



L21 Worth Noting

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Worth Noting is the journal of research and conferences company L21. It is focused on social, economic, political and international issues of relevance and interest to senior executives.

Do current account deficits really matter?

We periodically hear doom and gloom reports about our current account deficit (CAD) which is currently at about 6% of GDP. The U.S. CAD is even worse, running at about 6.5% of GDP. Given that the IMF cautions that anything over 4% for developed economies becomes tricky to manage, the numbers make for scary reading. Translated into dollar figures, Australia has a CAD of about AUS\$60 billion. The U.S. has a CAD of about US\$850 billion which is larger than Australia's entire GDP.

Scary as these numbers seem, do they really matter? CADs seem to make the front pages of the business section when they are released, followed by a brief collective wrap on the knuckles for poor economic management, and then almost as quickly is forgotten again until figures for the next period are released.

'Deficits' sounds like bogeymen but are they? After all, Australia in particular is motoring along. Our economy has never been stronger. We have never been more affluent. Unemployment has never been lower, and interest rates and inflation remain low. Are the reports about our CAD becoming out of control merely scaremongering by financial reporters looking to create a bit of news?

The question whether CADs really matter is a serious one and is keenly debated by academics, financial analysts and economists. In this edition of *Worth Noting*, we decided to assess a few arguments to see whether CADs are a beat-up or a genuine economic menace.

What is the current account deficit?

The CAD is one of the least understood but most frequently cited macro economic statistics. The simple description is that when the residents of a country (individuals, businesses and government) buy more assets from overseas than they sell, we have a CAD. It is actually more complicated than this and economists and accountants would not like us simplifying it like this.

Current accounts systems are based on the double entry principle with every item booked as a credit and a debit. Therefore, the overall result will be in balance and the equation for the balance of payments will be zero. A current account deficit does mean that a country spends more than it produces. If we consume \$100m worth of goods and services and produce \$60m, the difference of \$40m constitutes the accumulation of debt or the sale of domestic assets to foreigners. This \$40m is designated as 'foreign investment' which we will return to. Hence, a current account in deficit requires a positive capital and financial account and this implies that the holding of domestic assets by foreigners must increase.

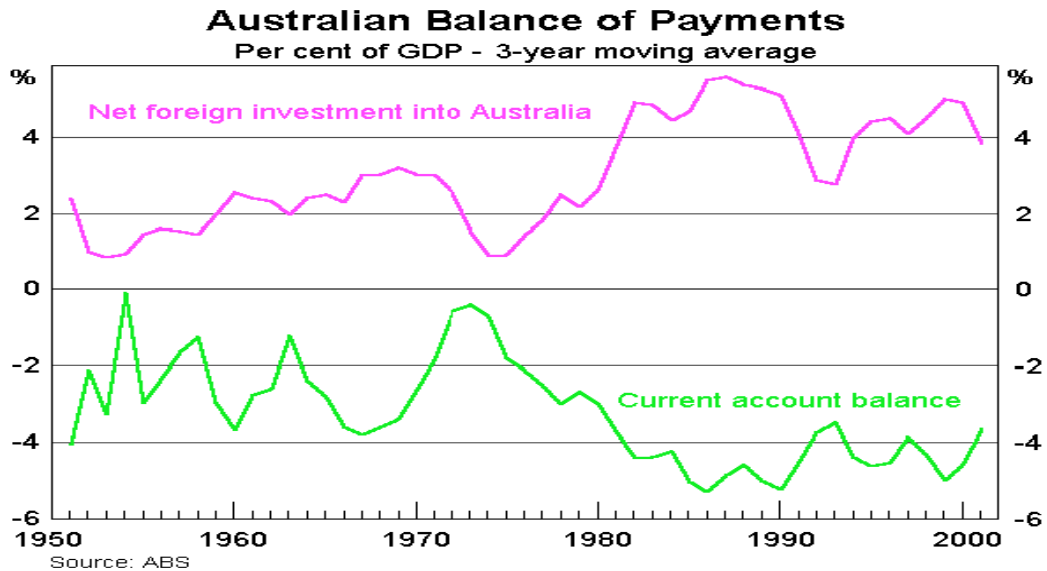
If we want to understand the debate about whether CADs matter or not, it is crucial to note that the Current Account includes not only the Balance of Trade - import and export of goods and services which make up about half the Current Account - but also includes all income inflows and outflows.

There are two aspects to this.

First, the only way goods and services can be paid for is by purchasing local currency with which to buy them. This imbalance in trade is offset by 'loans' of some kind which might or might not be invested in the country of consumption – termed 'foreign investment.' If we have a trade surplus, we are a net investor in the rest of the world. However, Australia is a net borrower: the rest of the world lends us funds to purchase the import surplus that we call foreign investment.

Second, the Current Account also includes Direct Foreign Investment coming in and going out of the country. This is capital used by Australians to directly invest in ventures overseas or overseas capital used to invest directly in Australia.

The graph below illustrates the point about the inverse relationship between the CAD and foreign investment.



Does the CAD matter?

A. CADs don't matter

A couple of decades ago, any CAD reaching six percent of GDP precipitated a momentary crisis of confidence. Remember Paul Keating's 'banana republic' warning in 1986, the slide into recession in 1990 or John Howard's taunt that the Keating Government had offered Australia "five minutes of economic sunshine" in 1995? These were all accompanied by a rising CAD that passed the six percent mark.

Since then, a new body of expert and common opinion has arisen, all agreeing that the CAD does not matter but for varying reasons. One example is the so-called 'Pitchford thesis' which says that international transactions are like the activities of consenting adults and should not be of 'public' concern. Behind this hands-off approach is the idea that if the CAD is driven by the private sector, then the deficit is not really a problem but a way the global market chooses to allocate resources.

In more recent times, the emphasis has been on the capacity to meet obligations and finance any CAD. If we export \$50 million and import \$100 million worth of goods, we are essentially \$50 million in deficit which may constitute a financial debt. The question for many is not how much the deficit is but whether we can feasibly manage and finance it.

One proponent of this approach is ANZ Bank Chief Economist Saul Eslake who focuses on whether our economy is able to sustain a deficit (i.e., keep importing more than we export) and sees no difficulty ahead for us in doing that. Similarly, Reserve Bank Governor Ian Macfarlane argues that the key is whether we are able to manage and finance our overseas borrowings. Macfarlane argues that given the increase mobility in international money and capital, we are much better at hedging risks and we are in a position to finance the CAD for a very long time. Moreover, these economists argue that past arguments that foreigners would grow tired of indulging Australia with larger and larger borrowings are

no longer valid as long as they have faith in the strength of the Australian economy, and faith in the capacity of borrowers to manage and repay their shortfall.

In this sense, it doesn't matter whether the CAD is four or five or ten percent of GDP as long as we have the capacity to meet our obligations. Therefore, even though the IMF is uncomfortable with a CAD that is anything above four percent of GDP, our CAD which is largely private sector driven is for many a reflection of economically rational decisions taken by the private sector that seems able to cope.

Behind this confidence in the face of growing CADs is recent history. The Australian economy has been in deficit for decades but has been growing for fifteen years. Similarly, the U.S. has generally run a CAD for thirty years, and economic historians tell us that they have pretty much had a CAD since the British settlement in Jamestown in 1607 until World War I. It was only between the two world wars and immediately after where the US had current account surpluses as they helped to rebuild a devastated Europe.

For those who do not believe CADs matter, the argument is also that economic woes have occurred only when governments have overreacted to CADs, mainly by raising interest rates, increasing domestic protectionism, or artificially manipulating the currency exchange rate and creating imbalances.

There is also anecdotal evidence that CADs don't seem to matter. Japan was running a huge current account surplus with the U.S. in the 1980s and 1990s. Japan was purposely depressing the yen to make their exports cheaper. The Japanese economy began to splutter in the 1990s for other reasons. The point is that whatever happened seemingly had little to do with trade surpluses or deficits – current accounts do not determine the direction of the broader economy and individual wealth.

B. CADs do matter

Let's now look at the other viewpoint.

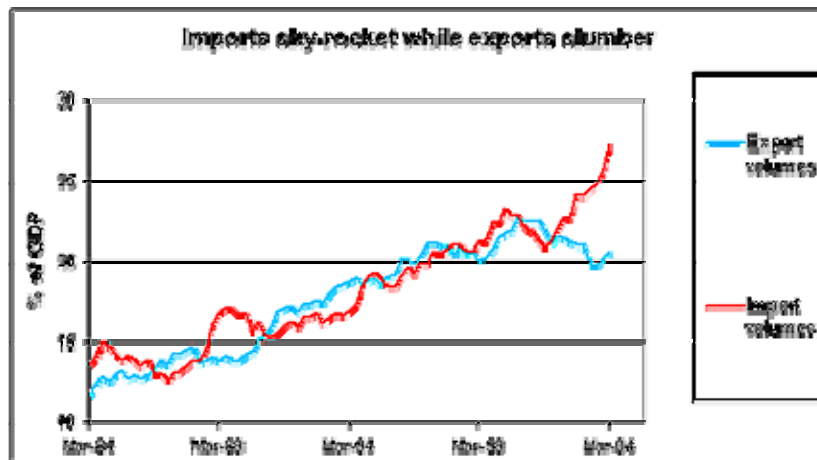
For those concerned with the CAD, why do they think we have a deficit? The first two reasons frequently put forward stand on rather shaky ground. The third one is worth investigating.

The first one could be called the 'populist' explanation. Australians and Americans are poor savers because we are insatiable consumers. We buy things that we cannot pay for today, think little about tomorrow, and are blind to the dangers of debt. In other words we consume more than we produce.

In this situation, the government will have no choice but to raise interest rates to limit our greedy lifestyles yearning for foreign goods and force us to save. When this happens, we endure the boom-bust cycles that were common place in the 1970s and 1980s. Hence, CADs are a precursor to economic pain and we should be concerned.

This logic is very much behind the 'buy Australian' campaigns, or what some have called the 'Dick Smith solution.' It is one which is picked up readily by the media in the name of patriotism and this logic

enjoys quite a bit of support throughout the population. In looking at five year trends, this argument has been prominently making the rounds since 2000 when import began to outstrip export volumes.



Source: ABS

The second explanation is that we are a high cost country. Our costs of production are too high, our wages too high, holidays too long, there has been too much union power, and our workers are uncompetitive. As a result, overseas producers especially in Asia produce more 'efficiently' and flood our markets with these cheap goods and services. According to this school of thought, it is no wonder we have a current account deficit. Hence, CADs are a warning either to raise productivity levels or to restrict the entry of cheap goods and services flooding our markets.

There are quite a few problems with these first two positions.

First, they only look at the balance of trade which deals only with goods and services, not capital inflows and outflows (including Foreign Direct Investment) which constitutes about half the CAD. Second, economic progress is largely driven by consumption. To say that we consume 'too much' in this context is like saying the price of a bottle of Grand Cru Bordeaux is too expensive because we find Grand Cru Bordeaux too magnificent. It's an empty truism. Besides, the argument that we consume too much does not address why CADs should alarm us. Should we merely consume less and slow down economic activity for the sake of lowering the CAD? That is just another way of saying we have to have a recession.

Likewise the implication that we should 'buy Australian' to eliminate the deficit problem doesn't really tell us why it is a problem. Besides, history has shown that artificially supporting a product or service that would not be chosen but for some form of protection or artificial appeal renders that industry less likely to be able to compete, adapt or evolve vis-à-vis global competition. Such moves also encourage domestic resources to invest in non-profitable and inefficient areas.

Moreover, there is no necessary link between our high wage labour market and a CAD. If we try to compete in low-skill or low value-added manufacturing for example, then we will fall behind. If as a developed market we compete in professional services to name one category, we will be competitive.

So where to from here? The strongest argument for why CADs matter and ought to trigger concern is the argument that the deficit is **indicative of a shortfall of overall savings** and therefore investment in the economy. This has been put forward by Dr. Hussman, a prominent financial analyst in the U.S.

Consider this equilibrium formula:

$$\text{GDP} = \text{Consumption} + \text{Gross Domestic Investment} + \text{Gross Domestic Savings}$$

In the U.S., Consumption and Gross Domestic Investment is about 90% of GDP which means domestic savings is about 10%. Fifty years ago, domestic savings was about 22%. Australia mirrors this downward trend in domestic savings.

Now consider this:

$$\text{Total Domestic Investment} = \text{Private Savings} + \text{Government Savings} + \text{Foreign Savings}$$

[$\qquad = \text{Gross Domestic Savings} \qquad$]

This essentially says that in a state of equilibrium, all investment is ultimately funded by net savings of the various participants.

Now consider a CAD. Under the standard double entry accounting measurements used to measure the Current Account, if we import \$100m worth of goods and services, we have to by definition export \$100m in order for the ledger to be in equilibrium (which is an accounting necessity.) If we only actually export \$70m worth of goods and services, we necessarily import \$30m of foreign savings in the form of 'foreign investment' under one of the sub-categories of Australia's Current Account. Remember that if the balance of trade is in deficit, we are importing what the CAD terms 'foreign investment' which is essentially 'foreign savings' (since 'Total Investment' is made up of 'Total Savings'.)

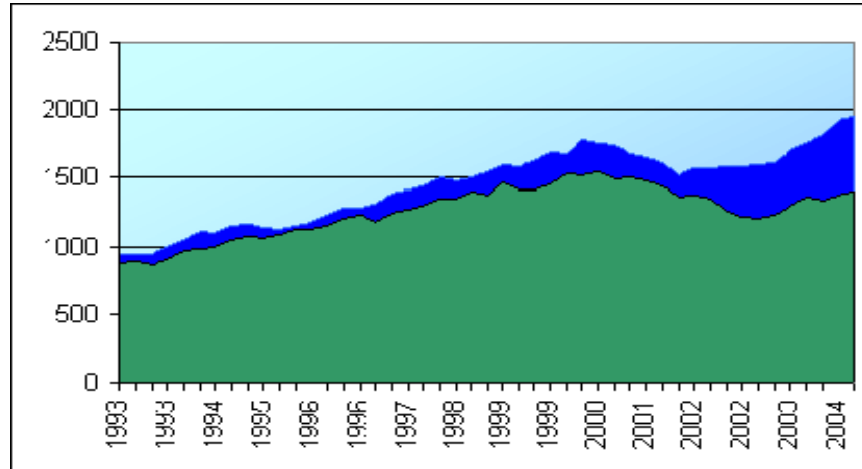
Confused? Look at it this way. Imagine there are only two countries in existence: Australia and U.S. Australia exports \$70m worth of goods and services to the U.S. The U.S. exports \$100m worth of goods to Australia. The difference has to be accounted for. The U.S. effectively offers a 'foreign investment' of \$30m to Australia which is the trade deficit. This US 'foreign investment' can effectively be treated as U.S. savings since ultimately:

$$\text{Total Investments} = \text{Total Savings.}$$

The argument therefore is that a large CAD means more than a trade gap. It implies that we are saving less than we are investing. This means that the larger the CAD, the more investment in the country is reliant on foreign savings and indicative of declining domestic savings.

There's nothing like a chart to clarify things. Look at the chart below.

US Gross Domestic Investment vs. U.S. Gross Domestic Savings



Source: Hussmann Funds, 2005

U.S. Gross Domestic Investment is in blue and U.S. Gross Domestic Savings is in green. The gap between the two directly corresponds to a measurement of the U.S. CAD which is close to a trillion dollars. As the gap widens (the blue bit becomes larger) between savings and investments, this means that the CAD is becoming larger. In fact, the U.S. currently absorbs about 80% of the world's excess savings simply to maintain its current level of economic activity, consumption and investment.

The argument here is that CADs go hand in hand with decreased domestic savings. If the boom in Australia, and to a lesser extent the U.S. has been financed by foreign investment (given the declining levels of domestic savings,) then the potential for continued growth is threatened if anything occurs to scare away foreign savings/investment.

So do CADs matter or not?

Let's continue with one aspect of the debate. Why do foreigners continue to supply us with goods, services and capital inflows? This is really where the two camps diverge.

On the one hand, the fact that importers are willing to extend credits to countries like Australia and the U.S. is perceived as a vote of confidence in our economy. Otherwise, why would they do so? This is the position taken up by influential commentators such as former U.S. Treasury Secretary Paul O'Neill and William Poole, President of the St. Louis Federal Reserve Bank. For these people, CADs are a sign of the strength of the economy and reflects the attractiveness of countries like the U.S. and

Australia as a harbour for international capital. As long as exchange rates remain flexible and responsive to the market rather than fixed, and countries with surplus capital continue to finance countries like Australia, any imbalances will tend to be stabilized and can go on and on for a long time.

For those concerned about the CAD, they would admit that running CADs can be sustained for quite some time. History shows that. But they would argue that the lack of domestic savings will lead to limits sooner or later. How?

One of the long term effects of CADs is that more domestic assets will go into foreign ownership. While most criticism and attention here is reserved for the sale of prominent national assets to foreigners, it is really the accumulation of debt which stands as a limit. As mentioned, trade in goods and services forms only about half of the CAD; the other half is capital inflows and outflows. As debt accrues, interest payments on debt become more and more significant. This leads to a greater crowding out of goods and services and servicing debt rather than importing goods and services will come to characterize the CAD. Hence, even though the CAD continues to grow, much of the deficit is used for servicing debt, not for local consumers buying more foreign goods and services or for foreign direct investment which benefits future growth.

In the worse case scenario, once foreign creditors realize that countries like the U.S. and Australia must use more and more foreign inflows to service debt rather than finance the import of goods, the financial advantage foreign creditors enjoyed in the past would be lessened. In this situation, no one really wins. Foreign creditors will be faced with the breakdown of an export market and also risk the value of their existing assets in that market should they attempt to abandon that market. The U.S. or Australia in this scenario, burdened by mounting debt service, will spend less on actually importing goods and services, and confront the possibility that there is no longer sufficient supply of goods and services to meet the declining levels of imports.

Talking about CADs is a blunt instrument for assessing the dangers or otherwise to our economy. **The key is really the proportion taken up by debt service levels compared to foreign investment and direct foreign investment.** History tells us that countries like Australia and the U.S. have enjoyed sustained booms driven by foreign investment and deficits. This occurs when capital inflows are used to invest and build. Gross foreign investment into the country enhances liquidity, access to capital and growth opportunities. Servicing debt benefits no one.

In this sense, talking about CAD's as a proportion of GDP is not really that helpful. We should be talking about debt servicing as a proportion of GDP, and in particular public sector debt servicing (since the private sector is more able to adjust.)

The CAD as a stand alone figure is more a symptom of other activity. We need to look further than the CAD figure to locate dangers. What we should certainly avoid, against human instinct to do so, is react too strongly to the symptoms by promoting policies that either decrease demand for goods and services (assuming other things are stabilized like inflation), increase protection for local producers, or block foreign ownership of assets that have nothing to do with the national interest. These initiatives do not address the genuine dangers of what CADs might imply (poor savings levels & mounting debt servicing burden) and serve to only create disincentives for improvements in productivity, innovation (exacerbating any deficit), as well as discourage foreign investors from parking their money here.