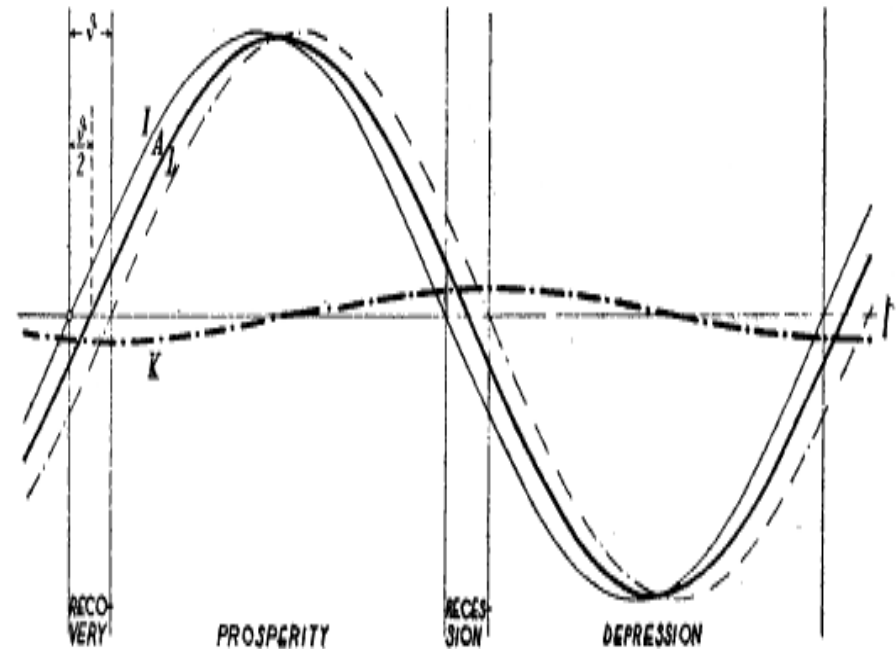




# Lecture on Macroeconomics: Balance of Payment and External Stability

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***FOCUS  
ON  
ECONOMICS***





# Why study economics?

***Here are some reasons to study economics.***

- ▲ To be culturally literate and better understand the world (you look more intelligent at a cocktail party!)
- ▲ Economy affects our lives (e.g. harder to get a job in recession, decisions on taking out a mortgage, saving and investment are affected, etc...).
- ▲ We can have better, if not best, answers to many questions and elect a better government to “*keep the bastards honest*” – Cheryl Kernot.



# What is a Nation's Balance of Payments?

## THE AUSTRALIAN BALANCE OF PAYMENTS, 2006-07 (\$billions)

### CURRENT ACCOUNT

• Exports of goods (1)	169.6		
• Imports of goods (2)	-183.4		
• Net export of goods (1) - (2) = (3)		-13.8	
• Net exports of services (4)		1.8	
• Trade balance (3) + (4) = (5)			-12
• Net income & transfers (6)			-46.3
• Current account balance (deficit=-) (5) + (6)			-59.2

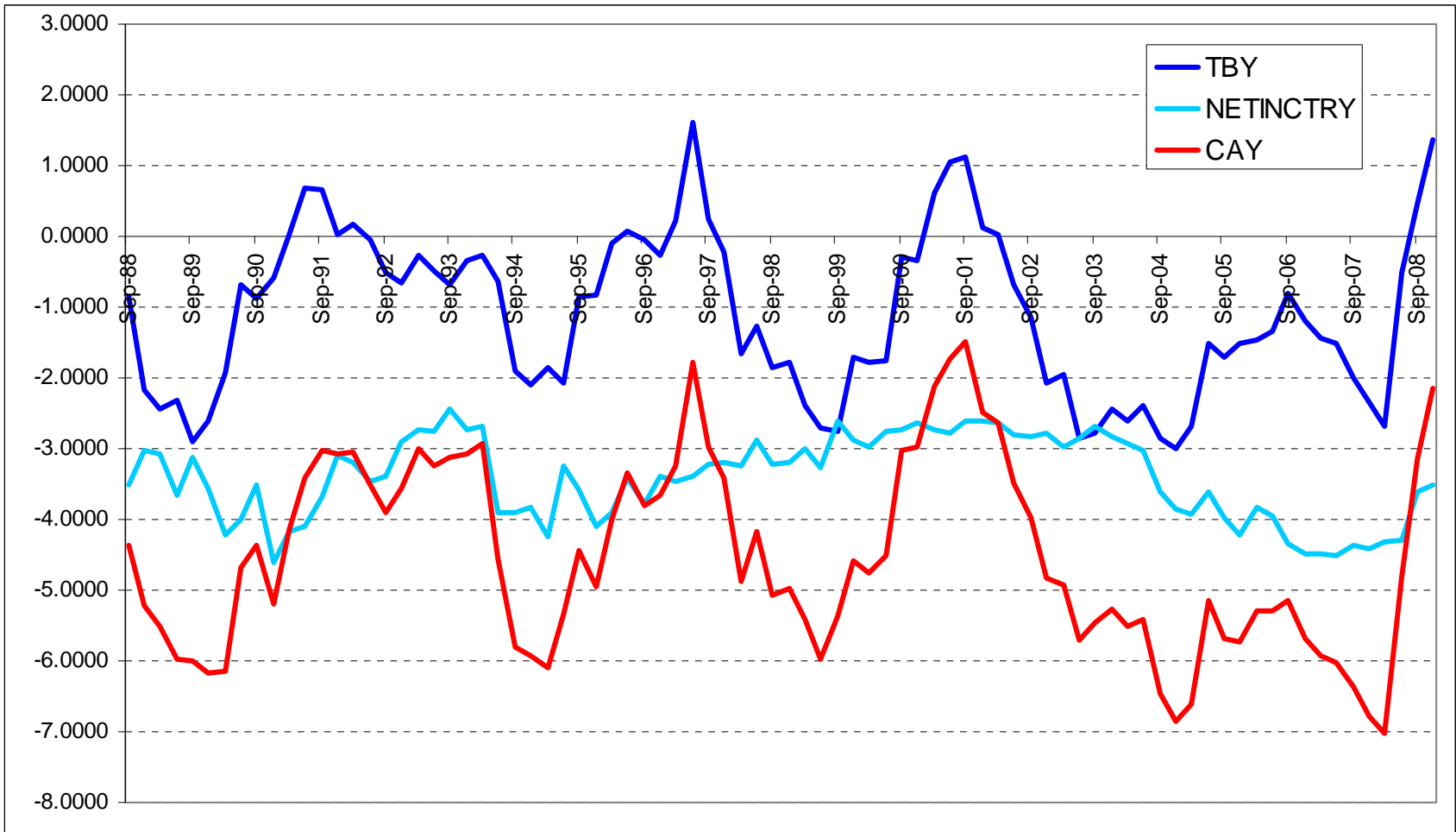
### CAPITAL (& Financial) ACCOUNT

• Net private portfolio investment inflows and transfers (7)		76.7	
• Net private direct investment inflows (8)		-0.04	
• Total net private investment inflows (7)+(8)=(9)			76.03
• Net other investment (10)			0.7
• Reserve assets (11)			-20.1
• Capital account balance (deficit=-) (9)+(10)+(11)			59.3



# The Current Account

## Australia's Current Account Balance (% of GDP) 1988 - 2008





# The Capital and Current Accounts

Why is there a balance between the current and capital accounts?

Tim

Buys an imported German car from an Australian dealer  
\$100,000A (paid into car dealers bank a/c)  
Current a/c debit of \$100,000A

Tong

Now has \$100,000A  
[1] Spend the \$100,000A on a Gold Coast holiday (Current a/c credit of \$100,000A)  
[2] Leave the money in the bank (Capital a/c credit of \$100,000A)  
[3] Buy shares in Australian companies (Capital a/c credit of \$100,000A)



# Capital Flows

Capital inflows = purchase of domestic assets by foreign residents



Any time an Australian resident borrows from an overseas resident, there is a capital inflow (recorded as a credit in the capital account)

Capital outflows = purchase of foreign assets by domestic residents



Any time an Australian resident lends to an overseas resident, there is a capital outflow (recorded as a debit in the capital account)



# The Capital and Current Accounts

## *Some Cautions*

- ▲ The  $\text{BoP} = \text{CA} + \text{KA} = 0$  does not hold for countries with capital controls (e.g. China)
- ▲ The sum of all CA deficits across the globe is still negative! Are we having a deficit against Martians? Measurement errors!



# Saving and the Trade Deficit

→ Balance on the current a/c + balance on the capital a/c = 0

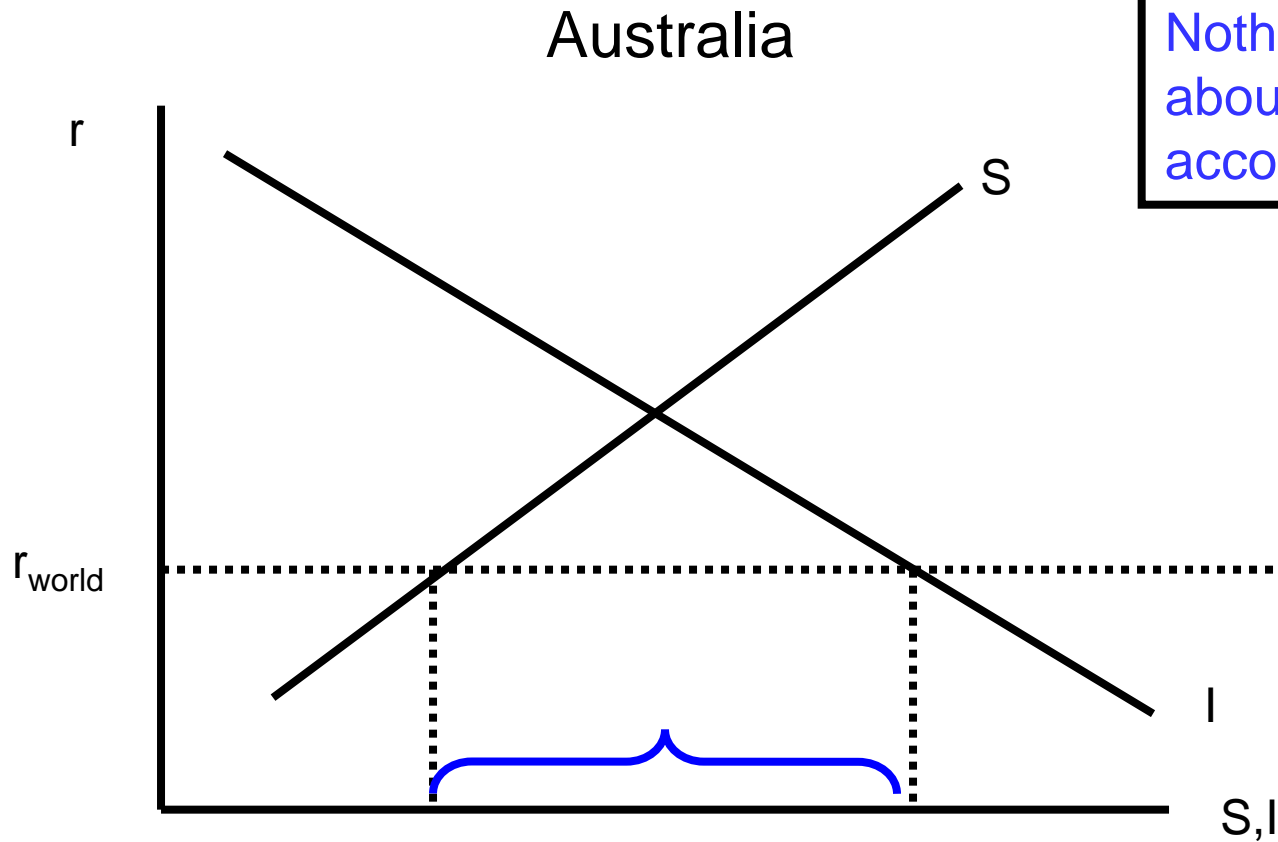
▲ Any current a/c deficit must be matched by a capital a/c surplus

$$\underbrace{S - I}_{\text{capital a/c surplus (deficit)}} = \underbrace{X - M}_{\text{current a/c deficit (surplus)}}$$

e.g. if  $NS > I$ , have a capital a/c deficit and this is associated with  $X > M$ , a current account surplus



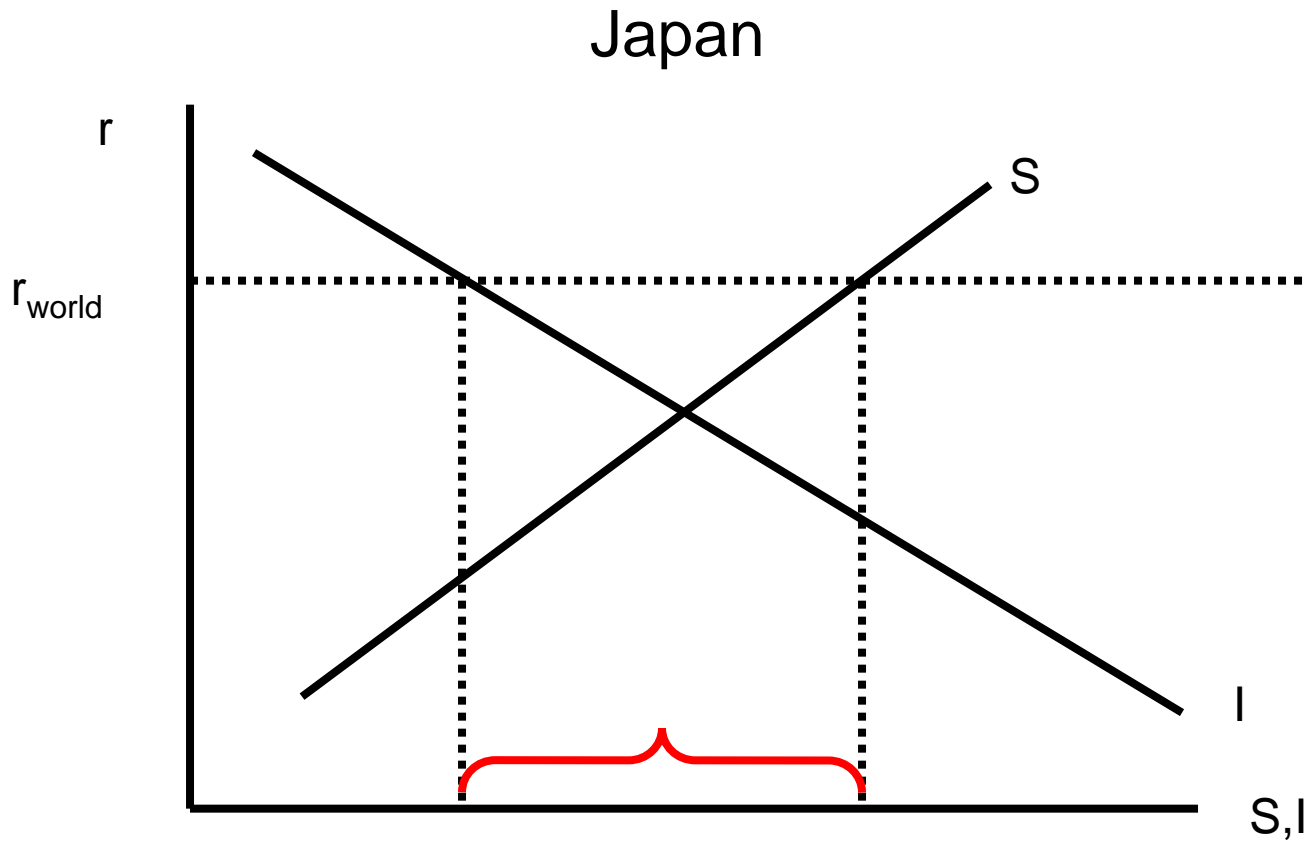
# Saving and the Trade Deficit



Capital Inflow: Capital a/c surplus & current account deficit



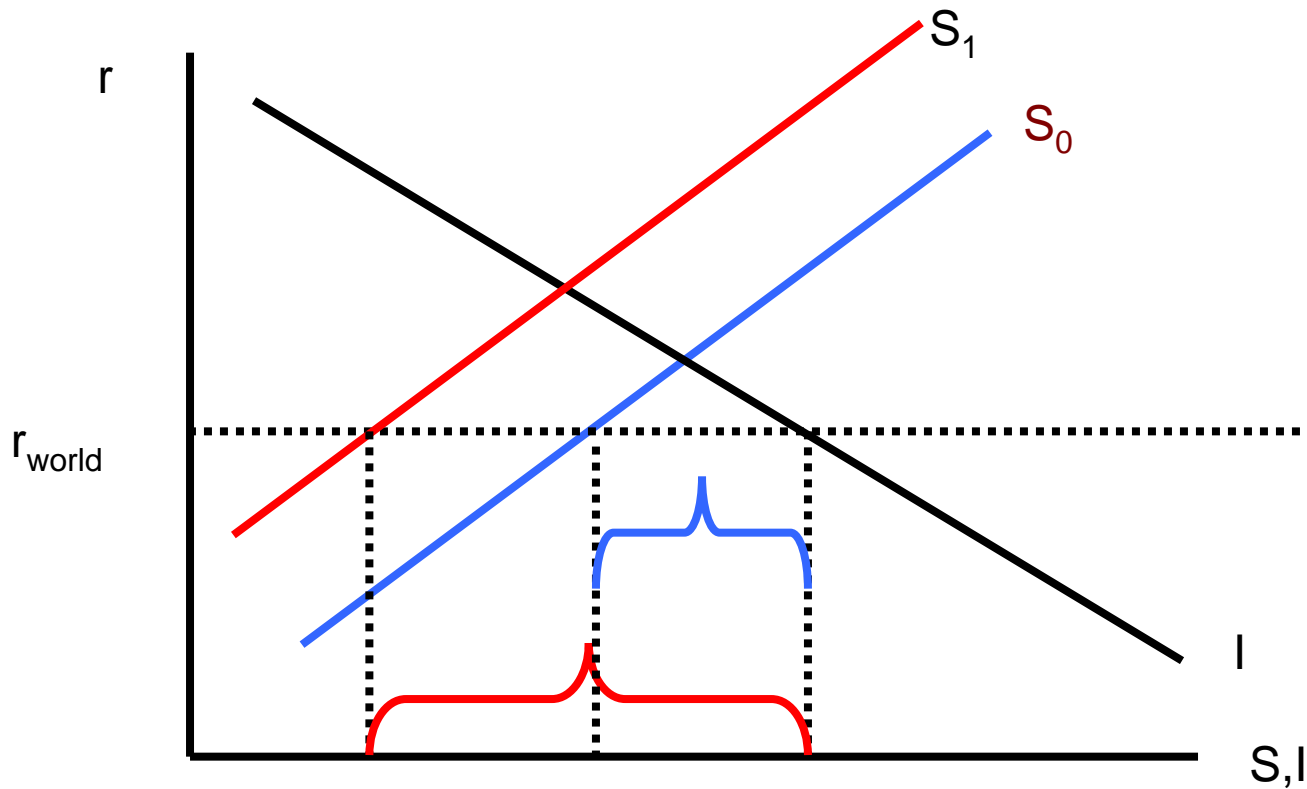
# Saving and the Trade Deficit



Capital outflow: Capital a/c deficit & current account surplus



# Budget deficits and External deficits



The "Twin Deficits" Hypothesis



# Saving and the Trade Deficit

What determines a nation's current account?

- S and I
- Domestic interest rates versus international rates.
- Choice between current vs. future consumption
- International savings and investment

*Should policymakers try to lower current account deficits?*

*Persistent CADs reflect a symptom of systemic imbalances in the economy.*

*BUT macro policy is ill-suited to correct for them. Why?*



# Saving and the Current Account

## Australians do not save enough to fund investment.

National saving and investment (% of GDP) in Australia, 1980–2005.

When Australia's national saving has fallen below domestic investment, there has been a trade deficit.



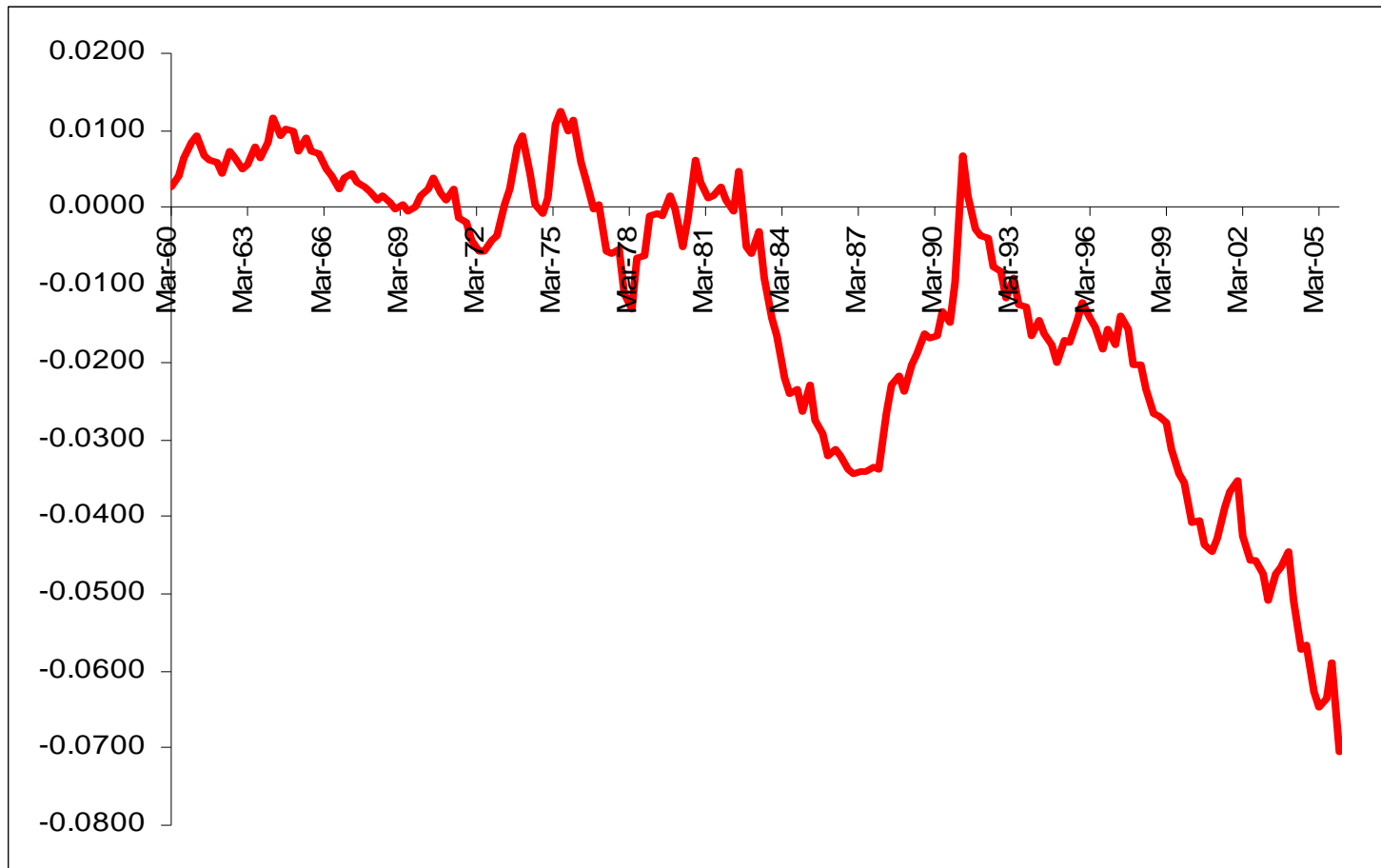
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Source: Bernanke and Blinder (2008)



# The Capital and Current Accounts

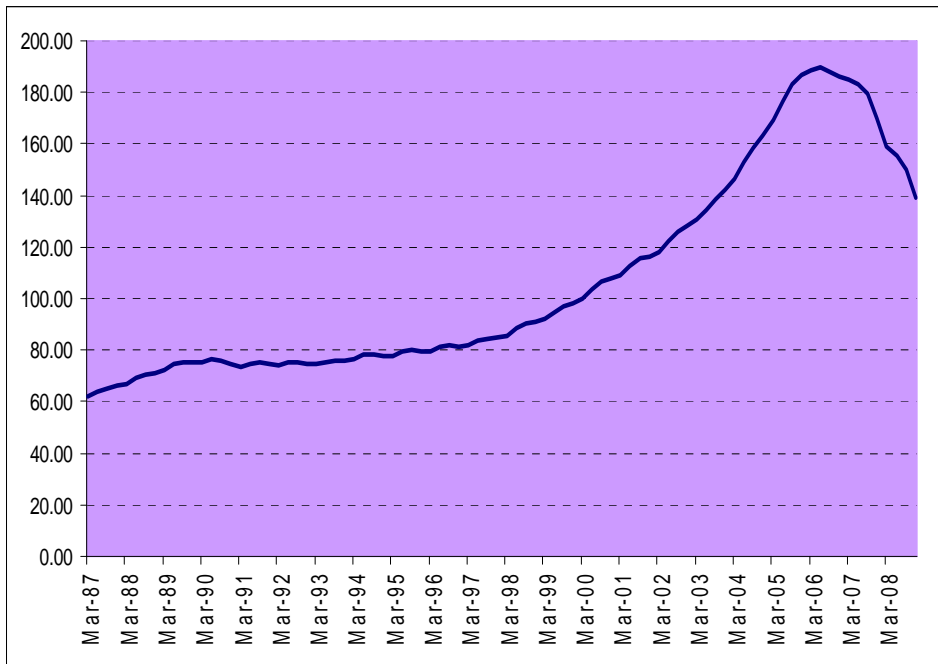
**The US current account deficits - persistent CA deficits can be a real problem!**





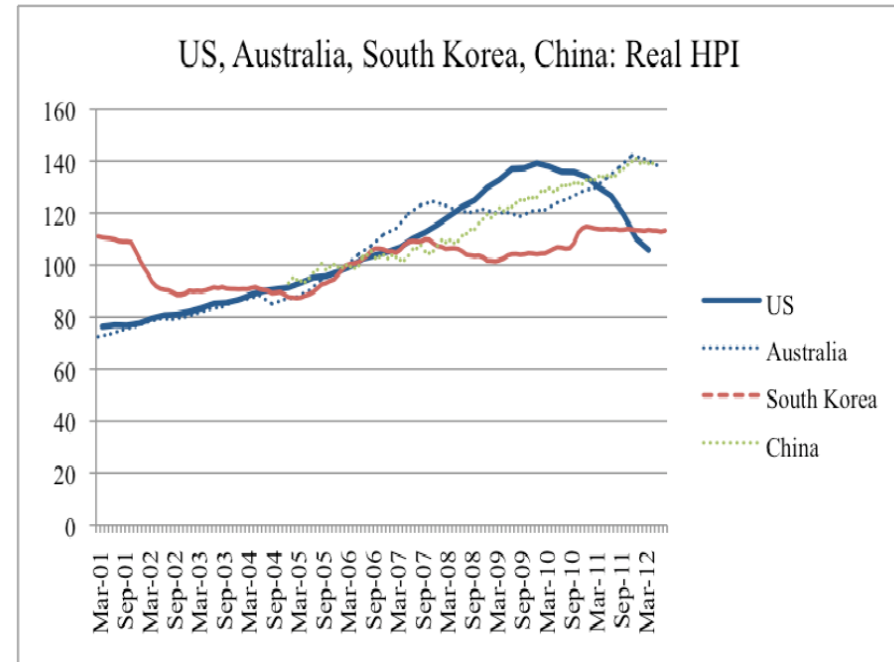
# The 2007/8 Global Financial Crisis

S&P/Case-Shiller U.S. National Home Price Index



Datasource: Case-Shiller

Real House Prices for United States, Australia, South Korea, and China: 1997 to 2007



Source: Hubbard and Mayer (2009)



# The 2007/8 Global Financial Crisis

## Bank Run in the UK



Source: <http://www.flickr.com/photos/89319548@N00/1378965141/>



# Summary

- For countries with a flexible exchange rate system, current account imbalances (as  $BoP = 0$ ) matter!
- Current account reflects how firms, households and governments save and borrow for consumption and investment.
- Persistent external imbalances imply some underlying domestic distortions, and global imbalances too!
- Macro policy is ill-suited for this. Target the causes not the symptoms!
- Rapid deterioration in the CAD signals a serious problem waiting to happen! Example: Asian financial crisis, US subprime crisis.