

Australia's current account deficit in a global imbalances context

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This article looks at Australia's current account deficits in light of concerns about the role of external imbalances in the global financial crisis and the difficulties now facing a number of countries that have run large current account deficits in recent years. Australia is clearly differentiated from other deficit countries in that recent high deficits have been driven by rises in non-housing investment — mainly in response to high resource prices — while national saving has been increasing. This suggests that our deficits are less likely to reflect underlying imbalances in the economy.

It is plausible that Australia could maintain large inflows of foreign capital for some time, given resource demands from China and India. This would imply a further rise in our net foreign liabilities as a share of GDP. However, the trade balance adjustment that will be needed eventually to stabilise this share does not appear onerous, particularly as investment in the resources sector will boost future export supply.

¹ The authors are from Macroeconomic Policy and Domestic Economy Divisions, the Australian Treasury. This article has benefited from comments and suggestions provided by Dr David Gruen, Tony McDonald, Robert Seaton, James Kelly and Helen Wilson and assistance from Danial Gaudry. The views in this article are those of the authors and not necessarily those of the Australian Treasury.

Introduction

Australia's current account deficit (CAD) has attracted considerable debate over the past three decades. The rise in the CAD from the early 1980s became a central focus for policymakers during that decade. High CADs were seen as a source of macroeconomic vulnerability and a constraint on economic growth. It was generally agreed that both macroeconomic and microeconomic policies should be directed at reducing the CAD.

In the early 1990s this consensus began to be challenged by the 'consenting adults' view that the CAD should not be seen as a problem if it is based on private saving and investment decisions that are not subject to significant policy distortions. Over time this view increasingly became accepted as the CAD remained high without much sign of adverse implications. The shift towards a more relaxed view of the CAD was assisted by improved macroeconomic policy and structural reforms that enhanced confidence that the preconditions for the 'consenting adults' view were met. A sign of this change is that the rise in the CAD to around historically high levels since the resources boom began six years ago has not generally been seen as cause for alarm.

However, the global financial crisis challenges the assumption implicit in the 'consenting adults' view that financing will always be available and financial markets never fail. Indeed the crisis seems to have confirmed earlier fears that external imbalances across major economies presented a risk to global macroeconomic stability – with many observers identifying these large global imbalances as a key cause of the crisis. In the wake of the crisis a number of deficit countries are facing significant adjustments that are likely to entail a shift to lower CADs. In contrast, Australia seems likely to continue to run large deficits to finance investment in the resources sector.

Against that background, this article examines the factors underpinning Australia's CADs and compares Australia's situation to those of other countries that have also had large current account deficits in recent times. It also examines the implications of continued CADs for our net foreign liabilities and the size of external adjustment that might be required for long-run sustainability.

Definitions and concepts

Balance of payments accounting defines the current account balance as the sum of the trade and net income balances. In a direct sense, Australia's CAD reflects the fact that imports and income paid to foreign residents exceed exports and income received from abroad. However, the CAD can just as validly be thought of in two other ways:

- acquisition of Australian assets by foreigners exceeds Australian acquisition of foreign assets; and
- domestic investment exceeds saving by Australian residents.

The saving-investment perspective is often the most useful as it recognises that the CAD reflects economy-wide factors. This helps to identify influences that can be overlooked in focussing on external transactions. For instance, it may seem counter-intuitive that the rise in Australia's terms of trade in recent years has been associated with a widening CAD, given its direct effect is to reduce the trade deficit. From a saving-investment perspective this is not surprising, as resultant high profits in the resources sector could be expected to lead to a surge in investment.

A saving-investment perspective also emphasises that the current account is best viewed in inter-temporal terms. Saving and investment are means of increasing future consumption by diverting output from current consumption. Hence, CADs can be considered optimal if they are consistent with achieving an optimal consumption path.

For instance, CADs that finance higher levels of productive investment can raise the economy's future output potential, allowing higher levels of consumption over time. Running CADs when income is unusually low or investment is unusually high also allows consumption to be smoothed over time.

Also important is foreign investors' willingness to finance CADs, which will depend on their confidence that liabilities will be serviced at face value in the long run. Technically, this requires that the borrowing country satisfy its inter-temporal budget constraint by generating future trade surpluses equal in present value terms to its current net foreign liabilities.² In other words, foreign liabilities must ultimately be serviced by a net flow of goods and services to foreign creditors. This transfer represents the real resource cost of foreign borrowing.

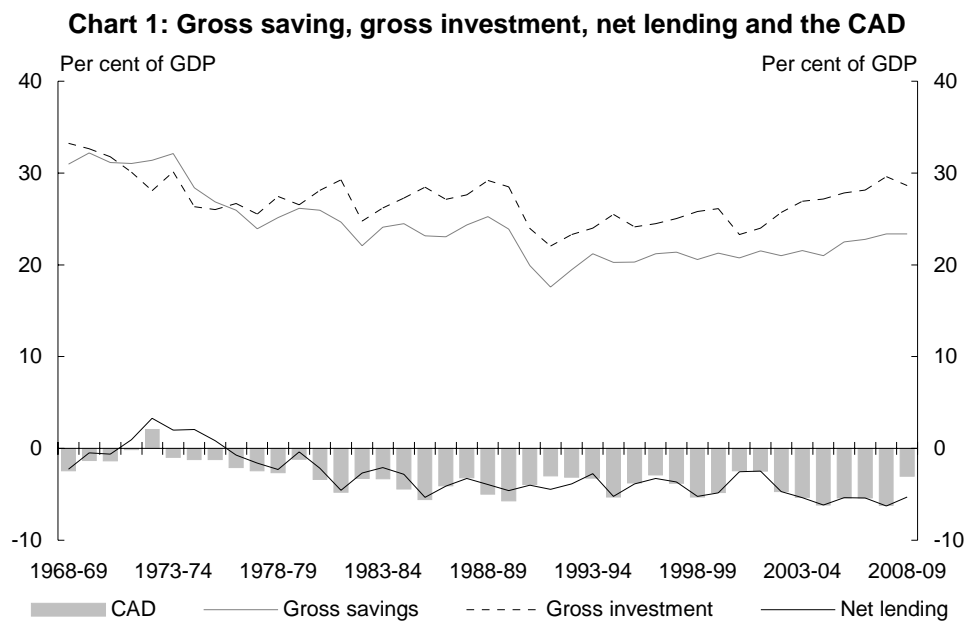
In practice, it is difficult to define when a country is at risk of breaching its inter-temporal budget constraint, as this depends on the evolution of the trade balance into the indefinite future. Whether a borrowing country continues to service its liabilities also depends on its willingness to make the necessary adjustments, and not only on its capacity. For these reasons, emphasis is often placed on the concept of sustainability.

Sustainability means that a country could satisfy its inter-temporal budget constraint without the need for a large adjustment in the future, which is a more stringent criterion. Large adjustments require a substantial rise in output relative to spending, which may be difficult to achieve. They may also require depreciation of the borrowing country's currency, imposing losses on foreign investors if liabilities are denominated in that currency. A common metric for assessing sustainability is the size of the trade balance adjustment needed to stabilise net foreign liabilities as a share of GDP.

2 The responsibility for servicing private sector liabilities lies with the issuer of the liability, rather than the country collectively. The aggregate inter-temporal budget constraint for a country is the sum of the budget constraints for each resident.

Evolution of Australia's current account, national saving and investment

Australia's current account has been in deficit for most of its history, and consistently over the past three decades (Chart 1). The deficit widened from the early 1980s, averaging around 4 per cent of GDP over this period, compared to an average of 1½ per cent of GDP over the preceding two decades. The CAD has widened further since the start of the resources boom, averaging 5¼ per cent of GDP over the past five years.



The initial widening of the CAD in the 1980s reflected mainly a rise in national investment as a share of GDP. Following the early 1990s recession, however, both investment and saving shifted down as shares of GDP. This meant that the long-term rise in the CAD up to the middle of the current decade could be attributed to a fall in the national saving rate. The national saving rate through the 1990s and early 2000s was more than 4 per cent of GDP below late 1970s levels.

In contrast, the recent widening of the CAD has reflected a rise in investment, which has averaged 3¼ per cent of GDP higher over the past five years than its average level over the preceding ten years. National saving has also increased in this period, averaging 1¾ per cent of GDP higher than over the preceding ten years. This implies that domestic saving has funded about half of the recent increase in investment.

Net lending by sector

From a sectoral perspective, the widening of the CAD since the early 1980s is explained by a turnaround in the net lending position of households, who were net lenders up to the late 1980s but have become consistent net borrowers since the late 1990s (Chart 2). Net borrowing by general government was a major factor from the mid-1970s to the mid-1990s, but this sector has been generally a net lender since the late 1990s. As a result the CAD has been largely driven by private sector net borrowing since the mid-1990s, whereas in the earlier period it was mainly public sector-driven.

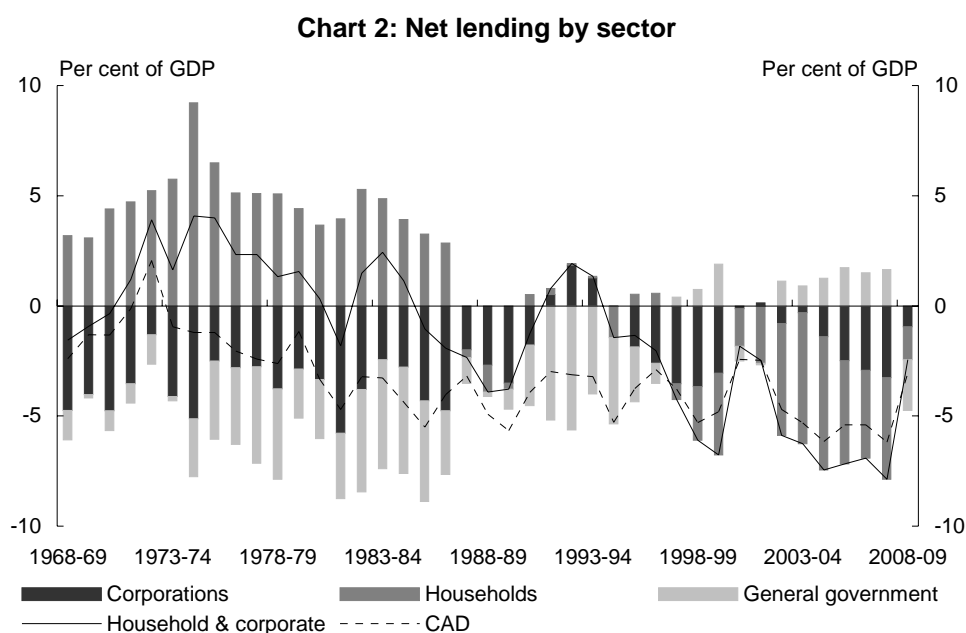


Chart 2 also shows that general government and corporate/household net lending normally move in opposing directions over the course of the economic cycle. It is important to abstract from these cyclical effects in considering structural influences on the CAD.

Economic downturns are associated with weakening private investment and consumption, so that corporate and household net lending increases (or net borrowing falls). Conversely, government net lending declines during economic downturns as a result of the automatic fiscal stabilisers and discretionary policy responses to support the economy. However, the reduction in government net lending normally only offsets partially the increase in household and corporate net lending, so that the CAD falls as a share of GDP during economic downturns. That is, the decline in government net lending moderates the cyclical fall in the CAD that would otherwise occur due to a sharper contraction in aggregate spending.

National saving

Underlying both the turnaround in household net lending and the long-term fall in the national saving rate has been a long-term decline in the household saving rate since the mid-1970s. There are a number of issues concerning the measurement of household saving that suggest the measured fall in the household saving rate exaggerates the actual fall (see Treasury 1999 for a detailed discussion).

One factor has been the long-term shift to incorporation of small businesses. As unincorporated business are part of the household sector, this has shifted business saving that was formerly counted as household saving into corporate saving. This suggests that household and corporate saving are better considered together, particularly as corporations are directly or indirectly owned by households (apart from the portion owned by foreign residents). The fall in combined saving over the long-term is around one-third less than the fall in household saving.³

The fall in the combined saving rate is partly due to the effect of inflation on interest receipts and payments. Conceptually, the inflation component of interest represents a repayment of principal rather than an income or expense. This factor artificially boosted measured saving in the 1970s when inflation was high and the private sector was still a net creditor.

Part of the measured fall in saving may be due to statistical discrepancies between income-side and expenditure-side measures of GDP. The discrepancy was over 2 per cent of GDP in the mid-1970s, suggesting that the high saving rate at this time may partly reflect over-estimation of income and/or under-estimation of consumption.

Even taking account of these factors, it is still clear that private saving (as conventionally defined) has fallen since the early 1980s.

A key cause of this fall is likely to have been the deregulation of the financial sector from the early 1980s. Deregulation and subsequent financial innovation have reduced previous constraints on the supply of credit, enabling people to borrow to smooth consumption and purchase dwellings and other assets. High saving rates before financial deregulation may have been an inefficient response to credit constraints that prevented households from achieving their preferred consumption paths.

Another (somewhat related) contributor to lower private saving has been growth in asset prices, particularly for housing, which comprises over half of household assets.

3 It would be preferable to consider total private saving, excluding public corporations. However, National Accounts data do not separately identify public financial corporations and only identify public non-financial corporations from 1988-89 onward.

Capital gains reduce the need to save out of current income in order to accumulate wealth, but are not included in the conventional definition of saving.⁴ House prices grew much faster than household incomes between 1997 and 2003, and this may explain much of the fall in the household saving rate over this period.

Since 2004-05 the household saving rate has begun to rise again. The reasons for this are not yet well understood, but may be related to strong growth in incomes arising from the resources boom. If households perceive part of their incomes as temporary then they are likely to save a higher share of income in order to smooth consumption over time.

National investment

Chart 1 showed that average levels of investment as a share of GDP fell during the 1970s but have recovered significantly over the current decade. The earlier fall in national investment is likely to reflect three factors:

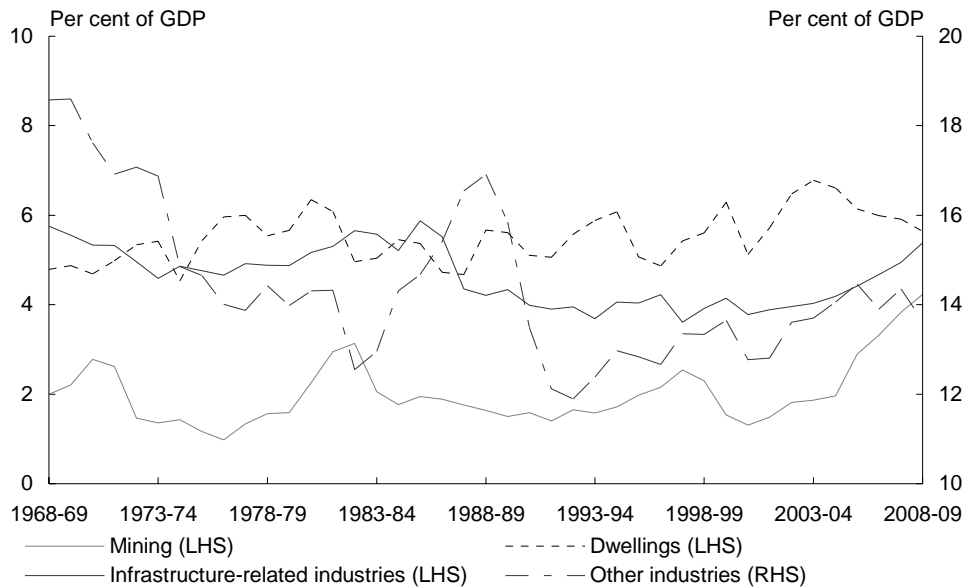
- a fall in population growth from an average rate of 2.2 per cent in the 1960s to only 1.3 per cent over the following three decades, reducing the level of investment needed to maintain a given ratio of capital to output;
- structural changes that have increased the share of output coming from service industries, which are generally less capital-intensive; and
- a rise in interest rates due to high inflation during the 1970s and 1980s, which continued until low inflation credibility was re-established from the mid-1990s.⁵

This fall in real interest rates from the mid-1990s fuelled strong growth in dwelling investment in the late 1990s and early 2000s (Chart 3). Since the housing market correction in 2004, dwelling investment has fallen back closer to 1990s levels as a share of GDP.

4 The Australian Bureau of Statistics publishes an alternative measure of household saving that includes capital gains and losses. This measure is more volatile, but shows a generally rising trend from 1991-92 to 2006-07, before falling sharply due to asset price falls over the past two years.

5 Prior to financial deregulation many interest rates were subject to controls that kept real interest rates low (or even negative). This meant that effects on investment occurred instead through credit rationing.

Chart 3: Composition of gross fixed capital formation



Notes: Infrastructure-related industries are electricity, gas, water and waste services; transport, postal and warehousing; and information media and telecommunications.
Source: ABS cat. no. 5204.0.

Since 2004-05 the main contributor to rising national investment has been mining investment, which has surged in response to high commodity prices arising from strong demand from China and other emerging economies. Mining investment has expanded by around 2½ per cent of GDP since the onset of the resources boom, contributing to most of the increase in national investment as a share of GDP over this period.

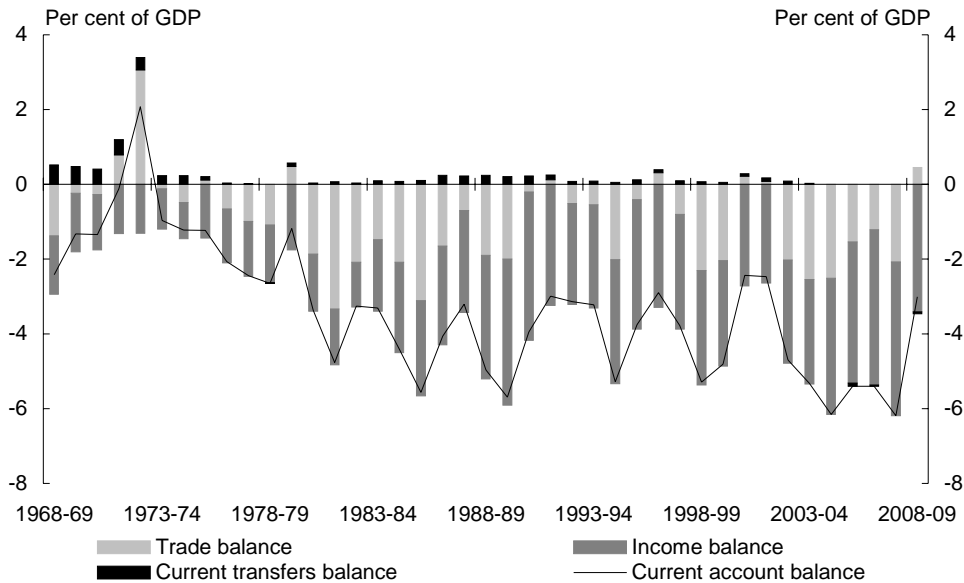
The other key contributor to the recent rise in national investment has been infrastructure. Total investment in infrastructure-related industries – electricity, gas, water, transport and telecommunications – has risen by nearly 1½ per cent of GDP over the past five years. This growth reflects increased demands for infrastructure arising from both the expansion of the resource sector and recent strong population growth, as well as some catch-up from past underinvestment.

These increases in the rate of investment will expand the nation's capital stock, which will boost future productivity and GDP. Provided the returns on investment exceed the cost of capital, this will raise future national incomes (notwithstanding the cost of servicing foreign borrowing to finance the investment).

Trade and net income balances

From a trade and income balance perspective, it is notable that the net income deficit now accounts for around three-quarters of Australia's CAD (Chart 4).⁶ This means that the CAD reflects mainly interest and dividends paid to foreign investors in Australia (net of income received on Australian investment abroad) rather than an excess of imports over exports. The rise in the net income deficit over time reflects the cost of servicing Australia's growing accumulation of net foreign liabilities.

Chart 4: Composition of the current account balance



Source: ABS cat. no. 5302.0.

Australia has also had a consistent deficit on trade, with only occasional small surpluses since the mid-1970s. The trade balance is more volatile than the net income balance, due to the effects on imports and exports of domestic and international economic conditions and exchange rate fluctuations. Over longer periods the trade deficit shows no clear trend, averaging around 1½ per cent of GDP since the early 1980s.

⁶ The very small balance on current transfers relates to current payments such as donations and workers' remittances that are not in exchange for goods or services.

International comparisons of the CAD, national saving and investment

Australia has a relatively high CAD compared to most other developed countries, which reflects a relatively high level of investment rather than low saving (Table 1). Australia's national investment rate has been significantly higher in recent years than that of any of the major (G7) economies. Our national saving rate is now close to the OECD average. It has been much higher than saving rates in the US, the UK and New Zealand, which have also had consistent CADs in recent times.

Table 1: Saving, investment and current account balances for key OECD countries

	Per cent of GDP					
	Gross Saving (ave 2004-08)			Gross Investment (ave 2004-08)	Current Acc. Balance (ave 2004-08)	Net Foreign Liabilities 2008
	General govt	Other	Total			
Australia	3	19	22	27	-5.6	58
Canada	2	22	24	22	1.4	0
US	-3	17	14	20	-5.5	24
Japan	-4	31	27	24	3.9	-51
Germany	-1	25	24	18	6.0	-25
France	-2	21	19	21	-0.7	18
UK	-1	16	15	17	-2.5	3
NZ	6	10	16	24	-8.1	73
Italy	-1	21	20	21	-2.2	20
OECD average			22		-1.0	
G7 Average	-1	21	20	20	0.1	-2

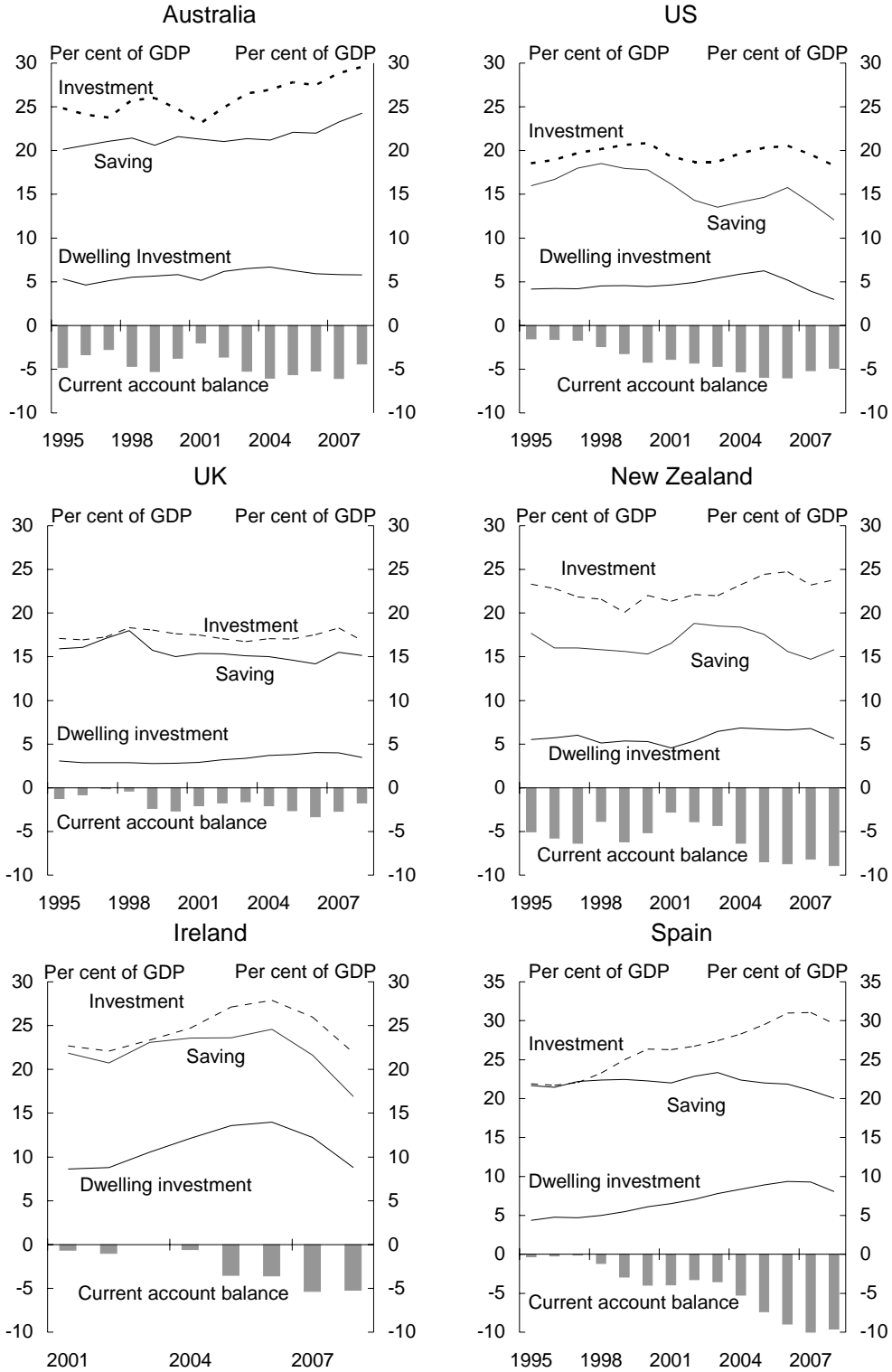
Notes: Averages are simple averages. Saving less investment may not equal the current account balance due to statistical discrepancies. For comparability, data are on the old System of National Account (SNA) 93 basis. The ABS recently moved to the new SNA08 international standard ahead of most other countries. SNA08 treats spending on R&D and defence weapons platforms as investment, significantly raising both saving and investment levels.

Source: ABS, IMF, OECD and SNZ.

Charts 5 to 10 compare the evolution over time of current account balances, saving and investment for Australia and a number of other OECD countries that have experienced persistent and/or widening deficits.

Australia stands out as the only country in this group that has experienced rises in both saving and investment rates over recent years. In contrast, widening CADs in the US and UK since the late 1990s have reflected falls in saving rates, with no increase in investment rates. A fall in the saving rate also accounts for a substantial part of the widening of New Zealand's CAD since the early 2000s, although its investment rate has also increased over this period.

Charts 5 to 10: Net lending and current account balance for selected countries



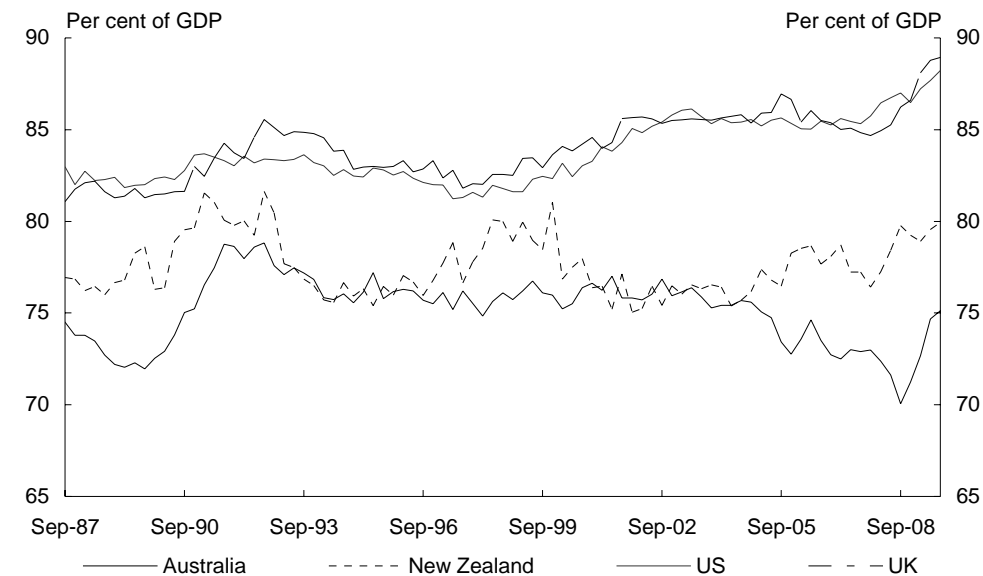
Charts 5 to 10 source: ABS, IMF and OECD

Australia's current account deficit in a global imbalances context

An increase in the CAD that reflects a fall in the saving rate implies that increased foreign borrowing is being used to finance higher current consumption at the expense of future consumption. A fall in the saving rate may be appropriate to smooth consumption over periods when national income is low relative to its expected future path. However, a persistent fall in the saving rate may be an indication that CADs are not optimal.

Chart 11 shows that Australia's CADs have not been used to finance higher consumption by households and governments. Indeed consumption in Australia is relatively low as a share of GDP, and this share has been falling in recent years. This is in marked contrast with the US and the UK, where consumption as a share of GDP has increased significantly since 1997. The consumption share of GDP has also risen in New Zealand in recent years.

Chart 11: Total consumption as a share of GDP



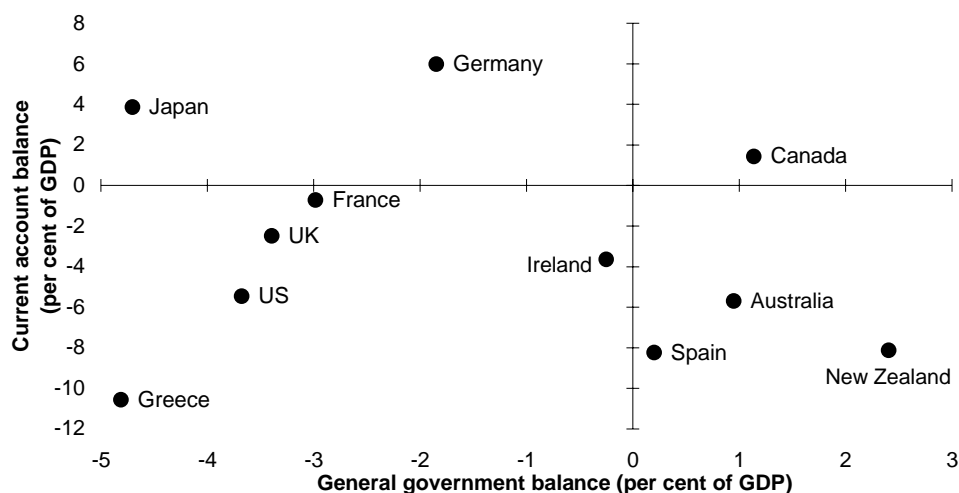
In contrast, an increase in the CAD to finance higher investment need not come at the expense of future consumption, provided the investment yields a rate of return sufficient to cover the cost of capital. However, this condition may not be met if investment decisions are distorted by government policies or over-exuberant market behaviour (asset price bubbles).

In the cases of the two other deficit countries shown here – Ireland and Spain – the widening of CADs over the past decade did reflect (until recently) increasing rates of investment. In contrast to Australia, however, this was due primarily to rises in dwelling investment. High dwelling investment appears to have been associated with

bubbles in housing markets in these countries. From peak levels, house prices have fallen by over 30 per cent in Ireland and by around 10 per cent in Spain (while there has been no sustained fall in Australian house prices).

Another factor distinguishing Australia from many other current account deficit countries is our strong fiscal position (Chart 12). CADs in a number of countries – the US, the UK, Greece, Portugal and several Eastern European countries – have been underpinned in part by large fiscal deficits. Australia, New Zealand, Spain, Ireland and Iceland have been in significant fiscal surplus in recent years, although the latter three economies have now experienced particularly sharp cyclical fiscal deteriorations. Notwithstanding the effect of the global financial crisis, government finances in Australia remain sound.

Chart 12: Current account and general government financial balances (average 2004-2008)



Note: Australian general government financial balance is the average for fiscal years 2003-04 to 2007-08.
Source: ABS, IMF and Treasury.

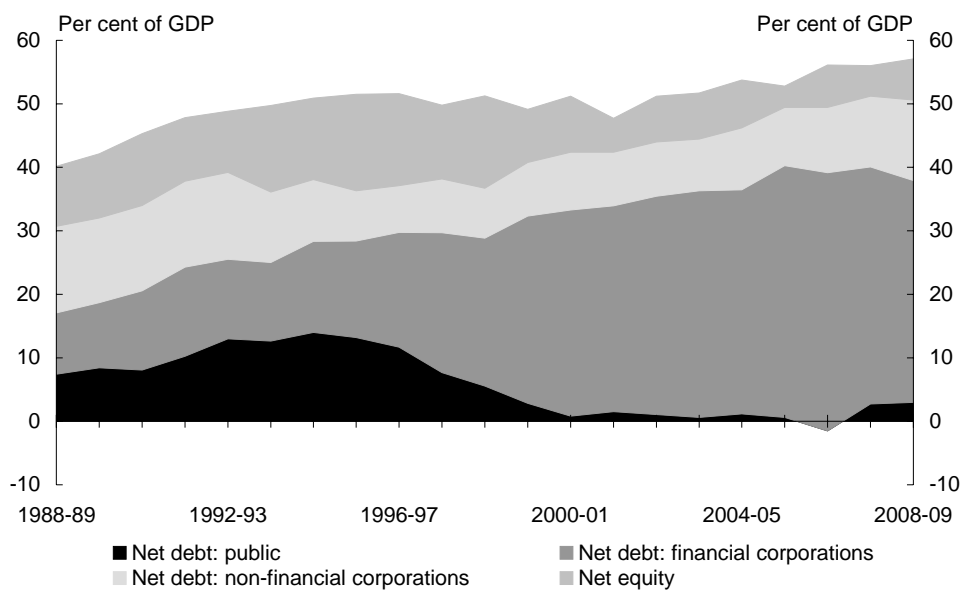
In summary, Australia's current account position differs in important respects from those of other OECD countries with persistent current account deficits over recent years:

- higher CADs in Australia have been due to high and rising investment rather than low or declining saving (indeed our national saving rate has been rising);
- higher investment has been to expand productive capacity, particularly in the export sector – it has not reflected over-investment in housing associated with a house price bubble; and
- Australia has maintained a sound underlying fiscal position.

Evolution of Australia's net foreign liabilities

The counterpart of inflows of foreign capital to finance CADs has been a steady rise in Australia's net foreign liabilities, from about 40 per cent of GDP 20 years ago to nearly 60 per cent of GDP in 2008-09 (Chart 13). This is the net effect of larger rises in gross foreign assets and liabilities, which reflect Australia's increasing integration with global financial markets. As a share of GDP, Australians' holdings of foreign assets have tripled from around 30 to 90 per cent over two decades, while foreign holdings of Australian assets have doubled from around 70 to over 140 per cent.

Chart 13: Australian net foreign liabilities as a per cent of GDP



Source: ABS cat. no. 5302.0.

The rise in net foreign liabilities has come from a steady rise in net foreign debt, which accounts for around 90 per cent of net foreign liabilities in 2008-09. Net equity liabilities have fallen as a share of GDP over the past decade. This reflects mainly increased Australian investment in foreign equities, which has shifted us from being a net importer of equity capital in the past to a net exporter over the current decade (although we became a net importer again in 2008-09).

The rise in net foreign debt has come from increased net borrowing by financial corporations, particularly since the mid-1990s. Financial corporations now account for three-quarters of net foreign debt. This has been partly offset by a reduction since the mid-1990s in net foreign debt of the public sector (including public enterprises), which accounted for less than 10 per cent of total net foreign debt in 2008-09.

The evolution of a country's net foreign liabilities as a share of GDP is described by the identity:

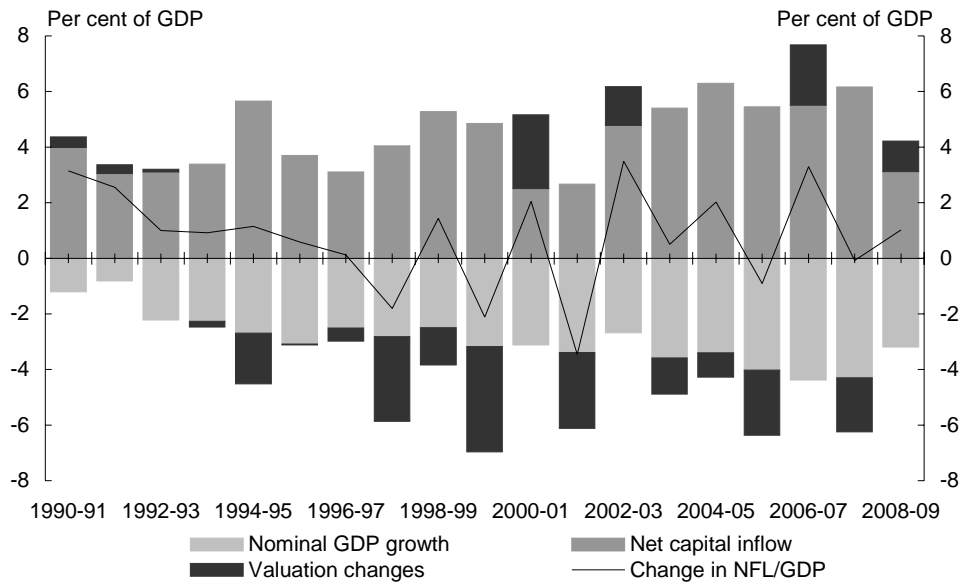
$$nfl_t - nfl_{t-1} = cad_t - \frac{g_t}{1+g_t} nfl_{t-1} - v_t$$

Where nfl , cad and v are net foreign liabilities, the CAD and net valuation gains as shares of GDP and g is the annual rate of nominal GDP growth. This equation shows that the extent to which CADs translate into growth in net foreign liabilities depends on nominal GDP growth and net valuation gains.⁷ The higher are these offsetting factors, the larger is the CAD that can be sustained before net foreign liabilities grow faster than GDP.

Chart 14 shows that nominal GDP growth and valuation gains have often substantially offset the effect of CADs. This was particularly true over the period from 1996-97 to 2001-02 when net foreign liabilities fell slightly as a share of GDP. In recent years, strong growth in nominal GDP as a result of rising terms of trade has helped to moderate the impact of higher CADs on the ratio of net foreign liabilities to GDP (indeed, this ratio has been stable over the last two years).

7 Net valuation gains or losses reflect changes in the value of foreign assets and liabilities due to changes in asset prices, exchange rates and other adjustments. Price changes are mainly due to changes in equity prices: Australia makes net gains when growth in the value of our foreign assets outweighs growth in the value of Australian assets held by foreigners. Exchange rate effects reflect changes in the Australian dollar value of foreign assets and liabilities denominated in foreign currencies (including foreign equity assets). Australia has a net foreign currency asset position, so we gain when the Australian dollar depreciates.

Chart 14: Contributions to changes in net foreign liabilities as a share of GDP



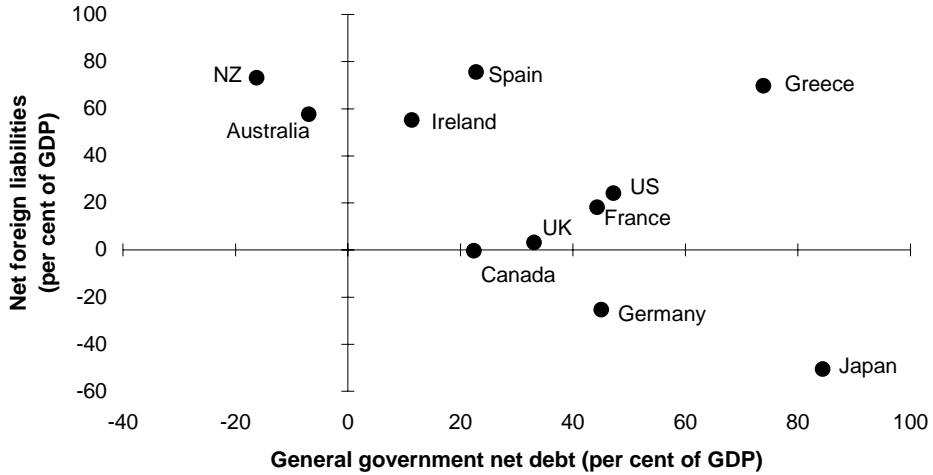
Source: ABS cat. no. 5302.0.

International comparison of foreign liabilities

Australia has a high level of net foreign liabilities compared to most other advanced countries, reflecting our long history of CADs (Chart 15). Australia's average CAD has been similar to that of the United States over recent years, but the US has much lower net foreign liabilities as it began to run persistent CADs only in the 1980s. Similarly, the United Kingdom has maintained a net foreign asset position due to past surpluses, despite running CADs over recent years.

Australia is not, however, an outlier. Several OECD economies have similar or higher net foreign liabilities as a share of GDP. Australia and New Zealand are distinguished from this group on account of their stronger government net debt positions.

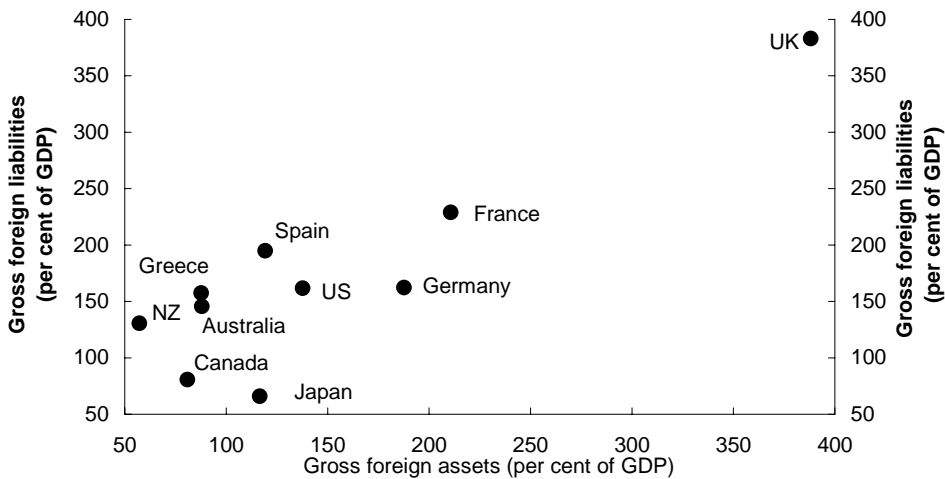
Chart 15: Net foreign liabilities and general government net debt for selected OECD countries (2008)



Note: Australian data are as at the end of 2007-08.
Source: IMF and ABS cat nos. 5302.0 and 5512.0.

Another important dimension is the size of gross foreign assets and liabilities. The extent of a country's exposure to shocks from global financial markets is a function of its gross positions, and not only of its net liabilities. It is notable that Australia (along with Canada and New Zealand) has significantly lower gross foreign assets and liabilities as a share of GDP than most other advanced economies (Chart 16).

Chart 16: Gross foreign assets and liabilities for selected OECD countries (2008)



Note: Not shown is Ireland, which had gross foreign assets and liabilities exceeding 1100 per cent of GDP.
Source: ABS and IMF.

Outlook for Australia's net foreign liabilities

Continued demands for resources created by development in China and India raise the prospect that investment and the CAD could remain at high levels for an extended period. This raises the question of how much further Australia's net foreign liabilities might grow as a share of GDP, and what might be required to stabilise this share at some point.

Ignoring valuation changes and assuming nominal GDP growth of 5½ per cent, a constant CAD of 4.1 per cent of GDP (the past 30-year average) would see net foreign liabilities exceed 70 per cent of GDP after 20 years. If CADs were to remain instead at their 5-year average of 5.2 per cent of GDP then net foreign liabilities would reach 85 per cent of GDP after 20 years.

These increases would be smaller if nominal GDP growth was higher or if Australia continued to benefit from net valuation gains. If nominal growth was ½ a percentage point higher, accumulation of net foreign liabilities would be reduced by around 4 per cent of GDP in each scenario. If net valuation gains were to continue at their average for the past 20 years of 0.6 per cent of GDP per annum, growth in net foreign liabilities would be reduced by 8 per cent of GDP.

Long-run sustainability requires that net foreign liabilities eventually stop growing faster than GDP, although this need not occur for some time. The trade balance that would stabilise net foreign liabilities at a given share of GDP is given by the following equation (for derivation see Garton 2007):⁸

$$tb = nfl \times \frac{(r^L - g)}{(1 + g)} - fa \times \frac{(r^A - r^L)}{(1 + g)}$$

Here tb , nfl and fa are the trade balance, net foreign liabilities and gross foreign assets as shares of GDP and r^L and r^A are average rates of return (including both investment income and valuation gains) on gross foreign liabilities and assets.

The intuition behind this equation is that the burden of servicing net foreign liabilities can be met in three ways: through nominal GDP growth reducing the burden of previously-accumulated liabilities, through excess returns on foreign assets and through trade surpluses. The higher are nominal GDP growth and the return on assets, relative to the rate of return on liabilities, the less the need to run trade surpluses.

8 If rates of return on assets and liabilities are equal this reduces to the more commonly used form: $tb = nfl \times (r - g)/(1 + g)$.

Past averages may provide a plausible guide to future relativities between these variables. While the rate of return on Australia's foreign liabilities has exceeded GDP growth in the past, we have received an even higher rate of return on our foreign assets (Table 2).⁹ If maintained, this excess return would allow Australia to sustain small trade deficits rather than having to move eventually into trade surplus.

Table 2: Sustainable trade balances under alternative assumptions^(a)

	20 year average	
Nominal GDP growth (per cent)	6.3	
Rate of return (per cent) on:		
Foreign assets	9.6	
Foreign liabilities	7.5	
Liability return less GDP growth	1.2	
Asset return less liability return	2.1	
Trade balance (% of GDP) to stabilise NFLs at:	60 per cent of GDP	90 per cent of GDP
Based on past relativities	-1.0	-0.6
Liability return 1 per cent higher	0.4	1.0
Without excess asset return	0.7	1.1

(a) Calculations assume unchanged gross foreign asset share of GDP.

Based on past relativities, a sustained trade deficit of 1 per cent of GDP would stabilise net foreign liabilities at their current share of GDP over the long term. The trade deficit has averaged 1.2 per cent of GDP over the past five years, so this would imply a relatively modest adjustment. Exports and imports are each around one-fifth of GDP, so a fall in the trade deficit of 0.2 per cent of GDP could be achieved with a ½ per cent rise in exports and a ½ per cent fall in imports.

As net foreign liabilities are likely to grow faster than GDP in the immediate future a key question is whether this would mean a significantly larger trade balance adjustment in the longer term. Table 2 shows that even if the ratio of net foreign liabilities to GDP was to rise by half, the required trade balance adjustment would rise by only 0.4 per cent of GDP.¹⁰

9 This reflects in part the fact that equities are around half of Australia's foreign assets but only one-third of our liabilities. Equities provide a higher rate of return than debt, so this would imply a higher rate of return on assets (all else equal). Another factor may be investments in fast-growing emerging economies, which should yield relatively high rates of return. While this entails greater risk on the asset side, the average long-run return should still be higher.

10 Conversely, a moderate change in the trade balance can make a large difference to the share of GDP at which net foreign liabilities eventually stabilise. This is why it is possible for a moderate adjustment to stabilise net foreign liabilities eventually at their current share of GDP, even though continued trade deficits at recent levels would imply a large increase in this share.

These calculations assume that the past is a good guide to the future. As the future is uncertain, it is worth considering the implications of less favourable future relativities. If the rate of return on foreign liabilities was to rise by 1 percentage point, holding nominal GDP growth and asset returns constant, the required adjustment would increase by 1.4 per cent of GDP, requiring a shift into trade surplus of 0.4 per cent of GDP.

This would still be a manageable adjustment if it occurred over a reasonable period of time: for instance, it could be achieved with a 4 per cent rise in exports and a 4 per cent fall in imports. At least part of the required future adjustment to the trade balance is likely to occur as a matter of course. This is because the massive investment to expand productive capacity in the mining sector will yield a long-term increase in export supply that should reduce the trade deficit over time.

Australia's situation can be compared with that of the United States, whose trade deficit in recent years has averaged around 5 per cent of GDP. The US has a much larger trade deficit, even though its CAD has been similar in size to Australia's, as it still has a small net income surplus. This means that the US is likely to need a much larger trade balance adjustment to stabilise its net foreign liabilities as a share of GDP.¹¹

The US faces additional challenges because external adjustment is harder to achieve in larger and more closed economies. Trade as a share of GDP is about one-third smaller in the US than in Australia, so proportionally larger changes in exports and imports are needed for a given shift in the trade balance. The size of the US economy also means that its own adjustment is likely to cause an adverse shift in its terms of trade, making adjustment even harder (Obstfeld and Rogoff, 2004).¹²

Conclusion

In light of the concerns about external imbalances following the global financial crisis it is important to bear in mind that current account imbalances are not inherently problematic. Whether deficits are optimal depends on whether the underlying decisions on investment and saving are optimal. This is essentially a question of inter-temporal optimisation: are CADs consistent with achieving a path of consumption over time that maximises the wellbeing of Australians?

11 The US has also earned an excess rate of return of its foreign assets over time. Using a similar approach to that outlined above, Kouparitsas (2005) estimated that the US could sustain a trade deficit of 1.4 per cent of GDP.

12 Adjustment requires either a fall in US demand or an increase in US supply of tradeable goods, both of which suppress US export prices. The demand affect arises from 'home bias', which means that a fall in US demand disproportionately affects US-produced goods.

Australia's current account deficit in a global imbalances context

Against that criterion, Australia's large CADs in recent years, and the prospect that these could continue for some time, do not appear to be a cause for concern. Increased external borrowing is financing investment, mainly in the resources sector, that is likely to yield high rates of return and will expand export supply capacity. In these circumstances we could expect external borrowing to raise the wellbeing of Australians and to be readily serviced. Although net foreign liabilities are likely to grow significantly as a share of GDP, the size of the trade balance adjustment needed to ensure long-run sustainability appears readily achievable.

Reliance on external borrowing — particularly short-term borrowing — does entail risks; particularly, in the event of disruption to global financial markets. Nevertheless, the fact that Australia has come through the demanding stress test posed by the global financial crisis provides grounds for confidence that the risks are manageable.

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