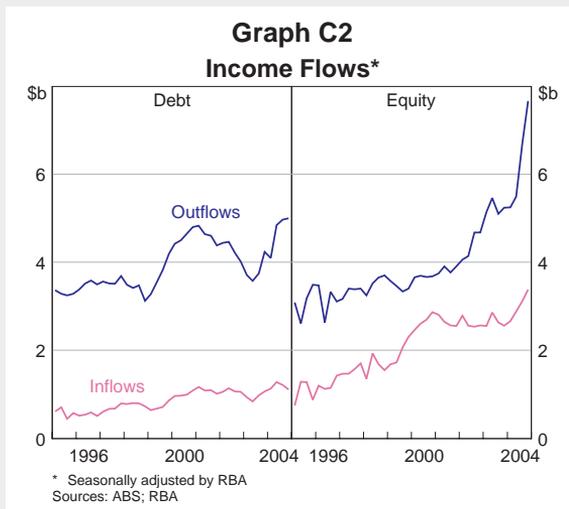
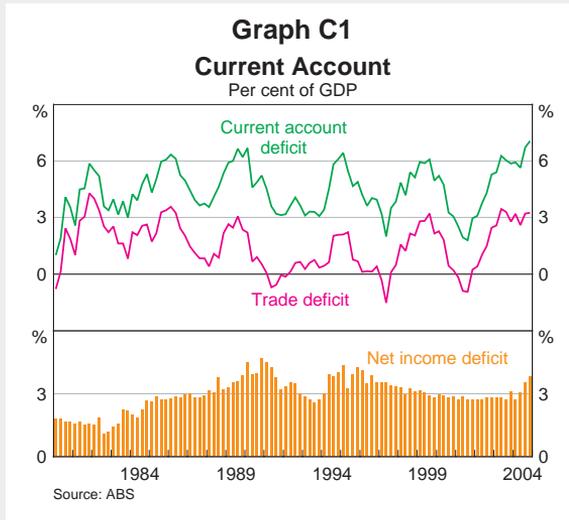


## Box C: Australia's Net Income Deficit

During the second half of 2004, Australia's current account deficit widened by almost 1½ per cent of GDP to over 7 per cent of GDP, the highest level since the early 1950s. In contrast to other movements in the current account deficit during recent years, which were mainly the result

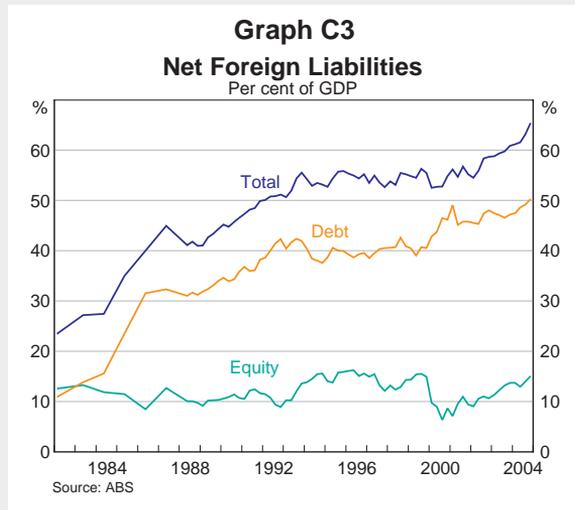
of fluctuations in Australia's trade balance, the most recent increase largely reflected rising payments on Australia's stock of net foreign liabilities – the net income deficit (Graph C1). At 3¾ per cent of GDP, the December quarter 2004 net income deficit (NID) was the largest recorded since September 1996.

The increase in the NID in the second half of 2004 was driven by an increase in income accruing to foreigners on their debt and equity investments in Australia, while returns received on Australian holdings of foreign assets remained broadly unchanged (Graph C2). There was a particularly marked increase in the income attributed to foreign owners of direct equity stakes in Australian firms, which was in contrast to trends in economy-wide measures of profitability, such as gross operating surplus. A substantial fraction of these earnings are not paid out, but retained by the Australian company, and are offset in the balance of payments by an equivalent notional capital inflow.<sup>1</sup> The latest increase has been almost entirely driven by this component.



<sup>1</sup> Direct investors are defined as foreign shareholders with at least a 10 per cent equity stake in the Australian company; all others are defined as portfolio investors. Dividend payments to all non-residents are included as debit items in the current account. In addition, retained earnings that accrue to direct investors appear in the balance of payments as notional dividend payments, along with an offsetting capital inflow item for the notional reinvestment of these earnings.

The large contribution of equity earnings to the recent increase in the NID stands in contrast to earlier episodes of a rising NID, which were mainly driven by developments on the debt side. Ongoing current account deficits have resulted in a steadily rising net foreign liabilities position, from around 25 per cent of GDP in the early 1980s to around 65 per cent of GDP by the end of 2004, over 75 per cent of which are net debt liabilities (Graph C3). The higher level of liabilities that must be serviced would normally have significantly increased the NID over



this period, but this effect was substantially offset by trend declines in global interest rates over the past two decades.

Looking forward, it is likely that the decline in global interest rates has now run its course, eliminating this source of downward pressure on the NID. As a result, the cost of servicing Australia's net foreign debt liabilities may rise from its current relatively low base, as global interest rates rise and the stock of foreign debt liabilities increases in line with projected ongoing current account deficits. ❖