

Appendix 3

Relationship between the current account deficit and foreign liabilities¹

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 not associated with a build up of debt because the deficits were generally lower and the capital inflow to finance these deficits was largely in the form of long-term equity investments. From the early 1980s, however, Australia experienced persistently high current account deficits (CAD) and almost all the capital inflow needed to finance these deficits was in the form of overseas borrowings.

While current account deficits contribute to a nation's net foreign liabilities, the CAD for a given period does not have to equal the change in net foreign liabilities that occurred over that period. For example, in round figures 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.

The Valuation Effect

A current account deficit in a given period is equal to the change in net foreign liabilities (i.e. debt plus equity) that occurred over that period minus the valuation effects. Valuation effects, which can be substantial, are those changes in the value of net foreign liabilities that are due to exchange rate movements and equity revaluations (mainly revaluations of issued shares and securities purchased by overseas investors).

1 Appendix 3 is largely based on Research Note No. 40 of 29 April 1996, titled *Relationship between the current account deficit and foreign debt* published by the Department of the Parliamentary Library. The figures in the original Research Note have been updated from ABS *Balance of Payments and International Investment Position*, Cat. 5302.0.

Table 1 illustrates the relationship between the current account deficit in 2004-05 and the change in net foreign liabilities that occurred during that 12 months.

Table 1: Relationship between CAD and net foreign liabilities

	Changes in levels June Qtr 2004 to June Qtr 2005		
	Total (\$m)	Valuation effects (\$m)	Capital transactions (total less valuation effects) (\$m)
Net equity liabilities	11052	9003	2049
<i>plus</i>			
Net foreign debt	35284	-18316	53600
<i>equals</i>			
Net foreign investment position	46336	-9313	55651
	2004-05		
	(\$m)		
Financial account surplus	55651		
<i>plus</i>			
Capital account surplus	1200		
<i>plus</i>			
Net errors and omissions	320		
<i>equals</i>			
Current account deficit	57171		

From the figures in Table 1, Australia had a financial account surplus of \$55 651 which, after adjustments, resulted in a CAD of \$57 171 million in 2004-05. That deficit was financed by an inflow of \$53 600m in debt (borrowings) and \$2 049m in equity investment. The valuation effects during the 12 months totalled -\$9 313m, so the increase in Australia's net foreign liabilities was \$46 336m.

In theory a current account deficit should equal the capital account surplus, but in practice these items are rarely in balance and equality has to be achieved by a balancing item, called 'errors and omissions' in Table 1.

It should also be noted that just as current account deficits can affect the level of Australia's net foreign debt, so the cost of servicing this debt can add directly to our current account deficit by increasing the income deficit.

Table 2 shows the value of the components involved in calculating the increase in net foreign debt (borrowings) since 1988-98. Table 3 shows the same process for net foreign equity. Table 4 shows how net foreign debt and net foreign equity added to net foreign liabilities or Australia's net international investment position (i.e. basically the total of Tables 2 and 3).

Table 5 shows the adjustments made to the CAD each year to arrive at the Financial Account Surplus figure.

Note that the figures in Table 1 are in \$ millions, but in Tables 2, 3, 4 & 5 are in \$ billions rounded to the first decimal point.

Effect of Revisions on the Size of the Current Account Deficit

The monthly balance of payments estimates are often subject to considerable revision.

Revisions may occur for a number of reasons, including:

- revisions to estimates provided by a data source;
- estimates from a more timely but less accurate data source are replaced by estimates from a different, less timely but more accurate data source;
- improvements in the method of compiling the balance of payments estimates from the data source; and
- changes in the concepts underlying the estimates.

A study of the monthly current account deficit figures published over the 10 years June 1986 to June 1996 found that initial estimates were lower than the later estimates on 55 occasions and greater than the later estimates on 66 occasions. So there was not a great difference in the frequency with which first estimates of the current account deficit are either underestimates or overestimates. Moreover, the size of the revision was about the same, being on average \$219 million for a revision upward to the current account deficit and \$212 million for a revision downward to the current account deficit.

Table 2: Components of Annual Increase in Net Foreign Debt (borrowings), \$billion

	Net foreign debt at beginning of period	Transactions	Valuation effects	Net foreign debt at end of period	Total increase in net debt
1988-89	96.5	14.9	2.6	114.0	17.5
1989-90	114.0	16.1	0.8	130.8	16.8
1990-91	130.8	6.7	5.7	143.2	12.3
1991-92	143.2	13.6	5.7	162.5	19.3
1992-93	162.5	7.9	7.1	177.5	15.0
1993-94	177.5	4.6	-10.7	171.3	-6.1
1994-95	171.3	19.4	0.05	190.8	19.5
1995-96	190.8	10.0	-6.9	193.9	3.1
1996-97	193.9	12.6	2.2	208.6	14.8
1997-98	208.6	5.1	14.0	227.8	19.2
1998-99	227.8	13.7	-10.8	230.7	2.9
1999-00	230.7	37.9	4.1	272.6	42.0
2000-01	272.6	5.2	24.7	302.5	29.9
2001-02	302.5	38.0	-16.3	324.2	21.7
2002-03	324.2	45.9	-12.2	357.9	33.7
2003-04	357.9	51.8	-15.0	394.7	36.8
2004-05	394.7	53.6	-18.3	430.0	35.3

Source: ABS, *Balance of Payments and International Investment Position* (Cat. No. 5302.0)

Table 3: Components of Annual Increase in Net Foreign Equity, \$billion

	Net foreign equity at beginning of period	Transactions	Valuation effects	Net foreign equity at end of period	Total increase in net equity
1988-89	31.3	1.9	2.8	36.0	4.71
1989-90	36.0	4.9	1.2	42.0	6.0
1990-91	42.0	9.2	-2.8	48.3	6.31
1991-92	48.3	-1.4	-3.2	43.7	-4.6
1992-93	43.7	6.0	-6.1	43.7	0.0
1993-94	43.7	12.2	8.9	64.8	21.1
1994-95	64.8	9.0	-9.1	64.7	0.1
1995-96	64.8	7.9	8.9	81.4	16.6
1996-97	81.4	5.0	-4.9	81.5	0.1
1997-98	81.5	19.5	-31.9	69.2	-12.3
1998-99	69.2	16.4	5.4	91.0	21.8
1999-00	91.0	-6.8	-28.0	56.1	-34.9
2000-01	56.1	11.1	-4.1	63.1	7.0
2001-02	63.1	-18.8	-3.2	41.0	-22.1
2002-03	41.0	-5.6	34.9	70.3	29.3
2003-04	70.3	-5.9	11.4	75.8	5.5
2004-05	75.8	2.1	9.0	86.9	11.1

Source: ABS, *Balance of Payments and International Investment Position* (Cat. No. 5302.0)

Table 4: Net international investment position at end of period, \$ billion

	Net foreign debt (borrowings)	Net foreign equity	Net international investment position
1988-89	114.0	36.0	149.9
1989-90	130.8	42.0	172.8
1990-91	143.2	48.3	191.5
1991-92	162.5	43.7	206.2
1992-93	177.5	43.7	221.1
1993-94	171.3	64.8	236.1
1994-95	190.8	64.7	255.5
1995-96	193.9	81.4	275.3
1996-97	208.6	81.5	290.2
1997-98	227.8	69.2	296.9
1998-99	230.7	91.0	321.7
1999-00	272.6	56.1	328.8
2000-01	302.5	63.1	365.6
2001-02	324.2	41.0	365.1
2002-03	357.9	70.3	428.1
2003-04	394.7	75.8	470.5
2004-05	430.0	86.9	516.8

Source: ABS, *Balance of Payments and International Investment Position* (Cat. No. 5302.0)

Table 5: Adjustments involved in calculation of the current account deficit and the financial account surplus, \$ billion

	Financial account surplus	Capital account surplus	Net errors and omissions	Current account deficit
1988-89	16.9	2.0	0.2	19.0
1989-90	20.9	2.0	-0.1	22.7
1990-91	15.9	2.1	-0.5	17.5
1991-92	12.1	2.1	-1.0	13.3
1992-93	13.9	0.6	0.6	15.1
1993-94	16.8	0.3	-1.0	16.1
1994-95	28.4	0.6	-0.6	28.4
1995-96	17.8	1.1	2.6	21.5
1996-97	17.6	1.3	-1.3	17.6
1997-98	24.6	1.1	-3.0	22.8
1998-99	30.1	1.2	2.3	33.6
1999-00	31.1	1.1	0.5	32.6
2000-01	16.3	1.1	0.8	18.2
2001-02	19.2	1.0	0.9	21.1
2002-03	40.3	1.0	0.3	41.6
2003-04	45.9	1.1	0.8	47.8
2004-05	55.7	1.2	0.3	57.2

Source: ABS, *Balance of Payments and International Investment Position* (Cat. No. 5302.0)

