Introduction

Australia is closely linked to the global economy through the flow of goods and services, the flow of financial capital and the flow of people including tourists, students, workers and migrants. Nobody can escape the global economy and no economy can afford not to participate in the global economy. The car you drive, the coffee you drink, the clothes you wear and the phone you use are all likely to be imported. Australia not only gains economic benefits from participating in the global economy, but also political, social and cultural benefits. Today, one in five jobs is export related, while around 20 per cent of Australia's income is generated by exports. Australia not only benefits from trade but also relies on foreign investment - the inflow of foreign savings which helps to fund our domestic investment needs, such as the mining sector.

If you board a flight to an overseas destination such as Bali or New York you are participating in global trade. Similarly if you download a music file from the internet or buy the latest smart phone you are engaging in an international transaction. Life would be very boring without access to the global economy. There would be no foreign films, foreign music or overseas travel. An international student studying in Australia, an Australian student backpacking overseas and a foreign firm buying shares in an Australian company are all examples of global economic transactions. Rapid developments in transport and communications have enabled people to interact with the global economy on a daily basis. Consumers benefit from the global economy by being able to consume a much wider variety of goods and services. Producers benefit because they can sell their output to a greater number of buyers. The exchange of goods and services is an important characteristic of any specialised economy. Specialisation and trade enable people to achieve a higher standard of living.

Did you know? Exports and imports each represent around 22 per cent of Australia's GDP. Without foreign investment, Australia would not have a mining sector.

The pattern of Australia's trade

Who does Australia trade with and what goods and services do we trade? The pattern of Australia's trade reveals much about the nature of the Australian economy. 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. We have an abundant supply of mineral and energy wealth and have vast tracts of land that can be used for crops and livestock. Australia's trade advantage is in the primary industries - resources and agriculture. Australia is a leading world exporter in iron ore, coal, natural gas, gold, bauxite, wool, wheat and beef. Australia is fortunate to be located within the Asia-Pacific region - the most populous and fastest growing region of the world. Australia's largest trading partners are China, Japan and the United States.

Figure 11.1 shows the direction of Australia's trade - our main trading partners in 2018. It is important to remember that trade is a two way process - it involves both

exports and imports. Australia's three largest export markets are China, Japan and the Republic of Korea, while the three most important import partners are China, the United States and Japan. If we add the value of both exports and imports together then Australia's three largest trading partners are China, Japan and the United States. These three countries account for 44 per cent of Australia's two-way trade. China overtook Japan as Australia's main trading partner in 2009. China's economy, with its huge billion plus population, continues to grow and develop and is a major buyer of Australia's resources such as iron ore, coal and natural gas.

In terms of Australia's exports, the top four countries account for over 50 per cent of total exports. Each of these four countries is part of the Asia-Pacific region.

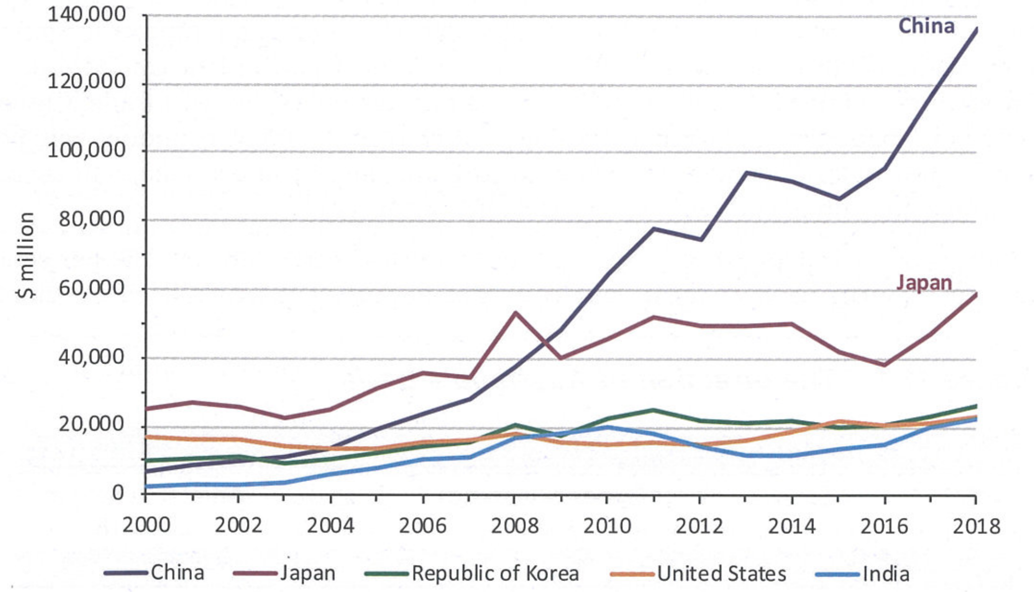
Figure 11.1 The direction of Australia's trade

A. Australia's Main Export Markets 2018				
Rank	Country	Goods & Services $m	% share	Annual % growth 2013-18
1	China	136,287	31.1	7.9
2	Japan	58,796	13.4	1.7
3	Republic of Korea	26,646	6.1	3.6
4	United States	23,098	5.3	6.2
5	India	22,316	5.1	15.5
6	New Zealand	15,039	3.4	5.3
7	Singapore	14,968	3.4	6.4
8	Hong Kong	13,419	3.1	2.9
9	Taiwan	12,201	2.8	8.6
10	United Kingdom	10,521	2.4	6.8

B. Australia's Main Import Sources 2018				
Rank	Country	Goods & Services $m	% share	Annual % growth 2011-16
1	China	78,321	18.9	8.6
2	United States	50,779	12.2	3.6
3	Japan	26,967	6.5	5.1
4	Germany	18,756	4.5	5.6
5	Thailand	17,900	4.3	5.8
6	Singapore	17,275	4.2	-3.3
7	United Kingdom	16,426	4.0	4.3
8	Republic of Korea	14,302	3.4	10.3
9	New Zealand	14,224	3.4	4.9
10	Malaysia	14,054	3.4	2.8

Source: DFAT Composition of Trade 2019

Figure 11.2 Australia's export markets



Source: RBA

Three quarters of Australia's two-way trade is with the Asian region. Obviously geographical proximity is a major factor in 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 complements the manufacturing giants of China, Japan and Korea. Australia has recently signed free trade agreements with China, Korea and Japan helping to increase trade flows with these countries. The graph above shows the changes in Australia's export markets since 2001. It is easy to see the emergence of China as Australia's main trading partner. In fact Australia's economic prosperity will be closely aligned to the Chinese economy in the foreseeable future.

Did you know? Australia's most important trading region is with Asia - especially China, Japan, Korea and India. Australia's most important export category is resources - mineral and fuels.

What are the main goods and services that make up our trade? Figure 11.3 shows the composition of Australia's trade - panel A lists Australia's top 10 exports and imports while panel B shows the main categories of trade. Coal and iron ore were Australia's leading exports in 2018 followed by natural gas, education and overseas tourists. Notice the dominance of the primary sector - eight of the top ten exports are either resources or rural goods. Primary exports account for over 60 per cent of Australia's exports. Many would be surprised to see that education exports are Australia's fourth largest, rating higher than other resource exports such as gold and aluminium. Services exports, including tourism and professional services, have been increasing over time and now account for 24 per cent of total exports. Notice that services exports have become more important than either manufactured or rural exports.

Figure 11.3 The composition of Australia's trade

A. Australia's Main Exports & Imports 2018						
Rank	**Exports**	**$m**	**%**	**Imports**	**$m**	**%**
1	Coal	66,860	15.3	Personal travel	44,804	10.8
2	Iron ore	63,277	14.4	Refined petroleum	25,266	6.1
3	Natural gas	43,298	9.9	Passenger motor vehicles	22,411	5.4
4	Education	35,234	8.0	Telecom equipment & parts	14,400	3.5
5	Personal travel	22,240	5.1	Crude petroleum	13,790	3.3
6	Gold	19,137	4.4	Goods vehicles	10,684	2.6
7	Aluminium ores	11,341	2.6	Freight services	10,108	2.4
8	Beef	8,661	2.0	Computers	9,686	2.3
9	Crude petroleum	8,097	1.8	Passenger transport	7,339	1.8
10	Copper ores	5,996	1.4	Medicaments	7,203	1.7
	All exports	438,127	100	All imports	414,991	100

B. Composition of Trade 2018			
Exports	% Share	Imports	% Share
Resources	51	Intermediate & Other	30
Services	23	Consumption	26
Manufactures	14	Capital	19
Rural	12	Services	24

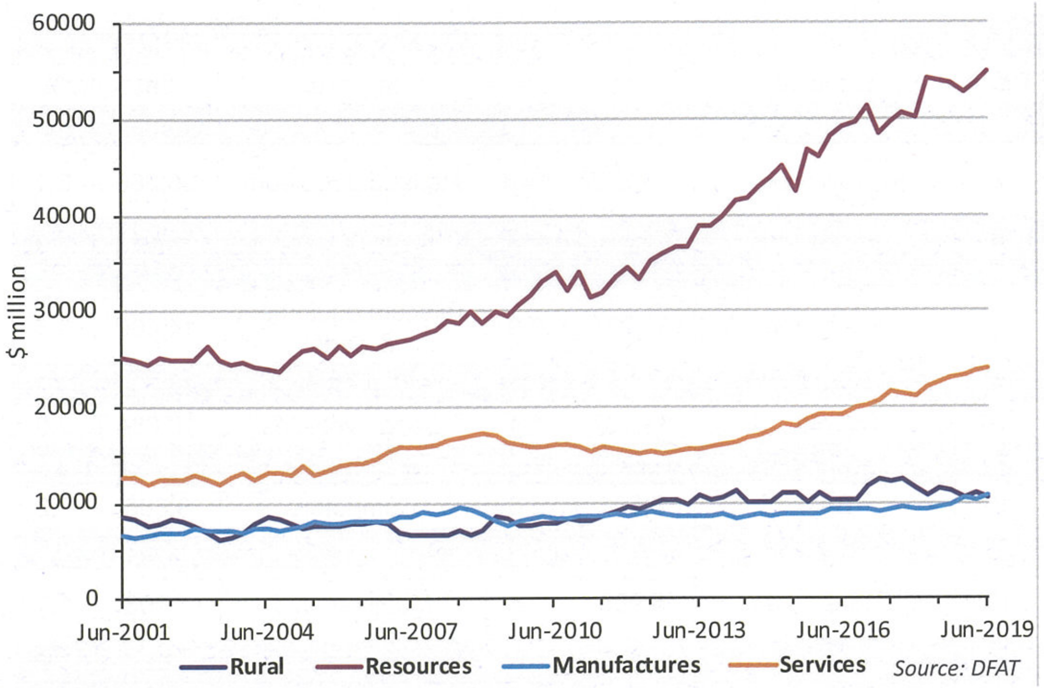
Source: DFAT

The largest imports were personal travel (Australian tourists travelling overseas), refined petroleum and passenger motor vehicles. Panel B in figure 11.3 shows the main categories of trade. The resources sector (mining) dominates exports accounting for over half of the total. Manufactured goods account for over half of Australia's imports - comprising consumption goods, capital goods and some intermediate goods. Intermediate goods are inputs, such as raw materials, used by firms to produce final consumer goods. It is interesting to note that the business sector import more goods than the household sector. Figure 11.4 shows the change in Australia's export categories since 2001.

Australia's trade balance

Many people believe that countries should try and increase their exports relative to imports - to aim for a trade surplus rather than a trade deficit. But this is a myth, dating back to the days of the Mercantilists who believed that exports were good and

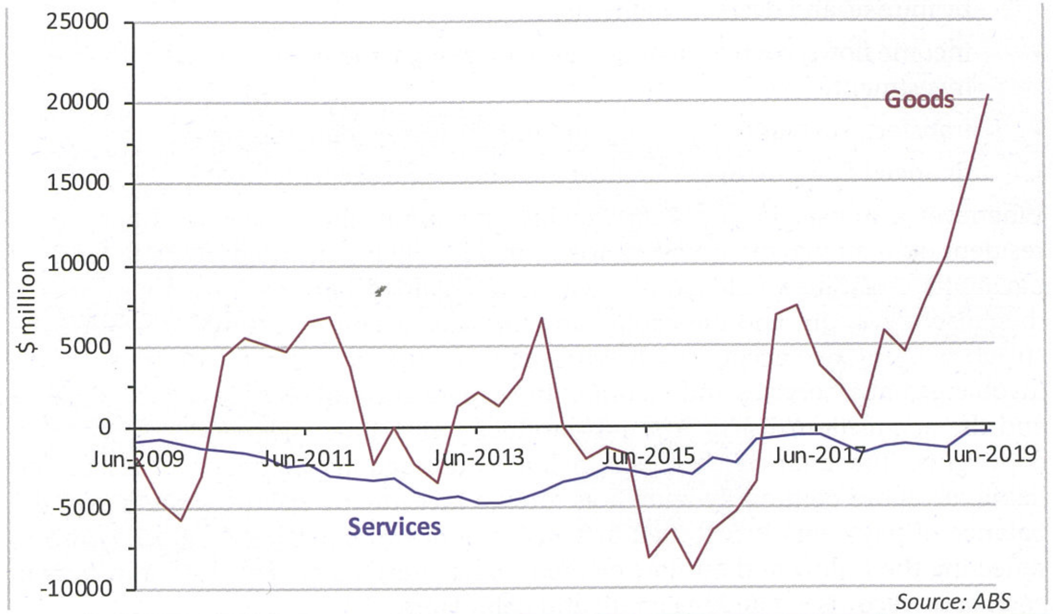
Figure 11.4 Australia's export categories



that imports were bad for the economy. It is simply not possible for every nation to have a trade surplus! Both exports and imports bring gains to the economy. Participating in international trade boosts economic development and growth and raises 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. At any point in time, a nation can experience a trade surplus or a trade deficit. A **trade surplus** occurs if the total value of gods and services exports exceeds the total value of goods and services imports. A **trade deficit**, on the other hand, occurs when the total value of imports exceeds the total value of exports.

Australia's trade balance fluctuates from deficit to surplus. Figure 11.5 shows the trade balance for both goods and services. Notice that the goods balance is far more volatile fluctuating from deficit to surplus while the services balance has been in deficit for the past decade. Are trade deficits a sign of a poorly performing economy? The media would have us think so, but as usual they do not understand their basic economics! The trade balance is determined by a multitude of factors chief of which are the business cycles of our main trading partners as well as our own. Australia's exports are determined by other countries demand for our goods and services. If the Chinese and Japanese economies experience strong economic growth, then

Figure 11.5 Australia's trade balance



our resource exports to these economies will increase. Australia's imports on the other hand, are determined by our own domestic growth. Strong economic growth in Australia will increase spending not only on consumer imports but also on intermediate and capital goods imports. For example, during the resources boom, the mining sector required significant quantities of imported capital goods such as specialised machinery and transport equipment. Australia enjoys a high standard of living which means that many consumers purchase imported motor vehicles, electronic goods and travel overseas as tourists.

An important factor affecting Australia's trade balance is the prices we receive for our commodity exports such as iron ore and coal. When commodity prices increase, our trade balance also increases because the value of our exports rises relative to imports. This occurred from 2015 causing Australia's trade balance to swing from a large deficit to a record surplus in 2019.

The Balance of Payments

The **balance of payments** is 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. Most transactions involve an exchange, for example, a good or service is traded for foreign exchange (money).

Economic transactions include:

- exports and imports of goods, such as iron ore, coal, gold, wheat, wool, computers, motor vehicles, machinery and clothing;

- exports and imports of services such as shipping, freight, insurance, expenditure by tourists and overseas students;
- income flows, such as dividend and interest payments associated with foreign investment;
- transfers, such as foreign aid and funds brought by migrants and
- financial flows, such as purchases of shares and securities and loans.

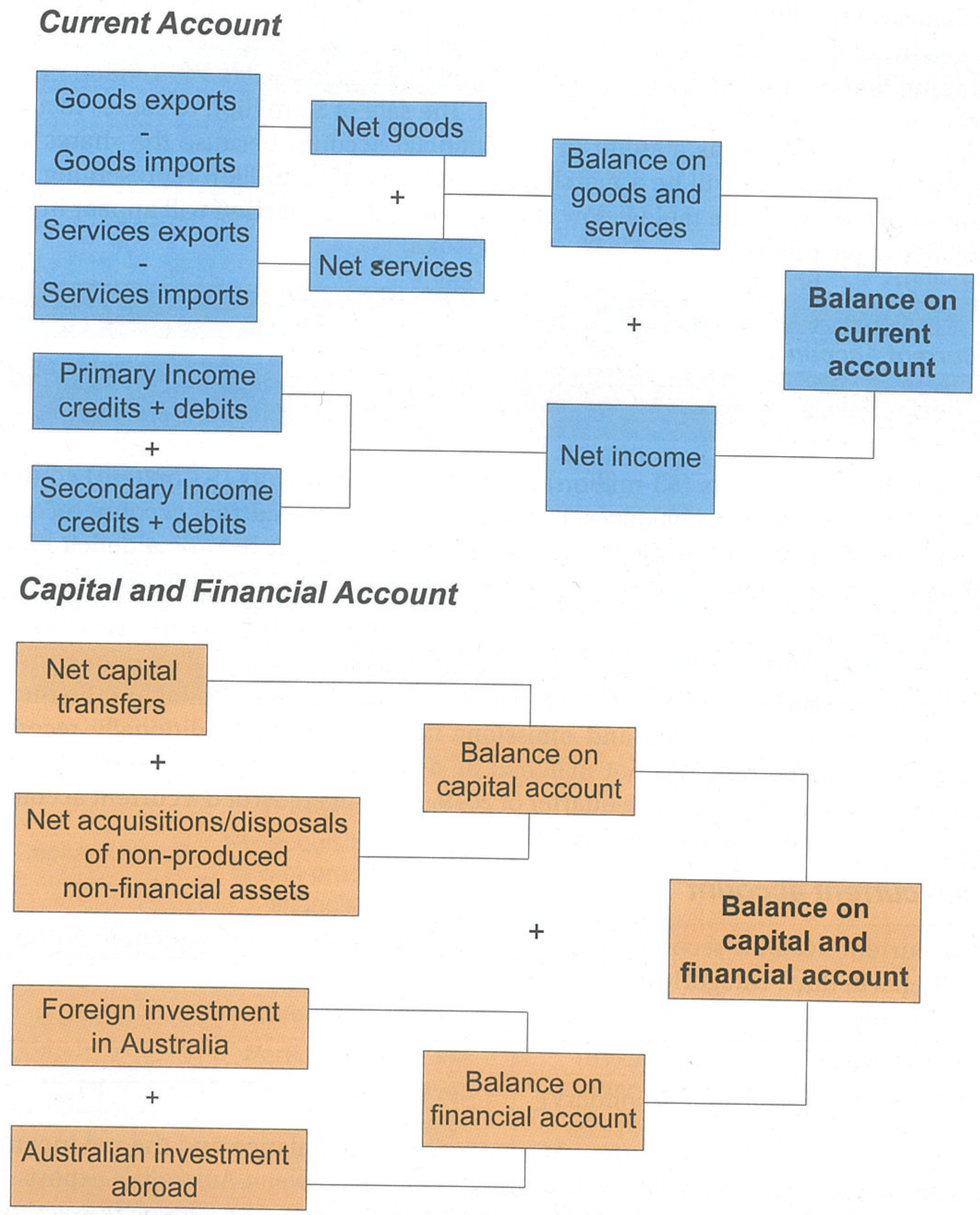
Whenever a transaction occurs involving any one of these categories between a resident of Australia and a non-resident, then it will be recorded in the balance of payments. Australia's balance of payments is divided into two broad accounts - the current account and the capital and financial account. Figure 11.6 shows the structure of the two accounts. 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. The financial account includes transactions in financial assets and liabilities, more commonly known as foreign investment. 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 liabilities, export of currency
- **Debit** — imports of goods and services, income payable, increase in foreign assets, import of currency

Since for each transaction there is a matching credit and debit entry, the overall balance of payments must always balance. This means that the sum of all credit entries will be exactly offset by the sum of all debit entries. But each of the two accounts can record either a deficit or a surplus. For example, if the current account recorded a deficit of $10 billion, then the capital & financial account would record a surplus of $10 billion. To illustrate how the recording of transactions works we will use a simple example consisting of an Australian resident purchasing a TV set from Japan for $AUD1,000 and a Japanese resident buying an Australian government bond for $AUD5,000. How will these transactions be recorded in Australia's balance of payments? Remember for each transaction there are two offsetting entries. The value of the imported TV will be recorded in the current account as a debit of $1,000, while in the financial account it will be recorded as a $1,000 credit, because $1,000 of Australian currency is exported to Japan. When the Japanese resident purchases the Australian government bond, it will be recorded on the financial account as a credit entry of $5,000 representing the bond which is exported and a debit entry of $5,000 of Australian currency which is imported.

The following table shows the entries for each transaction in Australia's balance of payments. Notice that the sum of debit entries ($6,000) is offset by the sum of the credit entries ($6,000). The current account shows a deficit of $1,000, while the capital/financial account shows a surplus of $1,000.

Figure 11.6 The structure of the balance of payments



	Credit	*Debit*
Current Account		*-$1,000 (TV)*
Capital/Financial Account	*+$1,000 (currency)* *+$5,000 (bond)*	*-$5,000 (currency)*

Now suppose an Australian firm sells $1 million of iron ore to China and a US firm purchases $2 million of Australian shares. How would these transactions be recorded? The value of the exported iron ore will be recorded in the current account as a credit of $1 million, while in the financial account it will be recorded as a $1 million debit, because $1 million of currency is imported. The sale of $2 million of shares to a US firm will be recorded as a credit in the financial account because the shares are exported while there will be a matching debit entry of $2 million representing the import of currency. The table below shows how each transaction will appear in the balance of payments.

	Credit	Debit
Current Account	*+$1 million (iron ore)*	
Capital/Financial Account	*+$2 million (shares)*	*-$1 million (currency)* *-$2 million (currency*

Notice that total credits ($3 million) are offset by total debits ($3 million) so that the balance of payments balances. But in this example, the current account records a surplus of $1 million, while the capital/financial account records a deficit of $1 million.

Figure 11.7 provides a breakdown of the components in the balance of payments for Australia from 2016-17 to 2018-19. Note that for each year, the balance on current account is equal and opposite in value to the balance on the capital and financial account plus the net errors and omissions item. Australia traditionally records a deficit in the current account matched by a surplus in the capital and financial account. Although for the June quarter of 2019, Australia recorded a current account surplus - the first time in over 44 years!

The current account

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

- goods
- services
- income (primary & secondary)

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. Some examples of transactions in goods and services include:

- an Australian mining company sells iron ore to a Chinese steel manufacturer. The iron ore sale represents an export of goods - a credit in the current account.
- the same Australian company may purchase new mining equipment from a German company. This transaction is an import of goods - a debit in the current account.

Figure 11.7 Australia's balance of payments

		$ million		
CURRENT ACCOUNT		**2016-17**	**2017-18**	**2018-19**
Goods		13631	12853	53912
	Exports	291464	315257	373104
	Imports	-277833	-302404	-319192
Services		-2780	-5287	-3729
	Exports	82276	88069	96787
	Imports	-85056	-93356	-100516
Balance on goods and services		**10851**	**7566**	**50183**
Primary Income		-47949	-57765	-60907
	Credits	54816	58943	69742
	Debits	-102765	-116708	-130648
Secondary Income		-1723	-1060	-1278
	Credits	8898	9155	9425
	Debits	-10621	-10215	-10703
Net Income		**-49672**	**-58825**	**-62185**
BALANCE ON CURRENT ACCOUNT		**-38821**	**-51259**	**-12002**
CAPITAL AND FINANCIAL ACCOUNT		**2016-17**	**2017-18**	**2018-19**
Capital Account	Net Capital transfers	-580	-849	-811
Capital Account	Net acquisition/disposal of non-produced, non-financial assets	141	169	40
Balance on capital account		**-439**	**-680**	**-771**
Financial Account	Direct investment	65093	61773	68774
Financial Account	Portfolio investment	18179	13959	-81878
Financial Account	Financial derivatives	-1280	-11282	-8447
Financial Account	Other investment	-22910	-15222	42128
Financial Account	Reserve assets	-19630	8952	3785
Balance on financial account		**39452**	**58180**	**24363**
BALANCE ON CAPITAL & FINANCIAL ACCOUNT		**39013**	**57500**	**23592**
Net errors and omissions		-192	-6242	-11590
Overall BALANCE OF PAYMENTS		**0**	**0**	**0**

Source: ABS 5302

- the same Australian company may also pay a Chinese shipping company to transport the iron ore from Port Hedland to Shanghai. This transaction is a service import in the current account.
- thousands of overseas tourists arrive in Australia every month. Their accommodation, meals and expenditures represent service exports - a credit in the current account.

Trade in goods includes exports and imports of raw materials, manufactures, minerals and fuels, food and rural products. Australian exports are concentrated in the agricultural and mining sectors, while imports consist mainly of intermediate and capital goods used by industry and consumer goods. In terms of absolute size, trade in goods is the largest item in the current account. Goods exports in 2019 amounted to $373 billion, of which $253 billion (73%) were resources, including iron ore, coal, natural gas, petroleum and gold. Goods imports equaled $319 billion of which 66 per cent comprised capital & intermediate goods. The merchandise (goods) trade account recorded a record surplus for 2019 equal to $54 billion.

Goods 2019 $ billion	
Credits (Exports)	
Rural	48
Resources	273
Manufacturing	53
Debits (Imports)	
Consumer goods	-104
Capital goods	-78
Intermediate and other	-133

Trade in services consist of transactions in the transport of goods (freight, shipping, and insurance), transactions involving travel by tourists, workers and students, and other services including financial, communication, construction and information. Trade in services is about a quarter of the size of trade in goods and has been increasing over time. In 2019, service exports totalled $97 billion while service imports were $101 billion. Australia normally records a trade deficit in services. Notice the large deficits in transport ($11bn) and personal travel or tourism ($24bn). The spending by Australian tourists travelling overseas is recorded as a debit in the current account while the spending of foreign tourists travelling to Australia is recorded as a credit. The export of education services has become an important service export for Australia totalling $38 billion in 2019. This actually exceeds the value of Australia's gold exports. Australia recorded an overall trade balance (both goods and services) for 2019 of just over $50 billion. This was the highest trade surplus ever recorded!

Services 2019 $ billion		
	Exports	**Imports**
Transport	8	-19
Education	38	-
Personal Travel	22	-46
Financial Services	9	-3

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).

Compensation of employees is simply the payment of wages and salaries to workers and is relatively small compared with the flow of investment income. In 2019, compensation of employees recorded a deficit of $5 billion. Investment income comprises income earned from the provision of financial capital or foreign investment and consists of income associated with direct investment and income associated with portfolio investment. Over 90 per cent of primary income transactions are associated with investment income. In 2019, Australia received $67 billion of investment income from overseas countries, but paid out $122 billion to overseas residents - a deficit of $55 billion. Australia records a relatively large primary income deficit in the current account because of the large amount of foreign investment that flows into the Australian economy. Reinvested earnings and dividends account for around 60 per cent of investment income while interest accounts for 40 per cent.

Primary Income 2019 $ billion		
	Credits	Debits
Compensation of employees	3	-8
Investment income	67	-122
- Direct	25	-63
- Portfolio	36	-51
- Other	6	-8
Total primary income	70	-131

The overall balance in primary income was a deficit of $61 billion - which forms the largest component of the current account deficit. Many people become alarmed at the size of this deficit but it is important to remember that it is due to the net inflow of foreign investment. A large outflow of investment income indicates that the Australian economy is performing well. If foreign investment into Australia increases, then the primary income deficit will also increase. The secondary income category involves transactions where real or financial resources are provided (goods, services or financial assets) but nothing of economic value is received in return. These type of transactions could be labelled as 'one sided.' Secondary income includes transactions in foreign aid, gifts, donations and pensions. An example of a debit transaction would be foreign aid given by Australia to Indonesia, while an example of a credit transaction would be gifts received by Australian residents from residents in a foreign country. The size of secondary income transactions is relatively small and insignificant - the secondary income balance for 2019 was around $1 billion and is dwarfed by the primary income account with a deficit of $61 billion.

To obtain the overall balance on current account, the balance on goods and services is added to the income balance (primary plus secondary). For 2019, the goods and services balance was a surplus of $50 billion while the income balance was a deficit of $62 billion. This meant that the balance on current account was equal to a deficit of $12 billion.

The Current Account	
	Balance on Goods and Services
+	Net Income
=	Balance on Current Account

The capital and financial account

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, and records transfers of non-produced, non-financial assets, flows of migrants' assets and the exchange of intangible assets such as patents and copyrights. This account is quite insignificant because the overall value of transactions is relatively small. In 2019, the capital account recorded a small deficit of $0.8 billion

The financial account is more important and records transactions in financial assets and liabilities such as shares, securities and loans between residents of Australia and residents of overseas countries. Basically, the financial account records foreign investment flows. It is important to remember that the current account records trade in goods, services and income, while the financial account records trade in savings and investment. Australia records a capital and financial account surplus to match the current account deficit. Remember that the two accounts must sum to zero. Australia has, for a very long time, relied on foreign investment to supplement its domestic savings to enable the development of its economy. Australia has had to rely on foreign investment to develop its vast mineral and energy wealth.

Capital Account 2019	$ billion
Net Capital transfers	-0.8
Net acquisition/ disposal of non-produced, non-financial assets	-
Total	-0.8

Financial Account 2019	$ billion
Direct investment	69
Portfolio investment	-82
Financial derivatives	-8
Other investment	42
Reserve assets	4
Total	24

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 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. If a resident investor obtains 10 per cent or more of the ordinary shares or voting stock of a foreign enterprise, then this is deemed to be direct investment. Direct investment enterprises include branches, subsidiaries and other businesses where the foreign resident has significant shareholding.

Portfolio investment consists of international equity and debt securities (mainly bonds and notes) not classified as direct investment. Portfolio investment is more short term in nature and speculative - the investor is not assumed to have any influence in the operation or decision-making of the enterprise. Other investment is a residual category that captures transactions not classified as direct or portfolio investment. Other investment comprises trade credits, loans, currency and deposits. Reserve assets are those financial assets controlled by the Reserve Bank of Australia. Reserve assets include monetary gold, Special Drawing Rights (SDRs) and foreign exchange. In 2019, the financial account recorded a surplus of $24 billion with the largest component being direct investment,

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 deficit (CAD), then the capital and financial account will be in surplus (FAS) and equal to the current account in absolute value (plus any net errors & omissions). In 2019, the current account recorded a deficit of $12 billion, while the capital/ financial account recorded a surplus of $23.6 billion (net errors/omissions = -$11.6 billion).

Balance of Payments	
	Balance on Current Account
+	Balance on Capital and Financial Account
+	Net errors and omissions
=	0

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

The balance of payments is an important set of accounts that summarise a country's transactions with the rest of the world. Changes in the balance of payments reflect changes in both the world economy and the Australian economy. The balance of payments is an important economic indicator providing information on a nation's trade account and its financial position with the rest of the world. Both the government and the financial markets use the balance of payments as a guide to analyse the relative performance of the economy. Changes in economic growth within Australia and in the world economy have an impact on a nation's balance of payments. The current account not only summarises the net movement of goods and services but also reflects changes in the financial account through the net income category. It is important to remember that the capital and 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 surplus which will cause an increase in the income deficit in the current account in terms of greater servicing costs, thereby increasing the current account deficit.

A current account deficit will always be matched with an equivalent capital/ financial account surplus.

On an annual basis, Australia normally records a current account deficit and therefore a capital and financial account surplus. But in the June quarter 2019, Australia actually recorded a current account surplus (the first time in 44 years) and a capital/financial account deficit. A quarter refers to a three month period. It will be interesting to see whether Australia will record a current account surplus in the following quarters. Many countries, such as Japan, record a current account surplus and a financial account deficit. Japan has an excess of savings which it lends to countries such as Australia. Australia has a shortage of savings to fund its investment needs and must rely on overseas savings in the form of foreign investment flowing into the economy. Australia is not a low saving country - it is just that Australia does not generate enough savings to finance its large investment needs and so relies on foreign savings. Australia is a very resource rich country with a relatively small population. Australia 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.

Because Australia relies on foreign investment to supplement its domestic savings, it records a financial account surplus.

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. It is important not to make the mistake of referring to a trade or current account deficit as being 'unfavourable' and a trade or current account surplus as being 'favourable'. But how often have you heard the media report that *'Australia's trade account / current account deteriorated'* when in fact they should report that the trade surplus fell or the trade deficit increased. The media need to do a refresher course in basic economics.

Many people worry if the size of the current account deficit increases, believing that it is a sign of trade weakness or a sign of declining competitiveness. But this may not be the case. The balance of payments is affected by many different factors. It is influenced by changes in consumption, savings, investment, interest rates and exchange rates. An increase in the size of the current account deficit may be a sign of economic strength. For example, if the domestic economy is growing, then imports will automatically increase which will increase the current account deficit. A surge in domestic investment will also lead to an increase in capital imports which will increase the current account deficit. In both of these cases, a rise in the current account deficit is a positive indicator that the economy is performing well.

If the level of foreign investment into Australia increases, this will increase the financial account surplus which will increase the current account deficit because of the increased flow of income payments, including interest and profits. 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. There may be times when an increase in the current account deficit 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 rise in the CAD is a sign that the economy is not performing well. The important point is to analyse the reason for the change before passing judgment.

In 2019 both the current account deficit and the financial account surplus fell to very low levels. For example, the current account deficit decreased from $51 billion in 2018 to just $12 billion in 2019. This was due to a record trade surplus due to an increase in commodity prices (e.g. iron ore and coal) which increased the value of Australia's exports. At the same time Australia's economy had slowed - real GDP was growing at less than per cent which reduced both consumption and investment and so spending on imports contracted. The weakness in the Australian economy also resulted in a large outflow of capital and so the financial account surplus decreased.

Chapter 11 Review

Worksheet - the reasons for trade

1. How is Australia linked to the global economy?
2. What percentage of Australia's GDP is attributable to exports?
3. Explain how consumers and producers benefit from the global economy.
4. List Australia's top five export and import partners. What factors might have contributed to their importance in our trade relationships?
5. Why has China become Australia's main trading partner?
6. List Australia's top five exports and imports. In what way does the pattern of trade reflect the structure of the Australian economy?
7. Distinguish between a trade surplus and a trade deficit.
8. Provide three reasons for why Australia's trade balance fluctuates.
9. Why does Australia normally record a trade deficit?
10. What are 'commodity prices'? Why are they important in affecting Australia's trade balance?
11. Explain why Australia recorded a record trade surplus in 2019.

Multiple choice questions - exports and imports

1. Free foreign trade may benefit the residents of a nation via
   a. higher real incomes for its people
   b. lower consumer prices.
   c. more efficient utilisation of resources.
   d. All of the above.

2. A nation will gain if
   a. exports increase and imports decrease.
   b. exports decrease and imports increase.
   c. both exports and imports increase.
   d. both exports and imports decrease.

3. Which of the following is not an important determinant of a country's exports?
   a. Its rate of economic growth.
   b. Its exchange rate.
   c. Its inflation rate.
   d. The rate of growth of trading partners.

4. Australia's top two trading partners are
   a. Japan and the United States.
   b. China and the United States.
   c. Japan and India.
   d. China and Japan.

5. Australia's largest category of exports is
   a. Rural
   b. Services
   c. Manufactures
   d. Minerals and fuels

6. Australia's largest category of imports is
   a. Consumer goods
   b. Intermediate goods
   c. Services
   d. Capital goods

7. Which of the following statements relating to Australia's trade over the last decade is correct?
   a. The total value of non-mineral exports has fallen.
   b. While Asia has become Australia's major market for exports, Europe has maintained its position as Australia's main source of imports.
   c. Mineral exports have increased as a proportion of total exports.
   d. Iron ore and gold have been Australia's largest exports by value.

8. Which of the following statements relating to Australia's composition of trade is correct?
   a. The USA has become the largest source of Australian imports.
   b. Education is Australia's largest services export.
   c. Rural exports have increased in importance over time.
   d. Freight services is the largest service import for Australia.

9. The three leading destinations, in order of importance, for Australia's merchandise exports are
   a. China, Japan, and Republic of Korea.
   b. China, United States, and European Union.
   c. United States, China, and Japan.
   d. China, Japan, and European Union.

Data exercise

Refer to the table opposite showing the composition of Australia's exports.

Export Category	*1991*	*2018*
Rural	*20%*	*12%*
Resources	*28%*	*51%*
Manufacturing	*21%*	*14%*
Services	*21%*	*23%*

Questions

1. Provide two examples of specific exports within the categories of rural, resources, manufacturing and services.
2. What is Australia's largest rural export, resource export and service export?
3. Describe the changes in the composition of trade over the period.
4. What factors have led to the increased share of resources in Australia's exports?
5. Explain why coal and iron ore has become Australia's largest exports?
6. Explain why China has replaced Japan as Australia's largest trading partner?

Worksheet - Australia's balance of payments

1. What is the balance of payments?
2. Distinguish between debit and credit entries in the balance of payments.
3. Explain why the balance of payments must always balance.
4. Complete the table below for the following transactions:
   a. Australian exports $10 million wheat to China
   b. Australia imports $20 million motor vehicles from Japan
   c. $30 million of Foreign direct investment from US into Australia

	Credit	*Debit*
Current Account		
Capital/Financial Account		

   Calculate the balance on the current account and the balance on the capital/financial account.
5. What types of transactions are recorded in the current account?
6. What are Australia's largest service exports?
7. Distinguish between primary income and secondary income in the current account.
8. Which is the largest category of investment income?
9. Why does Australia always record an income deficit?
10. Calculate the current account balance given the following information: exports = $25bn; imports = $28bn; net services = -$3bn; primary income = -$31bn; secondary income = $2bn.
11. Using the data opposite, calculate the goods and services balance, the current account balance and the missing value for net income.

Balance of Payments	$m
Goods credits	450
Goods debits	400
Net services	-150
Net income	?
Balance on capital/ financial account	500

12. When the level of domestic economic activity expands, the current account deficit normally increases. Why?
13. What is recorded in the capital and financial account?
14. Why is the financial account more important than the capital account?
15. Distinguish between portfolio and direct investment.
16. Why does Australia rely on foreign investment?
17. What happened to the current account and the financial account during Australia's mining boom?
18. What happened to the current account and the financial account during the GFC?
19. Predict what will happen to the CAD/FAS for each of the following events:
    a. Australia's economic growth decreases.
    b. China's economic growth increases.
    c. Foreign Investment in Australia increases.
    d. The Australian dollar appreciates

Multiple choice questions - balance of payments

1. The balance of payments is a record of
   a. a country's purchases and sales of goods and services on world markets.
   b. the value of goods and services bought and sold on world markets.
   c. a country's economic transactions with other countries.
   d. all investment flows between countries.
2. Which of the following would be a credit item in the current account?
   a. An Australian tourist's spending while on holiday in Singapore.
   b. An Australian firm hires a non-resident Indonesian citizen.
   c. An Australian firm invests overseas.
   d. An Australian firm sells computer software overseas.
3. Which of the following purchases by an Australian resident would be recorded as a service import in the current account?
   a. A foreign newspaper.
   b. Computer software from the U.S.
   c. Shares of an overseas company.
   d. A flight on a foreign airline.
4. If exports = $400; imports = $430; net services = -$20 and net income = -$50, then
   a. The capital and financial account has a deficit of $100 billion.
   b. The current account has a deficit of $50 billion.
   c. The capital and financial account has a surplus of $100 billion.
   d. The balance on net goods is a surplus of $30 billion.
5. The payment of dividends by an Australian company to a foreign investor will appear in Australia's balance of payments as a
   a. debit item in the primary income account.
   b. debit item in the financial account.
   c. debit item in the services account.
   d. credit item in the current account.
6. The financial account of the balance of payments shows the
   a. value of net foreign investment.
   b. interest repayments on borrowing from overseas.
   c. inflow of pensions and migrant funds.
   d. net trade in goods and services.
7. Which of the following is included in the financial account of the Australian balance of payments?
   a. Dividends paid to foreign investors.
   b. Expenditure by Australian tourists overseas.
   c. Expenditure by Japanese tourists in Australia.
   d. Purchases of shares in Australian companies by foreign residents.
8. When an Australian purchases a New Zealand financial asset
   a. Australia's balance of goods and services decreases.
   b. Australia's capital and financial account surplus is reduced.
   c. Australia's current account deficit increases.
   d. Australia's capital and financial account surplus is increased.
9. In the Balance of Payments, in what account is foreign investment into Australia recorded?
   a. the Current Account
   b. the Capital Account
   c. the Financial Account
   d. the Income Account

10. Which item is not included in the current account of a country's balance of payments?
    a. exports of services
    b. the purchase of foreign assets interest on foreign loans
    c. interest on foreign loans
    d. profits from foreign investments
11. Which of the following would be recorded as a debit in the current account?
    a. The sale of Australian wool to Italy
    b. An increase in the number of foreign tourists visiting Australia
    c. Interest paid on Australian Government bonds to overseas investors
    d. A Chinese company purchasing a farming property in rural Australia
12. If the value of imports exceeds that of exports, a country will record a:
    a. balance of payments deficit.
    b. current account deficit.
    c. financial account deficit.
    d. balance of trade deficit.

Data exercises - balance of payments

1. The table opposite records transactions between Ozland and the rest of the world.

a. For each transaction, compete the table below by recording the correct entry into the current account and the offsetting entry into the capital/financial account.

Account	Credit	Debit
Current	*260 (coal)*	
Capital/financial		*260 (currency)*

b. Then calculate the balance on goods and services, net income, the balance on current account and the balance on capital and financial account.

Item	$ million
coal exports	260
wheat exports	140
spending by overseas tourists in Ozland	10
interest payments on Ozland foreign debt	40
dividend payments to overseas residents	20
computer imports	90
machinery imports	100
car imports	150
wine exports	50
profits remitted to Ozland from overseas	10
education exports	30

2. Complete the missing values in the table opposite showing balance of payments data for a hypothetical economy. Assume that there are no errors or omissions.

Category	Year1	Year 2	Year 3
Merchandise exports	2000	1000	....
Merchandise imports	3500	....	1200
Balance on merchandise trade	....	-1000	300
Net services	-1000	....	200
Balance on goods and services	....	-1500	....
Net income	-500	-1000	....
Balance on current account	....	....	....
Balance on capital and financial account	....	....	1000

Article analysis

Refer to the article below to answer the following questions:

Australia records first current account surplus in 44 years

The largest quarterly goods and services surplus on record at $19.9 billion and a narrowing net income deficit to $13.9 billion, contributed to Australia recording a seasonally adjusted $5.9 billion current account surplus for the June quarter 2019, This is Australia's first current account surplus since the June quarter 1975. The surplus is both a price and volume story. Continued global supply interruptions have maintained high iron ore prices into the June quarter, boosting our export receipts to record levels. Export volumes for the key bulk commodities of liquid natural gas, coal and iron ore were up, while volumes fell across several import categories resulting in an increased June quarter trade surplus.

Source: ABS Media release Sept 5, 2019.

Questions

1. Why did Australia record a current account surplus in the June qrt 2019?
2. Why did iron ore prices rise? Does this increase or decrease the value of Australia's exports?
3. What may have increased the volume of Australia's commodity exports?
4. What are Australia's three largest imports?
5. What factors may have caused a decrease in Australia's imports?

Extended written answers

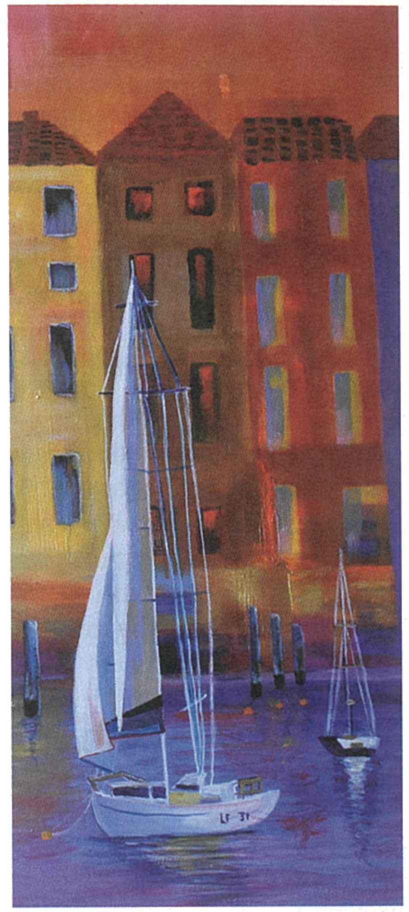
Answer each of the following questions in about 2 pages of normal writing. Use a model where appropriate.

1. a. Describe the direction and composition of Australia's trade.
   b. Discuss three factors that have contributed to Australia's large trade surpluses over the past few years.

2. a. Describe the structure of Australia's balance of payments accounts.
   b. Distinguish between the trade balance and the income balance
   c. Explain how the financial account is linked to the current account.

3. Describe how each of the following factors will impact on Australia's balance of payments:
   a. an increase in world economic growth
   b. a significant fall in the prices received for Australia's commodity exports
   c. an increase in economic growth in Australia.

12 The public sector



Learning objectives

In this chapter, you will learn about:

- ***the role of government in a modified market economy***
- ***the size of the government sector in the Australian economy***
- ***the size and composition of government revenue***
- ***the distinction between direct and indirect taxation, progressive, regressive and proportional taxation, taxes on income and expenditure***
- ***types of Commonwealth taxes***
- ***the concepts of equity, efficiency and simplicity in taxation***
- ***the concepts of income and wealth***
- ***income distribution in Australia***
- ***the Lorenz curve***