

# WHY STILL WORRY ABOUT THE CAPITAL ACCOUNT SURPLUS?

An arbitrary percentage of GDP is not the right measure of an unsustainable current account deficit, argues **Tony Makin**

**A**ustralia's current account deficit exceeded 7% of GDP in the March quarter of this year and reached a record 6.7% for 2004-05. These numbers have thrust the state of the economy's balance of payments back into the media and policy spotlight and well exceed limits that, back in the 1980s, former Federal Treasurer Paul Keating said befitted a 'Banana Republic'.

Opposition Leader Kim Beazley claims that 'The greatest risk we're now confronting is Australia's external imbalance',<sup>1</sup> a fear shared by former head of Foreign Affairs and Trade Michael Costello, who asserts that: 'No other issue should so preoccupy our economic policymakers.'<sup>2</sup>

Anxieties about Australia's current account deficit and foreign debt have of course been expressed many times before. The size of the external account imbalance has been a predominant, at times sole, focus of macroeconomic policy since the Australian dollar exchange rate was floated in the early 1980s.

Since that time, current account deficits of many advanced and emerging economies have also risen as a proportion of GDP compared to levels of previous post-war decades. Matching the increased capital flows around the world, the counterpart to current account deficit balances, were sharp changes in nations' external liability positions.

In the past, Australia's current account deficits have been used to justify many policy sins, most notably the major monetary policy induced recession we supposedly had to have in the early 90s. That recession, the major blot on the otherwise quite sound economic record of the reformist Hawke-Keating government, was essentially caused by a misunderstanding of what current account deficits signify.

Given this history, and the possibility that inappropriate policy responses may be repeated, it

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is timely to answer the following basic questions: What fundamentally causes external deficits and debt? Are they good or bad? Under what conditions may they be risky? And when are they unsustainable?

### What external deficits signify

Quite simply, under a floating exchange rate, current account deficits represent the foreign-funded gap between an economy's national income and expenditure. The equivalence of current account balances and net capital inflows from abroad can be shown easily with reference to familiar national accounting aggregates. In particular, gross domestic product (GDP) must equal the sum of private consumption ( $C_p$ ), government consumption ( $C_g$ ), public and private investment ( $I$ ), plus the trade balance minus exports of goods and services, less total imports of goods and services ( $X-M$ ). Hence,  $GDP = C_p + C_g + I + (X-M)$ .

From the above identity, it follows that the trade balance is the gap between GDP and total domestic spending,  $GDP - (C_p + C_g + I) = (X-M)$ .

When national spending exceeds national production, the trade balance is in deficit and in surplus when output exceeds expenditure.

If income paid abroad (mainly interest and dividends on foreign liabilities) is subtracted from both sides, it follows from the definition of national income, which is GDP less income paid abroad, and the current account deficit, which is the trade balance less income paid abroad, that

**National Income—Expenditure = Current Account Deficit**

A current account deficit can only persist if foreigners are willing to fund it. Hence, it must be matched by a capital account surplus. Therefore,

**Current Account Deficit = Capital Account Surplus**

Alternatively, the capital account surplus represents the difference between an economy's domestic saving and its investment. This follows once it is recognised that domestic saving is simply the difference between national income and private and public consumption. Hence,

**Domestic Investment—Domestic Saving = Capital Account Surplus**

It is only when an economy does not trade goods, services and assets internationally that its total investment spending is financed from its domestic saving. In contrast, in financially globalised economies, domestic investment can exceed domestic saving to the extent of foreign borrowing. Borrower countries thereby experience international capital account surpluses and rising levels of foreign liabilities including debt.

Large external account imbalances therefore simply reflect a divergence between economies' domestic saving and investment. Financial liberalisation and enhanced international capital mobility have facilitated the de-linking of saving and investment rates in many countries all over the world.

### Are external imbalances good or bad?

As I first argued in this journal some time ago,<sup>3</sup> when the current account deficit became a national policy obsession, focusing on the current account deficit in isolation is misleading. In particular, treating the current account deficit as a symptom of a serious trade competitiveness problem ignores the benefits stemming from the matching capital account balance. Capital inflow equal to the current account deficit allows productive investment to be higher than otherwise.

Similarly, a focus on the rise in external liabilities stemming from greater capital market integration with the rest of the world, can enable higher national wealth because it allows the nation's capital stock to grow larger.

External imbalances should therefore not be considered worrisome in and of themselves. On the contrary, since capital inflow or foreign savings complements domestic savings, it plays an important role in the process of domestic capital accumulation enabling faster economic growth. Meanwhile, the national income of creditor countries also rises to the extent that international lenders earn higher returns on their saving than possible in their own economies.

Any economy's external balance can change whenever its domestic saving or investment pattern changes or whenever saving or investment patterns change abroad. For instance, it is conceivable that if saving and investment prospects in Australia stayed exactly the same, but saving increased relatively faster

abroad than domestic investment opportunities increased abroad, then Australia's external account balance would widen commensurately as the additional foreign saving was invested here.

The larger external imbalance would be a sign of foreign investor confidence in the Australian economy. Under such circumstances, an enlarged external imbalance would result from factors beyond the control of the domestic authorities. With a larger capital stock, courtesy of increased foreign capital inflow, domestic production, employment and income levels would all improve. This obviously should be welcomed.

The theoretical economics literature presents a strong case for free international trade in saving and the macroeconomic gains that global finance can bestow. In particular, a now standard interpretation of the significance of external imbalances, known as the intertemporal approach to the current account, implies that current account imbalances essentially arise through discrepant expected rates of return on capital across borders being equalised. In the process, external borrowing also improves the economic welfare of an economy's residents through time by raising their consumption possibilities.

However, the pure theory of the benefits of foreign investment and increased trade in saving assumes well-founded expectations about the future and a sound banking and financial system for channelling foreign saving to ultimate borrowers. These assumptions may sometimes be violated, especially in emerging economies, so a qualification is necessary.

### **Risks associated with international capital flows**

Developing and emerging economies that experience large external deficits and foreign debt are more vulnerable to sudden capital flow reversals than advanced economies like Australia and the United States, with their strong banking and financial systems. In emerging economies, capital flight in response to new information about exchange rate risk, default risk or deteriorating fiscal and monetary policy settings can spark currency and financial crises like that experienced in East Asia in the late 1990s. Such crises impose substantial short term economic, social and political costs.

Before the Asian crisis in the late 1990s for instance, foreign funds were intermediated through a banking system that directed funds to unproductive investment activities encouraged by government interference. Substantial 'connected lending' and government 'directed lending' was undertaken and a lack of transparency delayed foreign investors' awareness of the extent of the underlying structural problems. However, once foreign investors realised the extent of these deficiencies, equities and debt instruments were quickly liquidated in favour of relatively more attractive, less risky investment opportunities elsewhere in the world.

The costs of currency crises that follow international capital reversals are transmitted in the first instance through higher domestic interest rates and lost output, as well as through large exchange rate depreciations and the associated higher inflation. Yet ultimately what makes emerging economies more susceptible to shattering currency and banking crises than advanced economies is not excessively mobile international funds as such, but relatively underdeveloped financial systems.

Re-imposing capital controls is not the solution to safeguarding against capital flow reversals because restrictions on international capital movements could prove costly to long-term development by retarding capital accumulation. The real solution is to bolster banking and financial systems in emerging market economies. With sound banking and financial infrastructure in place, appropriately monitored to prevent reckless lending, foreign saving can contribute positively to economic growth.

In advanced economies, foreign lenders may also view rising foreign debt levels with concern on the grounds that they perceive rising default risk. For instance, if the borrowing country's foreign debt level becomes very high, foreign lenders may then become less willing to lend to domestic borrowers. As a result, the differential between domestic and world interest rates widens because domestic interest rates incorporate a risk premium. In Australia's case, there is presently no compelling evidence of any significant interest risk premium of this kind.

Even if a sizeable risk premium did emerge, it can be shown theoretically that domestic interest rates inclusive of such a premium could never

exceed interest rate levels that would result if external borrowing were suddenly prohibited. In other words, rising foreign debt levels could push domestic interest rates above prevailing world rates, but never above rates that would prevail in the absence of capital inflows. In any event, a risk premium would automatically act to limit further external borrowing.

### **When are external imbalances unsustainable?**

External deficits really only become unsustainable once foreign investors cease to fund them. When this happens the currency depreciates to ensure balance of payments equilibrium automatically. Unfortunately, however, no existing measure satisfactorily defines what sized deficit will actually spark this kind of reaction by foreign investors.

Instead, an internationally recognised rule of thumb has developed that says an external deficit is excessive if it reaches 5% of GDP, below which Australia has not been for quite some time. Yet, this 5% limit has never been justified analytically and seems somewhat arbitrary in light of individual country experiences. For instance, Singapore ran current account deficits averaging 15% of GDP for a decade in the 1970s. More recently, in 2000 Iceland and Portugal ran external deficits of over 10% and Mongolia nearly 18% of GDP without adverse consequence.

Since the current account deficit reflects the difference between domestic investment and domestic saving, a limit on foreign borrowing conceivably exists when an economy's domestic saving shrinks to zero. At that point, foreign borrowing is funding all of the new investment in the economy.

The problem occurs beyond that point when additional foreign borrowing must be funding excessive consumption. This is because consumption, by definition, yields no future income with which to service foreign debt. Hence, an economy's productive investment opportunities alone set a feasible upper limit for the current account deficit. Economies with an external deficit may therefore be able to tolerate a further rise in the size of the deficit to the point where net saving disappears.

Put differently, for given domestic investment opportunities domestic saving could fall to nothing, thereby allowing domestic capital accumulation to be fully funded by foreign saving. At this point the current account deficit really could be a problem, as the economy would then be 'living beyond its means'. Before judging how serious the size of the external deficit is, we need to know how far Australia is from having zero saving.

Historical estimates of 'maximum feasible deficits' on this basis for Australia and the United States reveal that past external deficits have mostly been well below their feasible limits, except this has not recently been true for the US deficit. With its near zero national saving, the United States has been verging on its sustainable limit for several years. This easily explains why the US dollar has been struggling so much over that time.

The last time Australia's external deficit actually breached its sustainable limit was in 1991. At that time the economy suffered a major recession, ironically induced by policy reaction to the deficit itself, when interest rates skyrocketed to 18% and foreign saving temporarily funded excess domestic public and private consumption.

At the moment however, the investment share of GDP is at record levels, while national saving as a share of GDP is little changed. This confirms that the recent record deficit reflects an investment boom, not a slump in saving, as is commonly surmised.

Australia has also been a net exporter of direct investment capital in recent years, with Australian foreign direct investment abroad surpassing foreign direct investment inward. This implies that at least part of the overseas borrowing matching the current account deficit is financing the globalisation of Australian business. Accordingly, the strong investment picture is even more impressive than the record investment share of real GDP would suggest.

This notion of current account sustainability is subject to some qualification, even for advanced economies. For instance, sustainability depends on whether the financial system is channelling domestic and foreign saving to the most productive domestic investment opportunities. Moreover, in any economy, information problems such as asymmetric information between ultimate

borrowers and lenders may prevent the optimal allocation of saving.

In turn, this implies the additional income-generating capacity of foreign-funded capital accumulation may not be as strong as theory suggests. Nonetheless, judging external account and foreign debt sustainability with reference to the nation's saving pool would seem to improve on the arbitrary 5% of GDP rule.

On this basis, and given the sizeable fiscal surplus at present, Australia's current account deficit is sustainable. If its feasible limit gets closer should private and public consumption spending rises too much, what is the worst that can happen? The answer is that the exchange rate will experience another of its periodic big slides to restore current account sustainability. Yet, this is precisely what the export sector would welcome to improve its competitiveness.

## Conclusion

International financial flows play an important role in the process of economic growth by enabling domestic capital accumulation to be higher than otherwise. Current account deficits and their matching capital account surpluses remain the best measure of the extent to which foreigners are voting with their own money to express confidence in the Australian economy. They will endure for as long as that confidence is warranted.

Many economies have experienced larger external account imbalances than Australia's in the past without suffering adverse economic consequences. For instance, world capital flows, and hence the external imbalances of many nations, were quite large from the late 18th century to the First World War, during the so-called *belle epoch* era of free trade under the gold standard.

Since the breakdown of the Bretton Woods monetary system that prevailed for the period from after the Second World War to the early 1970s, there has been massive growth in the volume of international capital flows. This growth was due partly to the successive dismantling of exchange controls that supposedly facilitated the management of fixed exchange rates under the Bretton Woods arrangements.

The United States and New Zealand are other advanced economies that have experienced

relatively large current account deficits over this time. External deficits have persisted in these economies as well because foreign investors have deemed that excess national expenditure over production funded by their financial capital will prove sufficiently productive. Without earlier capital inflow from abroad, Australia, the United States, New Zealand and a host of other borrower countries, including many fast-growing emerging economies in our region would be on a considerably lower plateau of economic development.

The idea that international trade in saving confers mutual welfare gains on contracting parties is not as widely recognised or accepted as is the case for international trade in goods and services. This is because there is still an inherent suspicion of international financial markets and their tendency to deviate from economic fundamentals over short periods. On balance however, permitting international capital to flow liberally improves economic welfare for it frees borrower economies from the constraint of their own saving levels.

To conclude, it is worth repeating what Adam Smith, critic of Mercantilism and ever the most influential advocate of markets, said on the matter:

Nothing ...can be more absurd than this whole doctrine of the balance of trade....

When two places trade with one another, this doctrine supposes that, if the balance be even, neither of them either loses or gains: but if it leans in any degree to one side, that one of them loses, and the other gains in proportion to its declension from the exact equilibrium. Both suppositions are false...that trade which without force or constraint, is naturally carried on between any two places, is always advantageous...to both.<sup>4</sup>

## Endnotes

<sup>1</sup> Address to Australian Industry Group Forum, 15 August 2005.

<sup>2</sup> *The Australian* 19 August 2005.

<sup>3</sup> T. Makin, 'Why Worry About the Capital Account Surplus?' *Policy* 5:4 (1989), 5-8.

<sup>4</sup> A. Smith, *The Wealth of Nations*, bk. IV, ch. iii, part 2, para. 2