Chapter 2

Background to Australia's current account

The household sector has been borrowing (indirectly, via the banking system) from the rest of the world to fund spending in excess of income.[1]

What is the current account?

2.1 Put simply, the current account indicates whether a country has absorbed more goods and services and income than has it produced.[2] A current account deficit means that total payments exceed total receipts, while a current account surplus means the reverse.

2.2 Another way of looking at the current account is through savings and investment. If a country's balance on current account is in deficit, then national investment exceeds national saving and the country is a net recipient of investment funds from the rest of the world.

2.3 A current account deficit (CAD) is financed by borrowing from overseas and/or by foreign equity investments in Australia.

Australia's current account[3]

2.4 Since 1950, Australia has had a surplus on its current account in only four years: 1950-1, 1952-3, 1956-7, and 1972-3. The other years all recorded current account deficits. [4]

2.5 The annual balance on current account from 1959-60 to 2004-05 is shown in Table 2.1. In 2004-05 the balance on the current account was in deficit by $57.2 billion.

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1 The Treasury, *Submission 13*, p. 6.

2 The ABS defines the balance on current account as the sum of the balances on goods trade, services trade, income and current transfers. *Measuring Australia's Economy*, ABS cat. 1360.0. See also Footnote 6.

3 This description of Australia's current account is largely based on the submission from the Department of the Treasury (Submission 13). The Treasury was helpful in providing the Committee with updated versions of the graphs contained in its submission so that this report could reflect the latest available figures.

4 The Treasury submission states that since European settlement Australia has had current account deficits in 9 out of every 10 years (Submission 13, p. 1), but Australia has had only 4 current account surpluses since 1950, the most recent in 1972-3.

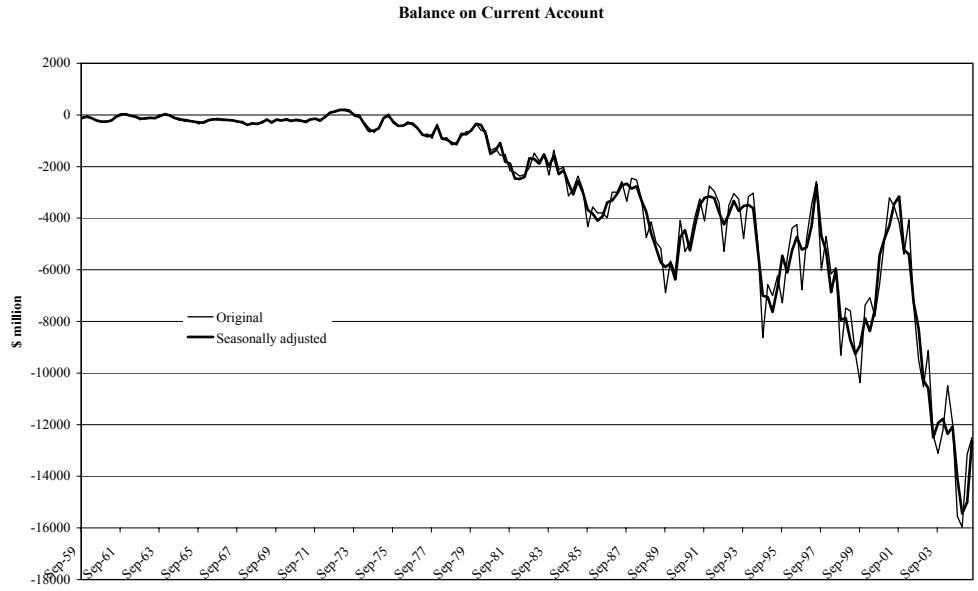
Table 2.1: Balance on current account, original, $billion[5]

Year	Balance on current account, $b	Year	Balance on current account, $b
1959-60	-0.5	1984-85	-11.3
1964-65	-0.8	1989-90	-22.7
1969-70	-0.8	1994-95	-28.4
1974-75	-1.3	1999-2000	-32.6
1979-80	-2.2	2004-05	-57.2

Source: ABS, *Balance of Payments and International Investment Position* (Cat. 5302.0)

2.6 Figure 2.1 shows the movement in the balance on current account on a quarterly basis since the September 1959 quarter, in value terms. Both original and seasonally adjusted figures are shown. Table 2.1 shows the annual results, while Figure 2.1 graphs the quarterly movements.

Figure 2.1: Australia's balance on current account, quarterly (September 1959 quarter to June 2005 quarter), $m, original and seasonally adjusted



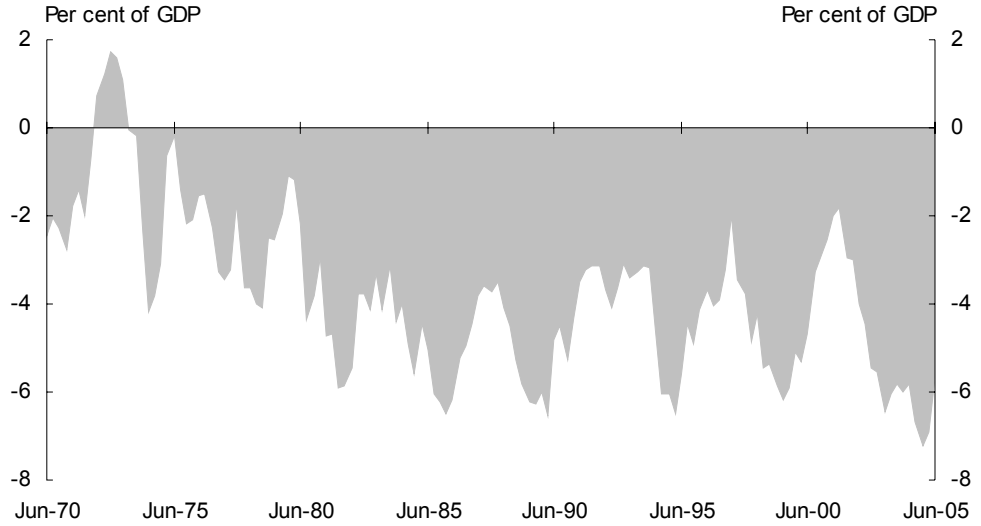
Source: ABS, *Balance of Payments and International Investment Position* (Cat. 5302.0)

[5] Unless otherwise stated, values in this report are expressed in A$ billions. $1 billion = 1000 x $1 million. The figures have generally been rounded to one decimal place.

2.7 The current account is often expressed as a percentage of Gross Domestic Product (GDP) to put its economic significance into context. The CAD fluctuated between 2 and 3 per cent of GDP in the 1960s and 1970s and between 4 and 6 per cent of GDP in the 1980s and 1990s. It has been over 5 per cent for the last 11 quarters (i.e. since the June 2003 quarter).

2.8 Australia's balance on current account as a percentage of GDP since 1970 is shown in Figure 2.2. Over that period Australia has recorded a deficit in every year except 1972-3.

Figure 2.2: Current account balance as a percentage of GDP, quarterly



Source: Australian Bureau of Statistics (ABS) catalogue no. 5302.0 and 5206.0.

2.9 Treasury's submission to the Inquiry explains that there are two ways of looking at the current account - from a trade perspective and from a savings/investment perspective.[6]

The current account from a trade perspective

2.10 From a trade perspective, a country's current account is the sum of its trade balance (exports of goods and services less imports of goods and services) and its

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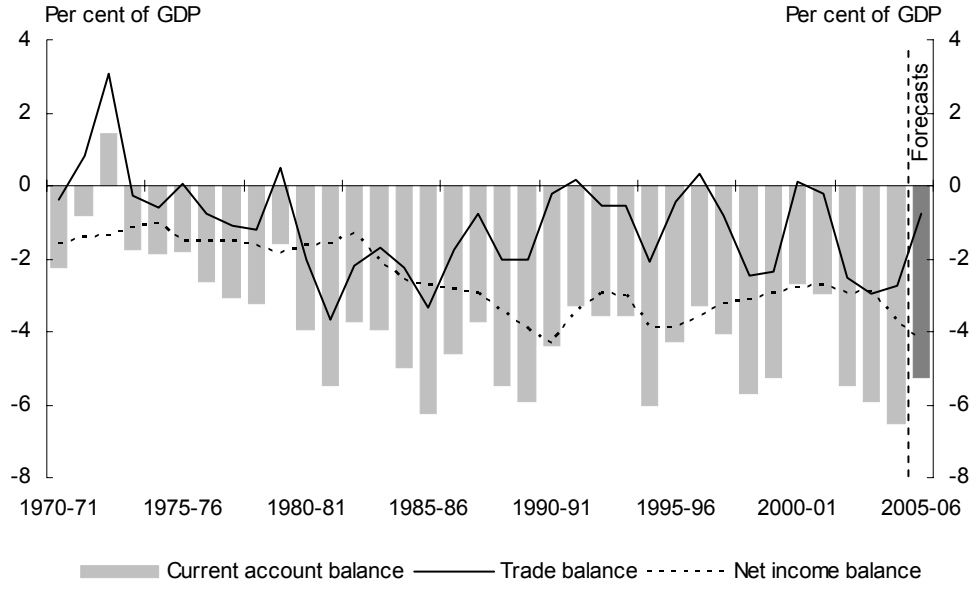
6 The Treasury, *Submission 13*, p.4.

income balance (interest payments and dividends received less paid) and current transfers.[7]

2.11 Figure 2.3 shows that the deficit in the income balance (the broken line in the graph) has usually been bigger than the deficit in the trade balance (continuous line) thus contributing more towards the overall deficit in the current account. However, most of the fluctuation in the current account has been as a result of fluctuations in the trade balance, as the net income deficit has been relatively stable, or slowly declining, since its sharp run up in the mid-1980s.[8]

Figure 2.3: Current account balance as a per cent of GDP, year average



Source: Australian Bureau of Statistics cat. no. 5302.0 and 5206.0, and Treasury.

Australia's trade balance

2.12 Australia has generally run a deficit in its balance of trade - that is, it tends to import more goods and services than it exports. Figure 2.4 shows that the gap between imports and exports has usually been relatively small. However, the value of exports of goods and services has exceeded the value of imports of goods and services in only 6 years since 1970.

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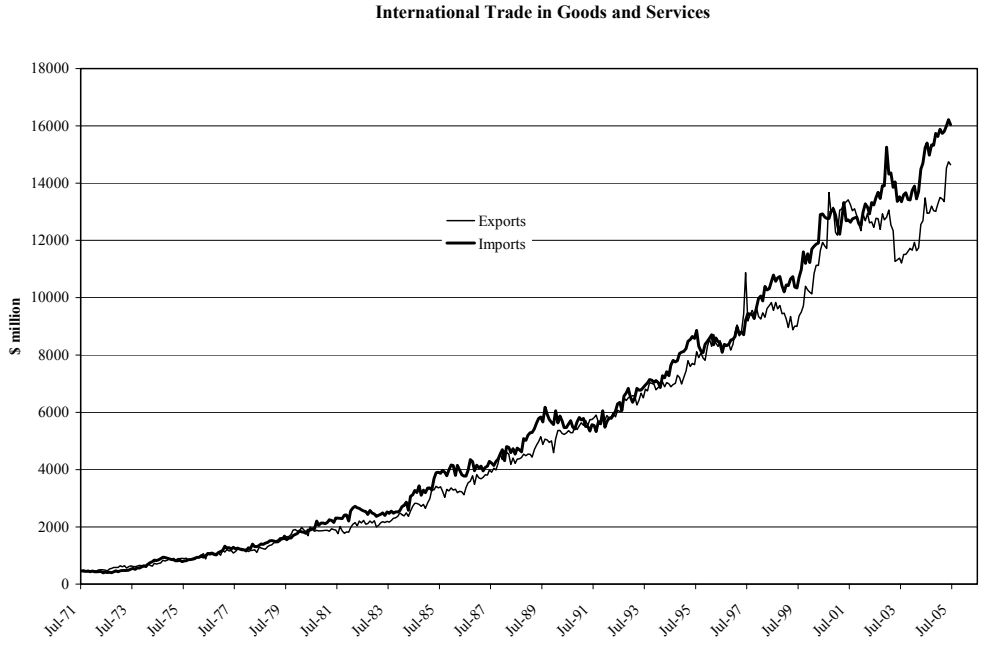
7 The trade balance is the difference between the total credit (export) value and the total debit (import) value of goods and services. The net income balance is the difference between the value of income (such as interest and dividends) earned by residents from non-residents (credits) and income earned by non-residents from residents (debits). Net current transfers are the difference between current transfer credits and debits (for example, Australian foreign aid is a debit, while pensions paid to Australian residents by foreign governments is a credit). These definitions are from *Measuring Australia's Economy*, ABS cat. 1360.0.

8 The Treasury, *Submission 13*, p. 2.

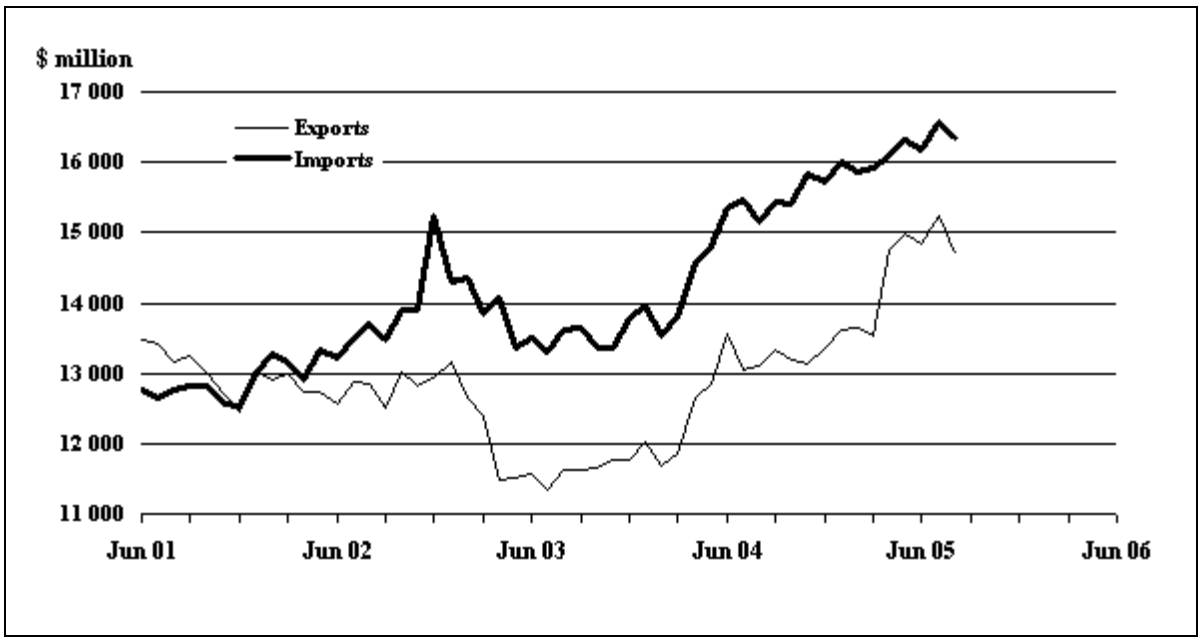
Figure 2.4: Australian imports and exports of goods and services, 1971 - 2005



Source: ABS, *International Trade in Goods and Services* (Cat. No. 5368.0). Monthly figures are seasonally adjusted.

2.13 Small balance of trade surpluses were achieved in 1996-97 and again in 2000-01, but then significant trade deficits were recorded in 2002-03, 2003-04 and 2004-05. Figure 2.5 shows these changes on an enlarged scale for the period June 2001 to June 2005. The trade deficit narrowed slightly in the June 2005 quarter as higher export prices for minerals and energy took effect and exports grew faster than imports, but then widened again in August 2005, when exports slowed more than imports.

Figure 2.5: Australian imports and exports of goods and services, 2001 - 2005



Source: ABS, *International Trade in Goods and Services* (5368.0)

2.14 Predictions are that export volumes of minerals and energy commodities are beginning to pick up, as infrastructure constraints are eased. The combination of high export prices and higher export volumes should result in the gap between exports and imports closing over the next few months.

2.15 The Treasury submission notes that the trade balance tends to move with the economic cycle. When domestic demand grows faster in Australia than in the rest of the world, import volumes tend to rise more than export volumes and so the trade deficit becomes larger (as has happened recently). During the recession of the early 1990s (and the slowdown around 2000), import volumes were more subdued and the trade deficit was correspondingly smaller.[9]

Australia's income balance

2.16 The income balance shows the annual cost of servicing Australia's net foreign liabilities. The change over the last 20 years in Australia's net foreign liabilities is shown in Table 2.2.

Table 2.2: Australia's net foreign liabilities[10], current prices, $billion

As at 30 June	Net foreign debt (borrowing), $b	Net equity liabilities, $b	Total net foreign liabilities, $b
1985	-53.1	-25.9	-78.9
1990	-130.8	-42.0	-172.8
1995	-190.8	-64.7	-255.5
2000	-272.6	-56.1	-328.8
2005	-430.0	-86.9	-516.8

Source: RBA monthly bulletin, *Table H5 Australia's net foreign liabilities*

2.17 Since 1950 Australia has always had deficits in its income balance - that is, Australia has paid more in interest payments and dividends on foreign borrowings and foreign investment in Australia than it has received from money Australia has lent and invested overseas.

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9 The Treasury, *Submission 13*, p. 2.

10 'Net foreign liabilities' is defined as Australia's gross foreign liabilities less gross foreign assets. This is also referred to as the 'Net international investment position'. RBA Bulletin, Notes to Table H5.

2.18 The main components of the income balance are payment of interest on foreign debt (borrowings) and payments of dividends and reinvested earnings on equity investments. These are shown in Table 2.3.

Table 2.3: Major components of Australia's income balance at current prices, 1999-00 to 2004-05, $billion[11]

Year	Net interest payments	% of total	Other net income payments[12]	% of total	Total net income payments	Total %
1999-00	-13.4	74%	-4.8	26%	-18.3	100%
2000-01	-14.6	78%	-4.1	22%	-18.7	100%
2001-02	-13.6	70%	-5.7	30%	-19.3	100%
2001-03	-11.6	54%	-9.9	46%	-21.5	100%
2003-04	-12.5	53%	-11.2	47%	-23.7	100%
2004-05	-15.4	49%	-15.8	51%	-31.2	100%

Source: RBA Monthly Bulletin, *Table H7 Australia's service payments on net foreign liabilities*

2.19 Figure 2.6 shows how the major components of the income balance 'net interest payments' and 'other net income payments' have changed since 1990, on a quarterly basis.

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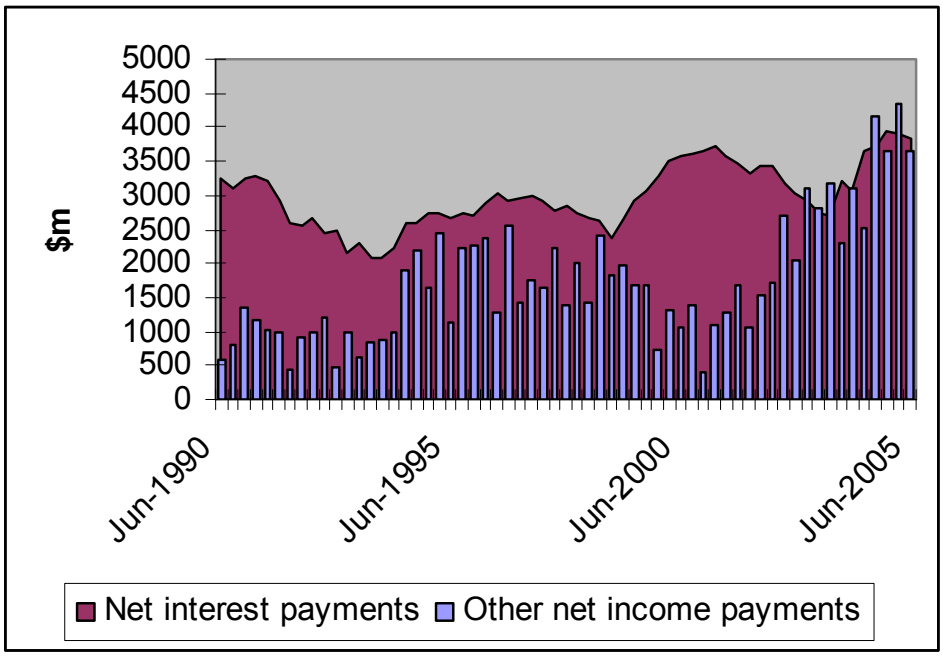
11 Current transfers are not included in this table. Net current transfers totalled -$420m in 2004 - 05. ABS, *Balance of Payments* (Catalogue 5302.0, June quarter 2005).

12 'Other net income payments' includes all non-interest income items such as dividends, reinvested earnings, and charges on accounts payable and receivable. RBA Bulletin, Notes to Table H7.

Figure 2.6: 'Net interest payments' and 'Other net income payments', quarterly changes, $m



Source: RBA *Monthly Bulletin,* Table H7

2.20 Until recently the 'Other net income payments' component of the income balance (shown as bars in Figure 2.6) was less significant than the 'Net interest payment' component within the total income balance. However, as Figure 2.6 shows that is changing with both components now representing about 50% each of the total. Changes in the income balance are discussed in more detail in Chapter 3 (paras 3.49 to 3.68).

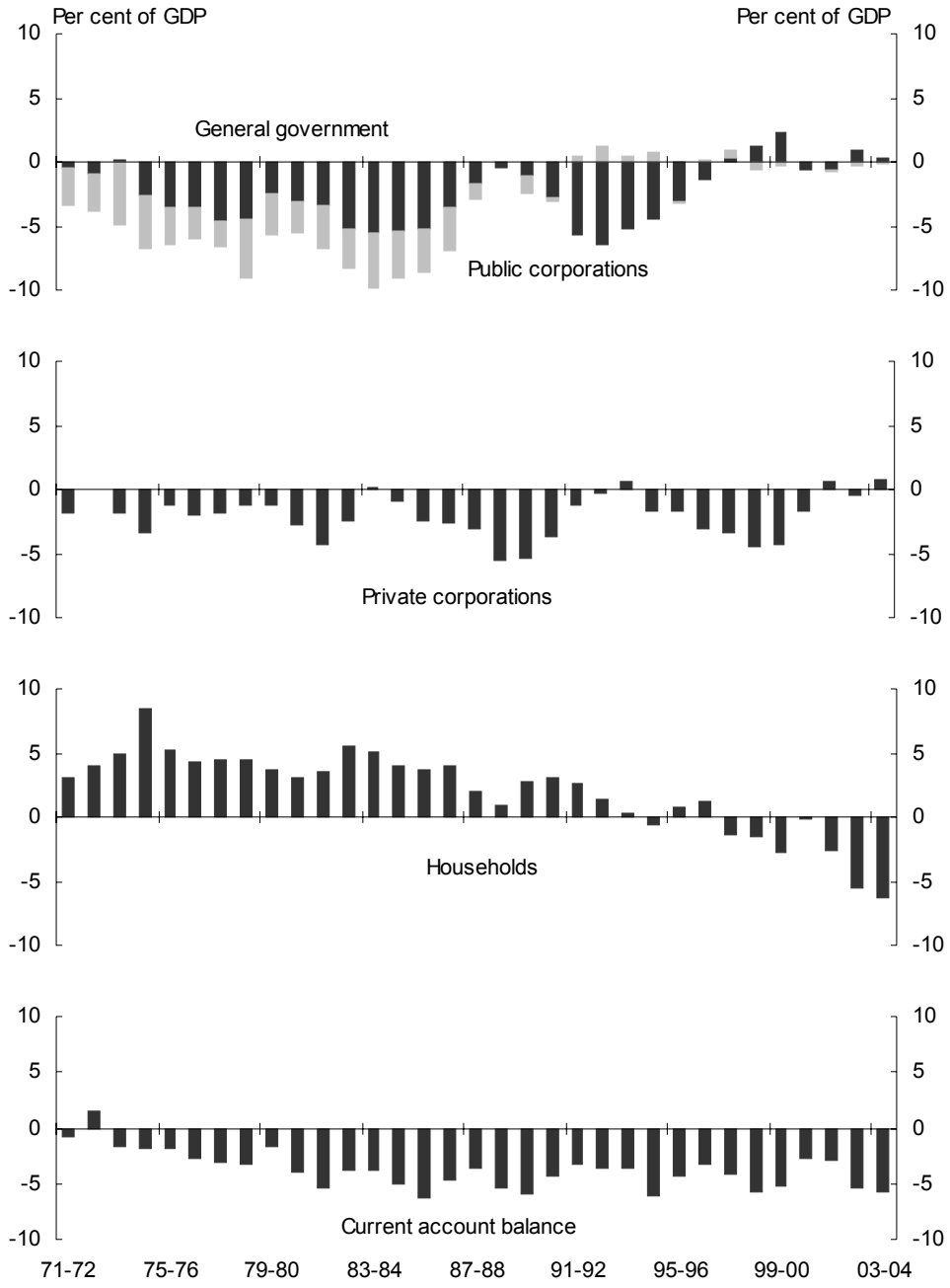
The current account from a savings/investment perspective

2.21 The Treasury submission explains that while the CAD is most commonly discussed from a trade perspective, it is best understood within a saving/investment framework. [13] This is illustrated in Figure 2.7.

2.22 The first three panels of Figure 2.7 show 'net lending' (when saving exceeds investment) or 'net borrowing' (when saving falls short of investment) by government, corporations and households in Australia. The final panel is the current account balance (which can be thought of as 'net borrowing' by Australia from the rest of the world). The numbers in first three panels add up to the current account balance shown in the final panel.

13 The Treasury, *Submission 13*, p. 4.

Figure 2.7: Net lending, year average



Source: Australian Bureau of Statistics cat. no. 5204.0, 5302.0 and Treasury (original data).

2.23 Figure 2.7 shows that for most of the period since 1970 the public (or official or government) sector (panel 1) was a net borrower, but it has now become a small net lender - that is, the public sector is in overall budget surplus.

2.24 The private sector is made up of private corporations and households. Panel 2 in Figure 2.7 shows that while private corporations have traditionally been borrowers, in recent years they have become net lenders as high profits exceed investment. In contrast, households (panel 3) have traditionally been net lenders (due to strong savings) but in recent years they have become net borrowers. Households have been

borrowing (indirectly, via the banking system) from the rest of the world to fund spending in excess of income.[14]

2.25 Over the past 15 years the household sector has changed progressively from being a net lender to the rest of the economy to being a net borrower. This reflects both an increase in household investment and a fall in household saving (see Chapters 4 and 5 for a detailed discussion of household debt in Australia).

2.26 The graphs in Figure 2.7 show that, from a savings/investment perspective, since about 2000-01 Australian household spending/debt has been the principal contributor to the current account deficit.

How does the CAD impact on net foreign liabilities?

2.27 Australia has nearly always had a deficit on its current account, although it wasn't until the 1980s that these deficits were associated with a build up of foreign debt (borrowings). Earlier deficits were relatively small and the capital inflow to finance those deficits was largely in the form of long-term equity investment. However, from the early 1980s the size of the average CAD almost doubled, to 4.4 per cent of GDP, over the next 20 years.[15] Almost all the capital inflow which financed these higher deficits was in the form of overseas borrowings rather than equity.

2.28 While current account deficits contribute to a nation's net foreign liabilities, the CAD for a given period does not necessarily equal the change in net foreign liabilities that occurred over that period. For example, in 2004-05 the current account deficit totalled $57 billion, but net foreign debt (borrowings) increased by $35 billion and net foreign equity increased by $11 billion, giving a total increase in net foreign liabilities of $46 billion over that 12 months.

2.29 The relationship between the CAD and net foreign liabilities is quite complex. A detailed explanation is provided in Appendix 3.

How does Australia's current account compare with other countries?

2.30 In 2004, of the 30 countries included in the bulletins of the Organisation for Economic Cooperation and Development (OECD), thirteen had current account surpluses and seventeen had deficits. The overall average for the OECD was a deficit of 1.2% of GDP.[16]

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14 The Treasury, *Submission 13*, p. 6.

15 See Figure 2 in Chapter 3 for details.

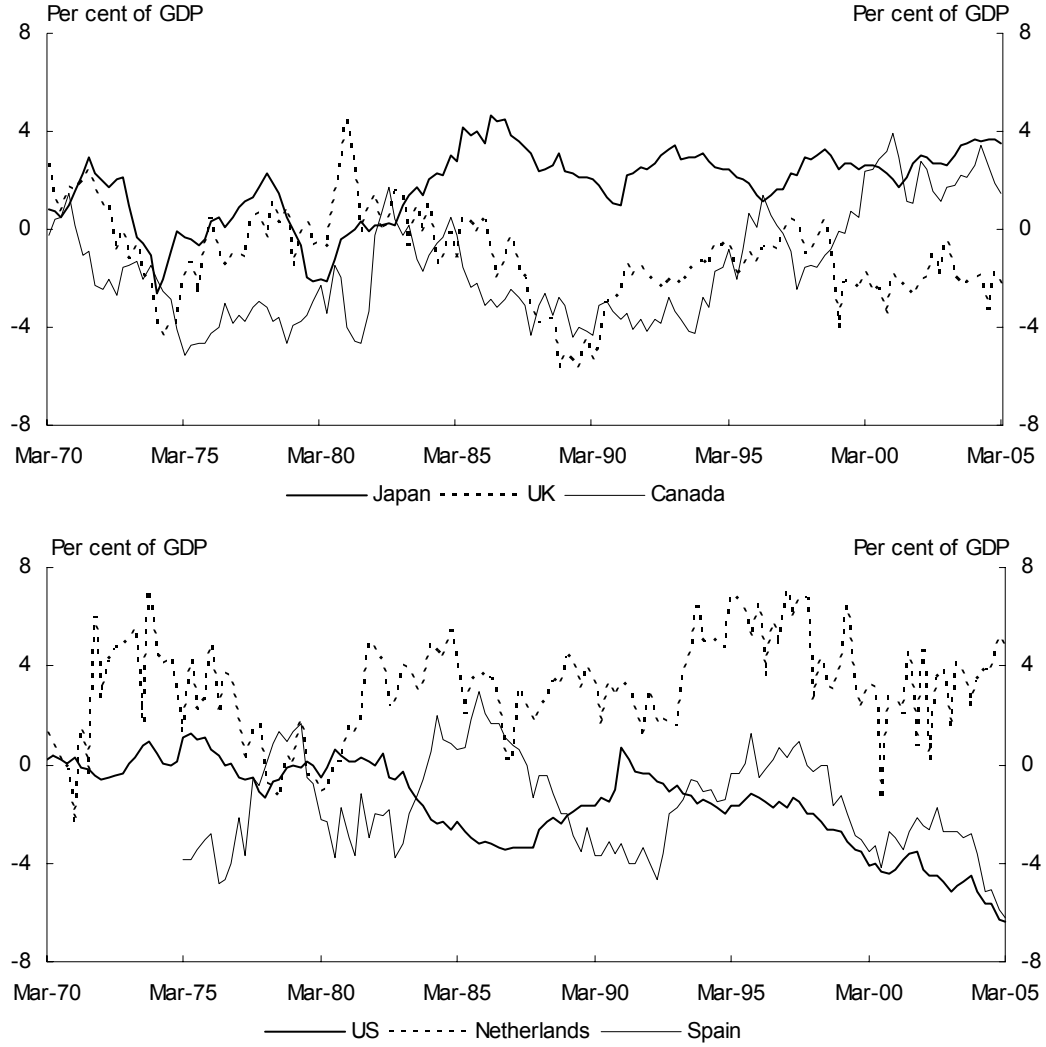
16 OECD, *Economic Outlook*, No. 77, June 2005.

2.31 Of the countries with surpluses, only Austria (0.3%) had a current account surplus of less than 2.6%. The highest surpluses were recorded by Sweden (8.0%), Luxembourg (8.8%), Switzerland (12.0%) and Norway (13.8%).

2.32 Of the countries with a current account deficit, the lowest was France (0.3%) and the highest were Australia and New Zealand (both 6.3%), Portugal (7.8%), Iceland (8.1%), and Hungary (9.4%).

2.33 Figure 2.8 (below) shows the movement in the current account as a percentage of GDP of six OECD countries since 1970: Japan, UK and Canada are shown in the first panel, and the USA, the Netherlands and Spain in the second panel.

Figure 2.8: Current account balance as a per cent of GDP, quarterly, selected countries



Source: OECD *Economic Outlook Bulletin*

2.34 The graphs suggest that the early 1980s were a turning point for several countries. Since then, the USA, UK and Spain have experienced mainly deficits in their current accounts while Japan commenced a period of sustained surpluses. That was also the time that Australia's average CAD stepped up to a new level (see Figure 3.2).

2.35 Canada has had an interesting experience with its current account. After recording a number of relatively high current account deficits in the 1970s and 1980s, in 1994 the size of the deficits started shrinking and Canada has recorded current account surpluses since 1999.

2.36 Given the similarities between Australia and Canada, the Committee feels that there may be salient lessons to be learnt from Canada's experience.