ECONOMICS

Examine the trends, causes and effects of external stability in Australia and the government's response to this issue.

Plan:

- External stability: the extent to which an economy is able to meet its international financial commitments
- Trends
    - Period of reduced CAD
- Causes
    - BOGS
        - Mining boom → mining boom slowing
- Increase in demand for commodities in the commodity market diagram
    - Appreciation of the $A and dilatory fall in value
- Increase in demand for the $A in the FOREX market diagram
- Due to:
    - Mining boom → slowing
    - Relative external stability - $A is a safe investment
    - Interest rate differentials
- Causes:
    - Dutch disease
        - Narrow export base
        - J-curve theory
    - NPY
        - Increased household savings rate
        - Investment into the mining sector → reducing
- Australia is a net capital importer
    - Valuation effect → reducing

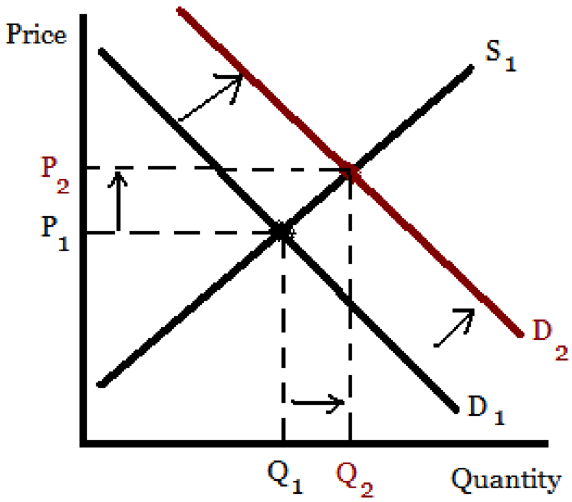
- Effects
    - Debt trap scenario
- Government responses
    - Fiscal consolidation
    - Contractionary macroeconomic policy
    - Microeconomic reform: deregulation of the system of wage determination

External stability is the extent to which an economy is able to meet its international financial commitments. Historically and in the present, Australia has had significant debts for several reasons, yet has maintained its external stability, never experiencing a debt crisis. This is partly due to the government responses to this economic issue.

Australia's current account is the record of Australia's non-reversible transactions with the world over a period of time. This is composed of the Balance on Goods and Services (BOGS), the net primary income account (NPY) and the net secondary income account (NSY). The current account deficit (CAD) is the amount by which Australia spends more than it earns on the current account in a year. This averaged 4% of GDP from the 1990s to 2000s, however is currently at a relatively low 2.4% of GDP (ABS, June 2013) indicating a period of reduced CAD's, however factors in the economy indicate that this period may be coming to an end. Continual CAD's may result in an accumulation of debt which may become unstable if Australia is unable to service this. This does not appear likely to occur in the near future however.

Several factors have affected the BOGS account which partly accounts for these trends. Primarily, China's rapid growth rates averaging 10% for the past 3 decades has caused it to have large commodity demands. This increased demand has increased commodity prices.

Fig 1: Increase in demand for commodities in the commodity market

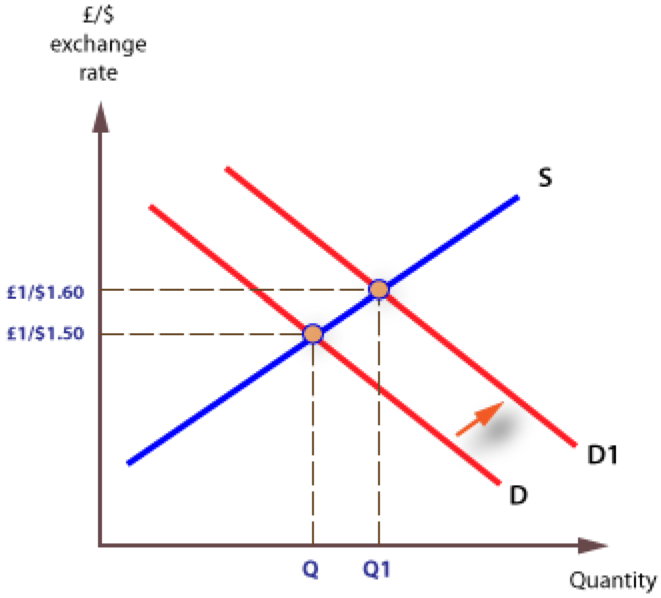


This has created a global resources boom due to the increased supply provided by commodity producers in response to this increase in price due to the potential for higher profits. Australia, due to its large factor endowments has hence experienced a mining boom in response to its terms of trade (ToT) almost doubling between 2000 and 2010. This has increased both exports and the earnings from these exports, hence improving net exports (export credits minus import debits) and hence improved the BOGS account.

The mining boom has recently slowed as the ToT has peaked at 106.5 index points in the third quarter of 2011 and reduced to currently just 91.5 index points in the second quarter of 2013. This is due to China's reduced growth rate to just 7.8% (2012, IMF). Reduced commodity earnings will act to worsen the BOGS into the future.

The mining boom has, by the same means also worsened the BOGS however. Australia's export revenues represent the payments of foreigners for its exports using the Australian dollar ($A). This has increased, hence demand for the $A to pay for these exports has increased and thus the $A has appreciated to a height of $1.09/$US in 2011.

Fig. 2: Increase in demand for the $A in the FOREX market



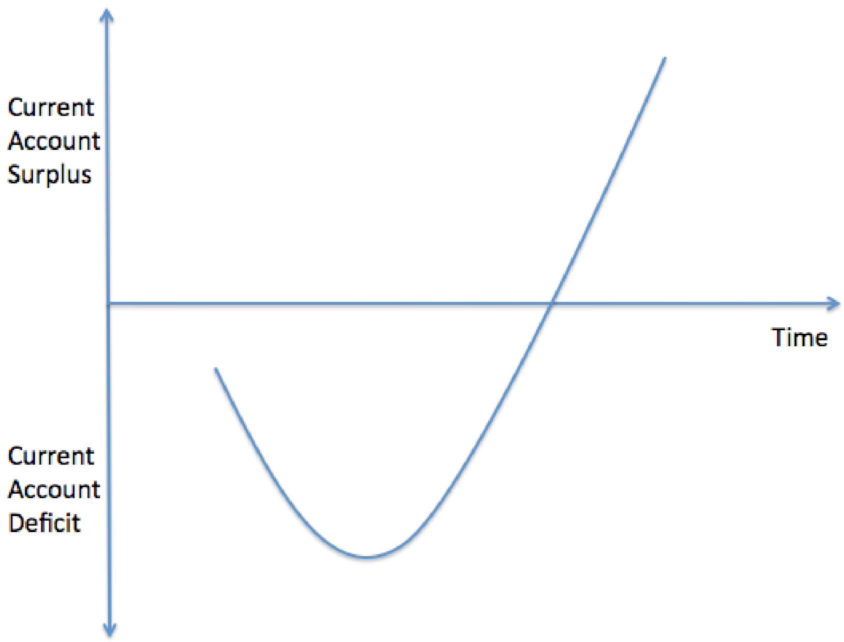
A high Australian dollar causes Australian exports to be more expensive for foreign importers to purchase. This is due to their need to convert their own currency to the $A which has a relatively heightened purchasing power. This decreases their international competitiveness and hence reduces demand for them by foreigners. Simultaneously, imports become cheaper for Australian's to buy on the domestic market due to the heightened exchange rate of the $A compared to that of the exporting country. Hence imports become more domestically competitive and import spending increases. This increases import spending and decreases export revenues, therefore worsening the BOGS.

In the medium-term, the slowing mining boom should result in a fall in the $A due to the decreased demand for it by foreigners to pay for commodities imports from Australia. However, the $A is experiencing a dilatory fall in value to just _____/$US currently. This is due to Australia's relative external stability compared to other countries in the world, many of which are still recovering from the GFC. Hence the $A is seen as a relatively safe investment for investors and speculators on the FOREX market. Investors in this market fear external instability because it results in a drastic fall in the value of a currency due to the lack of confidence in the economy and its currency. This results in losses in value for holders of this currency asset. This also contributed is Australia's relatively high cash rate of 2.5% (September 2013). This is compared to global interest rates for other major economies such as Japan with 0% and the US with 0.25%. This positive interest rate differential makes returns on investment into the Australian financial market higher, hence attracting overseas investment and increasing demand for the $A. This high exchange rate acts to perpetuate the effect of Dutch disease, in which exporting industries experience reduced revenues due to their lack of international competitiveness. This has mainly affected the manufacturing and agricultural sectors in Australia. This coupled with the reduced revenues of the mining sector acts to worsen the BOGS and thus worsen the CAD.

Due to Australia's narrow export base, the BOGS may not significantly improve even in the long-term. Australia has a large comparative advantage in producing commodities, hence its large revenues from this. However it does not have the same comparative advantage in producing other tradeable products such as agricultural products due to the high barriers to trade on these products of other nations. Also, its manufacturing sector is less competitive than that of many developing countries with lower labour costs, hence reducing production costs and allowing them to sell these products at a lower and more competitive price.

Even when the exchange rate does fall, the CAD may not improve immediately, hence further extending this time lag in effect. This is as according to J-curve theory in which BOGS will worsen in the short-term due to the degree of inelasticity in the demand for goods and services. Hence domestic spending on imports will initially rise due to the increase in price. Simultaneously, export revenues will initially decrease due to the decrease in price before international demand rises. This accounts for the time it takes for spending patterns to change.

Fig. 3: J-curve.



The NPY is the difference between payments and earnings on investment into and out of Australia and this account also contributes to the CAD. One of the main factors affecting this account is the household savings rate. This is savings by households as a percentage of disposable income. This has risen from -2% in May 2002 to 10.8% in the second quarter of 2013. This has reduced the growth in private debt from households due to the increase in saving, which generates revenue, over spending which often requires borrowing to undertake, which generates servicing costs on this debt. Hence this dual effect has improved the NPY.

Investment into the mining sector to fund its large capital expenditure needed for the development of mines is worsening the NPY. It is because of Australia's lack of domestic funds due to the small size of its economy that it needs to source funds from overseas. This is the reason it is a net capital importer in which the level of foreign investment into Australia is consistently close to double the level of Australian investment abroad. The NPY worsens due to the servicing costs on this debt accumulated by the mining sector. This effect is decreasing as the mining boom slows and the investment phase of the boom appears to be ending as the construction of mines finishes. This is evidenced in the decrease in Australian mining CAPEX from over $23 billion in 2012 to currently just $22 billion. Hence this account should improve in the future.

The benefit of a high $A has been the valuation effect. This is the effect by which changes in the exchange rate alter the value of debt denominated in foreign currencies. Hence an $A with a high purchasing power makes debt cheaper to pay if the $A is converted to another relatively cheaper currency. This has decreased debt servicing costs, hence improving the NPY. When the $A eventually falls however, this effect will decrease, hence worsening the NPY. It must be realised however, that most of Australia's debt is now denominated in its own currency to prevent this from occurring.

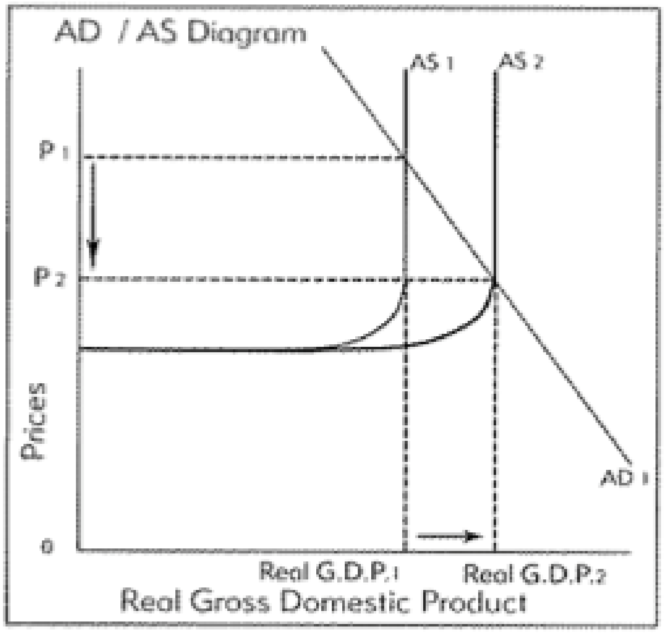
Whilst Australia may have persistent CAD's, it is not experiencing external instability, because it can still afford to service its debt. Though it is doubtful that this will occur in the near future as Australia will still be in possession of its resource endowment assets, even if they reduce in value. An inability to service its debts however may result in a debt trap scenario, resulting in a complete loss of external stability. This is the situation in which an economy needs to take foreign loans to finance its debt servicing costs on its existing debt. This creates more debt with the possibility of creating a cycle of increasing debt that undermines the economy's external stability. This can result in foreign lenders demanding 'risk premiums' on loans, hence only increasing the country's debt and its inability to pay it. This has large ramifications for the economy, such as the loss of investor confidence, resulting in lower investment flows into the economy (I), hence decreasing AD and thus economic activity.

Government responses to attempt to improve external stability include its reduction of budget deficits. This fiscal consolidation should result in lower increases in government debt at least over the Liberal Party's 3 year term in power, with a plan for a budget surplus by 2016-17. Whilst it is doubtful that this party will remain in power for the 4 consecutive terms needed to achieve this, this would result in a reduction in public debt. This policy should lower servicing costs and thus improve the NPY. It should be noted however, that public debt forms only a small part of Australia's debt.

Fiscal consolidation is a contractionary macroeconomic policy, so this should also improve external stability. This is because external stability is a conflicting economic objective with economic growth. Fiscal consolidation reduces the government spending (G) component of AD, for AD=C+I+G+(X-M). This hence decreases economic activity. This improves the CAD, for economic activity generally results in increasing disposable incomes for households and hence increased demand for imports, worsening the BOGS.

Government microeconomic reform aims to improve the productivity and efficiency of domestic producers, thus making them more internationally competitive on the global market. An example is the deregulation of the system of wage determination in Australia to increase wage flexibility such as the introduction of enterprise bargaining in 2009. This allows wages to more accurately reflect the productivity levels of employees, hence incentivising increases in labour productivity (output/labour input) to access higher wages. This higher output of the labour factor of production increases aggregate supply (AS).

Fig. 4: Increase in AS



As in the diagram, this results in a decrease in price from P1 to P2. This hence makes Australian products cheaper on the international market.

Australia's external stability is possibly on a trend of worsening due to mainly the cause of the slowing of the mining boom. This will not have a large effect however, and this is partly due to government policies to maintain external stability.