

# External Stability

# 10

## Multiple Choice Answers

1	C	6	D	11	C	16	A
2	D	7	C	12	C	17	A
3	A	8	B	13	A	18	D
4	D	9	D	14	B	19	A
5	B	10	D	15	C	20	C

## Short Answer Questions

### Question 1

- The balance of payments is a record of all transactions between Australia and the rest of the world over a period of time. It consists of the current account and the capital and financial account.
- Australia's current account deficit (CAD) moves in a cyclical manner, following the fluctuations in the balance on goods and services. However, the CAD tends to be in deficit, and only rarely records a surplus. This reflects the structural component of the CAD, the net income account, which is a persistent deficit of around 3-4 per cent.
- The current account is measured as a percentage of GDP so that it can be compared to other current account balances over time, and to economies of different sizes as measured by GDP.
- A sustained current account can lead to a reduction in an economy's economic growth rate. This is known as the balance of payments constraint. A sustained current account deficit caused by a balance on goods and services deficit will result in a constant leakage from the circular flow of income as money continually flows overseas as imports, reducing aggregate demand and economic growth. Also, a sustained current account deficit will result in a sustained level of net financial inflow, as current account deficits must be matched by capital and financial account surpluses. This will result in a continual rise in the level of foreign liabilities and increase future servicing costs of liabilities. In extreme situations, this may lead to a debt trap scenario where servicing costs are so high that businesses must look to overseas finance to pay off the servicing costs, further increasing foreign debt. Finally, a sustained current account deficit may weaken international investor confidence in the Australian economy, leading to volatility in the exchange rate and capital flight. This occurred in the economies of East Asia in the 1997 Asian Financial Crisis. However, some economists argue that a sustained current account deficit does not have any significant negative impacts upon the economy. Rather, the sustained current account deficit reflects the fact that overseas investors are willing to lend money to Australian firms because of the high profitability of Australian investments. This is the view of the Pitchford Thesis. Under this view, the current account is merely a reflection of the overseas share of the domestic profits which overseas investment helped to create.

**Question 2**

- a) Net foreign debt is the total stock of loans Australia owes to the rest of the world, minus loans owed to Australia. Debt must be repaid at the end of the loan period and is serviced with interest repayments. Net foreign equity is the total value of Australian assets owned by overseas investors, minus overseas assets owned by Australia. Foreign equity gives ownership to overseas investors, who are entitled to a share of the profits made by those assets, such as dividends from shares.
- b) The balance of payments is a reflection of all financial transaction flows between Australia and the rest of the world over a period of time. Net foreign liabilities, on the other hand, are a stock of Australia's total liabilities at a point in time. If an Australian firm borrows from overseas to finance investment, the initial inflow of money will be recorded on the financial account as a direct investment credit. The increase in debt will also increase net foreign liabilities. The higher level of net foreign liabilities will result in higher servicing costs on debt and equity, which must be paid to the overseas investors. The interest repayments to overseas will be recorded as a debit on the net income account, raising the current account deficit.
- c) Net foreign liabilities are a reflection of the net foreign debt liabilities that Australia owes to the rest of the world, and the net foreign equity that the rest of the world owns in Australia. Net foreign liabilities in Australia are private sector borrowing and not a reflection of government borrowing. This means that the level of debt primarily reflects firms borrowing to fund investment in the domestic economy, or overseas investors providing direct or portfolio investment in the Australian economy. Under the view of the Pitchford Thesis, it is important to consider why the liabilities exist. If Australia's foreign liabilities are high because they reflect a large amount of overseas financing of Australian investment, this would tend to lead to higher economic growth in the long run. Australia's level of national savings is too low to fund our high levels of domestic investment, and without foreign financing options, Australia would either be forced to reducing consumption to increase savings, or to reduce investment levels – either situation resulting in a fall in economic growth. However, a high level of foreign liabilities exposes Australia to a long term servicing cost, reflected in the net income account. This represents a continual outflow of income from the Australian economy (although, the Pitchford Thesis argues that incomes in Australia wouldn't be as high without the overseas finance to help with investment – in other words, the servicing costs are the overseas share of Australian incomes). If servicing costs becomes unsustainable high, however, Australian firms may face greater difficulty accessing overseas finance, resulting in lower investment levels and lower economic growth.

**Question 3**

- a) An exchange rate is the price of one economy's currency in terms of another.
- b) A depreciation of the Australian dollar would have mixed impacts upon the different components of the current account, but raise the level of foreign liabilities. In the short term, contracts for imports and exports are fixed, which prevents any change in the volume of exports and imports. However, the depreciation would increase the Australian dollar price of imports, increasing the cost of import expenditure, worsening the balance on goods and services. However, in the long run, the lower Australian dollar will decrease the foreign currency price of Australian exports, leading to an increase in demand for exports and an increase in export volumes, improving the balance on goods and services. Also, the higher price of imports would encourage consumers to switch to domestic substitutes, lowering import expenditure and improving the balance on goods and services. A depreciation would also increase the Australian dollar value of foreign debt denominated in foreign currencies, increasing the value of servicing costs on the net income account and worsening the current account. The value of Australia's net foreign debt would thus increase, raising the value of net foreign liabilities.

- c) The government may use macroeconomic policy and microeconomic policy to improve Australia's external stability by targeting the structural causes behind the current account and net foreign liabilities. The government may use microeconomic policy to improve the balance on goods and services. Reductions in protection force inefficient import-competing firms to restructure or close, which frees up resources which can be used in more efficient areas of the economy, increasing allocative efficiency. Whilst this may worsen the current account balance in the short term, in the long term, resources will flow to areas in which Australia has a comparative advantage, raising the level of exports and improving the current account balance. Additionally, the government has in recent years focused on improving the quality and efficiency of Australia's transport infrastructure, reducing the delay in shipping Australia's commodity exports, increasing dynamic efficiency and increasing potential export volumes. The government may use fiscal policy to raise the level of national savings and reduce Australia's reliance on overseas financing for investment. The policy of fiscal consolidation (running balanced or surplus budgets on average over the economic cycle) has reduced the government's drain on national savings to finance budget deficits and allowed the government to repay government debt. In 2006, net government debt was eliminated and the government now is a net saver in sovereign wealth funds such as the Future Fund. The government policy of compulsory superannuation and the superannuation co-contribution scheme has also raised the level of private savings in the economy. This should reduce overseas borrowing to finance investment, slowing the growth of foreign liabilities and reducing the net income account. Finally, the government may use monetary policy to influence the exchange rate and offset volatile movements. When the dollar depreciated rapidly in 2001, the RBA intervened in the market to dirty the float, buying Australian dollars. It also raised the level of interest rates to encourage capital inflow and increase demand for the dollar to offset the depreciation.