ECONOMICS

Examine the causes and effects of recent changes in Australia's Current Account Deficit.

Australia's Current Account Balance, or more specifically Australia's ongoing Current Account Deficit, has been caused by a multitude of structural and cyclical factors, including Australia's narrow export base and increasing savings investment gap, as well as the exchange rate and terms of trade. The effects of a CAD are predominantly evident through Australia's external stability, economic growth and Australian households and businesses.

The Current account is a major component of Australia's balance of payments and is the record of all transactions of a current nature, such as Balance on Goods and Services (exports and imports), net primary income and net secondary income. Australia's Current Account has and continues to be in a large deficit, primarily due to the deficit in the Net Primary Income, ranging from 3-6% of GDP every year. Following the floating of the Australian Dollar, this is reflected by an equal surplus in the Capital and Financial Account, accounting for Net errors and omissions.

Australia's exchange rate is a primary cyclical component behind Australia's CAD. Movements in the dollar affects the competiveness and subsequent demand for exports and imports. Theoretically, a depreciation in the AUD, seen recently in the 33% depreciation of the AUD since 2011 from an all time high of $1.06 USD to around 76c currently, should make our exports more competitive and improve the BOGS, thus improving the CAD. However, the depreciation in the AUD has negatively impacted Australia's external stability. This is primarily due to the valuation effect, where the lower AUD has increased the servicing costs on overseas debt, there has been an increase in the deficit on the net primary income account which rose from - $36.1bn in 2015 to -$46bn in 2016 which has contributed to an increase in the CAD, which stands at 4.6% of GDP. This is also evident during the GFC, where low consumer confidence and a higher exchange rate relative to other developed economies saw import spending decrease, thus improving BOGS and reducing CAD to a relative minimum of 3% of GDP. Thus, Australia's exchange rate is a fundamental cyclical reason for our consistent CAD.

Another cause of Australia's current account deficit is Australia structural problems, mainly our savings investment gap and narrow export base. Given Australia's small population, large land mass and extensive natural resources which offer significant investment opportunities for overseas investors, in addition to Australia's high savings ratio, businesses often look overseas for investment. This has resulted in high servicing costs due to the high capital inflow into Australia, leading to a high Net Primary Income Deficit. In addition, while Australia's secondary incomes such as services, tourism and LNG have steadily increased by about 2% p.a on average, Iron ore, coal and commodities contribute over 64% to Australia's total exports. Australia's narrow export base, therefore, is the primary controller of the BOGS outcome. While in 2009-12, high inelastic Chinese demand for Australian commodities, as well as strong levels of investment in mining, resulted in a BOGS surplus and a CAD of only 2% of GDP, the end of the mining investment boom, as well as the completion of mining projects, has seen the mining sector export volumes stagnate, thus contributing to an increased CAD. Thus, structural issues, such as a narrow export base and a savings investment gap, are predominant causes for Australia's CAD.

The effects of Australia's CAD can be seen on households and businesses. A high CAD often promulgates contractionary economic policy in order to discourage and limit Aggregate Demand, theoretically leading to reduction in household consumption and investment. By limiting consumer spending, businesses are forced to contract rather than expand, and will not therefore search for overseas investment, thus reducing medium term servicing costs. This was evident prior to the GFC, where the Howard Govt. ran multiple contractionary policies which reduced the CAD to an all time low of 2% of GDP. However, as can currently be seen, Monetary Policy, which is implemented by the RBA independently of the government, has maintained continuous expansionary monetary policies, lowering the OCR from 4.75% in Oct 2011 to an all time current low of 1.5% in an attempt to raise currently low inflationary pressures from 1%, thus benefitting households and consumers by offering cheaper finance on variable loans despite the slightly contractionary stance of the 2016-17 budget. Thus, while a high CAD typically leads to negative connotations for households and businesses, this has been offset by MP.

The effects of a CAD are also evident externally, carrying overall negative implications for the Australian economy. According to the debt trap scenario, a higher CAD will incur higher servicing costs to pay off the NPI deficit, often the largest component of the CAD due to the cause of a high KAFA surplus. These servicing costs will cause a higher CAD, causing a debt spiral continuously damaging Australia's external stability. Evidence of this can be seen prior to the GFC where continuously high NPI deficits saw the CAD peak at 6.3% of GDP in 2007-8. On the other hand, the Pitchford thesis suggests that substantial deficits in the NPI account will not necessarily be detrimental for the Australian economy, provided that the account is as result of financing on investment, as if this is the case then the deficit would be paid for by businesses, who can easily cover the costs. Thus, by the Pitchford thesis, a high CAD, while contributing to Australia's current 3.3% growth rate, does not damage our external stability. However, a higher CAD can potentially increase premiums due to the higher risks associated with a large CAD, which may reduce Australia's Triple A credit rating which, while damaging Australia's Australia's international reputation, is arguably a negligible impact given how following the GFC the majority of OECD countries do not share this credit rating. Thus, while there are several potentially negative impacts of recent changes in Australia's CAD, these have currently been offset by recent global and domestic economic events.