CHAPTER 10

EXTERNAL STABILITY

Multiple choice

1. **B**
2. **D**
3. **D**
4. **A**
5. **A**
6. **C**
7. **A**
8. **C**
9. **C**
10. **B**
NB:Assuming the payment is from Australia to overseas.
11. **B**
12. **B**
13. **C**
14. **B**
15. **B**
16. **C/D**
NB:Answer D should read " Increase domestic investment" making C correct.
17. **C**
18. **A**
19. **D**
20. **C**

Short answer questions

Question 1

(a) **External stability refers to the achievement of a stable, sustainable balance of payments and foreign liabilities and a stable value of the Australian dollar in the medium to long term.**

(b) **Trend 1. Manufactured exports have grown considerably over the past decade, however they still only make up a small proportion of Australian exports compared to other high income countries.**

Trend 2. Australia has experienced a decline in the relative importance of rural goods in its export base since the early 80s, although total exports are still largely comprised of primary sector goods such as mineral exports.

(c) **Australians borrowing from overseas not only increases the amount of funds owed by Australians to overseas, but also increases the level of servicing costs that must be paid. When overseas borrowed funds enter Australia they increase the surplus on the capital and financial account which increases the size of the current account. Compounding this problem in the long run is the fact that servicing costs are a debit on the net income account of the current account which further increases the size of the current account. This can lead to a debt trap scenario for an economy where future generations are forced to borrow to fund the debts of old and the problem is compounded.**

(d) **A rising level of foreign liabilities increases the vulnerability of the Australian economy to external shocks, increasing the volatility of the Australian dollar. An economy's level of foreign liabilities is often looked at as an indicator of the stability of an economy. As investors become wary of increasing foreign liabilities they will retreat from the Australian economy which will put further downward pressure on the Australian dollar, increasing the size of our foreign debt – the majority of which is in foreign currency terms.**

Question 2

(a) **Movements in the value of the Australian dollar have a significant impact on both the level of foreign debt and the BOP. A decrease in the $A has a 'valuation' effect on foreign debt, with over 60% of Australia's foreign debt denominated in foreign currency terms. The depreciation of the dollar also thus increases the burden of servicing costs on the foreign debt, which causes a deterioration in the value of the current account - Australia's major structural problem.**

Movements in the value of the Australian dollar also impact on our external stability by influencing our balance on goods and services (BOGS). A depreciation of the dollar can increase the demand for our exports by lowering their price on world markets. As was the case following the large depreciation of the dollar in 2001, this can lead to strong export growth, improving our external stance. However, an appreciation of the dollar will reduce the international competitiveness of our exports, lowering demand – as is expected to occur in 2003 as the dollar appreciates strongly against the US dollar.

(b) **Australia's government have struggled in recent decades to make any significant inroads into lowering our current account deficit. A deteriorating CAD indicates a structural imbalance., meaning that short term macroeconomic solutions – as tried during the late 1980s in particular – have little to no long term impact. It is therefore necessary to implement long-term microeconomic policies as to correct such problems. Reduced protection levels for example force domestic export industries to be more internationally competitive which ultimately increases our international competitiveness and lowers our current account.**

The net income account must also be addressed under any strategy to address a deteriorating current account. Improving the net income balance requires an economy to reduce its reliance on overseas borrowings as a source of funds. Attempts at increasing savings levels in Australia in recent decades such as superannuation and running fiscal surpluses have nonetheless had little impact on the size of our net income deficit. Despite the need for all these ling term structural reforms, the ability to control growth (and thus import spending) in the short term with contractionary fiscal or monetary policy is still an available, if not complete, solution to a short term deterioration in the current account.

Question 3

(a) **Measuring the size of the CAD as a proportion of GDP allows for accurate comparisons across time and between countries. The CAD is known to act as a constraint on growth, so measuring the Current Account balance in terms of GDP provides a useful indication as to the severity of the CAD problem in each country – something which a pure dollar comparison would not allow.**

(b) **I) Sustained high current accounts will lower international confidence in the Australian economy.**

II) If the government is committed to external balance, a high CAD may necessitate contractionary macroeconomic policies which will constrain growth and could lead to a reduction in living standards.

(c) **The relationship between the BOP and economic growth is known as the "balance of payments constraint".Increased growth will lead to increased levels of aggregate demand which will include higher spending on imports. If this is not matched by a subsequent increase in exports, the balance of payments will deteriorate.This may force the government to slow the rate of economic growth to lower the size of the deficit on the current account.**

d) **Australia has one of the lowest levels of household savings among high-income countries, with household savings recently becoming negative. Compounding the low level of household savings experienced in Australia in recent decades is the extent to which the government has drained the level of national savings for budget deficits. During the 1980s and 1990s, the low level of national savings lead to an explosion in the size of Australia's foreign debt as investors were forced to look overseas for funds.This has subsequently lead to an epidemic imbalance in our external sector with the net income deficit on the current account remaining a significant structural problem for the economy. The net income account is now the largest component of Australia's current account deficit and despite a return to fiscal surpluses in the late 1990s and a reduction in government debt level, little progress has been made into addressing Australia's poor national savings.**