Balance of Payments

Running a persistent, sizeable deficit on the current account may seem to suggest a fundamental disequilibrium or imbalance in an economy. However, the extent of the problem depends on the cause of the current account deficit.

If the main cause of the current account deficit is a trade deficit this may reflect an underlying lack of international competitiveness or a tendency for people in the economy to live beyond their means and this will have to be addressed.

This can't continue for too long because financing the deficit through foreign investment inflows leads to an increase in interest payments overseas. After a time a 'debt trap' situation may develop where money is being borrowed to pay the interest due on previous borrowing. If foreign investment inflows don't cover the current account deficit the exchange rate will fall until the two sides of the balance of payments accounts balance again. The fall in the exchange rate will cause inflation and reduce the real income of people in the economy.

If, however, the cause of the deficit is net incomes outflows, this could reflect strong economic performance rather than weak performance. Income outflows in the form of interest, dividends and profits are the result of previous inflows of foreign investment. The inflows of foreign investment, either through borrowing from non-residents or sales of equity to non-residents, suggest investors expect their investment to generate a good rate of return, especially if the investment comes from the private sector.

The inflow of foreign investment tends to push up the exchange rate value of the Australian dollar, and this, in turn, pushes the trade balance into deficit. A strong economy keeps the debt servicing ratio relatively low, allowing the rise in the level of liabilities to be financed (or serviced) without any great alarms. However, even if the economy is performing well, any future disruption in global financial markets could threaten our ability to borrow sufficient money to finance the deficit.
(Source: AQA Economics)

(a) Explain how a current account deficit is financed? What are the main forms this overseas finance can take? (4 marks)
(b) Describe three reasons why a persistent and sizeable current account deficit could be a problem. (4 marks)
(c) Describe three reasons why reducing the current account deficit is not a policy priority for the Australian Government. (4 marks)

Answer Guide

(a) A current account deficit must be matched by a surplus on the capital and financial account. Essentially this means a surplus in the financial account – that is an inflow of foreign investment. Foreign investment comes in two forms – foreign borrowing or foreign sale of assets. Borrowing can be done by the private sector or by governments. Sale of assets can be direct (more than 10% ownership) or portfolio (less than 10% ownership)

(b)

First problem	The first problem is that debt has to be serviced. CAD leads to build up of debt, which has to be 'serviced' by payment of interest. If lenders think that a country could find it difficult to meet interest repayments, interest rates may rise in to a drop in the country's credit rating. Any interest payments result in an opportunity cost, given that something else is sacrificed or foregone in order to make the interest payments.
Second problem	The second problem is that debt makes the country vulnerable to external shocks. As in 2008-2009, when global financial and capital markets do not operate as expected, debtor countries may find it difficult to borrow new money and renew their existing debt.
Third problem	The third problem is that the country gets caught in a debt trap. The country could find itself in a debt spiral or debt trap where it is forced to borrow money to pay interest on its debt, a process that causes the level of debt to rise

(c)

First reason	The first reason why the Australian government does not see the CAD as an urgent problem is that by international standards the indicators of the burden of the foreign debt and foreign equity are relatively low. The Debt Servicing Ratio (interest payments as a % of export income) was about 7% in 2016, down from 13% in 2007. This fall in the DSR is attributed to the declining world interest rates, reducing payment on loans and Australia's improved export performance. Australia's net foreign debt as a percentage of GDP is manageable and was about 64% in 2016, much lower than other countries.
Second reason	The second reason is that most of Australia's foreign debt held by the private sector, rather than by the government. In 2016 private sector debt was 76%. The liabilities have risen as a response to the strength of the resource rich' Australian economy with 'consenting' private sector businesses investing in the Australian as a result of commercial economic decisions. Central government debt (or sovereign debt) is low in Australia even after the effect of the 2009-10 fiscal stimulus package. Government debt has averaged 25% of the total over the past 4 years.
Third reason	The third reason is that for resource rich, capital starved countries, such as Australia, a CAD tends to be a way of life. The CAD is seen as a reflection of a strong financial account surplus resulting from an influx of foreign investment to fill our savings-investment gap. This leads to net incomes deficits as the foreign liabilities are serviced through interest payments, profits and dividends. (This capital inflow also pushes the exchange rate up (creating the so-called resources curse) which makes it hard to achieve a surplus on goods and services trade. further contributing to the CAD).