# ECONOMICS

**Discuss the main causes and economic implications for the Australian economy of Australia's continuing current account deficits.**

The balance of payments record all financial transactions between Australian residents and the global economy and is based on the flow of credits (finance flowing IN) and debits (finance flowing OUT) in the current account, and the capital and financial account. The current account is the record of all transactions of current nature such as credits and debits of net goods, net services, net primary income and net secondary income. Net goods are tangible exports and imports, net services are intangible exports and imports, net primary income is the earnings on investment (direct and portfolio, interest and dividends) and net secondary income is the non-market transfers were products or financial resources are provided without commodities being exchanged.

The capital and financial account is the record of credits and debits of transactions associated with direct and portfolio investment or financial derivatives. The capital account records transactions for the acquisition and/or disposal of non-produced and non-financial assets brought into Australia by migrants and the financial account records transactions associated with direct and portfolio investment, financial derivatives and other investments. In general, during 2001 – 2015, the Australian economy has been experiencing a persistent current account deficit (CAD) between -2.5% and -6.3% of GDP. During the Global Financial Crisis in 2007 – 2008, the Australian economy was growing faster than the world economy which resulted in a sharp decline in the demand and price for their exports relative to their the increase imports which was indicative in the large goods and services deficit of -$24.6 billion.

Following the GFC, there was a dramatic reduction in Australia's CAD due to the global resources boom provoked by China's rapid economic growth and development which lead to an increasing demand for Australian mining resources which was 53.5% of total exports in 2013/14 (peak of 55% during global resource boom) which ameliorated the volume and value of commodity exports by 10% from 2012/13 to 2013/14 due to the 14% increase in the value of mining exports, leading to a proportional increase in Australia's export income. Due to the large surplus in goods and services, where Australian exports exceeded imports, Australia's CAD shrunk from approximately -$40 billion (-3.2% of GDP) in 2008/09 to -$33 billion (-2.5% of GDP) in 2010/11. However, despite the volume of Australian mining exports being consistent, the fall in the price of Australia's commodity exports of iron ore by 45% have resulted in the deterioration of Australia's terms of trade which fell by approximately 10.2% in 2015 establishes the slowing growth rate of the global economy.

This stagnation of the global economy has been due to China's economic growth rate stabilising from a 12% p.a during the 1990s to a 7% p.a in 2014 and attempting to rebalance its economy by shifting away from its extreme dependence on manufacturing and its export market towards domestic consumption, services and innovation. This has ultimately led to a reduction in the demand for Australia's mining exports. Thus, in 2011/12, Australia's CAD has slowly climbed back to approximately -$40.3 billion (-2.8% of GDP). This continual deterioration in Australia's terms of trade – ratio of export prices to import prices – due to the decreasing value of mining and oil exports have led to a decrease in the goods and services surplus, and a larger CAD which has climbed to -$47.50 billion (-3.2% of GDP) in 2013/14 and eventually reached -$56.98 billion (-3.5% of GDP) in 2014/15.

Savings fund investment HOWEVER when I > S, there will be a need for foreign borrowing…

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| **CAPITAL & FINANCIAL ACCOUNT SURPLUS**<br>(borrowing funds from overseas = foreign borrowing) |

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| **INCREASE NET FOREIGN DEBT** (Interest payments)<br>*AND/OR*<br>**INCREASE NET FOREIGN EQUITY** (dividends payment) |

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| Results in…**INCREASED NET FOREIGN LIABILITIES** |

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| **INCREASED INTEREST PAYMENTS** *AND/OR* **INCREASED DIVIDEND PAYMENTS**<br>• Net foreign debt is <u>Australia's main contributor to Net Foreign Liabilities</u><br><br>• Australia is experiencing a <u>negative value</u> in an increase in net foreign equity…more equity is coming in. |

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| **INCREASED NET PRIMARY INCOME DEFICIT**<br>(More money is going out as compensation to non-residents in interest/dividend payments) |

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| CURRENT ACCOUNT DEFICIT |

When there is a capital and financial account surplus, where investment exceeds savings, there will be a need for foreign borrowing to fund for the investment activities which will incur a rise in net foreign liabilities – debits which is mainly compromised of net foreign debt (interest payments from foreign borrowing) and net foreign equity (dividend payments to foreign investors).

As displayed in the CAD diagram above, an increase in foreign borrowing results in an increase in net foreign liabilities because of an increase in net foreign debt and net foreign equity from $923b (52% of GDP) in September 2014 to $993.8b (56.2% of GDP) in September 2015. Since an increase in net foreign liabilities is characterised by an increase in interest payments to overseas banks and/or an increase in dividend payments to foreign investors, the income paid by Australians to non-residents through interest payments and/or dividend payments will increase and exceed the income received by Australian entities on their overseas investment which characterises the increase in net primary income deficit (NID). Thus, since net primary income is a large contributor in the current account, an increasing NID will result in a deterioration of the CAD.

Whilst a CAD may suggest an economy's lack of exports relative to imports or low valued exports, the Pitchford Thesis states "As long as there are no distortions to savings or investment decisions…and the government budget deficit is small, the CAD will reflect utility-maximising decisions by customers and profit-maximising decision by firms making investment decisions" meaning a CAD can be a product of increase in foreign investment flows as a response to stronger economic growth in the global economy and confident investment prospects. This correlates to higher living standards as investments facilitate higher economic growth and development as it builds the economy's productive capital stock.

However, due to the capital inflows that occur with a CAD, there is an increase in foreign-owned assets within the local economy which raises the risk of exposure to a financial crisis when changes in investor expectations can lead to a sudden surge in capital outflows which results in the exposure of a weak currency. Despite running persistently high current account deficits since 2001, Australia – a commodity exporter with high levels of foreign debt - has avoided the GFC experienced by other CAD countries such as the United States and Great Britain because it was safeguarded from the GFC by underlying strength of its domestic banking and financial systems.