

Worrying about the Current Account

The monthly release of trade statistics which reveals seemingly large deficits in Australia's balance of trade in goods and services, and a subsequent increase in Australia's Current Account deficit, has again started to elicit headlines reminiscent of Paul Keating's "banana republic" days.

Understanding exactly what these statistics mean, and finding comparable information for other countries is the first step in deciding whether there is cause for alarm. Australia's rural exporters, heavily dependent on overseas markets, have more reasons than most to examine these statistics carefully.

On the July 29th, 1999, the Australian Bureau of Statistics released statistics showing that Australia's June trade deficit in goods and services was \$1.5 billion, which was the fifth consecutive month where this figure had exceeded \$1.5 billion.¹

The response from media commentators was immediate. A commentator in the Financial Review, projecting the likely affect this figure would have on Australia's Current Account balance stated "Any fragility in confidence after such a high Current Account deficit is likely to be manifest in downward pressure on the Australian dollar and rising bond yields. The stockmarket would also suffer from a lack of confidence."² Another opinion column stated "Our concern is the vulnerability to a major currency shock in the second half of the next decade driven by the problem of the Current Account and the buildup of foreign liabilities"³

Curiously, at the same time the Governor of the Reserve Bank, pictured under the headline "Don't panic on deficit", was quoted as saying "This would be the fifth occasion in the last two decades that this has occurred (the Current Account Deficit exceeding 6% of GDP) and on this occasion the circumstances surrounding it are much more favourable than on earlier occasions."⁴

Who is right? Do the statistics signal the start of the end of Australia's charmed economic run, or is it just part of a cyclical trend and in fact an appropriate response, given the recent history of events in Asia?

What makes up the Current Account Balance?

Understanding what constitutes the Current Account balance is one of the first challenges. The Balance on goods and services, which elicited the response from commentators, is just one component of a figure the Australian Bureau of Statistics describes as "a statistical statement designed to provide a systematic record of Australia's transactions with the rest of the world." and "the entries refer to economic transactions between residents of Australia and non-residents."⁵ Encompassed in that simple definition is a host of decisions that must be made about different transactions, and how they impact on the statistic.

The components, which make up the Current Account balance statistic include:

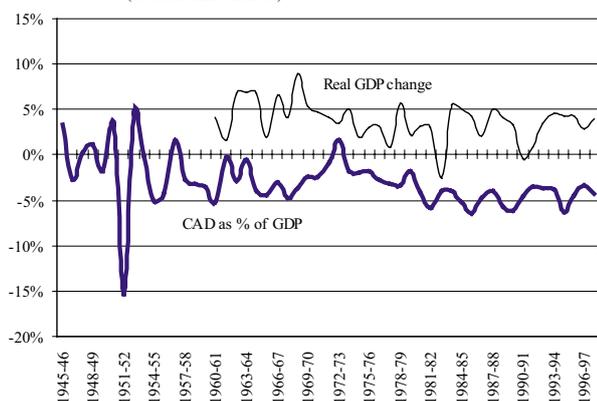
- the net value of merchandise imports and exports during the relevant period
- the net value of service imports and exports during the period, including items such as travel
- the net value of income paid to Australian residents from non-residents, and vice versa
- the net value of transfers, which refers to items such as foreign aid, migrants transfers, gifts, pensions etc.

The first point about the statistic is that the comments of the Reserve Bank Governor are accurate, as can be seen in Figure 1. There are at least four times in the last twenty years when the Current Account deficit has exceeded 6% of GDP, and during the 1960's when Australian GDP regularly grew by more than 5% per annum, the Current Account deficit was at or near 5% of GDP for much of the decade.

In fact, it could be argued that an inverse relationship exists between the Current Account balance and GDP growth. Higher rates of GDP growth seem to coincide with increasing deficits, a relationship worthy of further comment.

The second point, which is evident in Figure 2, is that in excess of 80% of the total Current Account balance is actually a deficit of income – that is – it is money being paid by Australian residents to non-residents. The balance on services (including sectors such as tourism) has progressively moved to be at or near credit in recent years, and while the balance on goods is in deficit, it is relatively small in comparison with the deficit on income.

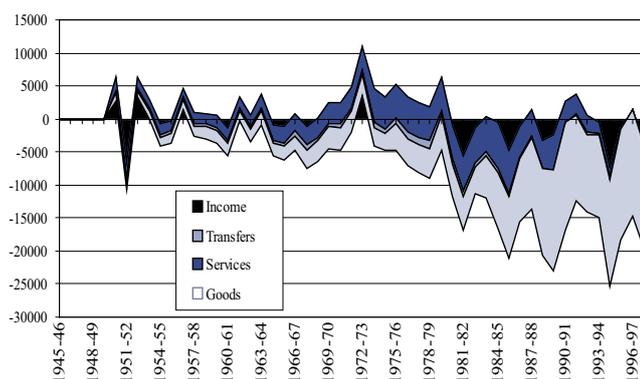
Fig 1: The Current Account Deficit and real GDP change.
(Source: ABS various)



A third point to note is that very little of the income component of the Current Account deficit is attributable to the Government sector. Since 1992/3, the Government share of gross income debits has varied from 7.7% to 10.2%, and was 7.9% for the 1997/98 period.⁶

A fourth point is that approximately 42% of the gross income debits that contribute to the Current Account deficit are repayments on debt, with most of the balance being

Fig 2: Components of Australia's Current Account Deficit
(\$m 1989/90 prices) Source: ABS



dividends and distributed branch profits that are payable to overseas owners.

This puts the income deficit in somewhat of a different light. Rather than simply being repayments associated with Australia's overseas 'debt', almost half is dividends and profits being paid on equity owned by non-residents who choose to invest in Australia because of the returns they are able to generate here, compared with returns available elsewhere.

How Accurate is the Current Account Statistic?

Understanding what makes up the Current Account balance statistic is an important step, but perhaps just as important is understanding how accurate the various estimates of this statistic are. To comprehend the complexity of this question, imagine that a large Australian-resident Company has acquired a significant shareholding in a subsidiary

company overseas and uses overseas borrowing to fund the acquisition. Should that transaction be recorded as adding to Australia's current account deficit? Further, if an unknown proportion of the Company's shareholders are non-residents, how much of that transaction should be apportioned to Australia and taken up as part of the official Current Account statistics?

These questions highlight that the complexity of business structures under which many trans-national corporations operate means that attributing "residency" is almost meaningless. Additionally, the fact that direct portfolio investment is possible and increasingly common across international boundaries, and that investment funds often have a multi-national subscriber base means there must be serious qualifications about the accuracy of some aspects of Current Account statistics.

Further complicating this issue is the trend towards trade being increasingly carried out between the international branches of large trans-national corporations. The result is that the value of, and revenue associated with particular transactions are increasingly being determined by internal corporate considerations. While statistics on this are not readily available, it is noteworthy that in 1995-6 almost half of Australia's export earnings were generated by the largest fifteen exporters, six of which were Japanese trading houses.⁷

These complexities have been recognised by the ABS which has revealed that for a number of the components of the Current Account statistic, the sample from which monthly estimates are made is quite small.⁸

For example:

- the ABS figures published for Service debits and credits are based on a sample of between 15-36% of all transactions
- the ABS estimates for monthly Income debits are based on a sample of 17% of transactions
- the ABS figures for monthly Income credits are based on a sample of just 7% of transactions.

Not surprisingly, the result is that the initially published monthly Current Account balances are normally subject to large subsequent revisions. ABS figures show that the mean absolute revision to monthly Current Account balances within twelve months of their initial publication is \$134 million, or around 13% of the estimate. In addition, the ABS comments that "for many series, significant revisions remain to be processed several years after the initial estimates have been made."⁹

How does our Current Account Compare?

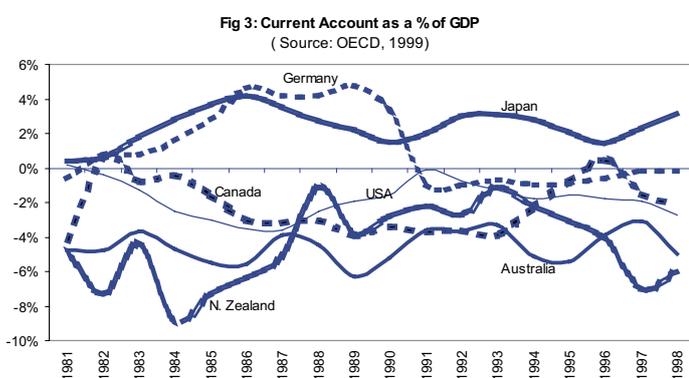
Notwithstanding the qualifications surrounding the robustness of the official Current Account statistics, the data displayed in figure one shows that Australia has constantly experienced a Current Account deficit since the mid-1970's, and since 1980 this deficit appears to have fluctuated around

5% of GDP.

Of interest is how the Australian data compares with that of other countries, and this can be observed in Figure 3. Canada, the USA, New Zealand and Australia have typically experienced Current Account deficits of between 2 and 5% over much of the past two decades, while Japan has had a current account surplus over the whole period. Germany had a strong surplus up until unification in 1990, and since that time has had a balanced or marginally negative current account position.

On the basis of these figures, Australia and New Zealand seem to experience Current Account deficits that are as large as any experienced by other OECD countries, although they do not appear to be extreme.

The recent increase in Australia's Current Account deficit is also a trend that has been experienced by other exporting



nations in the wake of the Asian crisis, as demand for imports stopped almost overnight in some of our major export markets.

In a recent report, the OECD has noted that between 1996 and 1998, the combined Current Account balances of Korea, Indonesia, Malaysia, the Philippines and Thailand (the Asia-5) increased by more than \$125 billion, from a deficit of \$60 billion in 1996 to a combined surplus of \$65 billion in 1998.¹⁰ This was largely as a result of a dramatic drop in imports into these countries.

In the case of Australia and New Zealand, between 1996 and 1998 the combined trade balance with the Asia-5 worsened by \$7 billion, equivalent to 1.5% of Australia and New Zealand's combined GDP.

In the case of the USA, its trade balance with the Asia-5 worsened by over \$100 billion between 1996 and 1998. Also severely affected was Japan, where the reduction in exports to the Asia-5 represented about 8% of Japan's total exports.

Overall, the conclusion seems to be that while Australian (and New Zealand) Current Account deficits are larger as a percentage of GDP than most other OECD countries, recent trends in this statistic in response to the Asian crisis are neither unique nor unexpected, and are indeed quite appropriate.

Is the Current Account Important?

Knowing how Australia's Current Account balance ranks internationally is of interest, but the question remains about how much significance should be attached to this particular statistic. The trends evident in Figure 1 suggest that over recent decades, Australia's GDP and Australia's Current Account position may be inversely related, with periods of strong economic growth coinciding with increasing Current Account deficits. Available statistics suggest that this is a phenomenon that may not be unique to Australia, as can be seen from Table 1.

Table 1: Average GDP growth and Current Account balances for selected OECD countries, 1993-1998.

Country	Average annual GDP change (%)	Average Current Account (% of GDP)
Australia	4.3	-4.3
USA	3.2	-1.9
Canada	3.0	-1.7
UK	3.0	-0.3
France	1.8	+1.5
Germany	1.5	-0.6
Italy	1.3	+2.2
Japan	1.0	+2.5

Source: OECD 1999

The inclusion of different countries in this table can obviously bias the apparent relationship – for example Ireland is an obvious exception. It has had an average annual GDP growth of 8.2% over the relevant period, yet has had an annual Current Account surplus that has averaged 2.8% of GDP. This perhaps reinforces that, while economists often refer to the 'balance-of-payments constraint' in relation to long-term economic growth, Current Account balances by themselves provide only a very limited picture of an economy at a particular point in time.

This is emphasised by a range of other statistics that compare national economic performance.¹¹ For example, Australian Government net financial liabilities were reported by the OECD to be 10.5% of GDP in 1999, in comparison with an OECD average of around 44%. Australian general government net debt interest payments are estimated at 1.6% of GDP, in comparison with an OECD average of 2.5%. Consumer prices increased by just 0.9% in Australia during 1998, in comparison with an OECD average of 3.8%

Even in areas where the Australian economy is considered to be weak, such as national savings, the statistics are not unequivocal. For example, the gross national savings rate for Australia is reported as 18.4% of GDP, which is below the OECD average of 21.1%, but above the ratios recorded for countries such as the USA, the UK, New Zealand and Sweden.

The Governor of the Reserve Bank recently discussed the significance of Australia's Current Account balance.¹² He conceded it is a weakness in the Australian economy, but

was careful to differentiate the factors contributing to it. He identified external shocks, cyclical movements and fundamental structural problems as three categories of factors that could affect the statistic.

In relation to recent increases in the deficit, he commented that an increase in the Current Account deficit is “virtually inevitable because a significant number of countries that make up our major export markets are likely to contract, or not grow as quickly over the next eighteen months.” As such, much of the recent increase in the deficit is clearly the result of an external shock.

Compounding this effect, statistics displayed earlier showed that an increased deficit would also be expected at the current stage of Australia’s economic cycle, given the strong economic growth that has recently been experienced. In part, it is a normal cyclical movement, an observation reinforced by the fact that it is the fifth such event in the past two decades.

He also pointed out that in terms of Australia’s ability to fund the resulting deficit, net foreign debt as a percent of GDP has remained relatively stable throughout most of the 1990’s, and the proportion of exports needed to service foreign debt has actually declined. In 1990, servicing foreign debt cost 22% of the value of Australian exports, whereas by 1997, this figure was down to 12%.

The conclusion was “we should be prepared for a higher Current Account deficit in the short run – to try to avoid it would place intolerable strains on the rest of the economy.” He continued “Notwithstanding these changes, we feel that over the next twelve months, Australia will continue to experience an economic outcome that will place it among the better performers in the OECD.”

A number of conclusions arise from this analysis. The first is that as a statistic, the Current Account balance, especially when it is first released, is not very robust. This is no fault of the Australian Bureau of Statistics, but simply a reflection of the increasing complexity of international goods, services and income transfers as economies become more internationally open.

The second conclusion is that, by itself, the Current Account statistic does not mean a great deal. It is just one of a large number of economic indicators that combine to provide a picture of a national economy. Like any normal business, it is the ability to service a deficit that matters, rather than the size of the deficit.

A third conclusion is that while Governments are routinely urged to ‘do something’ about the Current Account deficit, almost all the decisions about transactions contributing to this statistic are made by corporations and individuals. If Australian corporations are increasingly seeking off-shore funds for their businesses, then perhaps there is a need to examine domestic savings policy, but equally there is a need

to examine Australian banks policies in relation to their risk profile and their willingness to provide business finance.

A final conclusion comes from the somewhat telling comments made by both the Reserve Bank Governor and the OECD recently. Both addressed the issue of Australia’s Current Account balance from the perspective of the confidence of financial markets, rather than concern about economic fundamentals. Perhaps the real problem lies with some commentators and financial markets operators who are inclined to make instant decisions about the future of the Australian economy on the basis of a single, limited, and relatively inaccurate statistical measure.

(Footnotes)

- 1 ABS. 5368.0 International Trade in Goods and Services, Australia
- 2 Stephen Koukoulas, Australian Financial Review. 30/7/99
- 3 Frank Gelber & Peter Jones. Australian Financial Review, 30/7/99
- 4 Australian Newspaper. 30/7/99
- 5 ABS. Balance of Payments Australia. Concepts, Sources and Methods. 1990
- 6 ABS (1999) Balance of Payments & International Investment position 5363.0
- 7 Bryan & Rafferty (1999) The Global Economy in Australia.
- 8 ABS (1997) Do we need monthly Balance of Payment statistics ? (5336.0)
- 9 ABS (1996) Quality of Australian Balance of Payment Statistics. (5342.0)
- 10 OECD (1999) Economic Outlook
- 11 OECD (1999) op. Cit.
- 12 Mcfarlane. Reserve Bank of Australia Bulletin, April 1998.

COMMENTS CONTAINED IN THIS DOCUMENT ARE BASED ON INFORMATION AVAILABLE AT TIME OF PUBLICATION.

This paper originally appeared as an edition of the Primary Report published by NSW Farmers’ Association. Re-published in 2004 by the Australian Farm Institute.