

AUSTRALIA'S TRADE AND FINANCIAL FLOWS



Multiple choice

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

Short answer questions

Question 1

(a) i) Year 2:

$$\begin{aligned} \text{Terms of Trade} &= (\text{Export Price Index} / \text{Import Price Index}) \times 100/1 \\ &= 98/102 \times 100/1 \\ &= 96.1 \end{aligned}$$

ii) Year 3:

$$\begin{aligned} \text{Terms of Trade} &= (\text{Export Price Index} / \text{Import Price Index}) \times 100/1 \\ &= 107/95 \times 100/1 \\ &= 112.6 \end{aligned}$$

- (b) i) Rising terms of trade should improve the balance of goods and services (BOGS) outcome (if trade quantities remain fixed).
- ii) Rising terms of trade should increase export revenue which will reduce the debt servicing ratio.
- (c) **Structural change plays a long term role in improving Australia's balance on goods and services outcome, and thus improving the current account deficit. Over the past two decades, successive Australian governments have undertaken a wide range of structural reforms, including the reduction of tariffs, enhancing competitive pressures through National Competition Policy and increasing the flexibility of the labour market. Such reforms help to reallocate resources towards the most productive areas of the economy, force businesses to increase their international competitiveness, and have also promoted increased labour productivity growth. In recent years, Australia has seen the dramatic growth of exports from the manufacturing sector – led by the \$5bn per year car industry – and the relative decline of the agricultural sector. Australia's export growth, 8 per cent per year over the past decade, is well above export growth in the rest of the world, which was just 5.5 per cent over the same period. While the CAD remains high – largely because of the**

persistent deficit on the net income account – trade outcomes have showed moderate improvement in recent years because of structural change policies adopted by the Australia Government.

Question 2

- (a) **i) During the period shown in the table, there has been a large general increase in financial flows (18 times increase in foreign investment in Australia and a 35 times increase in Australian investment abroad).**
- ii) Since the early 19990s, the growth of foreign portfolio investment has outstripped the growth of foreign direct investment in Australia.**
- (b) **The general increase in financial flows means that the AUD is likely to become more volatile as speculators play a larger role in foreign exchange markets.**
- (c) **The major difference between direct and portfolio investment is the length of time that the investment remains in the country for: portfolio investment tends to be short-term speculative investment, whereas direct investment is a long-term undertaking, and often involves large capital expenditure. As a result, governments tend to prefer FDI because it adds to the productive capacity of the economy, and thus increases economic growth. While portfolio investment will facilitate economic growth, this type of investment can be short-term and speculative in nature, and can thus increase volatility and our vulnerability to external shocks.**
- (d) **In recent years, the Australian government has implemented structural changes to the economy to improve Australia's trade outcomes. Over the past decade, the government reduced protection levels for all major industries, creating an average general tariff level of 5 per cent. While the short-term effect of this was to worsen Australia's trade outcome, we are now experiencing the benefits of these reductions, namely, improved international competitiveness for our export industries, which has improved the trade outcome.**

More recently, the government has pursued bilateral free trade agreements with a number of countries, including the US and Thailand, as well as signing an agreement with Singapore (SAFTA) in 2002. Along with our involvement in regional trade negotiations and participation at the Doha Round of the World Trade Organisation, these agreements should open up new markets for our exporters, and help improve the balance on goods and services.

Question 3 (

- (a) **Foreign debt refers to the accumulation of all funds borrowed by Australians from foreigners. In addition to paying back the principal borrowed, Australia must also pay back interest on foreign debt. Foreign equity, on the other hand, refers to the total value of Australian assets such as land and shares that have been sold to foreign investors. Australia must pay back returns on these assets, such as dividends and rent.**
- (b) **During the boom of the 1980s, there was a large increase in foreign debt, from \$6.8bn to \$130.8bn in a decade. However, as foreign debt approached unsustainable levels, there was a shift toward foreign equity, and the value of foreign equity jumped from \$43.6bn in 1992-93 to \$90.9bn in 1998-99. Since the Asian financial crisis of the late**

1990s, there has been a steady decline in the level of net foreign equity. At the same time, net foreign debt has increased in size, largely due to the depreciation of the AUD – as 60 per cent of Australia’s foreign debt is denominated in foreign currencies.

- (c) **The major impact of high foreign debt is that interest must be paid back on that debt. A continual outflow of funds of the net income account leads to a sustained current account deficit that must be further financed through additional borrowing. At the extreme, this cycle can lead to a ‘debt trap’ scenario. Another major impact is that if foreign debt becomes too high, international investors may worry about the sustainability of the debt, and downgrade Australia’s credit rating, leading to higher international interest rates, and making it more costly for domestic investors to borrow. Finally, a reliance on debt may undermine confidence in the AUD, leading to a depreciation, which would in turn increase the size of the 60 per cent of Australia’s foreign debt that is denominated in foreign currencies through the ‘valuation effect.’**