Guy Debelle: In defence of current account deficits

Address by Mr Guy Debelle, Assistant Governor (Financial Markets) of the Reserve Bank of Australia, at the ADBI/UniSA Workshop on Growth and Integration in Asia, Adelaide, 8 July 2011.

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Thank you to Tony Cavoli and the other organisers for putting together this interesting conference examining issues around trade and capital flows. I'm very pleased to be in my home town to give this talk which will address the theme of the conference.

Current account deficits have a pretty poor reputation, unfairly so in my opinion. While in some instances this reputation is earned, today I want to provide some arguments in their defence, highlighting that there are a number of circumstances in which one should not be concerned about their presence. In particular, I want to make the point that deficit does not have to equate to imbalance. Deficits are not always and everywhere a bad thing, notwithstanding the pejorative connation of the word deficit.[1]

Cross-border capital flows, which are the mirror of current account positions, can convey large benefits. As the BIS states in its recent Annual Report: "international financial flows … free firms' investment decisions from domestic financing constraints while allowing investors to reduce risks and optimise returns by globally diversifying their assets. International financial flows thus enhance the efficiency with which capital and know-how are allocated."[2] This is very much the argument I wish to prosecute, but the BIS then follows this positive statement with a chapter highlighting the risks of international flows.

Much of my argument is presented considerably more eloquently in a recent paper by Max Corden, and I commend that paper to you.[3] I hope I can do some justice to the position Max puts.

I will start by presenting a short summary of the global imbalance argument. Then I will present a framework with which one can think about the issue and present a case for the defence. In the final part of the speech, I will describe some recent developments in the Australian current account position and particularly the associated capital flows.

Current account imbalances

Olivier Blanchard and Gian Maria Milesi-Ferretti provide a concise summary of the global imbalance argument in a recent IMF paper.[4] They describe the difference between "good" and "bad" current account deficits. Bad current account deficits are those which result from domestic distortions or excessive fiscal positions. Good ones are those which do not have such causes.

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1 It is interesting to note that the language associated with current account deficits also tends to be pejorative. Current account deficits worsen rather than widen and improve rather than narrow.

2 BIS (Bank for International Settlements), BIS Annual Report 2010/11, p 33.

3 Corden WM (2011), "Global Imbalances and the Paradox of Thrift", *CEPR Policy Insight*, No 54; see also Corden WM (2008), "The Global Imbalances: What is the Problem", Revised version, Wincott Lecture, September 2007 and Corden WM (2007), "Those Current Account Imbalances: A Sceptical View", *The World Economy*, 30(3), pp 363–382.

4 Blanchard O and GM Milesi-Ferretti (2011), "(Why) Should Current Account Balances be Reduced?", IMF Staff Discussion Note 11/03.

This is effectively Pitchford/Lawson redux.[5] As you may recall, John Pitchford and Nigel Lawson (then Chancellor of the Exchequer) presented the "consenting adults" view of current account positions. As long as current account positions are the result of savings and investment decisions by the private sector which are not affected by distortions, then there is no cause for concern.

Pitchford and Lawson used this framework to argue that the current account positions in their respective countries (Australia and the UK) did not represent an imbalance, given the absence of any apparent distortions. In contrast, Blanchard and Milesi-Ferretti conclude that even good current accounts are mostly bad too and hence most current account deficits are imbalances.

Blanchard and Milesi-Ferretti also make the point that it is important to look beyond current accounts to the whole structure of the capital (financial) accounts. While disagreeing with their conclusion just mentioned, this is a point I would wholeheartedly endorse for two reasons:

- Firstly, current accounts are fundamentally endogenous. They reflect the net outcome of a raft of savings and investment decisions taken by households, businesses and government across the whole economy. The current account position is a symptom not the cause. If one is concerned about the imbalance, the focus should be on the policy that is causing it.
- Secondly, the capital (or financial) account, which is the mirror of the current account, is the net of a large array of gross capital flows. These flows reflect the financial decisions taken by both domestic and foreign investors.

For example, in the global imbalances debate, it is often noted that Europe has a current account position that is close to zero. This is true, but it masks large divergences between current account positions within the euro area, which are symptomatic of the problems manifesting themselves now. Secondly, there is nothing intrinsically optimal about zero. It may well be the case that the appropriate balance for Europe is not zero but distortions of one form or another have delivered such an outcome. If that were the case (and I am not arguing that it necessarily is), then Europe would be contributing to global "imbalances" as much as those with large current account positions. Thirdly, behind the European zero balance, there are very large capital flows in both directions. Some of these, most obviously investment in US sub-prime mortgage securities, were clearly problematic, while others were clearly beneficial.

Similarly, the US current account deficit through the 2000s was the net balance of very large capital inflows and outflows. Much of the inflows were into either US treasuries or to US mortgage securities and related products, while a sizeable share of the outflow was foreign direct investment by US corporations. The US was able to earn relatively more on its stock of foreign assets than it paid on its foreign liabilities such that its net income position was often in surplus.[6] Some of the flows were "bad", at least *ex post*, such as those which found their way into poor-performing securities. However, very few were able to identify *ex ante* the distortion that was generating these "harmful" flows. Other flows were clearly "good". But the point to make is that focusing on the net balance of these flows, which is the current account position, is not particularly helpful relative to more scrutiny of the various components of the gross capital flows.

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[5] Pitchford J (1989), "A Sceptical View of Australia's Current Account and Debt Problem", *The Australian Economic Review*, 86, pp 5–14.

[6] This "exorbitant privilege" is examined in detail by Gourinchas P-O and H Rey (2005), "From World Banker to World Venture Capitalist: US External Adjustment and the Exorbitant Privilege", NBER Working Paper 11563 and Curcuru S, T Dvorak and F Warnock (2010), "Decomposing the U.S. External Returns Differential", *Journal of International Economics*, 80, pp 22–32.

Some context

To mount a defence of current account deficits, I would like to provide a bit of context with which to think about this issue. One place to start is with an overlapping generations model of a closed economy,[7] which we can think of as a country. Within this country there are households that are at various stages of their lifecycle. The younger working households save, the middle-aged households borrow, while the older households run down their stock of accumulated saving. So we have "imbalances" across the household sector.[8] The young households have current account surpluses, the middle-aged households like me are in current account deficit. But these "imbalances" are not generally cause for concern. It would not be socially desirable if there were no cash flows between households.

Alternatively, we could consider the Australian states. At any point, there can be large current account positions between the Australian states. There are large financial flows across state borders too. Are we even aware that this is the case and should we be concerned? By and large, we should not. Again it is useful to think about why any such imbalances across the Australian states are not a cause for concern. Here we are straying into the optimal currency literature, most famously associated with Robert Mundell, which is currently getting a fair working over in the context of the problems of the European periphery.

Some of the reasons we are not concerned about the current account "imbalances" of the Australian states are that the Australian states have a common currency, a federal fiscal system, sizeable interstate labour mobility (of which I and much of my Adelaide cohort are a good example of) and generally experience similar economic shocks. These are the main prerequisites identified for an optimal currency area.[9]

The point of the two scenarios I've described here is that current account positions, even large ones, can exist that are benign and could not be classified as imbalances. The capital flows that are the counterpart to these current account positions are "good", because they are associated with appropriate intergenerational transfers in the first case, and appropriate cross-border flows in an integrated economy in the second.

Max Corden distils the concern that many have about global imbalances down to a concern about the *"return journey"*. Lenders of capital expect to receive the money they have lent back with interest (dividends if it is an equity investment).

One reason that might increase concern as we move from transfers between households to crossing state borders to crossing national borders is that the information asymmetry about the return journey increases. Amongst other things, the geographic separation reduces the ability of the lender to monitor the use of funds by the end-borrower. One could question why this still remains true today, with increased transparency and lower cost of information.

For example, in the recent episode, the funds that made their way to the US housing market over the 2000s had a long and non-transparent chain between the provider of the funds and the ultimate borrower. There were major problems of information asymmetry and failures of due diligence right along the chain.

Another reason that borders matter is that the capacity to borrow in one's own currency is important. The claims across state borders are denominated in Australian dollars, which are

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[7] This is the model which Olivier Blanchard himself taught me!

[8] In this stylised world, one could also add the corporate sector to the mix. As they are generally a net borrower, they would be another generator of current account deficits.

[9] In the current economic climate in Australia, one could think about the possibility of the Western Australian economy experiencing an exchange rate appreciation relative to the rest of the country to mitigate the adjustment. However, the assessment is that the benefits of a common currency union for the Australian states vastly outweigh any costs.

easily settled without doubt in the integrated Australian financial system. Indeed, the system is so integrated that there is no easily obtainable measure of cross-border claims for the states.

A further aspect that appears to be a common cause for concern about current account deficits is the economic adjustment that might ensue were they to narrow precipitously. Much of this concern appears to stem from a fixed exchange rate world. In a fixed exchange rate world, sudden stops can (and did) occur that are very disruptive. Capital inflows dry up rapidly and capital outflow increases, necessitating a sharp contraction of domestic demand so that the trade balance moves into surplus. Inevitably, this is associated with a domestic recession.

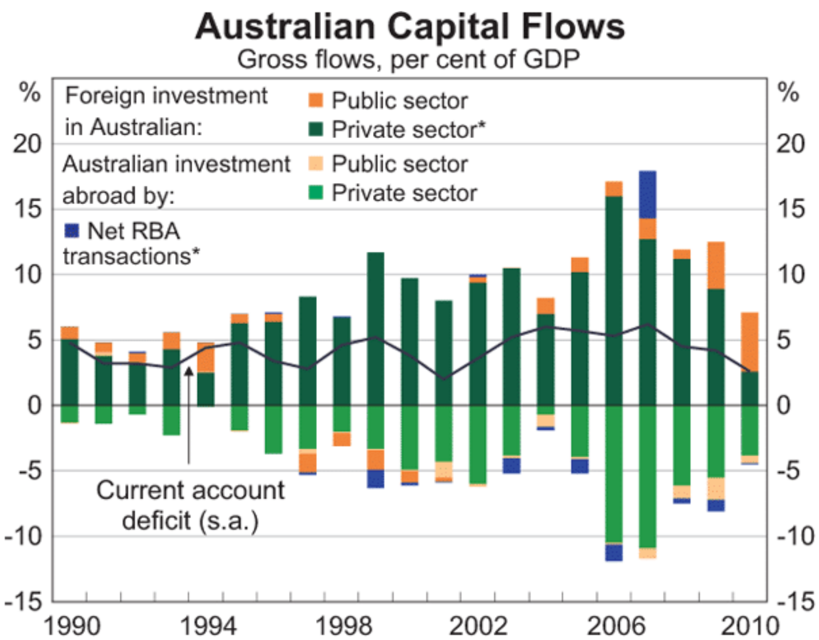
Such a scenario does not directly translate into a world of floating exchange rates. In that environment, the main mechanism of adjustment is the exchange rate. If global investors reduced their appetite for investment in a particular country, the exchange rate would depreciate until the point where investors would be happy once again with their allocation to the country in their overall portfolio. While the exchange rate might overshoot in this scenario, the depreciation is stimulatory to the economy, whereas in the fixed exchange rate world, the adjustment is contractionary.

The conclusion I wish to draw then is that there can be perfectly good reasons why current account balances are not zero, and indeed can even be quite sizeable, without them constituting imbalances or being a cause for concern. The accompanying capital flows are often beneficial. This is not to say that they should not be scrutinised but rather that the scrutiny should really be on the nature of those capital flows to examine whether they are being driven by inappropriate policies or distortions.

Recent changes in the composition of Australia's capital flows

With the previous discussion in mind, I will now turn to a short analysis of the Australian situation. Over the past three years, there have been some quite sizeable changes in the size and composition of Australia's current account and capital account.

Graph 1



* Adjusted for US dollar swap facility in 2008 and 2009
Sources: ABS; RBA

From the early 1990s until 2007, Australia recorded a current account deficit which averaged around 4¼ per cent of GDP (Graph 1).[10] There were cycles around that level, with the current account narrowing to 2 per cent of GDP in 2001 in the aftermath of the Asian crisis and widening to around 6 per cent of GDP in 2007.

At the same time, there was reasonable stability in the major components of the capital account. The inflow arising from the offshore funding of the banking sector was around 3½ per cent of GDP. This led to the common assessment that the Australian banking sector was "funding the current account".

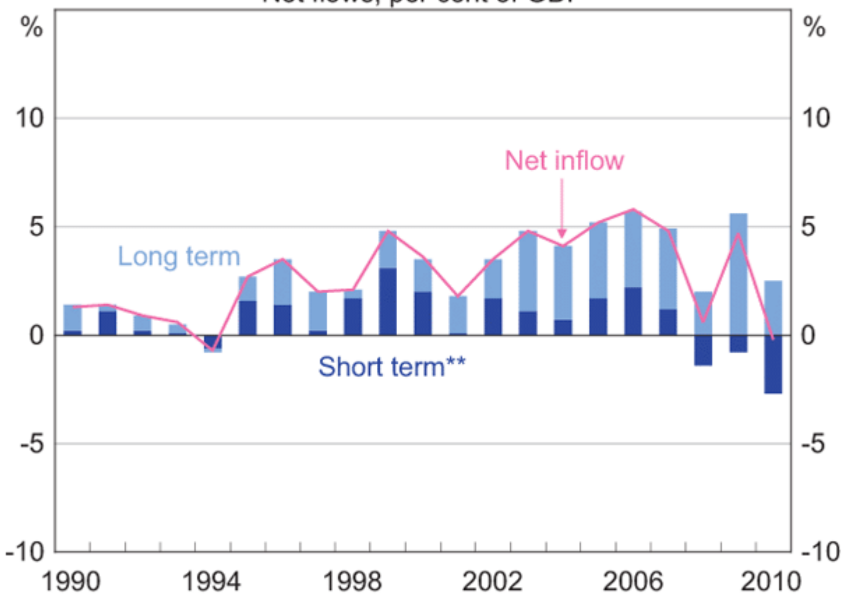
In my opinion, this analysis is incomplete. As mentioned earlier, a current account deficit and its equivalent capital account surplus is the net outcome of considerably larger gross flows. This is evident in Graph 1. Through this period there was substantial Australian investment abroad, particularly in the form of equity. Much of this was the result of the Australian superannuation sector investing a sizeable share of their funds in offshore equity markets. At times, there were also sizeable equity inflows to Australia.

Over the past few years, the composition of these capital flows has changed quite significantly, providing some contrary evidence to the hypothesis that the banks fund the current account. I don't think there was any particular problem with the structure of these capital flows previously, nor do I think there is one now.

Graph 2

Net Debt Flows to the Australian Banking Sector*

Net flows, per cent of GDP



* Excludes direct investment and financial derivatives

** Adjusted for US dollar swap facility in 2008 and 2009

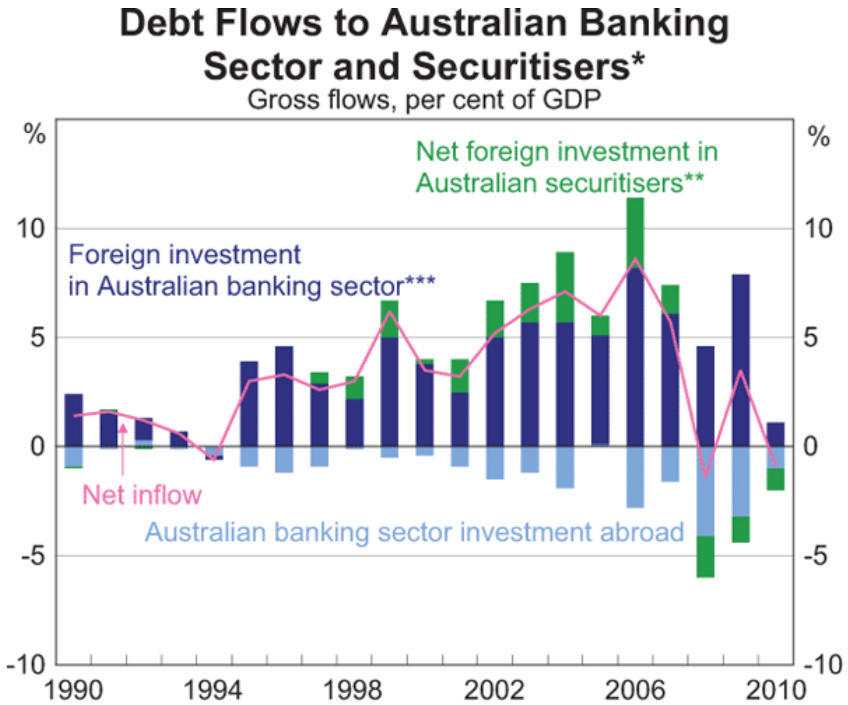
Sources: ABS; RBA

In 2010, the net inflow to the Australian banking sector was close to zero (Graph 2). Indeed, over the last three quarters of 2010, the Australian banking sector was a net repayer of its offshore liabilities. That is, maturities exceeded issuance. This did not reflect a lack of appetite for Australian bank paper, as the cost of issuance was broadly flat or even slightly

10 Indeed, Australia has recorded a current account deficit for much of its history.

lower over the period. Instead, as I discussed in a recent speech,[11] it reflected the fact that the banks had less need for wholesale borrowing given the conjuncture of fast deposit growth and subdued asset growth. The terming out of the banking sector's funding is also evident in the decline in the stock of short-term foreign liabilities but an increase in their longer-term liabilities.

Graph 3



* Excludes financial derivatives
** Securitisers' Australian investment abroad is zero
*** Adjusted for US dollar swap facility in 2008 and 2009
Sources: ABS; RBA

This picture is reinforced if we include flows into Australian non-bank securitised assets (Graph 3). After net inflows amounting to around 1–2 per cent of GDP through the first half of the 2000s, there have been net outflows over the past three years. This change in net flows reflects the sharp drop-off in global appetite for securitised products as the problems in the US housing market came to the fore. The decline in demand for Australian securitised assets in part reflects the fact that a lot of the buyers of the paper pre-June 2007, structured investment vehicles, are no longer around.[12] Recent developments suggest appetite for these assets is growing again, both on- and offshore.

In 2010, while the banking sector's net offshore borrowing was zero, the current account deficit, while narrower than earlier years, was still 2½ per cent of GDP. An increase in foreign purchases of Australian government debt and decreased Australian investment abroad offset the decline in net capital inflow to the banking sector.

Turning to the current account side of the balance of payments, the notable development has been the shift in the trade balance from deficit to surplus as the much-commented-on rise in

[11] Debelle G (2011), "Collateral, Funding and Liquidity", Address to Conference on Systemic Risk, Basel III, Financial Stability and Regulation, Sydney, 28 June.

[12] See Debelle G (2010), "The State of Play in the Securitisation Market", Address to the Australian Securitisation Conference 2010, Sydney, 30 November.

Australia's terms of trade has significantly boosted resource export earnings. In that respect, it is sometimes remarked that absent the terms of trade rise, Australia's current account would be markedly wider. But that ignores the fact that the exchange rate has also appreciated significantly alongside the rise in terms of trade, thereby reducing the boost to export earnings as well as causing changes in domestic absorption and production.

Another effect of the rise in the terms of trade has been on the net income deficit. Because a sizeable share of Australia's resource sector is foreign-owned, the increased income of that sector partly "leaks" into a higher payment to the foreign owners, either in the form of dividend payments or retained earnings, thereby increasing the net income deficit. This also would not be occurring if the terms of trade were not at their current level.

Conclusion

So in conclusion, I am reminded of some sage advice from *Hamlet*: "there is nothing either good or bad, but thinking makes it so".

Current account deficits have a bad reputation, which is not always warranted. While some current account positions are the result of distortionary policies that should be redressed, others are not. The examples I have discussed show that there are configurations of current account positions and capital flows that should not be a cause for concern. Indeed, in many cases, they are beneficial and facilitate a productive reallocation of global capital. At a minimum, a more nuanced examination of current account positions, and the associated capital flows, is appropriate, rather than a simple focus on headline numbers.