Australia's Trade and Financial Flows

4

Multiple Choice

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

Short Answers

Question 1

(a) Current account balance = balance on goods and services + net primary income + net secondary income

= 60-85-5

= -$30 billion

(b) The net primary income account records the income flows from investments made by Australians overseas, less income paid to foreign investors in Australia. The net primary income account therefore covers the *servicing costs* on foreign liabilities. On the other hand, the financial account records the actual transactions on foreign assets and liabilities themselves ie borrowings and investments.

(c) A persistent current account deficit will increase the level of financial inflows, 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. The specific impact of persistent current account deficits depends on their cause. If the CAD is caused by increased consumption and not investment, economic growth will fall as import growth (a leakage) outstrips export growth (an injection) in the economy, subtracting from the level of aggregate demand. If this continues over a period of time, it may undermine the confidence of foreign investors, resulting in adverse economic impacts such as reduced investment, a weaker currency, higher interest rates and slower economic growth.

(d) The balances on the current account and the capital and financial account are closely related because in every year they add up to zero. In other words, a deficit on the current account will be equal to the surplus on the capital and financial account (although there is usually a small difference explained by statistical errors and omissions). This means that an increase in the capital and financial account surplus will result in an increase in the current account deficit and vice versa. A long term relationship also exists between the two accounts, because over time surpluses on the capital and financial account will increase foreign liabilities, which in turn will increase the current account deficit (through servicing costs for foreign liabilities on the net primary income account).

Question 2

(a) The terms of trade is a measure of the 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) Australia's terms of trade has seen a dramatic increase since around 2003, rising from 66 to a peak of over 130 in 2011. This is the largest sustained increase in the terms of trade in Australian history. However, the terms of trade briefly deteriorated in 2008 from around 113 to 93 in 2009, before seeing strong growth again in 2010 and 2011.

(c) In recent years, rising global commodity prices – reflected in the large increase in Australia's terms of trade – have driven a significant increase in export revenue, leading to an improvement in the BOGS and the current account balance. Record high mining and mineral prices have also seen a large increase in the share of export earnings coming from resources. This reflects Australia's comparative advantage in the mining sector, which now accounts for over half of Australia's total export revenue. However the higher terms of trade have also contributed to an appreciation of the Australian dollar, which has reduced the international competitiveness of manufacturing and service exports and reduced the share of total exports from these sectors.

(d) The direction of Australia's trade has shifted significantly in the last few decades due to changes in the global economy and the Australian economy. Half a century ago, Australia's historic ties to the United Kingdom meant that most of its key markets were in the UK and Europe. However, Australia shifted its focus to the Asia-Pacific region in the years after the UK joined the European Economic Community (now the EU) in 1973. The newly industrialising Japanese economy became an increasingly important export market between the 1960s and 1980s, while in the 1990s and 2000s China, Korea and other economies in Asia became key markets for both exports and imports. The rapid industrialisation of China has had a dramatic impact on Australia's export growth during the past decade, becoming the nation's major export partner and the major contributor to Australia's improved trade performance. Nevertheless, Australia still imports substantially from high-income economies like the US and European nations, reflecting these countries' comparative advantage in high value-added capital and consumer goods.

Question 3

(a) The balance on goods and services (BOGS) is the sum of net goods and net services, equal to the difference between exports and imports. The BOGS is a component of the current account of the balance of payments. An increase in the balance on goods and services surplus will generally improve the current account balance (assuming it is not offset by changes in the net primary income and net secondary income accounts).

(b) An increase in net foreign liabilities means there is an increase in financial inflows (credits) on the financial account, as Australia has increased its overall level of foreign borrowing (debt) and investment (equity). The servicing costs on debt and equity, namely interest repayments and dividend remittances, will be recorded as an outflow (debit) on the net primary income component of the current account. Thus, an increase in net foreign liabilities generally increases the net primary income deficit and results in a higher current account deficit. In turn, this can lead to further increases in foreign liabilities to service debt, thereby creating a cycle of increasing foreign liabilities and a deteriorating current account deficit

(c) Australia has seen the current account deficit fluctuate in recent times, from lows of below 3 per cent to highs of over 6 per cent of GDP. Its average over the past two decades has been just over 4 per cent of GDP. A number of structural factors account for the high CAD. Australia has a savings-investment gap, meaning there is an excess of investment demand over a low level of national savings. Australian firms and households thus rely on a large sum of foreign borrowing (debt) and investment (equity) in order to fund investment. This results in a cycle of higher servicing costs for foreign borrowings and equity, reflected in the persistent structural deficit on the net primary income component of the current account. The current account is also influenced by cyclical factors. Strong growth in China and high commodity prices has seen export revenues rise very strongly in recent years, creating a surplus on the balance of goods and services and reducing the CAD. The CAD has also been reduced as a result of a mild decrease in the net primary income deficit, as the higher exchange rate has reduced servicing costs on foreign liabilities.

Class Activity

- Current account, Goods credit
- Capital and financial account, Direct investment debit
- Capital and financial account, Capital account debit
- Current account, Primary income debit
- Capital and financial account, Portfolio investment credit
- Current account, Services credit
- Current account, Goods debit
- Capital and financial account, Reserve assets debit
- Current account, Primary income debit
- Current account, Secondary income credit
- Current account, Services debit
- Capital and financial account, Portfolio investment debit
- Capital and financial account, Direct investment credit
- Current account, Primary income credit
- Capital account, Capital account debit

Skills Revision

- Financial account = $31bn
- Direct investment = –$18bn
- Net primary income = -$33bn
- Financial account = $36bn
- Net primary income = -$10bn
- Portfolio investment = $13bn
- Financial account
- Capital account
- Net secondary income = -$7bn