

Australia's Trade and Financial Flows

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Multiple Choice Answers

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

Short Answer Questions

Question 1

- a) The terms of trade is a measure of the relative movement in export prices relative to import prices over time. It is calculated by dividing the export price index by the import price index and expressed as an index relative to a base year of 100.
- b) There has been a deterioration in the terms of trade.
- c) First, growth in financial flows has been much higher than the growth in trade flows. Since the deregulation of financial markets in Australia in 1983, financial flows have increased rapidly, more than doubling over the past decade. Secondly, growth in portfolio investment inflows has been far greater than growth in direct investment inflows. At the start of the 1980s, direct investment inflows were higher than portfolio investment inflows. However, due to rapid growth in portfolio investment inflows, portfolio investment is now three times larger than direct investment inflows.
- d) An improvement in the terms of trade indicates that Australia is either paying less for its imports relative to its exports, or that it is receiving more for its exports relative to its imports. This means that Australians are paying less for imports, reducing the value of import expenditure and improving the balance on goods and services; or that Australian exporters are receiving higher prices for their exports, increasing export revenues and improving the balance on goods and services.

- e) In recent years, volatile commodity prices on global markets have changed the composition of Australia's exports. As prices for mining and mineral exports on world markets have risen close to record highs, Australia's export revenue has significantly increased, improving the current account balance. However, since commodity prices tend to be volatile, this exposes the current account to sudden changes in global commodity prices. Over the longer term, Australia's manufacturing exports have increased as a percentage of total exports. This reflects an improvement in international competitiveness, which in the long run should lead to higher export revenues and a lower current account deficit. On the other hand, Australia has experienced an increase in imports of finished consumer goods. As a result, imports are often a direct substitute for consumption goods, and so when consumption rises, so does the level of imports. For example, strong growth rates driven by high consumption over the mid 2000s saw a worsening of the balance on goods and services due to increased import consumption. Finally, Australia's direction of trade has shifted steadily to the East Asia and Pacific Region over the past two decades. In particular, Australia is exporting more to China and the ASEAN economies. As a result, over the 2000s, Australian exports have gained access to one of the fastest growing regions of the global economy, which should improve the balance on goods and services. For example, the booming manufacturing sector of the Chinese economy over the 2000s saw a large increase in demand for Australian commodity exports.

Question 2

- a) The current account is measured as a percentage of GDP so that it can be compared to other current account balances over time, and to economies of different sizes as measured by GDP.
- b) The financial account is a record of all reversible financial transactions between Australia and the rest of the world. It consists of direct, portfolio and other investment flows and reserve assets. The net income account, however, is a component of the current account, which records all non-reversible transactions. The net income account records all servicing costs on financial assets such as interest repayments and dividends.
- c) Australia's current account deficit (CAD) moves in a cyclical manner, following the fluctuations in the balance on goods and services. However, the CAD tends to be in deficit, and only rarely records a surplus. This reflects the structural component of the CAD, the net income account, which is a persistent deficit of around 3-4 per cent.
- d) Australia's current account deficit (CAD) is affected by cyclical and structural causes. The balance on goods and services is affected by four cyclical causes. The international business cycle affects demand for Australia's exports. A downturn in the international business cycle will decrease demand for exports and worsen the CAD. The domestic business cycle, on the other hand, will affect demand for imports. An upturn in the domestic business cycle will increase domestic incomes, raising domestic spending levels which spills over to an increase in imports, worsening the balance on goods and services. Australia's strong growth rates over the 1990s and 2000s meant that import growth consistently outstripped export growth, resulting in a persistent balance on goods and services deficit. The terms of trade affects the price of Australia's exports and imports. A poor terms of trade, such as over the 1990s, will result in lower prices for Australia's exports, reducing export revenue. An appreciation of the exchange rate will reduce export competitiveness, and lower import prices, worsening the balance on goods and services. The balance on goods and services is also affected by structural factors. Australia suffers from a narrow export base and low international competitiveness. Australia tends to export low value-added products and imports high value-added products, resulting in a persistent deficit on the CAD. The net income account is also in a persistent deficit due to structural factors. Australia's low level of national savings and high level of domestic investment results in a savings and investment gap. As a result, firms must turn to foreign finance to fund domestic investment, raising Australia's level of foreign liabilities and increasing Australia's servicing obligations to overseas. This results in a persistent net income deficit, contributing to the persistent CAD.

Question 3

- a) Net Foreign Liabilities = Net Foreign Debt + Net Foreign Equity
 = 600 + 80
 = \$680 billion
- b) Net foreign debt is the total stock of loans Australia owes to the rest of the world, minus loans owed to Australia. Debt must be repaid at the end of the loan period and is serviced with interest repayments. Net foreign equity is the total value of Australian assets owned by overseas investors, minus overseas assets owned by Australia. Foreign equity gives ownership to overseas investors, who are entitled to a share of the profits made by those assets, such as dividends from shares.
- c) The balance of payments is a reflection of all financial transaction flows between Australia and the rest of the world over a period of time. Net foreign liabilities, on the other hand, are a stock of Australia's total liabilities at a point in time. If an Australian firm borrows from overseas to finance investment, the initial inflow of money will be recorded on the financial account as a direct investment credit. The increase in debt will also increase net foreign liabilities. The higher level of net foreign liabilities will result in higher servicing costs on debt and equity, which must be paid to the overseas investors. The interest repayments to overseas will be recorded as a debit on the net income account, raising the current account deficit.
- d) A high current account can lead to a reduction in an economy's economic growth rate. This is known as the balance of payments constraint. A high current account deficit caused by a balance on goods and services deficit will result in a decrease in economic growth as imports (a leakage) outstrip exports in the economy. This directly reduces the level of aggregate demand in the economy. Also, a high current account deficit will result in an increase in financial inflow, as high current account deficits must be matched by capital and financial account surpluses. This will raise the level of foreign liabilities and increase future servicing costs. In extreme situations, this may lead to a debt trap scenario where servicing costs are so high that businesses must look to overseas finance to pay off the servicing costs, further increasing foreign debt. Finally, a high current account deficit may weaken international investor confidence in the Australian economy, leading to volatility in the exchange rate and capital flight. This occurred in the economies of East Asia in the 1997 Asian Financial Crisis. However, some economists argue that a high current account deficit does not have any significant negative impacts upon the economy. Rather, the high current account deficit reflects the fact that overseas investors are willing to lend money to Australian firms because of the high profitability of Australian investments. This is the view of the Pitchford Thesis. Under this view, the current account is merely a reflection of the overseas share of the domestic profits which overseas investment helped to create.

Class Activity

- Current account, net income debit
- Current account, goods debit
- Capital and financial account, direct investment credit
- Capital and financial account, direct investment credit??
- Capital and financial account, capital account debit
- Current account, net income credit
- Current account, services credit
- Current account, services debit
- Current account, current transfers credit
- Capital and financial account, portfolio investment debit
- Current account, goods debit
- Capital and financial account, capital account debit
- Capital and financial account, direct investment debit
- Current account, net income debit

Skills Revision

- Financial account = \$20bn
- Direct investment = -\$18bn
- Direct investment = -\$65bn
- Financial account = \$36bn
- Net income = -\$10bn
- Net income = \$60bn
- Financial account
- Balance on goods and services = -\$35bn
- Net income