EXTERNAL STABILITY 10

MULTIPLE CHOICE

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

SHORT ANSWER QUESTIONS

Question 1

(a) A current account deficit is recorded when the debits in the current account, consisting mainly of imports and income payments to overseas, are greater than the credits, consisting mainly of exports and income payments from overseas.

(b) Australia experiences persistent current account deficits that tend to fluctuate between 3 and 6 per cent of GDP. The CAD results from cyclical fluctuations in the balance on goods and services combined with a stable net incomes deficit.

(c) Expressing the current account as a proportion of GDP better allows for comparisons over time and between different economies.

(d) Foreign liabilities and the current account may operate in a mutually-reinforcing cycle. Net foreign liabilities incur servicing costs, in the form of interest in return for debt and profit in return for equity. These servicing payments are recorded as outflows in the net incomes component of the current account, worsening the CAD. An increased CAD creates a need for yet more foreign liabilities, creating a cycle of debt. A debt-trap scenario may result, where the economy incurs more foreign liabilities just to servicing its existing debt repayments.

Question 2

(a) Australia's exchange rate has experienced significant fluctuations in recent years. It depreciated steadily throughout the late 1990s and early 2000s, reaching a record low in 2001. Since then the Australian dollar has appreciated rapidly on the back of higher interest rate differentials and a rising terms of trade.

(b) An answer to this question may include any two of the following:

- A high degree of speculation will cause volatility, as speculators shift funds between currencies at short notice to profit from currency movements.
- Frequent shifts in investor confidence in the economy will create exchange rate instability as levels of investment fluctuate.
- Volatility in demand for an economy's exports will create fluctuations in demand for the currency, leading to exchange rate volatility.

(c) An exchange rate depreciation increases the price of imports in local currency terms. As a result, demand for imports will fall, particularly where locally-produced substitutes are available, reducing the level of imports. However since Australia tends to import goods which have no close domestic substitutes, there is likely to be only a small change in imports.

(d) An exchange rate appreciation will reduce the Australian dollar value of any foreign debt which is denominated in foreign currencies. This will reduce the size of foreign debt and hence foreign liabilities. However this valuation effect only applies to about half of Australia's foreign debt. Australia's foreign equity tends to be denominated in Australian dollars. Thus foreign liabilities should decrease slightly. A sustained appreciation will worsen the current account deficit, with reduced export competitiveness, and increased imports. This deficit must be funded by a surplus on the capital and financial account, adding to foreign liabilities.

Question 3

(a) Net foreign debt refers to the total stock of loans that Australians owe foreigners, minus foreigners' debts to Australians, whereas net foreign equity refers to the total value of foreign-owned assets in Australia, minus the value of Australian-owned foreign assets.

(b) External stability is a goal of the government to achieve stability in Australia's external accounts. The three goals are to run a sustainable current account deficit in the long run (at about 3 per cent of GDP), to have servicable foreign liabilities (where Australia's rate of economic growth is sufficient to cover the servicing costs) and to stabilise the exchange rate.

(c) Macroeconomic policies are generally ineffective in improving external stability. Since macroeconomic policies can only change the short term demand for imports, they cannot address the structural causes of the CAD. Also running contractionary macroeconomic policies may reduce imports, but will also damage the level of economic growth in the economy. Microeconomic reform can improve the CAD through increasing international competitiveness of exports, and increasing the national savings rate. The government has implemented reductions to protection to increase export competitiveness, and has increased government saving through the establishment of the Future Fund, as well as providing regulations for compulsory superannuation savings. While these policies may take up to 20 years to have their full effect on the CAD, in the long run they should reduce the deficit on the CAD.