

Australia's trade and financial flows, Balance of Payments and free trade and protection – Past HSC questions 2011-2007

Marking guide and notes from marking centre included

4 The table shows selected data for an economy.

Component	\$ billion (\$bn)
Government spending	30
Investment	25
Saving	30
Exports	30
Taxation	20
Imports	35

Which of the following statements is true for this economy?

- (A) The economy is contracting.
- (B) Injections exceed withdrawals.
- (C) Withdrawals exceed injections.
- (D) The economy is in equilibrium.

7 The table shows data for a nation's terms of trade.

Year	Export Price Index	Import Price Index
1	110	100
2	105	100

All other things being equal, which of the following policy actions is most likely to reduce the economic impact of the change in the nation's terms of trade?

- (A) The Reserve Bank increases interest rates.
- (B) The Government increases income tax rates.
- (C) The Government increases discretionary expenditure.
- (D) The Reserve Bank intervenes to increase the value of the currency.

14 In which of these situations are the net foreign liabilities of an economy most likely to increase?

- (A) Current account deficit and currency appreciation
- (B) Current account deficit and currency depreciation
- (C) Current account surplus and currency appreciation
- (D) Current account surplus and currency depreciation

15 The table shows Balance of Payments data for a hypothetical economy with a floating exchange rate.

<i>Balance of Payments (BoP)</i>	<i>\$ billion (\$bn)</i>
Net Goods	-15
Net Services	5
Net Income	-50
Capital Account	5
Net Current Transfers	5

What is the value of the Financial Account?

- (A) \$45bn
- (B) \$50bn
- (C) \$55bn
- (D) \$60bn

(a) The table shows current account data for an economy.

<i>Component</i>	<i>Year 1 (\$bn)</i>	<i>Year 2 (\$bn)</i>
Exports of goods and services	250	300
Imports of goods and services	275	350
Net Income	-50	-60
Net Current Transfers	-5	-5

(i) Calculate the change in the current account balance from *Year 1* to *Year 2*. 2

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(ii) Outline ONE factor that may have caused the change in the Net Income component of the current account. 2

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(iii) Outline ONE factor that may have caused the change in the Imports component of the current account. 2

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Question 22 (continued)

(b) Why does Australia have a persistently high current account deficit?

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Question 22 (a) (i)

Criteria	Marks
<ul style="list-style-type: none"> • Correctly states the change in the value of the current account balance from Year 1 to Year 2 	2
<ul style="list-style-type: none"> • Correctly states the change in the direction of the current account balance <p>OR</p> <ul style="list-style-type: none"> • Correctly states the value of the current account balance 	1

Question 22 (a) (ii)

Criteria	Marks
• Sketches in general terms ONE factor that may have caused an increase in the Net Income component of the current account	2
• Correctly states that the Net Income component increased OR • Demonstrates a limited understanding of ONE cause of a change in the Net Income component of the current account	1

Question 22 (a) (iii)

Criteria	Marks
• Sketches in general terms ONE factor that may have caused an increase in the Imports component of the current account	2
• Correctly states that Imports increased OR • Demonstrates a limited understanding of ONE cause of a change in Imports	1

Question 22 (b)

Criteria	Marks
• Demonstrates a clear understanding of the reasons for Australia's persistently high current account deficit	4
• Demonstrates a sound understanding of the reason for Australia's persistently high current account deficit	3
• Sketches in general terms some understanding of the reasons for Australia's persistently high current account deficit	2
• States an aspect of why Australia has a persistently high current account deficit	1

Question 22

a)

i. Most candidates correctly calculated the change in the current account balance and stated the change of a decrease in \$35 billion from *Year 1* to *Year 2*. Many candidates also correctly calculated that the current account deficit increased by \$35 billion.

In weaker responses, candidates often only calculated the current account balance for *Year 1* and *Year 2* but did not calculate the change from *Year 1* to *Year 2*, and/or gave an incorrect calculation.

ii. In better responses, candidates demonstrated a clear understanding of one factor that may have caused the change in the Net Income component of the current account. They noted that the Net Income component had deteriorated from *Year 1* to *Year 2* and sketched in general terms one reason for this change. Reasons included: increases in foreign financial flows into the economy; subsequently increasing the payments of dividends and interest, which are recorded as debits in the Net Income component; depreciating exchange rates that increased the debt servicing costs; and increasing profits to foreign investors that resulted in increased dividend payments and higher interest repayments on foreign debt due to higher global interest rates.

In weaker responses, candidates did not understand the meaning of the Net Income component on

the current account and incorrectly referred to it as being part of the labour market with tax and unemployment factors being the cause of the change.

iii. In better responses, candidates demonstrated a clear understanding of one factor that may have caused the change in the Imports component of the current account. They correctly identified that imports had increased, and sketched in general terms one reason that had caused this change. Reasons included: increasing domestic growth with demand spilling over into imports, as increased consumer spending and business investment increases the demand for imports; an appreciation of the domestic currency results in increasing the volume of imports as the price of imports decreases; a depreciation of the currency can also result in increasing the value of imports as the cost of imports rises and decreasing trade barriers increasing the supply of imports.

In weaker responses, candidates merely stated one factor that may have caused the change in imports and did not attempt to explain how it may have caused the increase. Some candidates became confused with the effects of a depreciating currency, incorrectly stating that it made imports cheaper and easier to sell.

b) In better responses, candidates demonstrated a clear understanding of the reasons for Australia's persistently high current account deficit (CAD), linking their answers to its persistent nature and the structural and cyclical causes. Examples included: the role of the savings investment gap and Australia's high interest rate differential; narrow export base; high net foreign liabilities; high economic growth rates and increasing aggregate demand; twin deficits; the Pitchford thesis; the historic nature of the composition of Australia's trade; and the effects of the mining boom on Australia's current account. Responses were well structured with clear links provided in a specific rather than general way.

In weaker responses, candidates provided only general information on the CAD and failed to link their answers to its persistent nature. In addition, some of these candidates focused on general trade issues and current events without relating this back to the question.

3 The table shows selected data for an economy.

<i>Balance of Payments items</i>	<i>\$ billion (\$bn)</i>
Exports	500
Imports	540
Net services	-70
Net income	-115
Net current transfers	85
Capital transfers	30
Reserve Assets	-20

According to the information in the table, which statement is correct for the economy if it has a floating exchange rate?

- (A) There is a deficit of \$225bn on the balance of goods and services.
- (B) There is a surplus of \$140bn on the capital and financial account.
- (C) There is a surplus of \$950bn on the current account.
- (D) There is a deficit of \$10bn on the capital account.

Question 21 (10 marks)

(a) The table shows data for a nation's terms of trade.

Year	Export Price Index	Import Price Index
1	100	100
2	92	115
3	96	116

Using the information in the table, calculate the terms of trade for this nation in Year 2 and identify the trend from Year 2 to Year 3.

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(b) Why has there been an increase in Australia's service exports in the last two decades?

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Question 21 (a)

Criteria	Marks
• Correctly states the terms of trade for this nation in Year 2 and correctly identifies the trend from Year 2 to Year 3	2
• Correctly states the terms of trade for this nation in Year 2	
OR	
• Correctly identifies the trend from Year 2 to Year 3	1

Question 21 (b)

Criteria	Marks
• Sketches in general terms why there has been an increase in Australia's service exports in the last two decades	2
• Demonstrates a limited understanding of why there has been an increase in Australia's service exports in the last two decades	1

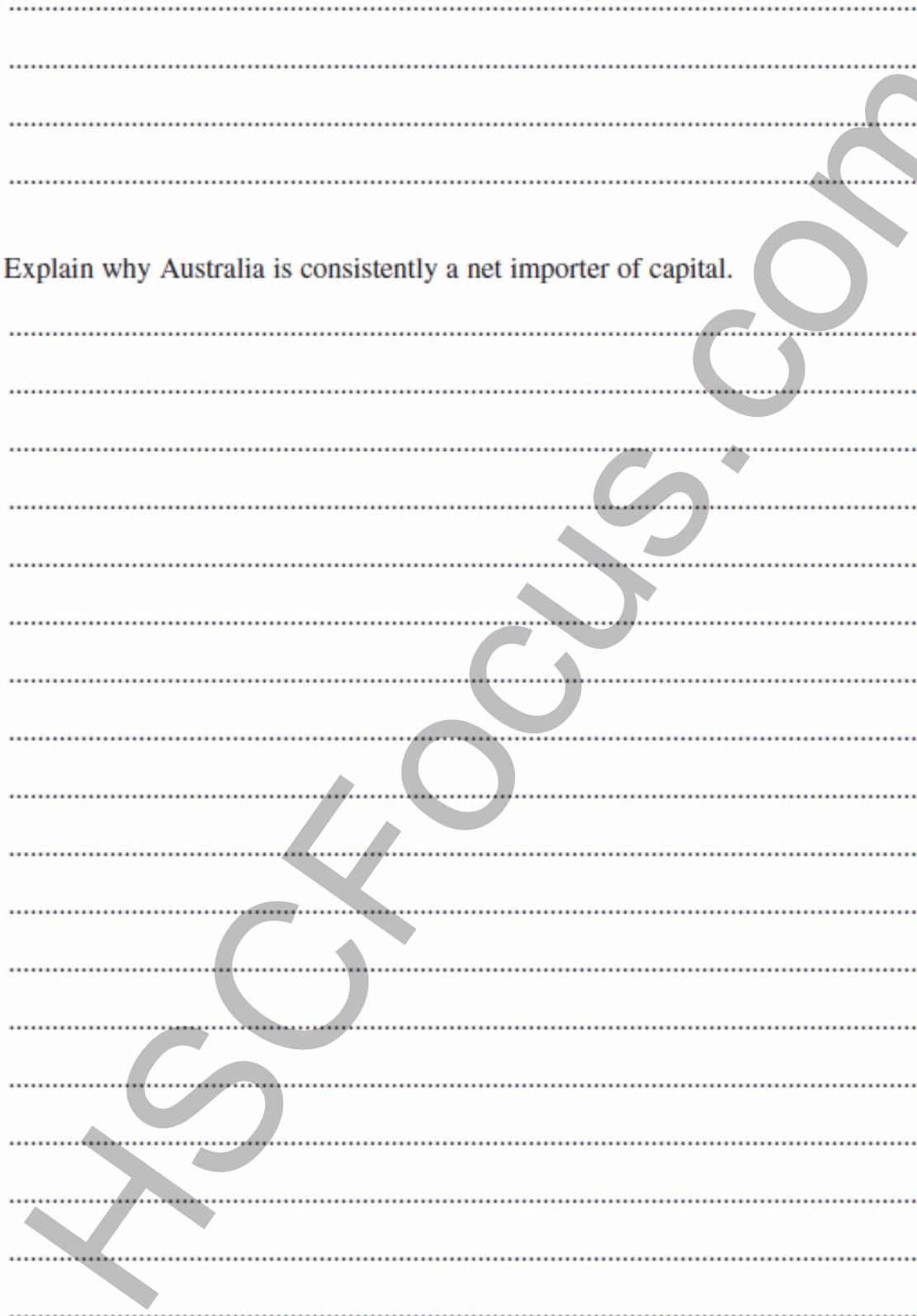
Question 21 (continued)

(c) Why has the value of Australia's imports from Asia increased in the last two decades?

2

(d) Explain why Australia is consistently a net importer of capital.

4



Question 21 (c)

Criteria	Marks
• Sketches in general terms why the value of Australia's imports from Asia has increased in the last two decades	2
• Demonstrates a limited understanding of why the value of Australia's imports from Asia has increased in the last two decades	1

Question 21 (d)

Criteria	Marks
• Demonstrates a clear, concise understanding of why Australia is consistently a net importer of financial and/or physical capital	4
• Demonstrates a sound understanding of why Australia is consistently a net importer of financial and/or physical capital	3
• Sketches in general terms why Australia is consistently a net importer of financial and/or physical capital	2
• List some reasons why Australia is a net importer of financial and/or physical capital	1

Question 21

- Most candidates correctly stated the terms of trade (TOT) for Year 2 in the given table as 80, and calculated that the TOT improved or increased from Year 2 to Year 3. A minority of candidates confused the definition of the TOT with the ratio of the import price index to the export price index.
- In better responses, candidates cited factors such as Australia's developing comparative advantage in the supply of services and government policies to promote this. They also commonly gave inbound tourism and education exports as prime examples. Globalisation and world economic growth were also frequently given as reasons for the growth in Australia's service exports. However, in weaker responses, candidates failed to provide a brief elaboration as to how these processes can lead to the trend in service exports.

In some weaker responses, candidates simply stated that Australia has shifted away from manufacturing towards services.

- In better responses, candidates linked the existence of comparative advantage and economic growth in Australia with increased imports from Asia.

In weaker responses, candidates commonly referred generally to globalisation or simply to an increase in demand for imports from Asia, without giving a reason why this demand has increased. In some poor responses, candidates included unjustified statements such as that economic growth in Asia was responsible for increased imports from Asia.

- In better responses, candidates talked in detail about the many interrelated links between imported financial capital, our balance of payments, our relatively high interest rates, our savings/investment shortfall, the current account deficit and surplus on the capital and financial account (and may have even mentioned our lack of comparative advantage with respect to the production of physical capital). Candidates also wrote about Australia's positive economic environment that is conducive to capital inflows.

In weaker responses, candidates referred at length to the lack of Australian efficiency at producing capital equipment. There were very few good attempts at explaining imports of physical capital as opposed to financial capital. In weaker responses, candidates tended to refer to the benefits of physical capital imports, not to the reasons why capital is imported.

2 How are the foreign company dividends paid to Australian investors recorded on Australia's Balance of Payments?

- (A) As a debit on the current account
- (B) As a credit on the current account
- (C) As a debit on the capital and financial account
- (D) As a credit on the capital and financial account

5 The table shows data for a nation's terms of trade.

<i>Year</i>	<i>Export Price Index</i>	<i>Import Price Index</i>
1	100	100
2	110	106
3	115	110

Which of the following statements about this nation's terms of trade is correct?

- (A) They improved from Year 1 through to Year 3.
- (B) They deteriorated from Year 1 through to Year 3.
- (C) They deteriorated from Year 1 to Year 2 and then improved from Year 2 to Year 3.
- (D) They improved from Year 1 to Year 2 and then deteriorated from Year 2 to Year 3.

9 Which of the following is most likely to improve Australia's international competitiveness?

- (A) Implementation of structural change
- (B) An increase in domestic interest rates
- (C) An improvement in the terms of trade
- (D) An increase in the value of the Australian dollar

4 What has contributed to Australia's persistent current account deficit?

- (A) Ongoing federal budget surpluses
- (B) Australia's low national savings rate
- (C) The high level of diversification of Australia's exports
- (D) A reduction in dividend payments to foreign investors

5 The table shows selected data for an economy.

<i>Balance of payments items</i>	\$ billion (\$bn)
Exports	400
Imports	460
Net services	-50
Net income	-110
Net current transfers	70

According to the data, which statement is correct for an economy with a floating exchange rate?

- (A) There is a surplus of \$150bn on the capital and financial account.
- (B) There is a deficit of \$150bn on the capital and financial account.
- (C) There is a surplus of \$290bn on the current account.
- (D) There is a deficit of \$290bn on the current account.

15 An economy is a net importer of commodities and a net exporter of manufactured goods.

Which of the following will lead to a deterioration in its terms of trade?

- (A) The volume of manufactured exports increases relative to the volume of commodity imports.
- (B) The volume of manufactured exports decreases relative to the volume of commodity imports.
- (C) The prices for commodities increase relative to prices for manufactured goods on world markets.
- (D) The prices for manufactured goods increase relative to commodity prices on world markets.

Question 24 (continued)

(b) The table shows current account data for Australia.

3

Australia's current account balance 2006–07 (\$m)

Balance on Goods and Services	-12 033
Income	
Credits	32 873
Debits	<u>-79 585</u>
Net Income	-46 712
Net current transfers	-444
Balance on the current account	<u>-59 189</u>

Balance of Payments
and International
Investment Position;
Catalogue #5302.0,
August 2007, ABS data
used with permission
from the Australian
Bureau of Statistics

Source: *Australian Bureau of Statistics*

Using the data, briefly explain how Net Income affects the current account balance.

A large, faint watermark is printed diagonally across the page. The watermark consists of the words 'HSCFocus' in a bold, sans-serif font. The text is oriented such that 'HSC' is at the bottom left and 'Focus' is at the top right, though the text is continuous. The watermark is rendered in a light gray color that is only slightly darker than the background paper.

Question 24 (continued)

(c) Analyse TWO possible economic consequences of foreign debt for an economy. 5

Question 24 (b)*Outcomes assessed: H1, H8, H9, H11***MARKING GUIDELINES**

Criteria	Marks
• With reference to the data demonstrates a clear and concise understanding of how net income affects the current account balance	3
• With reference to the data sketches in general terms how net income affects the current account balance	2
OR	
• Without reference to the data demonstrates a clear and concise understanding of how net income affects the current account balance	1
• Sketches in general terms how net income affects the current account balance	

Sample answer:

In 2006–2007, net income represented 79% of the CAD. This is mainly due to the large income debit resulting from the payment of interest on Australia's large foreign debt. The income debit also reflects the large dividend payments made by Australian companies (especially in mining companies) to foreign investors. This creates a CAD which must be financed by debt and equity borrowings which creates a surplus on the capital and financial account.

Question 24 (c)*Outcomes assessed: H1, H7, H8***MARKING GUIDELINES**

Criteria	Marks
• Draws out and relates clearly, accurately and concisely TWO possible economic consequences of foreign debt for an economy	4–5
• Draws out and relates TWO possible economic consequences of foreign debt for an economy	3
OR	
• Draws out and relates clearly, accurately and concisely ONE economic consequence of foreign debt for an economy and sketches in general terms the other	
• Sketches in general terms TWO economic consequences of foreign debt or an economy	2
OR	
• Draws out and relates ONE possible economic consequence of foreign debt for an economy	
• Correctly states what is meant by the term foreign debt	1
OR	
• List some economic consequences of foreign debt	

Sample answer:

A high foreign debt can impact negatively on a country's credit rating if international borrowers lose confidence in the country's ability to make payments. This can lead to creditors charging a risk premium (ie, a higher interest rate) on loans made to the country. This increases the cost of repayments and worsens the CAD leading to a "debt trap" scenario which adds further to the country's debt.

Increased foreign debt can increase economic growth by allowing the importing of foreign capital. Australia often needs to import capital as there are low levels of savings domestically. As such, in order to develop infrastructure Australia borrows from overseas. These borrowings can increase Australia's productive capacity, increasing employment and income.

Question 24

(a) Better responses provided a clear and concise definition of the term *direct foreign investment*. They referred to the fact that direct foreign investment was non-speculative, equity focused, achieved a greater than 10% share or a controlling interest in a firm and usually of a longer term duration.

Weaker responses ignored the significance of the word 'direct' in the definition, often confusing it with speculative investment and therefore provided a generalised definition of foreign investment.

(b) Better responses referred to the data in the table provided. These responses demonstrated effective use of the data through quoting and interpreting the figures and in many cases made calculations using the figures to further strengthen their arguments. Better responses showed a clear and concise understanding of the components of the net incomes account and effectively demonstrated how the net incomes account impacted on the overall balance of the current account.

Weaker responses tended to either refer to the data sparingly or not at all. These responses were more descriptive in nature and whilst they showed some understanding of the components of the net incomes account, they did not establish the connection between the net incomes account and its impact on the current account balance.

(c) The third part of the question asked candidates to analyse two possible economic consequences of foreign debt for an economy. Better responses articulated two clear and concise economic consequences of foreign debt for an economy using appropriate economic terminology. The consequences of foreign debt for an economy could have been analysed as either being positive or negative, with the vast majority of candidates choosing to answer the question using just negative consequences. Better responses established a strong causal link between the size of the foreign debt and its impact, either positive or negative, on the economy. Examples included such things as debt servicing, credit rating issues, the need for capital stock and the role of foreign capital in supplementing Australia's poor savings record.

Weaker responses tended to either describe or just list features of foreign debt. Some provided just one consequence. There was little if any attempt to provide a direct link between foreign debt and a possible impact, positive and/or negative, on an economy. These responses used generalised expressions instead of appropriate economic terminology. Weaker responses also confused foreign debt with budget deficits or simply wrote of foreign debt as being the difference between exports and imports.

13 Which of the following could be recorded as a credit in the current account of the Australian balance of payments?

- (A) Expenditure on imports
- (B) Interest paid to Australian lenders
- (C) Dividends paid to foreign investors
- (D) Foreign aid from the Australian government for capital works in Thailand

14 The table shows selected data for a hypothetical economy.

<i>Year</i>	<i>Export price index</i>	<i>Import price index</i>
1	100	100
2	110	105
3	130	140

Which statement is correct for this economy?

- (A) In Year 2 import prices rose faster than export prices.
- (B) In Year 3 export prices rose faster than import prices.
- (C) In Year 3 a given volume of exports will buy a larger volume of imports.
- (D) In Year 3 a given volume of exports will buy a smaller volume of imports.

Question 24 (continued)

(c) The government of a country that trades with Australia reduces subsidy payments to its farmers. Discuss the economic impact of this action on BOTH economies. 5

5

Question 24 (c)*Outcomes assessed: H1, H2, H3, H4***MARKING GUIDELINES**

Criteria	Marks
<ul style="list-style-type: none">• Demonstrates a clear, comprehensive and balanced understanding of the positive and/or negative economic impact on both Australia and the other economy of a reduction in subsidy payments to farmers in the other economy	5
<ul style="list-style-type: none">• Demonstrates a clear, and thorough understanding of the positive and/or negative economic impacts on both Australia and the other economy of a reduction in subsidy payments to farmers in the other economy	4
<ul style="list-style-type: none">• Demonstrates a sound understanding of the positive and/or negative economic impacts on both Australia and the other economy of a reduction in subsidy payments to farmers in the other economy	3
OR	
<ul style="list-style-type: none">• Demonstrates a clear and concise understanding of the positive and/or negative economic impacts on either Australia or the other economy of a reduction in subsidy payments to farmers in the other economy and sketches in general terms the other	3
<ul style="list-style-type: none">• Sketches in general terms the positive and/or negative economic impacts on both Australia and the other economy of a reduction in subsidy payments to farmers in the other economy	2
OR	
<ul style="list-style-type: none">• Demonstrates a clear, concise or sound understanding of the positive and/or negative economic impact on either Australia or the other economy of a reduction in subsidy payments to farmers in the other economy	1
<ul style="list-style-type: none">• Lists some impacts on either Australia or the other economy of a reduction in subsidy payments to farmers in the other economy	

- Better responses clearly articulated the impact of reducing a subsidy on BOTH economies. Impacts included international competition considerations, terms of trade, employment/ unemployment, economic growth, balance of payments and other economic variables for both economies. They identified both the short-run and long-run implications and provided a balanced consideration of the positive and negative impacts on both economies. Furthermore, better responses identified Australia's comparative advantage in agricultural production and integrated knowledge acquired from Topics 1 and 2 of the syllabus. Better responses also integrated into their answer a range of economic terms, concepts, data and theory to support their response.

Weaker responses tended to provide vague notions of the impacts and/or tended to assert wrongly that the reduction of the subsidy was instigated by the Australian government and not its trading partner.