# SCHOOLS BRIEF

## In defence of deficits

**Many people regard current-account deficits as dangerous and surpluses as a sign of economic prudence. The fourth article in our series on economic fallacies and misconceptions explains why running a current-account deficit is not necessarily bad**

FEW bits of economic management sound as irresponsible as running a current-account deficit. Perhaps it is the word "deficit" itself that conjures up notions of profligacy and excess, or it may be the apparent parallel with having an overdraft at the bank. Whatever the reason, many people regard a current-account deficit as self-evidently bad.

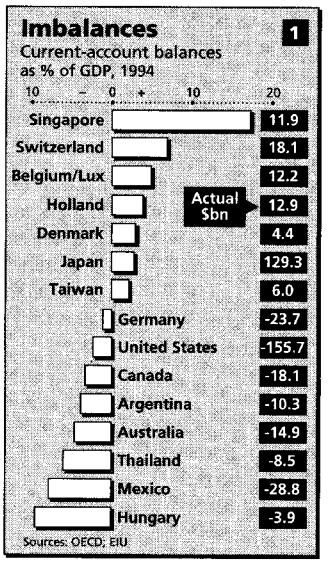
A casual glance suggests that such deficits do indeed lurk behind many countries' economic problems. Mexico's bungled devaluation in December 1994 could be traced back to its "unsustainable" current-account deficit of 8% of GDP (see chart 1). Other emerging economies with big current-account deficits, such as Hungary or Thailand, have suffered (albeit briefly, in Thailand's case) as investors have become fearful of funding such large deficits.

In rich countries, too, current-account deficits often seem to be the source of economic woes. The dollar's headlong decline in the first half of this year was blamed on America's hefty external deficit, among other things. Many economists fret about Australia's current-account deficit, which is estimated at over 5% of GDP in 1995.

Does all this mean countries should as a matter of course aim for a current-account surplus? Even if they could all succeed in doing this, which the laws of arithmetic forbid, it would be a mistake to try.

To see why, remember that the current account is only one part of a country's overall balance of payments, the record of all the transactions between a country and the rest of the world. Put simply, the current account measures mainly trade in goods and services; the capital account measures borrowing and lending.

Like a company's books, the balance-of-payments accounts must balance. A current-account deficit means that more goods and services are flowing into a country than are flowing out. This difference needs to be paid for, so the current-account deficit must be matched by an equivalent amount of foreign borrowing or investment (ie, a capital-account surplus) or by running down reserves of foreign exchange at the central bank.




Typically, the biggest components of the current account are the exports and imports of goods. The difference between them is known as the visible-trade balance. The close relationship between this and the current-account balance can lead to confusion. People often suppose that a current-account deficit means that a country is exporting too little because of restrictions in other countries. Many Americans, for instance, are fond of blaming their current-account deficit on Japanese import restrictions.

It is not that simple, because the current-account balance is not just a matter of trade in goods. It also comprises services (such as transport and banking); interest or dividend payments to foreign investors (and receipts on overseas investments); private transfers from workers (such as migrant Turkish workers in Germany sending money home to their relations); and official transfers (such as foreign aid).

Thus a country that has borrowed a lot from abroad in the past, but now has a trade surplus, can still find that the interest payments on its past debts turn the surplus into a current-account deficit (see box on next page). A way to avoid confusion is to see the current account as the change in a country's net external financial position. What running a current-account deficit really means is that a country is becoming more indebted to foreigners.

Whether this is prudent depends on why this increased indebtedness is occurring. Here again, a bit more national-income accounting is necessary. Assume first that a country has a closed economy: that is, it has no trade or financial flows with any other country. Its total production must be divided between what is consumed now and what is invested. At the same time the total income received by households (ie, the proceeds from the output) must be either consumed or saved. In such a closed economy the interest rate will be such that total saving equals total investment.

In an open economy, however, investment can be higher or lower than saving, with the current-account deficit (or surplus) being the difference between them. As chart 2 shows, a rise in interest rates is likely to reduce a current-account deficit (or push it into surplus) as saving tends to rise and investment falls.

In principle, for the world as a whole, the current and capital accounts must be in balance. Since the world is a closed economy (we do not, as yet, trade with Mars), world saving must equal world investment. It is logically impossible for every country to run either a surplus or a deficit. (In practice, however, the world ran a current-account deficit of $113 billion in 1994, due to statistical inaccuracies.)

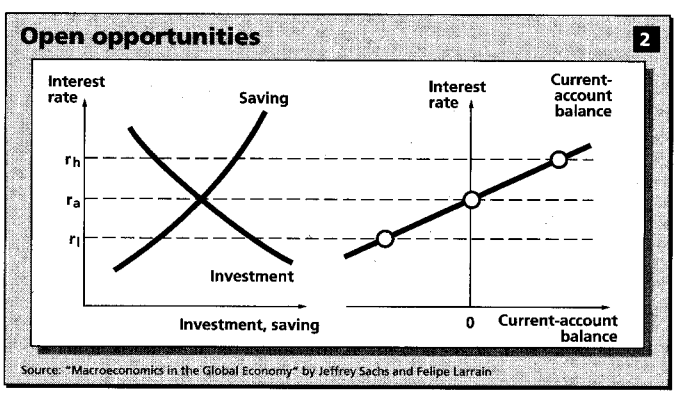
### Borrow young, lend later

The fear of current-account deficits stems from an era when economies were relatively closed. Under the post-war Bretton Woods monetary system, most countries fixed their exchange rates and imposed capital controls, making it hard to borrow from abroad. So having a current-account deficit meant drawing down reserves. Eventually these reserves would run out, and there would be a "balance-of-payments crisis".

Nowadays, with capital flowing relatively freely across borders, countries can run current-account imbalances for years. Whether it is wise to do so depends on the circumstances. Is saving too low? Is domestic investment too low? Is the money borrowed being used for productive investment?

On its own, the size of the current-account balance tells you little. Indeed, a large surplus may not always be a sign of strength. It could mean that a country's residents find it more profitable to invest abroad. If this is due to a lack of investment opportunities at home, the country may be forfeiting domestic growth. In Japan's case, its large surplus may be a sign of excessive saving.

Running a sizeable deficit may make sense for a country at a particular stage of development. Poor countries are likely to have accumulated less capital than richer ones. This means that any investment in capital should reap higher returns than in richer countries. So it makes sense for poorer countries to import capital (ie, run a current-account deficit). Examples abound of developing countries borrowing to finance growth: throughout the



1970s, for instance, South Korea's current-account deficit averaged more than 5% of GDP.

Economists have tried to formalise the idea that countries are more likely to be net borrowers or savers at different times. A "theory of balance-of-payments stages" has it that poor countries begin by running both current-account and trade deficits as they invest heavily. Over time the exports generated by investment generate a trade surplus, but the current account stays in deficit because of the interest due on the debt already accrued. After a while, the country pays off enough of its debt to shift into current-account surplus, and eventually becomes a net creditor to the rest of the world. Finally, at a mature stage, a country runs a trade deficit as it lives off the income from its investments, but it remains a net creditor.

Until recently, America seemed to conform to this view. For most of the 19th century it borrowed from the rest of the world and ran a current-account deficit. By the 1870s it was running a trade surplus, and by 1900 it had managed to notch up a current-account surplus.

During the first half of the 20th century, the United States became the world's biggest net creditor; by the 1970s it was at the mature stage: financing trade deficits with the income from investments abroad. In the late 1970s its current account, too, moved into deficit, although the country remained a net creditor. However, in the 1980s the current-account deficits became so large that America reached a new stage—one not foreseen in theory—of being a net debtor again.

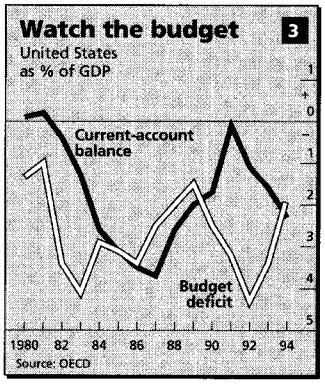
Many countries have never followed the pattern. Australia and Canada, for instance, have remained net debtors throughout their history. What matters is not that a country "grows out" of its habit of running current-account deficits, but that it remains capable of servicing its debts. This suggests that the first test of a sensible current-account deficit is that it must be used to finance profitable investment.

Another sensible reason for running a sizeable current-account deficit is to respond to a temporary shock. Consider the impact of a sudden drop in the price of a country's main export products, for instance. If the fall in price is temporary, it makes sense to maintain current consumption and allow the current-account deficit to rise. But if the price fall is permanent, a country needs to reduce its consumption, because it is now (permanently) poorer. So the best course is to finance a temporary shock but adjust to a permanent one—provided it is possible to tell the difference between them.

### Blame the budget

It is not always easy to work out exactly what a current-account deficit is financing. One clue comes from overall changes in saving and investment. If the current-account deficit is widening while saving is declining and investment is fairly stagnant, this is worrying. It implies that the borrowed foreign money must be financing consumption rather than investment, which will make it difficult to generate the resources needed to repay the debts later.

A budget deficit and a current-account deficit are closely linked. This is because a country's total investment and saving are each made up of two components: those of the private sector and those of the government. How much does it matter which of these two components, public or private, contributes most to a current-account deficit?




Much of the increase in America's current-account deficit in the 1980s can be explained by the sharp rise in its budget deficit (see chart 3). Since most of the government's expenditure goes on consumption (in the form of subsidies or transfers), a rising current-account deficit fuelled by a rising budget deficit is particularly dangerous.

But sometimes current-account deficits can occur when the government's budget is in balance, or even in surplus. Does this matter?

Many people think not. They argue that a current-account deficit that is driven by the private sector merely reflects the rational investment decisions made by private individuals. Nigel Lawson, a former British chancellor, famously held this view; as a result it is often known as the "Lawson Doctrine". But—as Mexico showed so spectacularly—large current-account deficits, even if the public finances are relatively healthy, can be a problem. Mexico's official budget deficit in 1994 was less than 1% of GDP, its current-account deficit almost 8%.

Contrary to the Lawson doctrine, there appear to be at least two good reasons for worrying about private borrowing. First of all, some private borrowers (particularly banks) may borrow more from abroad than is prudent, often because they think that governments will bail them out if they hit trouble.

Second, for all the talk of globalisation, capital markets are still not fully integrated, and the supply of funding from abroad is not limitless: again as Mexico showed, foreign funds can suddenly dry up if markets perceive a country to be too risky. At that point countries that have financed their current-account deficits with volatile portfolio capital, and especially with short-term debt, face problems.

For both these reasons, another test of whether a current-account deficit is healthy is the form and maturity of the financial flows into a country.

In sum, there are no simple rules to work out how much of a current-account deficit is safe. It depends on a country's stage of development, on how it is using the money, and on how markets perceive it to be using the money. What is certainly clear is that, contrary to what is often supposed, current-account deficits are not always bad. ■

## Dissecting the deficit

IN MATHEMATICS tests at school, achieving full marks means not only getting the answer right, but also showing the right method of getting there. Analysing countries' current-account deficits is similar. Though some information can be gleaned from the overall figure, this can often conceal as much as it reveals. Consider Canada and Mali, two of the countries in the table below. Both had a current-account deficit of just over 4% of GDP in 1993. But in Canada the visible-trade balance showed a surplus of almost 1½% of GDP, while Mali's was in deficit by almost 5% of GDP. Canada's interest payments on its large foreign debt, as well as net imports of services, dragged the overall current account into deficit. Mali also had huge net imports of services, of over 12% of GDP: the current-account deficit was saved from exploding only by massive foreign aid from governments overseas, worth 11% of GDP.

Turkey and Australia make another striking pair. Both had similar current-account deficits in 1993, but whereas Turkey had a visible-trade deficit of 8% of GDP, Australia's trade was in balance; again, it was net interest payments which pulled the country into current-account deficit. Proof enough that it is important to look beyond the bottom line.

**The devil is in the detail**

| as % of GDP, 1993 | Australia | Brazil | Canada | Mali | Turkey |
|---|---|---|---|---|---|
| Exports | 15.0 | 8.8 | 26.1 | 13.7 | 8.9 |
| Imports | -15.0 | -5.9 | -24.7 | -18.5 | -16.9 |
| Visible-trade balance | nil | 3.0 | 1.4 | -4.8 | -8.0 |
| Services* | -0.4 | -1.1 | -2.0 | -12.6 | 3.2 |
| Investment income* | -3.5 | -2.4 | -3.7 | -0.9 | -0.9 |
| Private transfers* | 0.3 | 0.4 | 0.1 | 3.4 | 1.7 |
| Official transfers* | -0.2 | nil | -0.1 | 10.8 | 0.4 |
| Current-account balance | -3.8 | -0.2 | -4.3 | -4.1 | -3.6 |

Source: IMF *Net

The next in our series of Schools Briefs will appear in January.