In a globalised economy such as Australia, external stability plays a very important role. Usually, the Balance of Payments (BOP) and the exchange rate are the major indicators of the level of external stability.

The Balance of Payments is a summary of Australia's financial transactions with the rest of the world. The BOP is divided into two sections, the Current Account, and the Capital and Financial Account. Under a floating exchange rate system, these two accounts must balance. In other words, the deficit on the Current Account must equal to the surplus on the Capital and Financial Account.

Historically, Australia has suffered from high levels of Current Account deficits (CADs). The CAD is measured as a percentage of Australia's Gross Domestic Product, or GDP. On the average, Australia has CADs of around 4.75% of GDP. This is considered

BOARD OF STUDIES
NEW SOUTH WALES

very high, as usually it is believed that in the medium to long term economies cannot be sustained with CADs of over 3% of GDP. Australia tends to hit the danger limit of 6% once every five years.

Australia's high levels of CAD can be explained by two main reasons. Firstly is the lack of domestic savings, and secondly is the narrow export base.

Australia is a net capital importer, meaning that Australian investments overseas are less than foreign investments in Australia. This is due to a lack of domestic savings. The government has been trying to improve this by introducing policies such as compulsory superannuation for all income earners.

Since Australia obtains much capital from overseas to fund local investments, returns to there foreign funds need to be made in the form of profits, dividends etc. There monies represent an outflow of funds from the Australian economy, and as a deficit on the Current Account.

Another major cause of Australia's high CAD is the nation's narrow export base and reliance on imports. Australia relies largely on its commodity exports, which are subject to large fluctuations in prices, as well as high levels of protection in many foreign economies. In order to improve this condition, the government has been encouraging the export of services as well as Elaborately Transformed Manufactures (ETMs), which are much more popular and stable in global markets.

The CAD is an important part of judging external stability. Often, foreign investors are unwilling to invest in economies with high levels of CAD, as it indicates an imbalance in the economy. This could

This information can be seen in the Reserve Bank Bulletin of Oct 2000

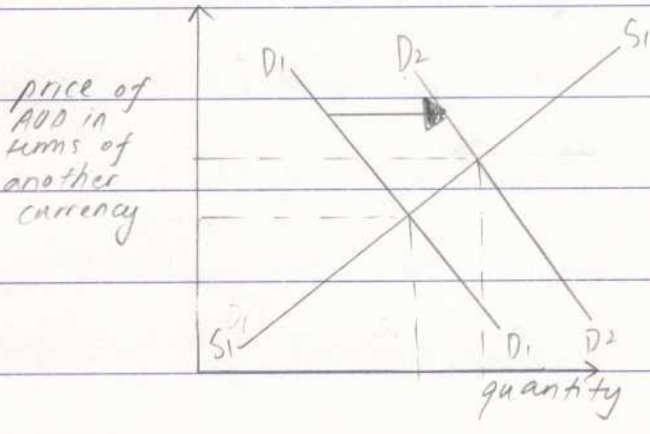
be a reason for decreased ~~causes~~ ~~[illegible]~~ foreign direct investment (FDI) entering Australia in recent years, due to decreased confidence in the Australian economy. Another ~~could~~ reason would be the opinion of foreign investors that Australia is an 'old-fashioned' economy, as it produces mainly commodity exports.

However, by improving the level of domestic savings and Australia's export base, the government hopes that by the beginning of the next financial year the CAD would have dropped to 3% of GDP, improving our level of external stability.

Foreign investors also judge Australia's level of external stability by the country's level of foreign debt. Foreign debt levels serve as an indicator to ~~[illegible]~~ the success of government macroeconomic policy, as well as the ability of the nation to service debt. This can be judged by the debt servicing ratio. This also helps determine the credit ratings of a nation.

The Howard Government has made a serious comitment to reducing Australia's foreign debt levels. The Government aims that by the end of this financial year foreign debt as a percentage of GDP will be down to 13% from over 30% in 1995-96. If this succeeds, the government would have achieved better levels of external stability by improving confidence by foreign ~~inv~~ investors in the ability of Australia to service debt.

The exchange rate is an important indicator of Australia's external stability, as it indicates the confidence foreigners have in the Australian economy. If foreigners are confident, there will be an appreciation of the exchange rate, as overseas investors wish to invest in Australia, thus requiring Australian currency. The mechanisms of demand and supply in determining exchange rate levels is illustrated in the graph below:



The increase in demand from D_1 to D_2 increases the value of the AUD.

According to a media release from the Reserve Bank of Australia (RBA) in April 2001, the recent devaluation of the AUD should improve export levels as they become more competitive. The worry is that this devaluation could reduce confidence of Australians in the domestic economy, dampening domestic demand.

Since the floating of the AUD in 1983, the government can now do little to influence the exchange rate. Occasionally dirtying the float may help, but usually only for short periods of time. Monetary policy is now the may way the government can influence the exchange rate.

By increasing interest rates, the government attracts foreign investors, who have to convert their currency to AUD. This increases demand for the AUD, thus boosting the exchange rate. The ~~There is a delicate balance be~~ government usually influences ~~exch~~ interest rates through Domestic Market Operations, by ~~affecting the cas~~ trading in second hand government securities in the overnight market.

There is a delicate balance between achieving external stability through ~~high levels of~~ increasing the value of the AUD, and maintaing a low CAD. By increaing the value of the dollar to gain confidence from foreign investors, the competitiveness of ~~the~~ domestic exports are reduced, resulting in a higher CAD. Therefore the government and economists believe that it is most favourable ~~to~~ in terms of external stability to sustain a very gradual depreciation of the AUD.

~~Ing~~ The inflation rate is another factor which affects Australia's external stability. If inflation rates are low, foreign investors are more confident that Australia will achieve a sustainable rate of growth with foreseeable prices. Australia has been able to achieve a very good level of inflation in recent years, as it has sustained inflation within the target range of 2-3%. The only exception was in 2000 when the GST and rising petrol prices pushed inflation rate past 6%.

The government has used monetary policy mostly to achieve this rate of inflation. The RBA has threatened to ~~increase int~~ raise interest rates when ~~it~~ unions argued for wage growths of over 4.5%, which is seen as the maximum rate which can still sustain the target inflation rate. By raising interest rates every time inflationary expectations are high, the government has also been able to sustain inflation.

When ~~mea~~ measuring the external

BOARD OF STUDIES
NEW SOUTH WALES

stability of countries, population factors such as the equitability of income distribution are also considered. Investors tend to have more confidence in economies with more equitable levels of income distribution, as this tends to reduce the level of unrest, and increase the overall rate of spending.

Achieving external stability is a major aim ~~f~~ of the Australian Government. In a globalised economy such as Australia, it is important to achieve external stability by maintaining the confidence of foreigners. ~~During the~~ The herd mentality of investors can have devastating effects on economies when sentiment is turned against those economies. This can be seen during the Asian Financial Crisis in 1997 when the collapse of the Thai

Baht triggered a wave of panic selling of other Asian currencies, giving the region its worse recession in the last 50 years.

In order to achieve external stability, the government can and has implemented fiscal and monetary policies, as well as used microeconomic reform.