The Federal Governments' most potent tool for economic growth, redistribution of income and external stability is its ability to use and implement fiscal policy. Fiscal policy, as it is noted is the use of the federal governments' budget to achieve its economic objectives in the domestic economy and by far exceeds the value of monetary policy in achieving economic growth, and redistribution of income and external stability which remain issues of great concern and consideration even as we approach the 21st century and economic stability.

Fiscal policy or the govt. budget can have three forms.

Fiscal surplus or budget surplus: whereby government revenue exceeds govt. spending in the economy.

Fiscal deficit or budget deficit: where govt. spending in the economy exceeds govt. revenue or

Fiscal Balance: Both govt. revenue and spending is in equilibrium or equal.

Economic growth is the increase in value of goods and services produced in a year or GDP (Gross Domestic Product) and is critical in harbouring many other govt. objectives which are tied in with it such as creating more employment and increasingly satisfying more needs and wants of society, or material living standards in the economy. To promote economic growth, the govt can implement an

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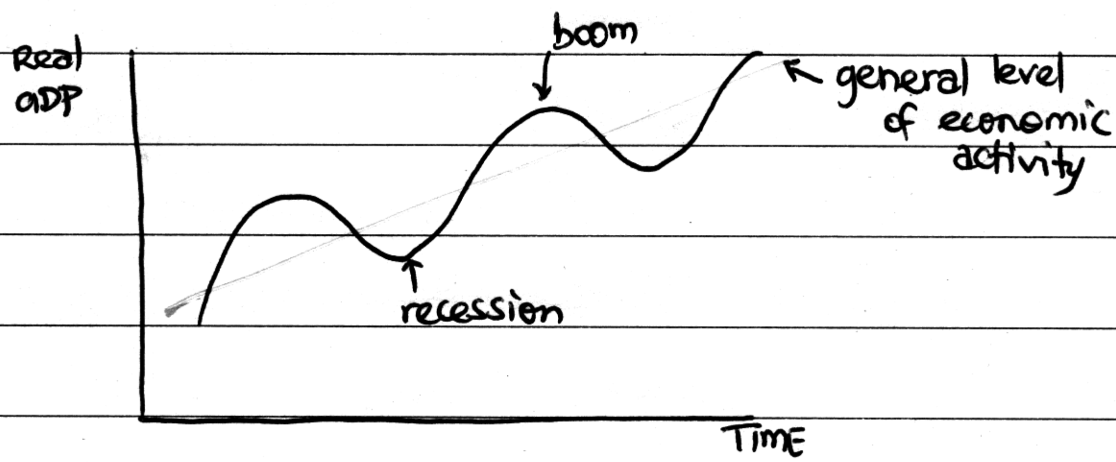
expansionary budget which will raise the level of aggregate demand in the economy. This will put pressure on firms to produce more output to satisfy the increase in demand and this will lead to economic growth over time as our GDP will increase due to the increase in demand. As displayed by the 'Statement on Monetary Policy' - GDP increased at an annualised rate of 4% over three quarters. However, the downfall of using and implementing expansionary fiscal policy is the increase in domestic inflation rates and worsening of external stability which are equally important in maintaining further growth, output and satisfaction of wants. Therefore, it is believed that fiscal policy can be used to implement counter-cyclical policies which aim to smooth out the fluctuations of the business cycle which represents the change in economic activity over time.



Thus, the ups and downs of the business cycle, pictured above can be made more smooth if economic growth is to be sustained over long periods. It is generally noted that growth has to remain within 3-4% of GDP if these counter cyclical policies brew advantages. Thus, there shouldn't be an excessive expansionary policy in the fiscal, as this could weaken our external stability which is determined by the levels of foreign liabilities of Australia, the value of the $A and the Current Account Deficit (CAD) which occurs due to our small savings and the fact that we have to rely on foreign funds to carry out domestic growth. Therefore, not only is is important for us to maintain growth, but also to ensure external stability is ~~not~~ achieved as Australia is heavily dependent on it.

In recent years, the govt. has implemented surplus budgets so that external stability can be maintained. This was done in response to our deteriorating external stability due to deficit budgets ~~and~~ as an increase in expenditure caused an increase in aggregate demand in the economy and consumers began to increase their wants through importing from overseas, leading to a decline in the goods and services balance on the Current Account. Therefore, aggregate demand had to be dampened and the surplus budgets that the govt.

implements fosters longer term growth as the govt. then does not have to borrow as well to cover for the deficit it creates with the budget. As can be seen in the Reserve Bank Bulletin the govt has had consistent budget surpluses since 1998 to 2001.

The great advantage of having a surplus budget is that it does not worsen our external stability while still increasing growth. Keynisian economic theory proposed by Mr Keynes suggested that to boost eco. growth, aggregate demand needs to rise which is composed of $Y = I + C + G + (x - m)$ _ investment spending + consumer spending + govt. spending plus balance on exports minus imports. However, in achieving a rise in agg. demand, this is bad for external stability as imports increase.

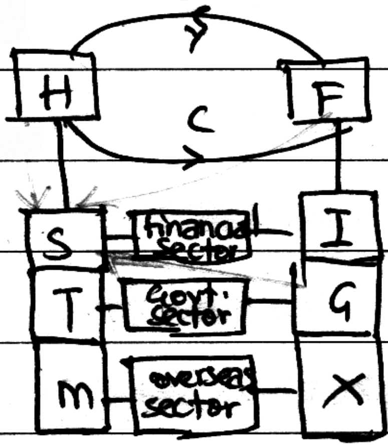
To achieve external stability, the CAD has to be reduced, this is because if it isn't the economy will be stuck in a debt trap scenario where it is borrowing more from overseas to pay for the debt that is already there. The Current Account deficit occurs when the goods and services or exports decline relative to imports, which decreases revenue from exports. The current account is composed of = Goods and Services balance + net income + net current transfers. The major growth of the

CAD is the increase in the income deficit in the current account. This is because Australia owes more in terms of foreign liabilities overseas than foreigners owe Australians. Australian liabilities overseas is due to the fact that our economy has a low savings level 2.9% and this forces govts and businesses to borrow from overseas to maintain further growth in the economy, as further growth requires investment funds which can be borrowed. We have low savings, and for the economy to be in equilibrium S=I, savings must equal investments, though in Australia Savings = 18% of GDP and Investment 22.5% of GDP, because of our low savings, the rest has to be borrowed from overseas for the economy to be in equilibrium.

In the past, a deficit budget would mean that govts. would have to borrow the deficit from the private sector to fund the deficit in the budget and this led to the 'crowding out' of the public sector, whereby both the govt. and private sector relied on the scarce savings to increase further output. However, lenders preferred to lend to the govt, causing a shortage of funds for the private sector to implement their own objectives. Therefore, in recent years, the Howard govt.

has placed emphasis on keeping budget surpluses ~~to~~ so that it does not have to borrow the deficit from the private sector. Therefore, fiscal policy is more contractionary to implement external stability by the govt.

As can be seen in the five sector model,



the govt competes with the private sector for funds, reducing output from the private sector. Therefore, the private sector is forced to borrow from overseas increasing the CAD.

Due to our continued low levels of savings, we must also rely on foreign investment to fund our lack of ~~sav~~ savings. To do this effectively, foreign investors' confidence in the domestic economy must be maintained, so more funds can come in and create more growth. Therefore confidence in the Aust. economy must be maintained. The value of the $A must be ~~high~~ low, so that we attract foreign investment.

The CAD has increased significantly over the years, but because the govt has implemented surplus budgets, it is not tempted to borrow from the private sector or overseas. This has seen the CAD decrease over the years. In the year 2001 CAD was 4.9% of GDP and in 2002 is 3.8% of GDP, this has been as a result of govt. surplus budgets. And, because ~~we to~~ the govt. borrows less, the size of foreign liabilities has also decreased from 50% of GDP to 48% of GDP.

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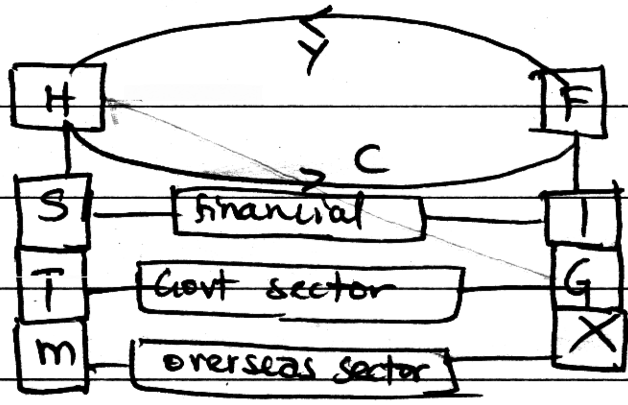

Govt. spending to the household sector.

The govt. also uses fiscal policy to redistribute income to some sectors, more than others. The budget has to take into account welfare benefits which compose around 30% of govt spending to the unemployed or those in low incomes, and it does this through transfer payments via the progressive tax system whereby the more one earns, ~~the~~ proportionately the more tax is deducted. ~~E~~ In this way, funds from the top income earners are redistributed to those of lower incomes via the tranfer payment.

The govt. can also redistribute income ~~or~~ in the form of export incentives to industries which may be more competitive in the global economy or export assistance. In this way, external stability is ~~man~~ maintained as well. Recently the govt. has given tax incentives to the Textiles Clothing & Footwear industries (TCF) which are declining due to globalisation, just as a way to secure domestic employment for a while, while the govt. is spending more to re-train and educate people as well.

In this way fiscal policy promotes economic growth, redistributes income and assists external stability in the long term.