ECONOMICS

Explain the causes of Australia's sustained Current Account Deficit (CAD) and explain the impacts of a high CAD on the Australian Economy.

Australia's persistent current account deficit at **-2.2% of GDP (2018)** is caused by the economy's low international competitiveness and narrow export base. This created Australia's trade deficits due to outflows from the balance of goods and services account. Additionally, Australia's savings and investment gap requires funding from foreign investments which results in outflows from the net primary income account in the form of dividends and interest payments. As a result, Australia's high CAD increases dependence on foreign capital, which exposes the economy to impacts of collapses in overseas investor confidence. thus, the costs associated with a sustained high CAD is that it places constrains on economic growth which can lead to increases in unemployment and risks of reducing credit ratings. Despite negatives, the Pitchford thesis suggests that CAD can be beneficial to the economy by increase its productivity.

The historic cause of Australia's high CAD is the lack of international competitiveness in exports. Australia's high minimum wage of **$18.29** per hour is considerably above the world average of **$7.25** an hour, making Australian manufacturer's cost of production significantly higher than that of foreign manufacturers like China where labour cost is lower. This added cost is passed on to overseas consumers in the form of higher prices which damages the international competitiveness of Australian exports.
A direct impact of deficit on the economy is an increased risk of a 'valuation effect' that can worsen Australia's net foreign liabilities. This is the case immediately after the floating of the Australian Dollar in 1983, where overseas investors began selling AUD which increased the supply of AUD that contributed to a depreciation. The depreciation directly increased Australia's net foreign debt and interest payments denominated in foreign currencies, most of which in **USD by 39%.**

Australia's large savings and investment gap also structurally causes the CAD to worsen. Historically, Australia has been an ideal investment destination with potential high returns. since the 1970s, investment has been increasing faster than savings resulting in an average of a **4.5% gap (2016).** Due to the economy's savings and investment gap, foreign funds are necessary to fund the domestic economy because Australia has low national savings. This increases the dependence on foreign capital that makes Australia more vulnerable to unfavourable changes in overseas investor's confidence. Deficits in the current account must be financed by credits in the capital and financial account. This is reflected by the increase of Australia's net capital and financial account from **2.1% of GDP in 1980s** to **3.7% by 2010**. The impact is evident during the **2008-09** GFC when the Federal Government adjusted Australian banks loans to encourage foreign investment as a source of finance due to lack of national savings. Hence, a high CAD which increases Australia's reliance on foreign capital poses a potential threat to the Australian economy, such as a sudden loss of investor confidence as Australia becomes more vulnerable to risks.

Moreover, Australia's sustained high CAD will result in high servicing costs which restrains economic growth over the long term. As Australia's net foreign liabilities increase to finance the economy's CAD, the outflow of funds in the form of interest payments, dividends, and profits also increases. Therefore, Australia's **net primary income debit of -$43bn (2016)** deteriorates the CAD whilst initiating a debt trap scenario where injections of foreign funds is continuously required to finance the CAD.

However, despite several disadvantages Australia's sustained high CAD can be justified as beneficial to the economy. The Pitchford Thesis fundamentally countered the established

opinion on the CAD where it is always unsustainable or can ultimately impose a constrain on economic growth.

The notion states that the desirability of Australia due to high returns as an investment destination due to high returns with **A$2,170,810m** (DFAT) investments aboard and **A$3,192,422m** investment in Australia automatically leads to high servicing costs. These investment flows can be put to productive use, to earn more than servicing costs, thereby, raising potential growth. Capital flows into Australia are presumably the result of foreign investors seeking high returns, which causes high primary income debit. The effect is that the funds from foreign investments are used to grow Australian businesses to reduce production costs and increase export revenues thus benefiting the Australian economy in the process.

Similarly, other economists argue that because Australia's public debt does not contribute to CAD or foreign liabilities, any external balances are the result of normal transactions in the global economy. Only **20%** of foreign debt is owed by the **Federal government** whilst the remaining **80%** is owed by **businesses.** This is beneficial to the Australian economy as these funds are used to generate profit in export and import competing industries to increase international competitiveness. Thus, rather than imposing constrains on economic growth, CAD is an advantage that can be taken of profitable investment opportunities, thereby raising the future productive capacity of the economy.

From the above analysis, it is evident that Australia's lack of international competitiveness and its saving-investment gap have contributed to a high CAD. This may cause a valuation effect of Australia's debt making the economy more vulnerable to collapses in overseas confidence and can become a long-term restraint on economic growth. Therefore, Australia's high CAD caused by the reasons mentioned can have many impacts on the economy.