Australia's Place In The Global Economy

In the 1950's, Australia traded mainly with the UK and other European countries due to strong political links. However, the UK joined the European Union trading bloc and this made Australian exports less competitive due to barriers. Australia's trade flows shifted to Asia because of the sustained economic growth, geographic proximity and resource complementation with Australia.

Japan became the major importer of Australian exports during the 1960's as its economy was booming and expanded demand for product inputs. There was a shift away from Japan to China because Japan's dampened slowed whilst China faced rapid industrialisation and this led to massive increases in their demand for Australia's exports.

China has become Australia's major trading partner with export volumes to China growing by 35% over 2008 to 2012. The APEC countries are also Australia's chief source of imports, reflecting the close geographic link with Asia, as well as the internationally competitive goods they produce due to their factor endowments of labour.

Trade has always been important to the Australian economy and represents a high proportion of its economic activity. Australia's trade intensity was 44% in the period between 2011 and 2012 which is 10% higher than its level in 1979.

In 2011 Australia's two way trade reached a record $608.2 billion. Australia's total goods and services export receipts reached $313.3 billion after a 10% increase in the value of its exports. This was driven by strong demand for metal ores, minerals and coals. A strong terms of trade and trade volume resulted in an $18.3 billion trade surplus. Australia's focus on exports has always been minerals and fuels, as it has factor endowments of land. Minerals and fuels especially iron ore and coal made up over half of Australia's total exports at 50.6% worth $158.7 billion. Over time, exports in services are likely to increase as three quarters of Australia's workforce is employed in services and industries. Consumer goods as a proportion of imports have increased to 80%. Exports of goods and services are forecast to grow by 6.5% in 2013-14 as resource exports increase and there is some recovering in manufactured and tourism exports. Imports of G+S are expected to grow by 6%, constrained by a modest rate of domestic growth and demand and a lower value of the Australian dollar which will lead to imported inflation.

Trends in financial flows – debt and equity

The rate of growth since deregulation in portfolio investment has been much higher than FDI. Australia has always been a **net capital importer** due to its savings-investment gap – a shortage of funds available for domestic investment, leading to the need of foreign funds. The level of investment which Australia receives have more than doubled since the start of the decade – up to 2011, there was just over $2 trillion invested into Australia compared to $1.2 trillion out. The advantages of this are that Australian businesses can finance investment for economic growth but this leads to loss of ownership and control of resources, and high foreign liabilities.

Australia's NFL is worth 60% of its GDP, growing rapidly due to globalisation. This leads to debt sustainability issues as if foreign debt grows as a % of GDP then more of Australia's production must be used to pay off debt which reduces standard of living and growth potential. In addition Australia's external stability is shaken, as since most loans are written in foreign currencies, movements in the dollar's exchange rate leave the economy susceptible to the valuation effect. Furthermore as debt rises as a % of GDP above a sustainable level then the credit rating of a nation could be downgraded, making borrowing more expensive and thus widen the CAD. Equity is not as critical of a problem as profit is only remitted if the investment is successful whereas debt must be repaid regardless.

Consequences of a CAD

There are two schools of thought towards Australia's high CAD, one suggesting that it isn't a concern and the other that it is a critical issue. Economists who are not concerned adopt the Pitchford thesis, focusing on debt as private debt and the growth in foreign liabilities as private investment. They argue that unlike public debt, private debt is a part of the operation of global markets and are beneficial as the funds are used to generate profit in export industries and increase the future productive capacity of the economy.

However, there are risks associated with a high CAD. A high CAD could lower an economy's credit rating and this is detrimental as most investment decisions are made by overseas lenders rather than domestic borrowers. Furthermore the increased servicing costs may lead to the debt trap scenario with the need to borrow to repay loans.

The CAD may also shake external stability by making exchange rates increasingly volatile as it can reduce the demand for the AUD and lead to a depreciation. This in turn may lead to imported inflation and restrain economic growth as monetary policy is tightened.

Calculating Debt

$$\frac{NFL}{GDP} X\ 100$$

Net Foreign Debt = the difference between Australia's foreign borrowings and Australia's foreign lending in the form of loans.

Net Foreign Equity= Total value of assets in Australia such as land, shares and companies in foreign ownership – the total value of assets overseas that are owned by Australians.

Net Foreign Liabilities= Net Foreign Debt + Equity

NFL = NFD + NFE

NFL is derived from primary income. The servicing of debt constitutes an outflow of funds in the CA and leads to a wider cad. Debt can be paid in three ways:

- Borrowing finance from other countries
- Borrowing finance from domestic financial institutions which leads to the crowding out effect.
- Selling reserve assets i.e Foreign currency, gold, oil which has inelastic demand.

Net Primary Income (NPY): The difference between income inflows and outflows in the Balance Of Payments such as interest repayments and dividends.

The NPI is the primary contributor to Australia's persistent CAD due to its high levels of investment inflows which must be serviced with interest. CAD small in comparison with NFL as the principal repaid is recorded in KAFA. Current Account only deals with interest repaid.

Australia's Balance Of Payments

Current Account

Exports (Credit) –
Imports (Debit)
Net Goods: Exports - Imports

Service Credits –
Service Debits
Net Services: Credit - Debit

Balance Of Goods and Services (BOGS)
=Net Goods + Net Services

Primary Income Credit –
Primary Income Debit
Primary Income
(Returns on the Four Factors of Income, interest repayments and returns)

Secondary Income Credit –
Secondary Income Debit
Secondary Income
(Difference between inflows and outflows of funds that are provided without receiving a specific good or service in return i.e insurance payouts, worker's remittances, unconditional aid)

Balance of Current Account = BOGS + PY + SY
<0 = Current Account Deficit (CAD)
>0 = Current Account Surplus (CAS)

Capital Account

1. Capital Transfers (Movement of money that is not related to primary or secondary income AND that is refundable and transferrable) e.g. exchange rates, ongoing aid, debt
   - Credits
   - Debits
2. Net Acquisition/disposal of non produced – nonfinancial assets (Intellectual property such as patents, copyrights, trademarks, logos)

Balance on the KA (Capital transfers + Net Acquisition….)

Financial Account

1. Foreign Direct Investment
2. Portfolio Investment (loans, shares)
3. Reserve Assets (Gold, foreign currency)
4. Financial Derivatives
5. Other Investment

Balance on the Financial Account=
Addition of the above

Balance on the Capital and Financial Account (KA+FA)

-Net Errors and Omissions (Anything that isn't counted)

Australia's Balance of payments summarises Australia's financial transactions with the global economy. It consists of three sections – Current account (CA), Financial account (FA), and Capital account (KA).

The Current Account records all transactions that are non-reversible and includes net goods + services, net primary income (the servicing cost of interest on debt, dividends on foreign assets that is remitted overseas) (Returns on the four factors of production) and net secondary income. **The CAD is expected to widen from -3.5% in 2012-13 to -3.75% of GDP in 2013-14, reflecting an increase in the trade deficit due to lower exports.**

The capital and financial accounts record transactions for borrowing, lending, sales and purchases of assets between Australia and the global economy over a period of time. These transactions are reversible – i.e borrowings can be repaid, and assets that are bought can be sold again.

The capital account consists of capital transfers and has two key elements – capital transfers and the net acquisition/disposal of non-produced, non-financial assets.

The financial account records Australia's transactions in foreign financial assets and liabilities. Australia as a net borrower of funds consistently records a surplus on the financial account. The five subsections of the financial account are:

1. Foreign Direct Investment covers the purchase of more than 10% of shares in an existing company.
2. Portfolio investment covers loans, government borrowing, land purchases and smaller share purchases (under 10%).
3. Financial derivatives cover financial assets whose value is derived from the performance of specific assets, interest rates and exchange rates.
4. Reserve assets
5. Other investment

Balance Of Payments Stats (2013)

Current Account Balance: -47 654$ (million)

Balance on Goods and Services: -10,487 (million)

Primary Income Balance: -$35,857 (million)

Capital And Financial Account Balance: $47,114 (Million)

Financial account balance: $48,228 (million)

Links Between Key Balance Of Payments Categories

Current Account+ Capital and Financial Account + Net errors and omissions = 0

Financial flows into Australia are recorded as credits in its financial account. International borrowing requires regular interest payments and these are recorded as debits on the net primary income account. The repayment of the principal is recorded on the portfolio investment account. Due to the servicing costs associated with foreign liabilities, the CAD may widen over time, forcing increased borrowing to pay it off and creating a debt trap scenario.

The CA has been persistently in debt and needs to be financed through foreign debt and equity borrowings. As such, the KA and FA has always been in surplus.

The BOGS is an indicator of exchange rates – high imports means there is a high supply of Australian currency (Depreciation). A high export means high demand for currency.

Factors Affecting Trends in Australia's Balance Of Payments

The **International competitiveness** of Australia's exports will influence its trade volume and hence the BOGS. The key factors affecting international competitiveness are relative inflation rates and the exchange rate. It is measured by real unit labour costs and the real exchange rate.

The **terms of trade** is the ratio of export prices to import prices and is calculated by export price index / import price index X100. A strong terms of trade will lead to a better BOGS, smaller CAD and encourage speculative investment into Australia, leading to a stronger KAFA. Vice versa. The export price index shows changes in the prices of exports and the import price index shows changes in the prices paid for imports.

International borrowing is the main contributor to the NPI deficit and hence the CAD. Changes in the exchange rate may affect the value of debt – known as the valuation effect.

Foreign Direct Investment into Australia is another factor that affects the NPI deficit and hence the CAD. Australia has relied on foreign investment to finance its savings-investment gap. Although many of Australia's mining companies contributed to a surplus in the BOGS during the resources boom they also contributed to the net income deficit as they have a significant amount of foreign ownership.

Exchange Rates - Refer to the price of a currency in terms of another.

The forces of supply and demand of floated currencies or government intervention of fixed currencies determine its price in terms of another.

Demand for Australian currency is a derived demand, equal to foreign demand for Australian exports, assets and currency.

Supply for Australian currency is equal to domestic demand for imports, foreign assets and foreign currency.

Hence the factors that affect the demand and supply of Australian currency are the factors that determine domestic and foreign demand for g+s, assets and currency such as:

- The level of Australian interest rates relative to overseas interest rates
- The international competitiveness of Australian exports
- Expectations of the AUD's future value for speculation.

Measurement of Exchange Rates

Direct quoting: The quantity of domestic currency needed for a unit of foreign currency i.e $US1 = $A1.27

Indirect quoting: The value of one unit of domestic currency to a foreign currency i.e $A1=$US0.789

Trade Weighted Index measures the value of the AUD against a basket of foreign currencies of major trading partners, weighted according to their importance towards Australian trade.

Determination of Exchange Rates

Under a floating exchange rate system, the forces of supply and demand interact to determine the equilibrium price of a currency. An upwards movement in the exchange rate graph is an appreciation, and a downwards movement is a depreciation.

A fixed exchange rate operates when the government or central bank officially sets the exchange rate, indexing it to another exchange rate on a daily basis. For this system to be implemented, a government would need foreign reserves of currency or gold. Increases and decreased in the currency's value for these systems are called valuations and devaluations.

A managed exchange rate is where the central bank pegs the value of the AUD to either the trade weighted index or another currency on a daily basis. The exchange rate is kept within a target band or zone of intervention.

The Influence Of The RBA On Exchange Rates

The RBA intervenes in the FOREX market as a buyer or seller of $A to influence the exchange rate. It does this to smooth out fluctuations in the exchange rate caused by short term factors such as the sentiments of speculators. The RBA influences the exchange rate in two ways:

1. Dirtying the float, whereby the RBA buys $A in the market if it feels the rate is too low or will fall rapidly and sells the $A if it feels that the rate is too high or will rise too steeply. However, its ability to do so is limited by its reserve assets. Though a benefit from this is that the RBA will always make a profit on these deals, selling the AUD when the price is high and purchasing them when the price is low, ensuring that its actions do not impact negatively upon Australia's external stability.
2. Monetary policy is rarely used to manage the exchange rate. The AUD's exchange rate may change alongside with interest rate changes – a rise in interest rates may raise its international demand leading to capital inflow and thus an appreciation due to greater returns, and a reduction in interest rates may lower its international demand leading to capital flight and a depreciation due to diminishing returns.

Effect of fluctuations in the Exchange Rate on the Australian Economy

Appreciation Note: For depreciation just inverse everything.

Positive effects

1. Increased utility value of income – Australians can buy more internationally competitive imports with the same amount of dollars which also leads to greater living standards and lower imported inflation.
2. Reduction of foreign debt due to the valuation effect
3. A stronger terms of trade which leads to an improvement in the BOGS for the short term – trade volume isn't affected as trade is conducted through contracts.

Negative effects

1. Decreased international competitiveness leads lower export volumes in the short to long term and alongside with higher import volumes results in a worsened CAD in the medium to long term.
2. Reduces the value of income earned from investment abroad, worsening the net income component of the CAD.
3. Increase in unemployment as industries may restructure and cut labour input to become international competitive.

Australia's policies regarding free trade and protection

The main aims of reducing protection are to:

- Increase competitiveness of domestic industries by exposing them to foreign competition
- Encourage reallocation of resources to sectors which have a comparative advantage leading to increased specialization and economies of scale.
- Allow consumers and businesses access to internationally competitive goods and services

After reform in its industry policy, Australia has been transformed from a highly protected nation to one with minimal protectionist policies over the period of globalisation. Australia is one of the least protected economies in the world with the average tariff level falling from 36% to 2.5% in 2008. Australia administers export assistance programs through Austrade – the Export Market Development Grants scheme subsidises exporters for promoting their products in new markets and has been found to generate $27 of export income per dollar spent.

Australia's Multilateral and Bilateral Free Trade Agreements

World Trade Organisation

A forum for sovereign nations to negotiate and enforce international trade agreements – has three main rules:

1. Most favoured nation rule – countries must grant all trading partners the conditions it grants to its 'most favoured nation' trading partner
2. National treatment rule – requires that countries should set conditions for imported goods and services no less favourable than those domestically produced
3. Transparency rules – require member countries to make trade laws and regulations publically available

Asia-Pacific Economic Co-operation (APEC)

A discussion forum for trade policy issues which has developed methods for closer trade and investment links in the Asia-Pacific region. is based on open regionalisation – the process whereby reductions in trade barriers are non-discriminatory, even to non APEC members.

ANZCERTA

The Australia and New Zealand Closer economic relations trade agreement aims to economically integrate Australia and NZ through mutual beneficial expansion of free trade. Since both countries have similar factor endowments, ANZCERTA has allowed for the

restructuring of manufacturing industries in both countries so that they are productive through greater competition and specialisation. Free flows of labour and capital resources have improved the efficiency of resource allocation in both countries.

AUSFTA

The Australian and United States Free Trade Agreement aims to reduce protection on agriculture, manufactured goods, services, investment and intellectual property. This has led to 97% of tariff lines being duty free, with the remaining 3% to be phased out by 2015. The Productivity Commission estimated that AUSFTA could increase Australia's GDP between 0.4 to 0.7% within 10 years of operation.

Implications Of Australia's Policies For Individuals, Firms and Governments

Generally, a reduction in protection has negative impacts in the short term that are heavily outweighed by the long term positive impacts.

Individuals

- Increase in structural unemployment in the short term as inefficient industries restructure and retrench workers
- Structural change causes reallocation of resources to internationally competitive/efficient firms that are profitable and expanding leading to an increase in employment.
- Allows consumers to purchase a wider variety of goods and services at lower prices, leading to higher standards of living.

Firms

- Productions in some sectors of the economy may cease due to structural change.
- Places pressure on firms to innovate and invest, as Australian businesses invest for better technology or economies of scale through expansion due to increased domestic competition.
- Abolishment of tariffs on capital will reduce costs of production and make exporting firms more internationally competitive as input costs are lower.

Governments

- May face a budget deficit as spending may be required to assist structural adjustment in the form of unemployment benefits and training programs.
- CAD will increase in the short term as imports rise but in the longer term should fall as competitive industries experienced a raised volume of exports.
- To reduce the negative impacts Australia has phased out tariffs over a 30 year period rather than just cut them out overnight.

Implications for Australia of Protectionist policies of other countries and trading blocs

- When other countries erect protection barriers, Australian exports become less competitive, leading to lower market share and lower X revenue. This is particularly true for the agricultural sectors of the EU and USA – despite Australia's agriculture industry being competitive.

- When other countries subsidise their exports, they raise the export's supply and thus reduces its prices, eroding the competitiveness of domestic industries. This in turn may contract those industries as demand for their product is mitigated for imports. As a result unemployment may rise and economic growth stunted as M begins to rise against a falling X. However this may lead to deflationary pressures.

- No matter how competitive Australian firms are, they will have a difficult time competing, cutting down on the economy's potential GDP growth. It is projected that if global protection is cut by 50% Australia's GDP would grow by about $7 billion.