ARE EXTERNAL DEFICITS A CONCERN?

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Summary

The current account imbalances of many advanced and emerging economies have widened significantly as a proportion of GDP in the wake of the international capital market liberalisation that began in the early 1980's. As a result, international borrower countries, especially Australia and New Zealand, have experienced sharp rises in external indebtedness. This has concerned policymakers on both sides of the Tasman and, at various times, been a major focus of macroeconomic policy. Misinterpretations of the causes of current account imbalances can lead to misplaced policy reactions that impose large economic and societal costs. Accordingly, this lecture explains the key factors that determine external deficits and debt, their policy significance, and the macroeconomic benefits and risks they entail.

Introduction

New Zealand's current account deficit exceeds 8 per cent of GDP and is one of the highest external deficits in the world. According to IMF forecasts, within the OECD only Iceland and Portugal are expected to experience larger deficits as a proportion of GDP in 2006, although the United States, Australia, the United Kingdom and Spain have also been running sizeable deficits.

Recent rises in the external deficits of advanced economies have largely coincided with a major shift in the pattern of saving and investment in East Asia following the Asian crisis of 1997. Since that time, saving in crisis affected East Asian economies has risen significantly, accompanied by an especially rapid increase in saving by China. Meanwhile, East Asian investment rates have fallen over the period when compared to pre crisis rates (IMF 2005). This excess East Asian saving over investment has been invested abroad.

Current account deficits of advanced and emerging economies have risen sharply as a proportion of GDP compared to levels of the post war decades. Matching the increased capital flows around the world, the counterpart to current account deficit balances, have been marked changes in nations' external liability positions.

In financially open economies, national saving and investment are largely independent. Current account imbalances reflect saving-investment gaps and recent large external deficits have been a major source of concern for policymakers (see IMF 2005) and financial market commentators. Specifically, policymakers worry that sizeable external deficits and debt levels may over-expose an economy to sudden shifts in investor sentiment that may precipitate currency and financial crises and recession.[1]

Concerns about external account deficits and foreign debt levels have surfaced frequently in both Australia and New Zealand and the magnitude of their external account imbalance has been a major focus of macroeconomic policy attention on both sides of the Tasman at different times over recent decades. External imbalances between individual economies or regions are also often seen as symptoms of "unfair" trade that necessitate retaliatory protectionist measures to restrict imports or subsidize exports.

Yet, current account deficits have been frequently misinterpreted and used to justify inappropriate economic policy responses, including a monetary policy induced recession in Australia in the early nineties and protectionist measures in the United States. A proper understanding of the causes and economy-wide implications of external imbalances is critically important to forestall enactment of welfare-reducing commercial policies, such as higher tariffs and quotas that limit world trade flows.

For this reason it is important to answer the following basic questions. Are external deficits really a concern? When are they unsustainable? And under what circumstances do they imply excessive risk for economies?

Contrasting Theoretical Perspectives

Since the breakdown of the Bretton Woods monetary system that prevailed from 1945 to the early 1970's, there has also been massive growth in the volume of international capital flows. This growth was due partly to the successive dismantling of exchange

1 See International Monetary Fund (2002) and Mann (1999, 2002) and Fischer (2003).

controls that supposedly facilitated exchange rate management under the Bretton Woods arrangements.

These exchange controls reflected a somewhat xenophobic view of foreign money which prevailed during the interwar period and with which the noted economist John Maynard Keynes sympathized. Writing in 1933, Keynes stated that: "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."

Present imbalances are large compared with Bretton Woods or even with 1930's and 1940's outcomes. However, capital is arguably as mobile as in the relatively frictionless international environment of the late 19th and 20th centuries. Then, for example, the flow of capital from the United Kingdom averaged 5 per cent of GNP between 1870 and 1913 and the flow of capital into Canada averaged 13 per cent of GDP between 1910 and 1913.

This earlier era of high capital mobility was undoubtedly influenced by the pro-trade view of the classical economists, Adam Smith, David Hume, David Ricardo and John Stuart Mill. With reference to the benefits of trade and to the (in)significance of trade imbalances Adam Smith declared:

"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 then 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." (*The Wealth of Nations* 1776)

This view contrasts starkly with the negative sentiment expressed by Keynes about international trade in goods and funds in the first quote above. To this day, interpretations of the significance of trade imbalances may be said to reflect either a predominately Keynesian or classical view of international exchange and also of how open economies essentially behave at the macroeconomic level. Those who tend to be pessimistic about external deficits and the capacity of the private sector to make the right consumption and investment choices at heart reflect Keynes' sentiments, whereas more optimistic interpretations, including those of this paper, are more classically oriented.

Gains from Trade in Saving[2]

Financial liberalization has facilitated the de-linking of domestic saving and investment rates in many countries all over the world and thereby enhanced international capital mobility. External account imbalances reflect this divergence between economies' domestic saving and investment, as more formally modelled by many authors (see, *inter alia,* Makin 2003, Obtsfeld and Rogoff 1996 and Sachs 1982).

Capital inflow equal to the current account deficit allows productive investment to be higher than otherwise. Similarly, a focus on the rise in external liabilities stemming from greater capital market integration with the rest of the world can enable higher national wealth because it allows the nation's capital stock to grow larger.

As argued some time ago in the Australian context (Makin 1988) when the current account deficit was the paramount macroeconomic policy concern, focusing on the current account deficit alone is misplaced for it ignores the benefits stemming from the matching capital account balance. External imbalances should therefore not be considered worrisome, in and of themselves.

On the contrary, since capital inflow or foreign saving complements domestic savings, it plays an important role in the process of domestic capital accumulation enabling

2 The following sections draw on Makin (2005a).

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.

Any 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 and investment prospects in New Zealand stayed exactly the same, but saving increased relatively faster abroad than domestic investment opportunities increased abroad, then New Zealand's external account balance would widen commensurately as the additional foreign saving was invested here.

The larger external imbalance would be a sign of foreign investor confidence in the 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. This obviously should be welcomed.

The theoretical economics literature presents a strong case for free international trade in saving and the macroeconomic gains that global finance can bestow. In particular, a now standard interpretation of the significance of external imbalances, known as the intertemporal approach to the current account, implies that current account imbalances essentially arise through discrepant expected rates of return on capital across borders being equalized. In the process, external borrowing also improves the economic welfare of an economy's residents through time by raising their consumption possibilities.

From a flow of funds perspective the criterion which should be used to judge whether an external deficit is "good" or "bad" is simply whether the debt is being used productively. Alternatively, does the output gain arising from the capital inflow exceed

the cost of acquiring the additional real capital? If so, both creditor and debtor nations gain through trade in saving.

It is essentially New Zealanders' saving propensity combined with the productivity of capital which explains the persistent external deficit. As suggested by Claus, Haugh, Scobie and Tornquist (2001) domestic saving at the macroeconomic level in New Zealand does not appear to have constrained investment and growth, and at the microeconomic level, saving for retirement appears adequate (Scobie, Gibson and Le 2004). Hence, evidence has yet to be provided that New Zealand's saving is somehow sub-optimal. Nor is consumption tilted towards the present from an intertemporal perspective, as shown by Kim, Hall and Buckle (2006).

A relatively higher real rate of return on domestic capital will induce capital inflow and its counterpart is the deficit on current transactions, including trade in goods and services. When capital inflow is money willingly provided by foreigners to finance investment it should generally be assumed that individual enterprises, especially privately owned ones, correctly assess that if they borrow offshore, the return on the activity funded by their overseas loan raising is greater than the servicing costs of the debt including provision for repayment.

We can expect that firms borrow offshore when the marginal efficiency of capital exceeds the cost of the external finance after allowing for exchange and foreign interest rate risk. On the other side of the borrower-lender relationship, foreigners are unlikely to finance the investment if they do not expect its return to be high enough.

When Are External Imbalances Unsustainable?

Since the current account deficit reflects the difference between domestic investment and domestic saving, a limit on foreign borrowing conceivably exists when an economy's domestic saving shrinks to zero. At that point, foreign borrowing is funding all of the new investment in the economy. The problem occurs beyond that point when additional foreign borrowing must be funding excessive consumption.

This is because consumption, by definition, yields no future income with which to service foreign debt. Hence, an economy's productive investment opportunities alone set a feasible upper limit for the current account deficit. Economies with an external deficit may therefore be able to tolerate a further rise in the size of the deficit to the point where net saving disappears.

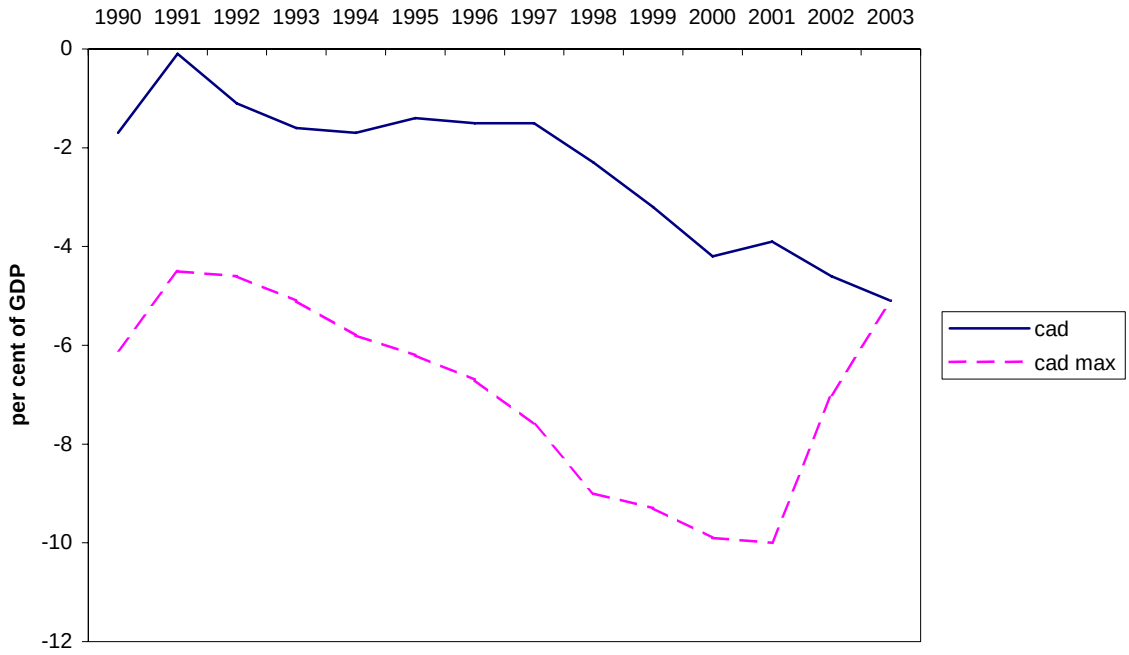
In other words, for given domestic investment opportunities domestic saving could fall to zero, thereby allowing domestic capital accumulation to be fully funded by foreign saving. At this point the current account deficit really could be a problem, as the economy is then 'living beyond its means'. To judge how serious the size of the external deficit is, it is necessary to estimate how far New Zealand is from having zero saving.

Historical estimates of 'maximum feasible deficits' on this basis are depicted in the following charts which reveal that past external deficits have mostly been well below their feasible limits. However, this has not recently been true for the United States deficit. With its near zero national saving, the United States has recently been verging on its sustainable limit which explains why the US dollar has been relatively weak against most floating currencies.

Only in 1991-1992 have New Zealand deficits exceeded estimated limit values. Given the recession at that time, it is likely that foreign saving temporarily funded excess domestic public and private consumption, consistent with the consumption-smoothing role that the current account deficit may play in the short run, but from which this method abstracts.

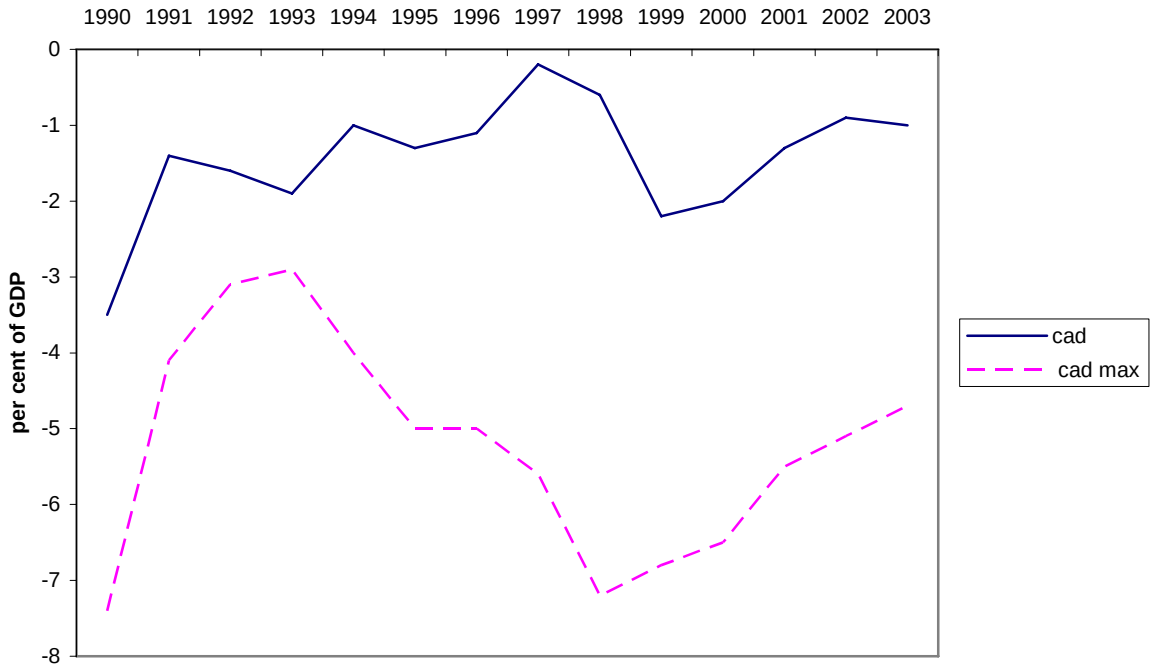
A continuous series of maximum feasible *CADs* would eventually result in foreigners holding claims to the economy's entire capital stock. Consequently, the maximum feasible limit in terms of the foreign debt to GDP ratio is ultimately equal to the capital-output ratio, as derived in Makin (2005b).

Chart 1 – United States



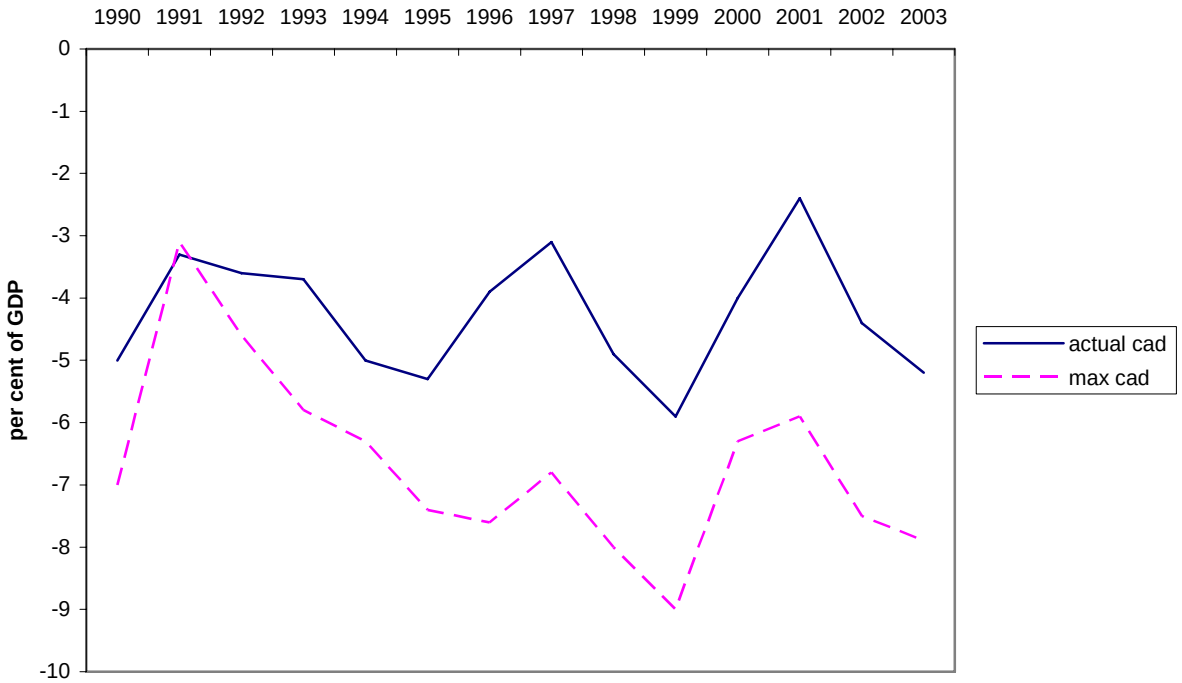
Data source: IMF *International Financial Statistics*, 2004, *IMF World Economic Outlook,* September 2003.

Chart 2 – United Kingdom



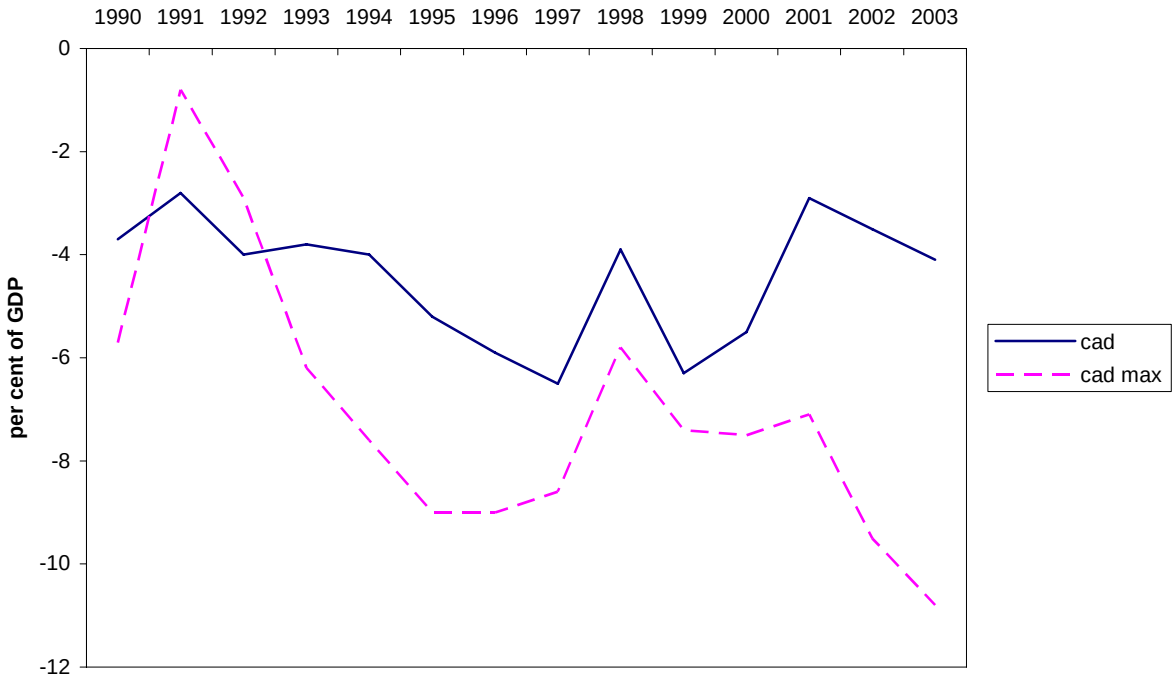
Data source: IMF *International Financial Statistics*, 2004, *IMF World Economic Outlook,* September 2003.

Chart 3 – Australia



Data source: IMF *International Financial Statistics*, 2004, *IMF World Economic Outlook,* September 2003.

Chart 4 – New Zealand



Data source: IMF *International Financial Statistics*, 2004, *IMF World Economic Outlook,* September 2003.

This notion of current account sustainability is subject to some qualification, even for advanced economies. For instance, sustainability depends on whether the financial system is channeling domestic and foreign saving to the most productive domestic investment opportunities. Moreover, in any economy, information problems such as asymmetric information between ultimate borrowers and lenders may prevent the optimal allocation of saving.

In turn, this implies the additional income generating capacity of foreign funded capital accumulation may not be as strong as theory suggests. Nonetheless, judging external account and foreign debt sustainability with reference to the nation's saving pool would seem to improve on the arbitrary five per cent of GDP rule.

On this basis, and given the sizeable fiscal surplus at present, New Zealand's current account deficit is sustainable. If its feasible limit gets closer should private and public consumption spending rises too much, what is the worst that can happen? The answer is that the exchange rate will experience another of its periodic big slides to restore current account sustainability. Yet, this is precisely what the export sector would welcome to improve its competitiveness.

The pure theory of the benefits of foreign investment and increased trade in saving assumes well founded expectations about the future and a sound banking and financial system for channeling foreign saving to ultimate borrowers. These assumptions may sometimes be violated, especially in emerging economies, so a qualification is necessary.

Risks Associated With International Capital Flows

Developing and emerging economies that experience large external deficits and foreign debt are more vulnerable to sudden capital flow reversals than advanced economies like New Zealand, Australia and the United States their strong banking and financial systems. In emerging economies, capital flight in response to new information about exchange rate risk, default risk or deteriorating fiscal and monetary policy settings can

spark currency and financial crises like that experienced in East Asia in the late 1990's. Such crises impose substantial short term economic, social and political costs.

Before the Asian crisis in the late 1990's for instance foreign funds were intermediated through a banking system that directed funds to unproductive investment activities encouraged by government interference. Substantial 'connected lending' and government 'directed lending' was undertaken and a lack of transparency delayed foreign investors' awareness of the extent of the underlying structural problems. However, once foreign investors realised the extent of these deficiencies, equities and debt instruments were quickly liquidated in favour of relatively more attractive, less risky investment opportunities elsewhere in the world.

In advanced economies, foreign lenders may also view rising foreign debt levels with concern on the grounds that they perceive rising default risk. For instance, if the borrowing country's foreign debt level becomes very high, foreign lenders may then become less willing to lend to domestic borrowers. As a result, the differential between domestic and world interest rates widen because domestic interest rates incorporate a risk premium.

Even if a sizeable risk premium did emerge, it can be shown theoretically that domestic interest rates inclusive of such a premium could never exceed interest rate levels that would result if external borrowing was suddenly prohibited. In other words, rising foreign debts levels could push domestic interest rates above prevailing world rates, but never above rates that would prevail in the absence of capital inflows. In any event, a risk premium would automatically act to limit further external borrowing.

Conclusion

A fundamental reason for the persistence of external deficits is that domestic private savings fall short of investment opportunities as perceived by residents and non-residents alike. While this may suggest public policy initiatives of a microeconomic nature to encourage greater domestic saving, attempts to change saving behaviour

permanently may well be frustrated since consuming less out of disposable income would immediately lower living standards for households.

External deficits endure in select advanced economies because foreign investors deem that excess national expenditure over production funded by their financial capital will prove sufficiently productive. Without earlier capital inflow from abroad, Australia, New Zealand, the United States and a host of other borrower countries, including many fast growing emerging economies in our region would be on a considerably lower plateau of economic development**.**

Permitting international capital to flow liberally improves economic welfare for it frees borrower economies from the constraint of their own saving levels. Nonetheless, it may be argued that external deficits suggest domestic saving is 'too low' and that the external imbalance should be targeted by increasing saving relative to domestic investment via reduced private and public consumption.

Yet at given income levels, higher private saving implies lower household consumption and hence living standards in the short term. Scope may exist to raise overall domestic saving through fiscal measures that reduce public consumption. However, notwithstanding domestic macroeconomic policy initiatives, targeting the external deficit could prove elusive if it continues to result from international economic factors beyond domestic policymakers' control.

Similarly, a focus on the rise in external debt stemming from greater capital market integration with the rest of the world can enable higher national wealth because it allows the nation's capital stock to grow larger. In judging the macroeconomic significance of New Zealand's foreign debt level, it is the measure of the difference between total national assets inclusive of the business capital stock, government capital stock and dwellings against the value of external liabilities that is of critical importance, not simply the size of the debt to GDP ratio, measured in isolation.

Currently, a national balance sheet for New Zealand is not regularly published. However, developing one would seem to be a high priority as new estimates of the gains in national wealth relative to rises in external debt would put the scale of foreign debt into its proper macroeconomic accounting context. Should such estimates mirror Australia's national wealth gains since the mid-1980's, New Zealand's foreign debt would not be a matter of concern.

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