Economic observers may be worrying unnecessarily about Australia's current account deficit and level of foreign debt, writes TONY MAKIN. Automatic adjustment mechanisms operate in ways that limit over-borrowing and benefit domestic economic activity.

Many concerns have been expressed in recent years about Australia's balance of payments position – specifically about the current account deficits and level of foreign debt. However, some of these concerns have not been founded on sound economic principles. Moreover, much of the commentary on the external accounts has failed to appreciate the role that the internationalisation of capital markets has played.

Global financial markets have become more integrated over recent decades in the wake of the widespread dismantling of exchange controls, especially in the developed economies, and the pace of change in communications technology and multinational banking. Since the onset of this integration of international capital markets, a number of economies have experienced comparatively large current account deficits and higher foreign debt levels. Australia is among this group of external deficit or borrower economies, which also includes Canada, Germany, Hungary, Malaysia, Thailand and the United States (see Figure 1).

The progressive deregulation of Australia's financial system since the early 1980s, in line with the recommendations of the Campbell and Martin Group reports, involved some sweeping reforms which greatly facilitated international borrowing and which permitted increased domestic economic activity. The most important of these were the abolition of exchange controls in 1983 and the entry of foreign banks from 1985.

Figure 2 shows that the easing of foreign borrowing constraints generally coincided with the rise in Australia's foreign debt level.

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SAVING, INVESTMENT AND THE EXTERNAL ACCOUNTS
First, we need to be clear about what the external deficit signifies in a macroeconomic sense. The external accounts are in effect part of the set of national accounts, and provide a detailed record of Australia’s economic transactions with the rest of the world. There are two sides to the external accounts – the current account and the capital account. In principle, the sum of the balances on these accounts under a floating exchange rate must be zero though, in practice, there are measurement problems involved which mean that the Australian Bureau of Statistics uses a balancing item to ensure both sides of the external accounts equate.

The current account includes transactions in goods, services and income between Australian residents and foreigners and is divided into sub-accounts – merchandise trade, services trade, property income and other income transfers. The capital account of the external accounts shows transactions in financial assets and liabilities which are classified according to whether the official sector or commercial sector is involved.

The detailed flow transactions in assets and liabilities recorded on the capital account are also reproduced separately in the foreign investment statistics. In these foreign investment statistics, flow transactions in foreign assets and liabilities are reconciled with stock levels of Australia’s external liabilities and foreign assets. The amount of net foreign investment is therefore equivalent to the difference between total domestic investment and national saving as measured in the national accounts. The main relationships between the components of the external accounts and domestic saving and investment are shown in Figure 3.

Australia’s current account deficit, or capital account surplus, has since the mid-1980s averaged around 5% of GDP, reflecting the fact that domestic investment has exceeded domestic saving to that extent over that time. In fact, for as long as balance of payments statistics have been compiled in Australia, a current account deficit has been the norm, although this was not seen as particularly worrisome by the authorities until its size as a proportion of GDP rose above 5% several times in the 1980s.

Australia’s saving rate over recent decades has been roughly the same as the saving rate of the other OECD nations, taken on average. A major reason for the current account deficit has therefore been that Australia’s investment rates have tended to be above the average rates of OECD investment.

IS EXCESS SPENDING A PROBLEM?
Because the trade deficit component of the current account is definitionally equivalent to the difference between national output and national expenditure, it is frequently asserted that our external deficits are a sign that the nation...
is "spending beyond its means". Although it is true that householders cannot continue to spend more on consumption than they earn in income, without eventually having their access to credit denied, this analogy cannot be sustained for the economy as a whole.

This is because, as a whole, the economy is best considered as an aggregate production unit, rather than a large household. The value of gross domestic product is literally the total value of the output of all firms and farms operating in the economy.

These enterprises also happen to account for the bulk of the nation's foreign borrowing, which in net terms finances the excess of economy-wide investment over domestic saving. In other words, capital account surpluses provide a measure of the extent to which foreigners finance additional investment in Australia.

To the extent that the productivity of the extra physical capital acquired through foreign borrowing exceeds the servicing costs on those foreign borrowings, then national income can grow faster than otherwise. Empirical evidence confirms that this is the case. Indeed, it would be surprising if this were not the case, since in that situation, by implication, firms which had borrowed according to profitability considerations would on average be sustaining losses.

OTHER CONCERNS
A number of other concerns have been raised about Australia's foreign debt level. First, it has been argued that the greater internationalisation of Australia's financial markets from the early 1980s rendered certain offshore borrowers (for example, governments and their instru-

mentalities) more prone to downgrading by major international credit-rating agencies such as Moody's and Standard and Poor's.

If the nation's creditworthiness is downgraded, this really only makes it harder for domestic borrowers to continue borrowing at previous international interest rates, since foreign lenders will demand an additional risk premium on their interest rates. Of itself, a downgrading of creditworthiness makes foreign borrowing self-limiting. For this reason, it is somewhat contradictory for anyone to be concerned about lower creditworthiness and at the same time presume that foreign debt levels will continue rising.

Second, it may be argued that a growing absolute value of external debt will eventually precipitate capital flight, which is defined as a sudden outflow of foreign capital. In practice, capital flight involves the liquidation by foreigners of financial instruments denominated in the local currency. If this ever happened on a truly large scale, a significant proportion of the existing stock of Australia's foreign debt would disappear. This would be accompanied by a sharp depreciation of the exchange rate which would improve competitiveness in the tradables sector of the economy (that is, export and import-competing industries). This improvement in competitiveness would eventually reduce domestic expenditure on tradable goods and raise tradable production. Again, an automatic external adjustment mechanism would be activated, so that the economy's net exports would subsequently rise.

CONCLUSION
Academic and popular discussion of the behaviour Australia's balance of payments over recent years has often centred on the widened current account deficit, and ignored the possibility that the matching capital account surplus allowed real investment and hence national output growth to be higher than otherwise.

Similarly, the focus on the rise in external liabilities often failed to appreciate that higher foreign investment, reflecting a higher degree of economic integration with the rest of the world, enabled the nation's real capital stock to be significantly higher than otherwise.