

# Are External Deficits A Concern ?

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2 May 2006



## Main Themes

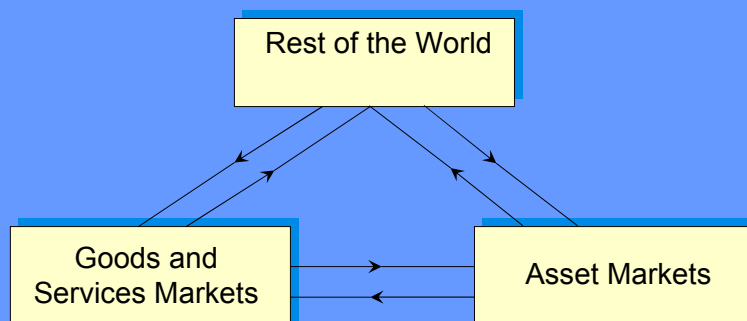
- International Developments
- Major Concerns About External Deficits
- Saving-Investment Imbalances
- Interest Risk Premium
- Internally or Externally Driven?
- National Balance Sheet Analysis
- Currency Crises
- Capital Inflow and Economic Growth

## Developments in the Global Economy

- Large expansion of trade flows
- Deeper financial markets in emerging economies
- Relaxation of capital controls
- International financial market integration
- Importance of private capital flows
- Emergence of East Asia
- Exchange rate regime change to accommodate capital flows

## Domestic - International Linkages

- Over recent decades economies have become far more globalised through increased trade in goods, services and assets



## A Keynesian View

“Ideas, knowledge, science, hospitality, travel – these are the things which should of their nature be international. But let goods be homespun whenever it is reasonable and conveniently possible, and above all else let finance be primarily national.”

John Maynard Keynes (1933) “National Self-Sufficiency”

## A Classical View

“Nothing ...can be more absurd than this whole doctrine of the balance of trade....When two places trade with one another, this doctrine supposes that, if the balance be even, neither of them either loses or gains: but if it leans in any degree to one side, that one of them loses, and the other gains in proportion to its declension from the exact equilibrium. Both suppositions are false...that trade which without force or constraint, is naturally carried on between any two places, is always advantageous...to both.”

Adam Smith (1776) *The Wealth of Nations*

## Elements of BOP Analysis

- Trade Balance
- Current Account Balance (CAB)
- Capital and Financial Account
- Exchange Rate Regime
- Measurement Issues
  - foreign exchange value (\$US)
  - inflation adjustment of CAD
  - size of balancing item

## Macro-accounting Relations Between Income - Absorption, Saving - Investment and External Imbalance

- $GDP = C + I + X - M$
- $Y = GDP - yf$
- $= (C + I) + X - M - yf$
- $= A + X - M - yf$
- $Y - A = X - M - yf = CAB$
- $Y - C = S$
- $S - I = CAB$

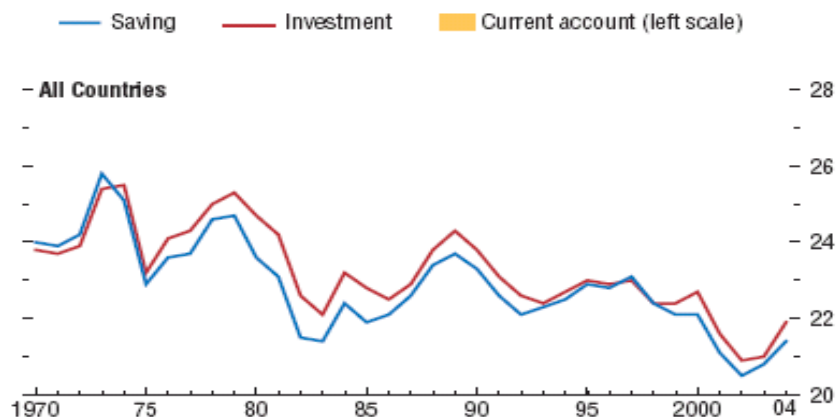
## External Account Imbalances: Recent Global Developments

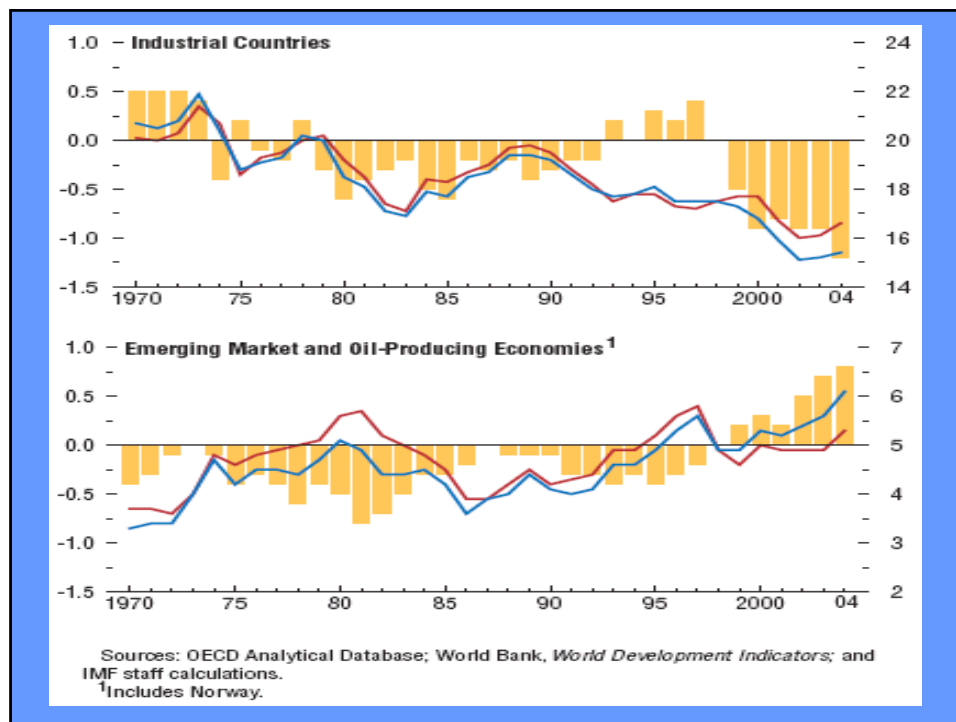
- Current account imbalances and external liability positions across major trading areas have grown markedly over recent decades
- Major advanced borrower economies are the United States, Australia, New Zealand, the United Kingdom (the 'Angloshere') plus Spain, Greece, Portugal and Iceland
- external deficits are largely funded by East Asia, especially Japan and China, and oil exporters

**Figure 2.1. Global Saving, Investment, and Current Accounts**

*(Percent of world GDP)*

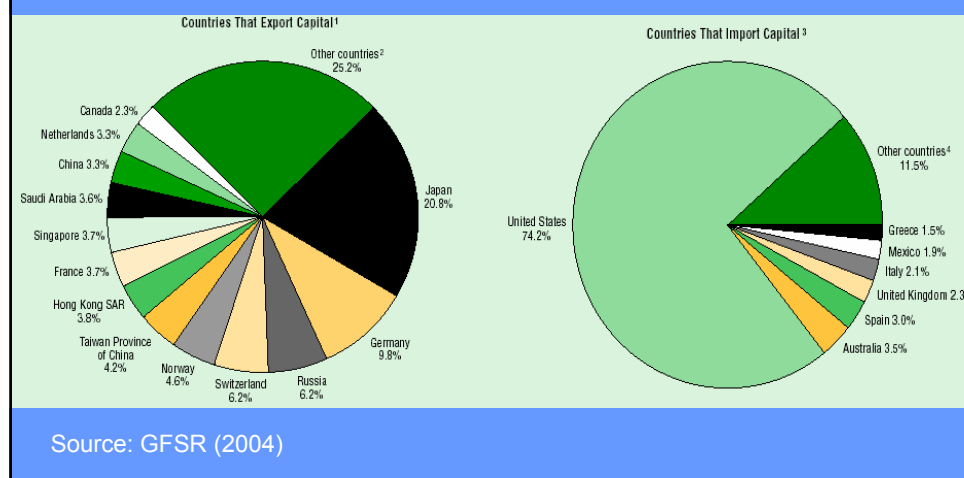
Global saving and investment have been trending downward since the early 1970s. They reached historic lows in 2002, and have recovered modestly since then.





## Capital Flows: Recent Developments

### Sources and Uses (2004)



## Popular Concerns About External Deficits

- Trade Deficits are Unsustainable
- We Are “Living Beyond Our Means”
- Domestic Saving is Too Low
- Investment is Too High
- Interest Rates are Too High
- Foreign Debt is Too High
- CAD's Cause Currency Crises

## CAD Sustainability

- financial markets and policymakers worry that sizeable external deficits and debt levels are unsustainable
- sudden shifts in investor sentiment that may precipitate currency and financial crises and reduce economic growth

## ..But There are Gains from Trade in Saving

- treating the current account deficit as a symptom of a serious trade competitiveness problem ignores the benefits stemming from the matching capital account balance
- capital inflow equal to the current account deficit allows productive investment to be higher than otherwise

## Gains from Trade in Saving

- external imbalances should not be considered worrisome, in and of themselves
- on the contrary, capital inflow or foreign saving complements domestic savings and assists domestic capital accumulation, enabling faster economic growth
- meanwhile, the national income of creditor countries also rises to the extent that international lenders earn higher returns on their saving than possible in their own economies



## Are We Really “Living Beyond Our Means?”

Recall  $X - M - yf = Y - (C + I + G)$

- CAD reflects  $A > Y$
- however, this does not necessarily imply consumption is too high or saving is too low
- an economy is better imagined as a production unit rather than a household

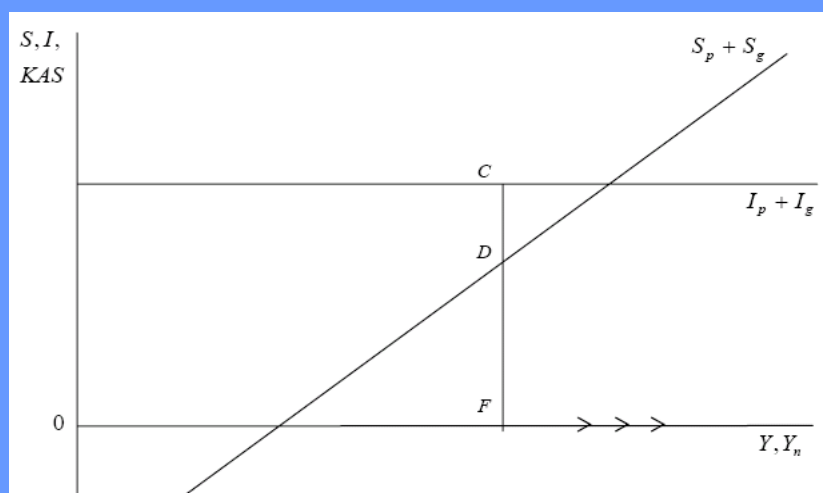
## Saving, Investment and the External Accounts

- a number of models, including the *intertemporal* model of an open economy explain the interaction between saving, investment, the external accounts and national income
- it suggests that capital flows are welfare enhancing as they permit higher growth through additional real capital accumulation

## Saving, Investment and the External Accounts

- however, the economy experiences a net welfare gain overall as the higher income ( $Y$ ) generated by the extra investment ( $\Delta I$ ) permits higher consumption, both now and in the future
- this presumes that the  $\Delta I$  is productive enough to service the debt incurred to acquire it
- if not, enterprises make losses, are liquidated and the debt disappears

## Saving, Investment and the External Accounts



## Is Saving Too Low?

- ❖ *household saving* has declined following financial deregulation in many advanced economies, though recently offset by rises in business saving (‘seeing through the corporate veil’) and in *public saving*
- ❖ for given investment, a rise in public saving, offset by a fall in household saving supports the Ricardian Equivalence proposition but negates the “*twin deficits*’ hypothesis

Household Saving	Gross National Saving	Gross Investment
Corporate Saving		
Public Saving		
	Capital Account Surplus	

Components of saving

- ❖ conventional saving measures are understated because public expenditure on education and health is treated as consumption when such spending may be perceived as investment in human capital
- ❖ *demographic factors* also influenced domestic household saving
  - social security system can partly explain differences in saving rates across countries
  - the more generous is the publicly funded pension scheme, the lower household saving is likely to be (China vs Australia and New Zealand)

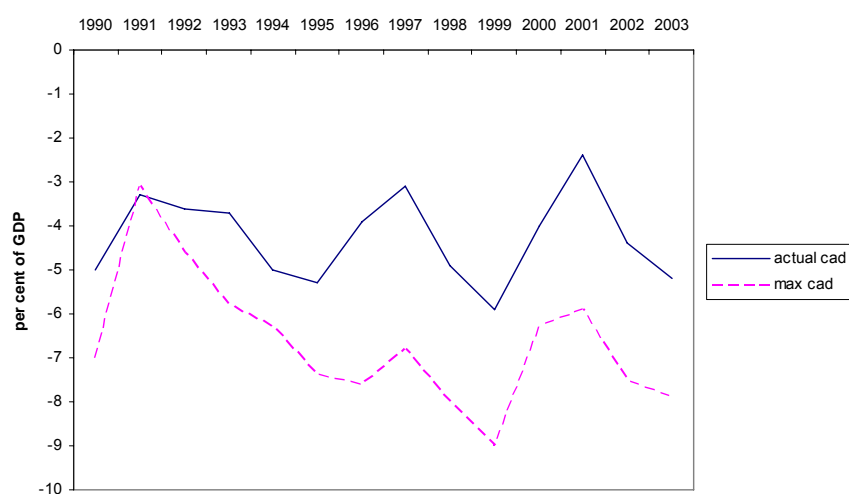
### 'Feasible Limits' to CADs

- a feasible limit is reached for an economy's current account deficit when its net domestic saving reaches zero
- beyond this point, the economy would be borrowing externally to fund consumption in excess of national income that would not be sustainable in the longer run
  - then 'living beyond means'

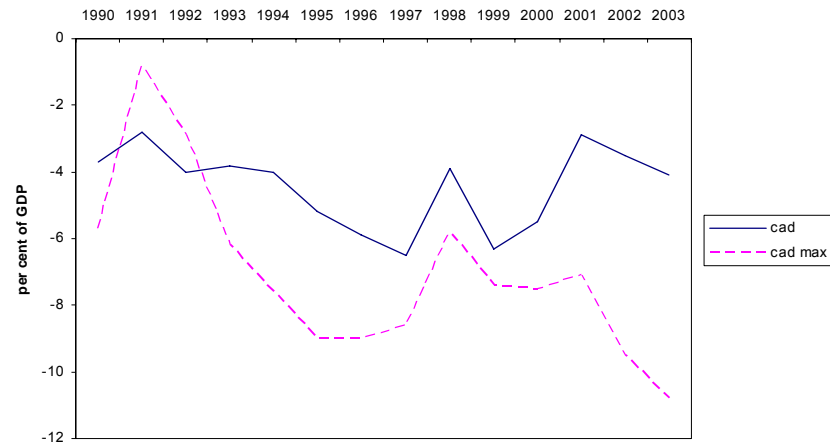
## 'Feasible Limits' to CADs

- hence, an economy's productive investment opportunities alone set a feasible upper limit for the external deficit
- can show that an economy's capital-output ratio ultimately sets the limit of its foreign debt ratio (Makin 2005)

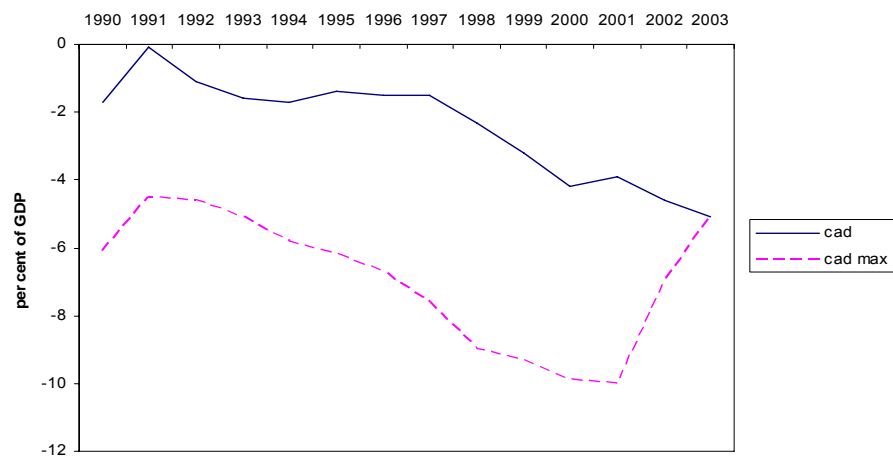
## Australia's CAD



## New Zealand's CAD



## United States CAD



### ....An Alternative Measure of Saving

- conventional saving measures the flow of domestic funds available for investment, whereas a broader measure reflects total consumption possibilities

$$\text{Alternative Saving} = W_1 - W_0 = S + k$$

(or change in national wealth)

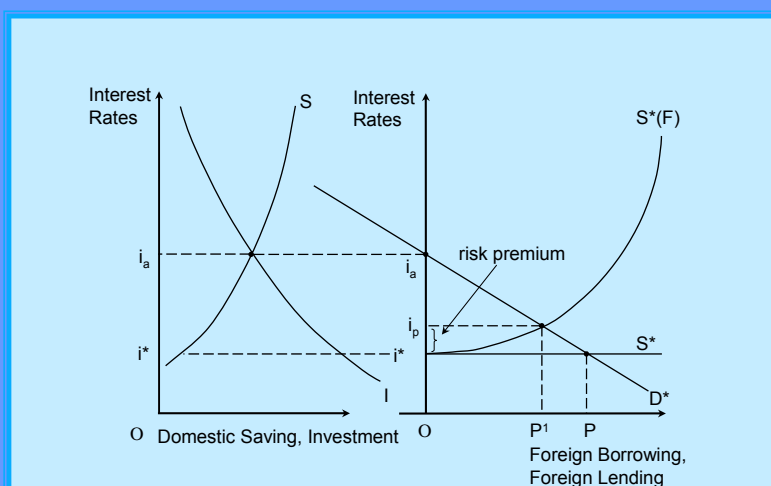
- national wealth changes due to conventionally measured saving plus market revaluation of residents' net assets

(for Australia, this measure normally higher than the conventional measure, except during recessions)

### Other Benefits of Capital Flows

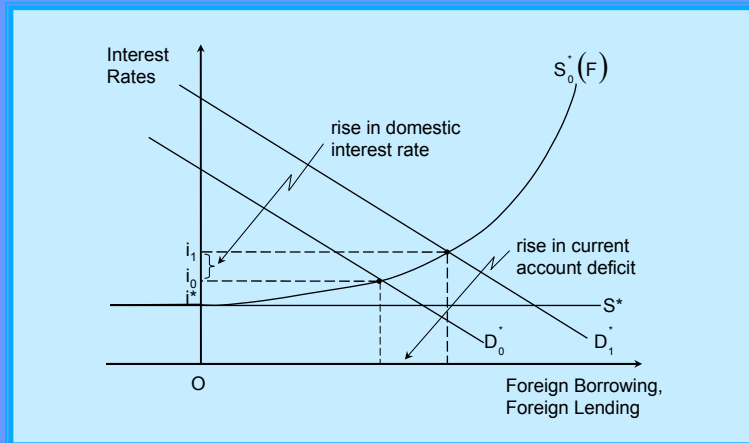
- recall inflows of FDI capital also promote technology transfer, and is a source of growth
- external financing can allow consumption smoothing during poor harvests, periods of low export prices

- large external deficits and rising foreign debt can also lead to an ***interest risk premium***
- assume saving and investment are responsive to changes in interest rates and that foreign lenders are averse to a rising external debt
- the greater the perceived debt risk
  - the wider the interest differential between domestic and foreign interest rates



Domestic saving, investment and external borrowing





Rise in borrowing requirement

## Exogenously Determined CAD's

- an economy's external balance can change whenever its domestic saving or investment pattern changes or whenever saving or investment patterns change abroad
- for instance, it is conceivable that if saving increased relatively faster abroad than domestic investment opportunities increased abroad, then NZ's external account balance would widen commensurately as the additional foreign saving was invested here

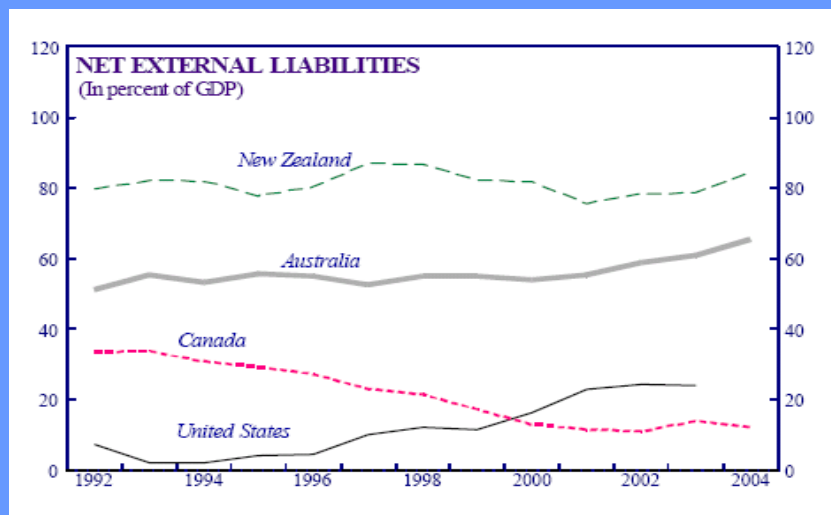
## Exogenously Determined CAD's

- the larger external imbalance would be a sign of foreign investor confidence in the NZ economy
- under such circumstances, an enlarged external imbalance would result from factors beyond the control of the domestic authorities
- with a larger capital stock, courtesy of increased foreign capital inflow, domestic production, employment and income levels would all improve

## Estimating Interest Risk Premia

- comparison with weighted average of interest rates in capital source countries would reveal actual size of risk premium
- but, even with a risk premium, *the interest rate of a debtor country will always be lower than its interest rate without foreign borrowing*

## Is Foreign Debt Too High?



## National Balance Sheet Approach

- focus on **stocks** (asset and liability positions) rather than **flows** (fiscal and current account deficits)
- analyse an economy's national balance sheet
  - Government sector (incl. Central Bank)
  - Private financial sector
  - External sector (rest of the world)

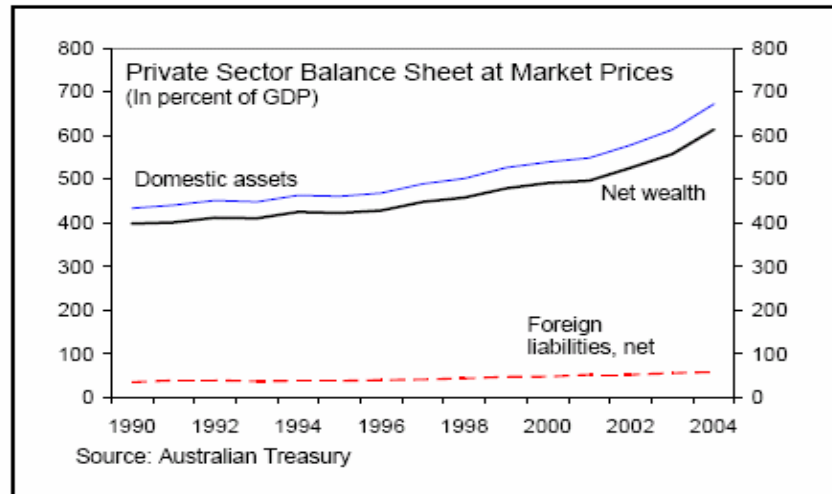
### National balance sheet analysis

<i>National Balance Sheet</i> ( <i>\$US billion</i> )					
<i>Assets</i>	<i>2000</i>	<i>2005</i>	<i>Claims on assets</i>	<i>2000</i>	<i>2005</i>
Private sector			Gross external debt		
Capital stock	215	430	Non-official	15	85
Dwellings	330	545	Official	10	25
Consumer durables	45	60		25	110
	590	1035			
Public sector			Foreign equity	35	60
Capital stock	175	220			
Dwellings	10	15	Foreign investment	60	170
	185	235			
Investment abroad					
Non-official	10	45	National wealth	735	1185
Official	10	20			
	20	65			
Total assets	795	1335			

*Notes:* The private sector capital stock at market prices is defined as the sum of equipment, non-dwelling construction and inventories

- here, though large, economy's external debt is less than 10 percent of total assets
- economy's can 'gear up' in a financial sense and raise national wealth

## Australian Experience



## Risks of Capital Flows

- FDI inflows increase foreign control
- premature capital account liberalization, especially with weak financial sector regulation, entails risks
- when banks are poorly managed and supervised, inflows can cause a credit boom, finance speculative investment in real estate, and cause asset price bubbles

## Large reversals in net private capital flows II

### Short-term debt inflows turned into outflows in 1998 (In billions of U.S. dollars)

	1997	1998
All developing countries	43.5	−85.0
East Asia and Pacific	0.8	−68.0
Korea	−8.0	−29.9
Thailand	−6.9	−15.1
Indonesia	1.1	−11.8
Malaysia	3.4	−5.3
Latin America and Caribbean	24.1	−5.7

Source: Bank for International Settlements.

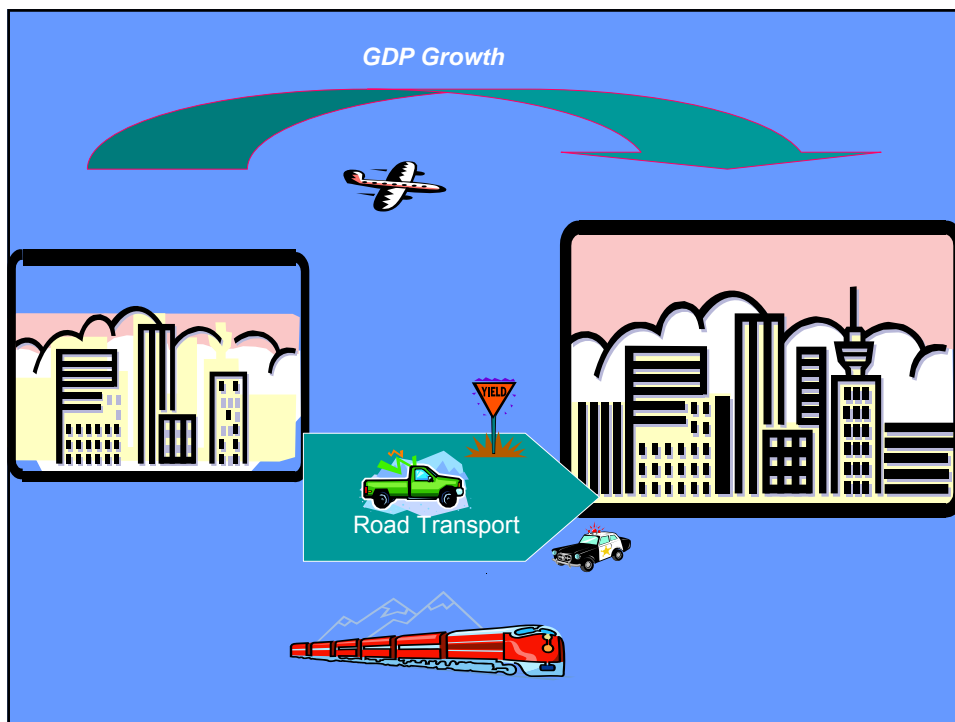
### Main Currency Crises since the 1990s



- if foreign investors re-assess economy's prospects, capital inflows may suddenly reverse  
→ the exchange rate comes under pressure
- the economy must then adjust through some combination of reserve losses and exchange rate depreciation that
  - lowers imports
  - eventually raises exports
- exchange rate adjusts to restore equilibrium if CAD's are judged unsustainable

## Capital Account Surpluses and Economic Growth

- consider a destination-vehicle analogy where the destination is higher growth and different forms of transport (air, rail, road) are different routes to growth
- assume capital flows are analogous to road transport and a major accident (crisis) has occurred due to an unsafe road (financial system)



## Capital Account Surpluses and Economic Growth

- the best way to minimize the risk of further accidents is to upgrade the highway (or financial system)
- provide more advisory signs along the highway (economic data, financial disclosure) and perhaps more traffic police (financial system surveillance)
- capital controls actually limit highway use and lower the volume of traffic traveling toward the destination of higher growth



### Questions to Consider

- Have CAD's been driven by internal or external factors?
- Is there an interest risk premium?
- What national income gains are attributable to past capital inflows/CADs?
- By how much have national wealth gains exceeded rises in external liabilities?

### Related Publications

- "Feasible Limits for External Deficits and Debt" (2005) *Global Economy Journal* 5(1), 1-14.
- "The Current Account, Fiscal Policy and Medium Run Income Determination" (2004) *Contemporary Economic Policy* (22), 309-317.