**Balance of Payments:**

The pattern of Australia's trade:

The direction of our trade is reflected in our close proximity to the Asia-Pacific region, while the composition of our trade reflects the nation’s natural resource wealth. Australia is rich in primary resources, and has an abundant supply of mineral and energy wealth. Australia is located in the Asia pacific region – the most populous and fastest growing region of the world. Australia’s largest trading partners are China, the US and Japan.

Geographical proximity is a major factor explaining who Australia trades with, but other factors such as political and historical links are also important. Australia has a rich endowment of natural resources which complement the manufacturing giants of China, Japan and Korea. Australia has recently signed free trade agreements with these countries to increase trade flows.

Australia's trade balance: Participating in international trade boosts economic development and growth as well as raising living standards. Exports of goods and services earn foreign exchange which is used to pay for imported goods and services. The balance on goods and services measures the extent to which the value of exports and imports differ. Exports and imports are equivalent in terms of their effects on economic welfare. Exports bring benefits to the production side of the economy while imports bring benefits to the consumption side of the economy. A country will gain if it increases both its exports and imports. A trade surplus is when the total value of goods and services exports exceeds the total value of goods and services imports. A trade deficit is when the value of imports exceeds that of exports. Services are usually a deficit. Goods are volatile. Our exports are determined by how the economies that we export to are performing, whereas our imports are determined by our own domestic growth. When commodity prices increase, our trade balance also increases because the value of exports rises relative to exports.

Balance of payments: A record of all economic transactions between the residents of Australia and the residents of the rest of the world. The residents of a country include individuals, firms and the government. An economic transaction occurs when something of value is provided by one party to another. Economic transactions include:

* Exports and imports of goods.
* Exports and imports of services.
* Income flows (dividends and such associated with foreign investment).
* Financial flows (such as purchases of shares).

When a transaction occurs involving any of these payments between a resident of Australia and a non-resident, then it will be recorded in the balance of payments. Australia’s balance of payments is divided into two broad accounts – current account and capital financial account. The current account is concerned with transactions involving goods, services, and income. The capital account records capital transfers and the acquisition/disposal of non-produced, non-financial assets, for example, copyrights.

Flow of exchange in balance of payments: Each transaction in the balance of payments is recorded as consisting of two equal and opposite entries, reflecting the inflow and outflow element to each exchange. For each transaction, each party records a matching credit and debit entry:

* Credit – exports of goods and services, income receivable, increase in foreign liabilityies, export of currency.
* Debit – imports of goods and services, income payable, increase in foreign assets, import of currency.

The current account: Records transactions between Australian residents and non-residents in three categories:

* Goods.
* Services.
* Income.

There are two parts of the current account – the trade balance and the net income balance. The trade balance measures the difference between Australia’s exports of goods and services and imports of goods and services. The income category of the current account is divided into primary and secondary income.

Primary income is the largest and most important of the two and refers to income earned by Australian residents from non-residents (credits) and income paid to overseas residents (debits). For example, if an Australian company borrowed money from overseas to finance capital investment, it would have to make an annual interest payment on that loan. The interest payment would be classified as an income debit. If an Australian resident receives a dividend payment from a US company, then that would be recorded as an income credit transaction. Primary income consists of two categories: **compensation of employees** (for the use of labour) and **investment income** (for the use of capital). Secondary income includes transactions in foreign aid, gifts, donations and pensions.

The capital and financial account: Records flows of funds into and out of Australia which create an income stream in the future.

The capital account is the smaller of the two, recording transfers of non-produced, non-financial assets, flows of migrants’ assets and the exchange of intangible assets such as patents and copyrights.

The financial account is more important and records transactions in financial assets and liabilities such as shares, securities, and loans between residents of overseas countries. Basically, the financial account records trade in savings and investment. Australia records a capital and financial account surplus to match the current account deficit. The two accounts must sum to zero. Australia has relied on foreign investment to supplement its domestic savings to enable the development of its country.

A financial account surplus means that a country draws on the savings (foreign investment) from the rest of the world. Transactions in the financial account are classified by the type of investment:

* Direct investment.
* Portfolio investment.
* Other investment.
* Reserve assets.

Direct investment is undertaken with the objective of obtaining a lasting interest in a foreign enterprise and exercising a significant degree of influence in its management. This is when a resident investor obtains a 10% or more of the ordinary shares or voting stock of a foreign enterprise, then this is deemed to be direct investment.

Portfolio investment consists of international equity and debt securities (bonds and notes) not classified as direct investment.

Other investment comprises of trade credits, loans, currency and deposits.

To obtain the overall balance of payments, the current account balance and the capital financial account balance are added together. The total balance of payments must always sum to zero. This means that if the current account is in a surplus (CAS), then the capital and financial account will be in a deficit (FAD) and equal to the current account in absolute value (plus any net errors and omissions).

The relationship between the current account and the capital/financial account:

Changes in the balance of payments reflect changes in both the worlds economy and the Australian economy. The balance of payments is an indicator providing information of a nation’s trade account and its financial position relative to the rest of the world. Both the government and the financial markets us e the balance of payments as a guide to analyse the relative performance of the economy. It is important to remember that the capital financial account offsets changes in the current account and vice versa. For example, an increase in foreign investment into Australia will increase the financial account balance which while cause a decrease in the income balance in the current account in terms of greater servicing costs, thereby decreasing the current account balance.

Trends in the accounts: Australia normally records a current account deficit and therefore a capital and financial account surplus. But from the June quarter in 2019, Australia recorded successive quarterly current account surpluses and capital account deficits. Australia, with its low population, does not generate enough savings to finance its large investment needs and so relies on foreign savings. Australia is a very resource rich country and requires large amounts of foreign investment to fund its economic development. This means that Australia will normally record a financial account surplus and a current account deficit. By borrowing savings from overseas sources to supplement domestic savings, Australia is investing in future higher incomes and living standards. Foreign investment has been beneficial to the Australian economy, increasing its rate of economic development and standard of living.

Many people believe that countries should aim for a current account surplus believing that a trade surplus should be an objective in its own right. But this is incorrect. It is impossible for every country in the world to record a trade or current account surplus.

If the level of foreign investment into Australia increases, this will increase the financial account balance. This will generate increased outflows of income payments, such as interests and dividends, which will decrease the current account balance. Foreign investment flows into countries where profit opportunities are strong and economic prospects are positive. When the economy is weak and growing below trend, then foreign investment will fall. This happened in Australia during 2019-20 when the economy was in recession. There may be times when a decrease in the current account balance may be due to a fall in competitiveness due to an increase in production costs or an increase in the rate of inflation. In this instance, the fall in the current account balance is a sign that the economy is not performing well. The important point is to analyse the reason for the change.