

## **Topic Two**

### **Australia's place in the global economy**

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Australia's economy ranks 15<sup>th</sup> amongst the advanced economies making it larger than 200 economies in the world. But compared to the big economies, like the US and Japan, Australia is relatively small.

#### **Trends in Australia's trade flows**

Trade has always represented a large proportion of Australia's economic activity even though it is geographically isolated and only has a small population.

- § In the 1950's Australia's main trading partner was the United Kingdom, but due to the establishment of the EU, Australia has gone away from the UK and nowadays our major trading partner is Japan. The Asia-Pacific region is by far the most important trading partner that Australia has.
- § Australia has traditionally had a comparative advantage in the production and exporting in the primary industry, unlike other high-income countries, Australia is less competitive in the production of manufacturing.

#### **Trends in Australia's financial flows**

The rate of growth in financial flow has been much faster than trade, as international businesses invested into Australian companies. Deregulation has been a major reason for this dramatic increase in financial flows.

#### **The Balance of Payments**

The **balance of payments** is a record of all economic transactions between Australia and the rest of the world over a given period of time. It is broken into two accounts:

- § The current account
- § The capital and finance account

**The Current account** shows all money flow from all exports and imports of goods and services, income and current transfers for a period of time.

**Net goods** – refers to the difference between what Australia receives for its exports and pays out for its imports. Possible outcomes:

- § Balance – where export receipts = import payouts
- § Surplus – where exports > imports
- § Deficit – where imports > exports

**Net services** – refers to services are bought and sold without people receiving a good.

The **balance of goods and services** is an amount that is derived by adding net goods and net services together.

**Net income** – refers to earnings on investment. It covers interest payments on borrowings, and returns on foreign investment.

**Net current transfers** occur when real or financial resources are provided without a specific good or service been provided in return

**Balance of Current Account** – refers to the addition of the balance of goods and services, net income and net current transfers.

**The capital and financial account** – refers to the money flows that result from international borrowing, lending and purchase of assets.

**Capital account** – consists of capital transfers, with three main elements

- § Capital transfers from people migrating into or out of Australia
- § Capital transfers are from foreign aid to assist other countries to build their infrastructure or capital stock.
- § The purchase and sale of non-produced, non-financial assets (intellectual properties)

**Financial account** – shows Australia's transactions in foreign financial assets and liabilities. It is broken into 4 categories.

- § **Direct investment** – covers foreign financial transactions to fund new investment in Australia.
- § **Portfolio investment** - refers to buying of land, shares and other marketable securities in existing companies.
- § **Other investments** – is a residual category that captures transactions not classified to direct investment, portfolio investments and reserve assets.
- § **Reserve investments** – refers to those foreign financial assets that are available to and controlled by the central authorities for financing or regulating payment imbalances.

**Topic Two**  
**Australia's place in the global economy**  
**Summary of Balance of Payments**

**The current account** = net goods + net services + net income + net current transfers

**The capital and financial account** = capital account + direct investments + portfolio investments + other investments + revenue assets

**The balance of payments** = current account + capital and financial account + net errors and omissions = 0

**Links between key balance of payment categories**

§ **Supply of \$A**

Payments for imports of goods and services (M)

Income/Transfers overseas (Y debits)

Capital and financial outflows (K outflow)

=

§ **Demand for \$A**

Receipts for exports of goods and services (X)

Income/receipts overseas (Y credits)

Capital and financial flow (K inflow)

Therefore, equilibrium in FOREX market:

Supply of \$A = Demand of \$A

Deficit of Current Account = Surplus on capital and financial account

A high level of capital and financial account surpluses will result in a widening CAD because of the servicing costs. This can lead to a "Debt trap" where the country has to borrow from overseas to pay back debt.

**Australia's Balance of Payments performance**

Australia has experienced a relatively large CAD since the 1980's. The as a percentage of the GDP is the best measure of the CAD. Australia has one of the worst CAD performances amongst all advanced economies. A high CAD can be a result of high levels of direct investments, which would, allows for high levels of economic growth. A general rule is that the CAD should not be above 3% of the GDP. Australia's is currently around 4.5%. a CAD above 6% cannot be maintained in the short-term as it causes serious imbalance within the economy.

§ **Net foreign debt** – reflects the total liabilities of Australians to foreigners **minus** the liabilities of foreigners to Australians

§ **Net foreign equity** – reflects the total value of Australian assets in foreign ownership **minus** the total value of overseas assets owned by Australians.

Equity doesn't directly add to Australia's foreign debt. However we do have to send back profits. Borrowing does add to foreign debt, because the initial borrowed amount must be repaid and the debt must be serviced. The effect of debt servicing on the CAD is very significant and is the largest single cause of Australia's high CAD. Australia's net foreign debt has grown dramatically from the beginning of the 1908's. in the long term, the growth of Australia's foreign debt can lead to a debt sustainability problem, meaning that it becomes more difficult to service the debt.

The **Debt servicing ratio** indicates the proportion spent on interest payments on foreign debt.

**Issues with trends**

§ **Structure of Australia's export base**

Australia's export base is heavily weighted towards the primary industry. In comparison to other advanced economies, Australia has a high reliance on the exports of primary industries. In the long-term, this is bad for Australia's CAD as more countries are focusing on sophisticated manufactures and services. Also prices of primary goods can fluctuate a lot depending on global economic conditions. Australia's narrow export base is regarded as an economic problem. Australia produces few advanced technology items, making the economy reliant on imports.

§ **International Competitiveness**

The major reason for Australia's limited progress in trade performance is that we are not internationally competitive. To be competitive Australia must restructure the economy to allow for greater efficiency.

## **Topic Two**

### **Australia's place in the global economy**

The two main aspects of international competitiveness are cost and non-cost issues. By cutting cost a business is able to sell at lower prices without reducing their profit.

Non-cost issues include the quality of the good or service, the reliability of supply, the effectiveness of marketing effects and the quality of customer service.

#### **§ Structural change**

**Microeconomic reform** attempts to address the factors that affect international competitiveness.

§ Australian exporters are at a disadvantage if the Australian inflation rate is higher than other countries. Recently, Australia has been successful in maintaining low levels of inflation.

§ Keeping labor costs low is important for businesses, as they are the most significant part of the business costs. Excessive wage growth will put Australian exporters at a disadvantage as they have higher production costs.

§ To reduce production costs, Australian firms must increase productivity, that is use their resources more efficiently.

§ The Australian government tries to pursue improved international competitiveness, through a smaller public sector and an efficient public sector. Most government businesses have been privatized, and governments have given high priority to keeping fiscal deficits under control.

§ **Terms of trade** – is expressed as a number known as the terms of trade index. It shows the ratio of the price index to import price index

$$\text{Terms of trade index} = \frac{\text{export price index}}{\text{Import price index}} \times \frac{100}{1}$$

Changes in Australia's terms of trade can have a large influence on Australia's balance of payments. A deterioration of the terms of trade would increase Australia's CAD, but an increase in Australia's terms of trade has the opposite effect of improving Australia's CAD.

#### **§ The cost of servicing foreign liabilities**

A higher level of foreign debt contributes further to the CAD, because an outflow of funds is needed to service the interest rates. Changes in Australia's exchange rate can also influence the size of foreign liabilities. The actual amount of Australian dollar needed to purchase the foreign currency increases.

#### **§ National savings**

Australia has a low level of national savings, which contributes to foreign liabilities, because Australians have to rely more on savings of foreigners to fund local investments.

#### **The consequence of a high CAD**

§ The growth of foreign liabilities, will mean that lenders will be more reluctant to lend to Australia or invest in Australia

§ Increased servicing costs will reflect a large net income deficit on the CAD. This can contribute to the problem of the debt trap.

§ Increased volatility for exchange rates – a high CAD may decrease the confidence of overseas investors in the Australian economy. This may result in a depreciation of the \$A, which will increase the price of imports and increased cost of servicing foreign debt increases.

§ Constraints of future growth. Growth is forced to be limited to keep the CAD at a sustainable level. This means that the RBA would have to use a contractionary economic policy.

**Exchange rates** – are simply the price of Australia's currency in terms of another country's currency, which allows traders and investors to swap Australian currency for another currency. The currency conversion occurs in the foreign exchange rate market.

#### **Demand is effected by**

§ The size of financial flows into Australia from foreign investors

§ Expectations of a future appreciation of the \$A will increase demand by speculators.

§ The demand for Australian exports

§ Australia's international competitiveness

§ Changes in global economic conditions.

#### **Supply is effected by**

§ The level of financial flows out of Australia

§ Speculations that the \$A will drop, will cause speculators to sell \$A which will lead to increased supply

§ The domestic demand for imports

## **Topic Two**

### **Australia's place in the global economy**

The **trade weighted index** is a calculation by measuring the value of the \$A against all the currencies of Australia's trading partner against a base year. In other words, the currency that has more importance is given more weighting.

#### **Types of exchange rates**

- § **Fixed exchange rates** – the exchange rate is set at a certain level by the government or central bank. Fixed exchange rates require intervention by the central bank to maintain the currency at a certain level. This can be very expensive for governments especially if the currency is overvalued.
- § **Floating exchange rate (clean float)** – the exchange rate is determined by the demand and supply of the currency, not the central bank. A clean float occurs when there is no government intervention in the determination of the exchange rate. This can mean that the currency is volatile. The balance of payments is always in equilibrium. Overseas transactions do not alter the domestic currency
- § **Managed exchange rates (dirty float)** – when there is official intervention in the setting of the exchange rate. The central bank only intervenes to minimize large fluctuations in the currency, but it is still set by the market forces.
- § **Managed fixed peg** – is when the central bank changes the levels of exchange rates each day depending on the current market forces.

#### **Balance of payments and the exchange rate**

The performance of the balance of payments is one of the most important influences on exchange rates. Using a floating exchange rate, \$A supply will always equal \$A

#### **Effects of exchange rate changes**

	<b>Positive</b>	<b>Negative</b>
<b>Appreciation</b>	<ul style="list-style-type: none"> <li>§ Reduce \$A needed to service foreign debts</li> <li>§ Reduced inflation pressures</li> </ul>	<ul style="list-style-type: none"> <li>§ Currency becomes more expensive to buy</li> <li>§ Possibilities of increased CAD</li> <li>§ Expensive for foreign investors</li> </ul>
<b>Depreciation</b>	<ul style="list-style-type: none"> <li>§ Exports become cheaper -&gt; improved CAD</li> <li>§ Imports become dearer -&gt; discourages import spending -&gt; decreased CAD</li> </ul>	<ul style="list-style-type: none"> <li>§ Raise level of foreign debt in terms of \$A</li> <li>§ Inflationary pressure</li> <li>§ Negative effect on CAD</li> </ul>

#### **Protection in Australia**

##### **Main aims of reducing protection:**

- § Force domestic industries to become efficient
- § Force domestic industries to become internationally competitive
- § Increase living standard
- § Promote structural change in the economy

##### **Effects on firms**

May be beneficial in the long run for the business. Firms competing with import industries will struggle unless they can improve their competitiveness. The aim of removing protection for local industries is to force them to compete on the world stage, which will make them have to become more efficient

##### **Effects on individuals**

There may be an increase in unemployment associated with restructuring of industries and cuts in local production. The jobs that are generally lost are the low-skilled, production line jobs.

##### **Effects of governments**

Cutting tariffs will lead to a reduction in government revenue. It may also change government spending as they offer assistance for structural change, unemployment benefits and retraining programs.