.

Reducing dependence on imported goods and services can be achieved through policies aimed at diversifying the economy and strengthening domestic production capabilities. Encouraging sectors with export potential, promoting small and medium-sized enterprises, and incentivizing import substitution industries can contribute to narrowing the current account deficit.

Policy measures that promote a stable investment climate and attract long-term FDI can help reduce reliance on short-term capital inflows. Creating an enabling business environment, ensuring policy consistency, and improving governance and transparency are crucial for attracting sustainable investments.

The implications of a persistent current account deficit on the Indian economy are complex and multifaceted. While there are potential benefits associated with capital inflows, technology transfer, and improved standards of living, the risks of external vulnerability and structural weaknesses should not be overlooked. It is crucial for policymakers to strike a balance between fostering economic growth, managing external imbalances, and addressing structural challenges through proactive policies that promote export competitiveness, diversify the economy, and attract long-term investments.

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