Does Australia Really Have a Current Account Problem?

John Pitchford

Australia's current account deficit consists very largely of additions to the private sector's foreign debt. ***John Pitchford****, Professor of Economics at the Australian National University, argues that no good case has been made for government intervention to inhibit private debt-creation, and concludes that the government's present macroeconomic approach to reducing the deficit is not cost-effective.*

PERHAPS the major preoccupation of economic policy since the 1982-83 recession has been the state of the current account in the balance of payments (hereafter referred to as 'the deficit': the government's budget deficit is referred to as 'the fiscal deficit' to avoid possible confusion). During the 1980s the deficit on the current account has risen from its previous average of around 3 per cent of GDP, and now fluctuates between 4 per cent and 6 per cent. All manner of policy measures have been brought into operation to try to 'correct' what is thought to be an abnormal imbalance; in addition, several automatic corrective mechanisms have been expected to bring the deficit down. Yet the balance has remained obstinately above target levels. The authorities and many commentators infer from this that there is still more to be done; more dampening of demand, more belt tightening, more wage restraint, more sharing the burden, more emphasis on allocating resources with respect to 'national priorities'. But there is another way of looking at the issue; and this involves completely different policy implications.

Reviewing the state of the economy in 1985, I became doubtful about the economics of the Australian authorities' approach to the current account deficit ('The Australian Economy: 1985 and Prospects for 1986', *The Economic Record* 62 [March 1986], 1-21) and expressed some of these misgivings in a paper on budget policy ('The Budget, Real Wages and Restructuring, 1988/89', Discussion Paper no. 1, *Parliamentary Library*, Canberra, 1988). This article questions the conventional approach to current account issues in Australia, and argues, first, that those who claim that it is a serious problem have not properly established their case, and second, that if it were shown to be a serious problem its remedy would lie largely in a class of **microeconomic** policies which are not at present being considered.

The first section of the paper deals briefly with definitions of various balance of payments concepts and then outlines the history of recent policies designed to correct the deficit. The second section explores the implications of a current account deficit in an effort to understand why a higher than normal deficit is regarded as a policy problem. This analysis suggests a different view of the deficit from the usual one in Australia, and argues that it can be established as a genuine policy problem only by careful investigation of the microeconomics of debt creation. The third section considers the necessarily different policy approach to the deficit which is implied by this view.

The Current Account and Policy Responses

The term 'current account deficit' conveys almost nothing about what this concept is supposed to measure and what its economic significance may be. Formally, the current account balance measures the excess of exports over imports of goods and services, plus net income from international transactions, which mainly consists of net receipts of interest and dividends from abroad. When the current account is in deficit the agents in an economy are spending more than they earn, including net interest payments. Excess spending must be financed either by borrowing or by running down assets; the change in foreign net assets is measured by the capital account. When the monetary authorities intervene in the foreign exchange market, for example to prevent the value of the dollar falling when market agents believe it will depreciate, they run down official reserves. A deficit on the balance of **payments** means that there is an undesired fall in the level of reserves. A current account deficit thus means an increase in the net level of foreign indebtedness by the private or public sector .

The official view through the 1980s has been that the rate of increase in foreign debt has been excessive, and that the current account deficit should therefore be reduced. Hopes for a reduced deficit have been pinned on many mechanisms and policies. It was argued that an important factor in the 'deterioration' of the current account was a 15 per cent worsening of the terms of trade which occurred in 1985-86. An interesting perspective on this can be obtained from Figure 1, which shows the terms of trade since 1948. Apart from the substantial fluctuations associated with the Korean and

Vietnam wars, Australia's terms of trade have steadily deteriorated. More to the point, there have been many previous fluctuations of the magnitude of 1985-86, none of which seems to have caused the deficit to rise to the levels of the mid-1980s. Furthermore, the fall in the terms of trade was reversed in 1988, but there is little sign as yet that the deficit is being reduced.

The nominal exchange rate (trade-weighted index) devalued by about one third during 1985-86, and expectations were generated that this would assist the hoped-for correction. When there is already a deficit, a real devaluation may in the short run raise its domestic currency value — the so-called J-curve effect — but in favourable circumstances it can ultimately 'improve' the balance. It has not been clear that the nominal devaluation caused a lasting real devaluation, and in the event it has not been easy to identify a lasting effect from devaluation. To some degree this is because the use of tight monetary policies in 1985-86, which were at least partly aimed at reducing the deficit, induced a slowdown in activity in 1986 and so reduced imports. A pattern of policy response has emerged in the 1980s which involves using monetary policy to curb demand and so reduce imports, followed by easier monetary conditions to assist the economy out of recession, followed by rising imports and so on. By itself such a policy would seem to lead to repeated recessions with no permanent solution to the current account issue.

Fiscal restraint has also been employed in the battle against the deficit. Tax increases and expenditure cuts have turned the 1983-84 fiscal deficit of $9 billion into an estimated fiscal surplus of $5.5 billion in 1988-89. As the current account deficit results from domestic agents spending more than domestic income, it is equal to the sum of governments' fiscal deficits and private excess spending. Cuts in expenditure and increased taxation receipts would have been expected to reduce the current account deficit directly through the elimination of government excess spending and indirectly through effects on private spending. In addition, the Commonwealth government has embarked on a far-reaching program of economic restructuring, in part based on the identification of 'national goals' amounting essentially to approval and possible encouragement of import-competing and exporting, and in some cases ('buy Australian') disapproval of importing activities. Some restructuring proposals would seem to promote economic efficiency generally. But others, which stand or fall on the notion that there needs to be a diversion of resources towards, and of demand away from, traded goods, are questionable if the current account should not be a major target of economic policy.

Finally, there has been the wages policy embodied in the so-called Accord. In its early stages, the Accord seems to have been a response to the state of the labour market, in particular to the high unemployment in the aftermath of the 1982-83 recession; and perhaps this is part of the reason for its continued existence. However, much of the **stated** purpose of the policy of wage restraint seems to have shifted to current account considerations, the implication being that it will help both to reduce import demand and to increase the supply of import-competing and exportable products. If it is effective, wage restraint **redistributes** income from wages to profits. But the direction of its impact on demand for imports depends on propensities to spend and invest. Whether wage restraint diverts resources from traded to non-traded goods production depends on the relative labour intensity of these sectors. There seems to be no good reason to assume that traded goods are relatively more intensive users of labour than non-traded goods sectors.

Despite all these policies, the current account deficit has shown few signs of returning to its pre-1980s level of about 3 per cent of GDP. Some of those policies have had the effect of curbing excess demand at certain times in the 1980s and in improving economic efficiency. To this extent, their use seems justified. However, the central question is whether it is really necessary and/or appropriate to use them purely to reduce the current account deficit.

The Nature of a Current Account Deficit

The monthly publication of estimates of the current account deficit in Australia is now regarded by the press as a major event. Not only do the figures draw comment from financial journalists; they can be headline news for general consumption. Of course, this may be so not because of the intrinsic importance of the figures themselves, but because they are regarded as indicators of future changes in government policy. There is

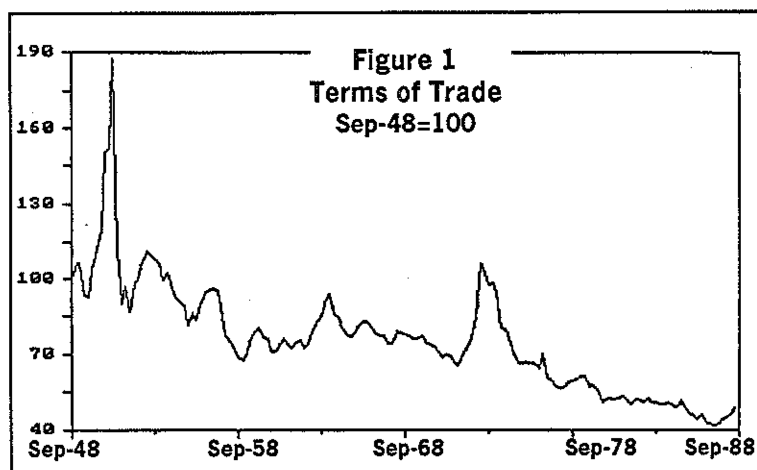

Figure 1
Terms of Trade
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some recognition that the figures imply increasing external indebtedness, but almost no discussion of why this is thought undesirable.

Sometimes it is suggested that Australia faces a 'balance of payments' crisis; but this is a distinct problem from long-term debt accumulation. When exchange rates were pegged, a balance of payments crisis could occur if the market came to believe that the rate was pegged at the wrong level. In particular, movement out of the currency based on the expectation of a devaluation could cause a rapid depletion of reserves,

with the authorities eventually being forced into devaluation. Under a flexible rate system, and so little or no intervention, this could not happen. (The nominal exchange rate could possibly be continually devalued, but this is unlikely to occur unless the money supply gets out of hand.)

If, alternatively, the 'problem' with the current account deficit is not that it heralds a balance of payments crisis, it must have to do with the rise in debt which it implies; and this, in turn, is a problem because it adds to a debt level that is regarded as already excessive.

When the current account is in deficit, spending by the public sector and by private agents exceeds total income. As already noted, the Commonwealth government's budget is now in surplus; the public sector borrowing requirement for 1988-89 is low. Assuming a responsible attitude on the part of governments, the size of the fiscal deficit will be decided on the basis of the legitimate borrowing needs of the public sector. If the correct decisions have been made in this area, concern about the current account deficit must focus on **private sector** debt.

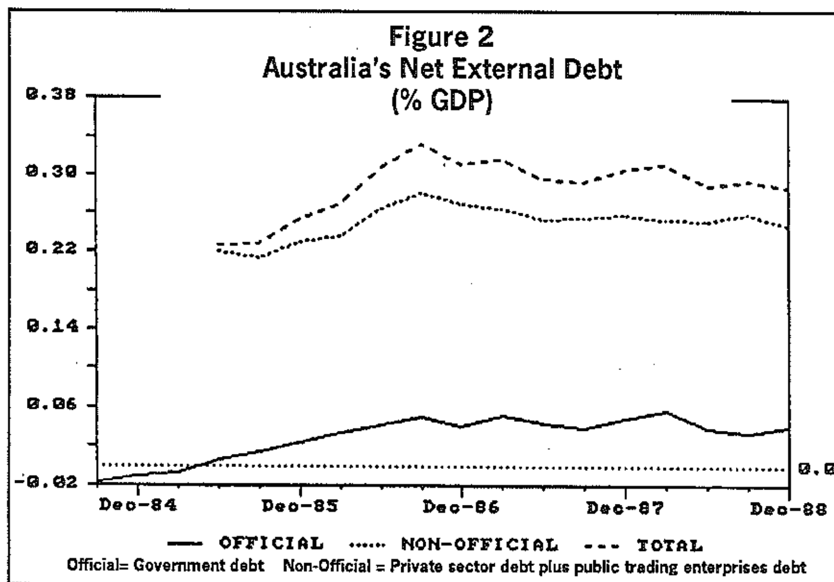

Figure 2
Australia's Net External Debt
(% GDP)

Official= Government debt Non-Official = Private sector debt plus public trading enterprises debt

The ratios of public and private external debt to GDP are shown in Figure 2. These data show that both official and non-official debt (the latter including government trading enterprises) rose substantially as a percentage of GDP in the mid-1980s, but have stabilised or even fallen since then.

If the fiscal deficit is zero, a current account deficit must be matched by an excess of investment over domestic private sector saving. Firms must borrow abroad to finance this gap. The following two exercises are designed to reveal the nature of this phenomenon. First, suppose Australian households were suddenly to become more thrifty: they decide to save an additional amount equal to the present excess of investment over saving, so causing the current account deficit to virtually disappear. Would concern still exist about the amount of business borrowing? Second, suppose Australia entered into a political union with a lending country whose current account surplus was about the same size as our deficit. The new country's current account would balance. Would there then be concern about the borrowing by the geographical area which had previously constituted Australia? In both these exercises there is still the same level of debt creation, but the debt has become domestic rather than foreign.

These exercises suggest that concern over the current account deficit must be based either on the belief that overall borrowing by firms is too high, or on the belief that **foreign** debt is undesirable. For brevity's sake, in what follows I assume that it is the foreign nature of the debt that is thought to be the problem.

One frequently heard view is that it is more acceptable for a rise in the deficit to be due to an increase in imports of investment goods than of consumer goods. But not only does this involve the fallacy of labelling investment 'good' and consumption 'bad'; it can be misleading even if this judgment is made. A rise in investment demand may be satisfied either by diverting resources from domestic production of consumer goods, the demand for which is satisfied from imports, or by importing more investment goods. Such views have no force if it is recognised that, with zero excess demand in domestic goods markets and in the absence of market failure, the private sector has the capacity to make its own saving and investment decisions.

Does the Deficit Stem From Market Failure?

There are many reasons why the community may dislike foreign debt (though not all of them can form the basis of a case for intervention). For instance, foreign investment and ownership of domestic resources by foreigners can bring undesired political influence, and for this and other reasons may be unwelcome when it reaches a critical level. Such a view could be used to justify a tax on foreign borrowing. The literature on the theory of foreign investment contains an argument for taxing foreign investment based on a possible increasing cost of foreign borrowing. Suppose that the higher the level of a country's external debt, the higher the cost of borrowing for an additional loan. For example, this could happen because lenders feel the risk of default increases with the overall size of debt. In a competitive market a new borrower will not take account of the fact that his/her loan may be forcing up the cost of borrowing on existing loans. For simple cases, it can be shown that it is then optimal for the domestic economy to tax the earnings of foreign lenders. However, this conclusion is not at all clearcut when allowance is made for tariffs and subsidies, and for a variety of traded and non-traded goods sectors which may be doing the borrowing. Indeed, it can turn out that the optimal policy is to subsidise foreign invest-

ment. When account is taken of the fact that the lending country can retaliate by taxing lending abroad, it seems likely that the route of taxing (or subsidising) foreign investment earnings would have a most uncertain outcome.

If private sector decisions made in the institutional environment produced by government laws and regulations are regarded as wrong, this must reflect either the belief that market processes have failed to deliver the best outcome, or the belief that the laws and regulations have undesirable consequences. Those who use aggregative policies to control the current account balance have an obligation to state where they stand on these issues. To illustrate their nature consider three possible examples, the first having to do with debt appraisal, the second with the amount of private saving and investment, and the third with future commodity price movements.

Debt appraisal. Are the proponents of policy to check the current account deficit prepared to argue that domestic and foreign firms and the financial and banking systems fail to make a proper appraisal of the risks involved in investment and foreign borrowing? Could it be argued that the authorities have a better overall view of the present and future prospects of investment projects? If this were true, shouldn't the authorities be much more concerned with detailed investment issues than they appear to be? Should they not be releasing their superior information and appraisals to the private sector, rather than operating rule-of-thumb aggregative policies? Alternatively, shouldn't there be further regulations on financial markets to control their tendency to be too accommodating to private external debt (why then were the financial markets deregulated)? Given that no case for such policies has been made, why is there such consternation about private external debt?

The failure of a private firm normally concerns only the private borrowers and lenders. However, there are exceptions, most notably the banking sector, whose solvency has traditionally been regulated by the monetary authorities. In some cases, governments have become involved in the solvency of firms on the fringe of, and even outside, the banking sector. This may give some firms the impression that governments will help them with solvency problems, causing them thereby to borrow more than they otherwise would and potentially involving the government in their possible failure. Surely if this is the case it should be treated as a microeconomic issue of the same type as that involving bank solvency; alternatively, there should be strong statements and credible action to ensure that borrowers do not rely on government intervention. There seems to be no case for employing macroeconomic measures to solve such a problem.

Savings too low. It is frequently said that households do not save 'enough', though current account deficits may equally be said to arise from firms investing and borrowing 'too much'. Consumption is one of the chief ends of economic activity, and decisions to change consumers' plans need to be carefully justified. A case against foreign borrowing (and so current account deficits) on these grounds can be rigorously established only on the basis of demonstrable market failure or because of the effects of government regulations. Moreover, if market failure can be demonstrated it should be treated at its source. Those who feel that private external debt is too high, or growing too fast, and who wish to check the growth of the economy for **this** reason, have an obligation to establish why the private sector cannot be relied on to make responsible decisions about savings, investment and borrowing.

For instance, the tax treatment of interest possibly involves a distortion in times of inflation, such that the inflation component of the interest on nominal assets is essentially a repayment of capital (though this possible source of inefficiency is due to inadequacies of the institutional framework rather than the market). If taxation of interest receipts ignores this, it involves taxing capital as well as income. Correcting this distortion, both with respect to interest receipts and interest as a business cost, could stimulate saving and reduce investment, so reducing the current account deficit. In this case microeconomic action is possible and appropriate.

Future prices. It is commonly said that if the current account deficit is not reduced Australia's debt position will resemble that of some Third World countries. The parallel is inappropriate to the extent that some Third World debt consists of public borrowing to fund welfare programmes. But consider the case of a typical less-developed country, which borrowed to develop its petroleum resources. This seemed a sound investment in the light of 1970s oil prices; subsequent price falls undermined it. Is the mistake any worse because the capital involved was from foreign sources? Can it be said that the market 'fails' when a subsequent fall in product price renders a previously profitable investment unprofitable? To return to the first example: do the authorities have superior knowledge about the future course of commodity prices? If they do, why not make it available? In any case would such a problem be better handled by macroeconomic control of current account deficits?

Conclusions

There may be a case for believing that current account deficits have been excessive, but if so it has not been made. The costs of macroeconomic measures to reduce the deficit are so great that the authorities have an obligation to make such a case. Even then it would be necessary to judge whether microeconomic policies would be more appropriate. Only if it could be shown both that serious consequences were likely to arise from current account deficits and that feasible microeconomic policies were incapable of remedying them, would macroeconomic policies be justified.

Policy