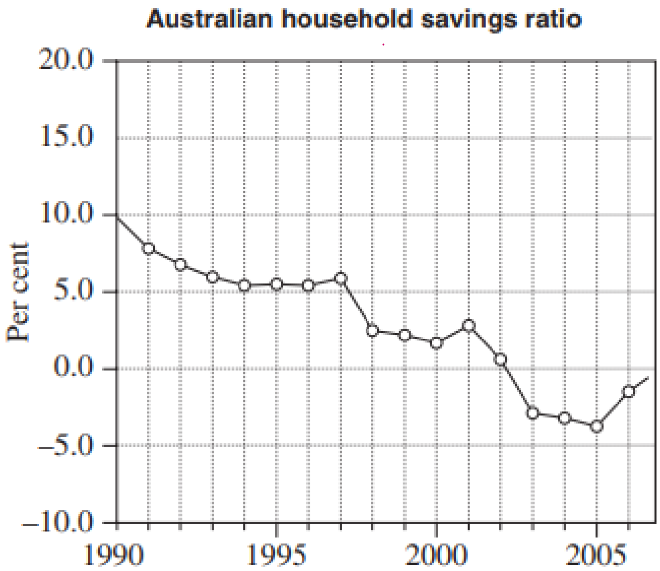
ECONOMICS

Question 26 (20 marks)

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

> There are opposing views about the effect of Australia's continuing current account deficit. While some argue that Australians are spending beyond their means, others believe the current account deficit reflects Australia's increasing productive capacity.



MARKING GUIDELINES

Criteria	Marks
• Integrates appropriate economic terms, relevant concepts, relationships and theory • Synthesises own knowledge with the economic information provided to develop a sustained, logical and well-structured response • Provides a clear and comprehensive understanding of the positive and/or negative economic implications for the Australian economy of continuing current account deficits	17–20

The Australian current account deficit (CAD) is defined as debits (imports and income payments overseas) in the current account being greater than the credits (exports and income payments overseas). It is made up of the current account which records all non-reversible payments for trade and returns on factors of production. Australia has had a large current account deficit since the 1980's.

Australia had the second highest current account deficit as a percentage of GDP (-3.1%) compared to the OECD Major 7 countries in 2017/18. This essay shall examine the implications of Australia's continuing CAD respective to both views that Australians are spending beyond their means and that the increasing CAD reflects Australia's increasing productive capacity.

An economic effect of Australia's persisting CAD which is financed by foreign debt and foreign equity borrowings which increase the size and servicing costs of net foreign liabilities in the future leads to a larger net primary income deficit in the current account. This leads to a perpetuating CAD issue, especially if borrowings are invested into consumption rather that exports. As the Pitchford thesis argues, CAD isn't necessarily an issue if the funds borrowed are invested in export industries such as mining, which would generate export income in the future allowing the debt to be sustainable. This is because CAD is majorly generated by the private sector (accountable for 82% of debt in 2017) and assist private investment projects or are direct investments into firms. Through an ongoing CAD, Australia runs the risk of a current account deficit-foreign debt accumulation cycle with a larger stock of net foreign debt needed to finance persistent CAD. Through this argument Australia's increasing productive capacity despite an accumulating CAD can be justified.

This essay shall now examine the view that Australians are spending beyond their means and saving needs to be encouraged and emphasised upon.

When the CAD emerged as a major problem in the 1980's, it was proposed to be a product of Australia's trade problem. The deficit on balance of goods and services (BOGS) accounted for by the CAD, caused by a combination of slow export growth and expanding demand for imports. Australia lacks international competitiveness in the highly valued areas of global trade, such as elaborately transformed manufactures (ETMs). Australia's traditional manufacturing industries have lost their markets both domestic and foreign because of their inability to compete with overseas competitors who specialise in large-scale, low-cost manufacturing such as China. Many areas of manufacturing have moved offshore, Australia's manufacturing sector has significantly declined as a share of total output increasing our reliance of imported goods. During the past decade, a sustained period of high commodity prices caused an appreciation of the Australian dollar, making Australia's non-commodity exports less competitive. The term "Dutch disease" describes this situation in which the success of a specific sector causes a decline in other sectors. Thus, the demand for a type of export may drive up the value of the exchange rate making other exports less competitive.

Another implication of exposure to a high CAD and net foreign debt liabilities is the downgrading of Australia's AAA credit rating by international rating agencies making future borrowings costlier. In the 1980's after CAD and level of foreign borrowings increased dramatically it became costlier for Australian firms to borrow funds in overseas financial markets. In the 1990's there was an emphasis towards a shift to foreign equity investment which has been actively encouraged in Australia by governments in the 1990's which led to an upgrading in Australia's international credit rating.

Tighter monetary policy in the form of higher interest rates may be needed to slow down economic growth in Australia to reduce the demand for imports if GNE growth exceeds the growth in GDP (output). High interest rates can potentially result in falling output and

investment and causes higher unemployment. The CAD represents an external constraint on domestic economic growth as the economy's limit to growth is determined by external factors rather than resource availability and productivity within the economy.
Another explanation of CAD is that it results from an excess of domestic investment over domestic saving – the saving-investment gap. If spending exceeds domestic output, resulting in a deficit on the current account, in order to compensate financial inflows are required from overseas by selling domestic assets to foreign residents. Thus, foreign savings are used to finance domestic investment rather than domestic savings. If the government runs a budget deficit the savings-investment gap widens by reducing the level of national savings. A rise in household and corporate savings in recent years since the GFC (2008-09) saw the savings-investments gap narrow. As illustrated in the graph above there has been a declining trend in the Australian household saving ratio since the 1990's till the GFC, preceding which there is an increasing in household savings due to reluctancy to spend in erratic and uncertain conditions. Recently a fall in investments has helped to narrow the saving-investment gap and contribute to a lower CAD. Australia's persistent CAD and need for capital inflow is partly explained as a natural consequence of specific features of the economy including the small population, large land mass and extensive natural resources, to develop the economy historically Australia has relied on foreign investments to fill the saving-investment gap. Importing capital and investments has allowed growth to more rapid than it would have been without. According to the consenting adults theory if foreign investors and foreign loans are increasing Australia's productive capacity they will consolidate to Australia's capacity to serve it foreign obligations making CAD more sustainable.

An ongoing CAD and large foreign debt increase the exposure of the Australian economy to external shocks such as terms of trade (TOT) deterioration which may reduce export income and increase servicing costs of the foreign debt. It also increases the possibility of capital outflows if foreign investors or lender lose confidence in the Australian economy and the governments capacity to manage the CAD. Due to the fostered reluctancy foreign investors may withdraw their investments in Australia or raise interest rates on foreign loans to minimise the risk of lower investment returns and a potential depreciation in the exchange rate. If this scenario occurs, Australian businesses may pay higher interest rates and therefore higher cost of capital if they borrow overseas to finance investment projects. Australia's susceptibility to exchange rate fluctuation due to a number of contributing factors may lead to valuation effects on the foreign debt. If a depreciation occurs because of a higher CAD, there is a valuation effect on that part of the net foreign debt denominated in foreign currencies, with more Australian dollar having been paid to foreign lenders. Depreciation may also cause higher domestic inflation as import prices will rise. Since imports account for about 40% of the goods and services in the CPI basket, higher import prices will raise underlying and headline inflation.

Thus, the opposing views and concerns about Australia's continuing current account deficit are valid due to the dire consequences they introduce. Many of these issues would have ceased to exist if Australia had a greater percentage of household savings. Australia's CAD has remained relatively stable at approximately 3.1%/ GDP (IMF recommends 4% as sustainable limit), the fact that only 10% of GDP is public debt (147 billion), the consenting adults theory suggests that these continued CADs due to global and local factors are not a large problem as such debt has been entered into rationally and with the long-term objective of profit maximisation.