TOPIC 2: AUSTRALIA’S PLACE IN THE GLOBAL ECONOMY

2. 1 Australia’s Trade and Financial Flows

2.1.1 Value, composition and direction of Australia’s trade and financial flows

- Trends in Australia’s trade pattern
- Trends in financial flows

2.1.2 Australia’s Balance of Payments

- Structure of the BOP
  - Current account
  - Capital and Financial Account
- Links between key BOP categories
- Trends in size and composition of Australia’s BOP
- Reasons for these trends

2.1.3 Issues associated with trends in the balance of payments, including:

- Terms of trade
- Size of the current account balance as a percentage of GDP
- Foreign debt and foreign liabilities
  - Debt and equity
- International competitiveness
- Structural change in the Australian economy
2.2 Exchange Rates

- Measurement of relative exchange rates
  - To other individual currencies
  - Trade Weighted Index

- Factors affecting the demand and supply for Australian dollars

- Changes in exchange rates including fixed, flexible and managed rates

- The influence of the RBA on exchange rates

- The effects of fluctuations in exchange rates on the Australian economy

2.3 Free Trade and Protection

- Australia’s policies regarding free trade and protection

- The implications of Australia’s policies for individuals, firms and governments

- Implications for Australia of protectionist policies of other countries and international organisations.
2.1 Australia’s Trade and Financial Flows

2.1.1 Value, Composition and Direction of Australia’s Trade Flows

Trends in Australia’s Trade Pattern

Despite Australia’s geographic isolation, trade has always represented a high proportion of economic activity in Australia – the expansion of global trade flows has had an important impact on small, open economies (such as Australia) for which trade has been a significant driver of globalisation and economic growth.

Between 1997 and 2008, the total value of Australia’s trade flows rose from $98.6bn (32.9% of GDP) to $564bn (47.7% of GDP).

Australia produces less than 2% of GWP – we are therefore considered a small economy by international standards.

Australia’s natural resources have always been demanded elsewhere – export opportunity.

Due to globalisation, global economic developments can significantly impact Australia – the international business cycle.

The Changing DIRECTION of Australia’s Trade Flows

The direction of Australia’s trade flows have changed significantly in recent years.

- 1950s: Australia traded mainly with the UK, reflecting historical ties with Britain – but the UK’s decision to join the EU in 1973 resulted in the UK needing to impose trade barriers to give trade preferences to other EU members – this meant that Australia lost many of its traditional export markets in the UK.

- There has been a shift in Australia’s trade focus – a turn to ASEAN nations for trade opportunities – the ASEAN economies are low-cost manufacturers of imported goods, attractive to Australia – overtaken the EU as Australia’s main source of imports.

  - The Asia-Pacific Region is the most important export destination for Australian exports today.

  - By the 1960s, Japan’s economy was rapidly expanding – Australia started to trade more with Japan, but an economic slowdown in Japan during the 1980s led to Australia shifting trade focus to other Asian economies – Japan (as of 2008) still remains Australia’s largest export destination, accounting for 23% of exports.

  - China has emerged a significant export partner for Australia – reflects its position as a driving force behind global economic growth – expected to overtake Japan in the coming years (currently accounts for 18% of imports and 19% of exports).

- Australia does not sell a significant proportion of its outputs to other advanced economies – it buys a substantial amount from economies such as the US and Germany – these imports are important for business equipment/other consumer items.

The Changing COMPOSITION of Australia’s Trade

EXPORTS (more significant shift in exports, while imports have remained constant.)

- Primary industries have traditionally been the focus of Australian EXPORTS – it is in commodity goods (such as agriculture and minerals) that Australia has the greatest comparative advantage.

  - Mineral/mining exports are Australia’s LARGEST EXPORT EARNING CATEGORY – growth in the global economy has led to increased demand for minerals + the global resources boom which led to a 40% increase in mining exports in 2008-09 - this has provided Australia with substantial export earnings (these earnings fluctuate based on the condition of the global economy and fluctuations in economic growth, which influences mineral prices + demand quantity).
Australia has continued to rely on primary industries as a source of exports – other HIEs have shifted towards developing manufacturing trade.

There has recently been an increased emphasis on the importance of service exports for future Australian economic growth – TOURISM is now the largest export earning service industry in Australia – smaller trade occurs in education, transport, health, insurance, financial services and communications.

In 2008-09, primary exports (rural and mining) were 59.1% of the total [rural = 10.3%, mining = 48.8%), manufacturing = 22% and services = 18.9%.

**IMPORTS**

Australia has been less competitive in manufacturing – therefore it has needed to rely on manufactures as a large source of imports – huge quantities of capital goods, transport equipment, supplies and consumer goods are imported.

In 2008-09, Intermediate goods = 39.5%; Consumer Goods = 21.9%; Capital goods = 18.5% of Australia’s total imports – this reflects the continued lack of competitiveness in Australia’s manufacturing industries.

The most important group of imports are intermediate goods which are used in production in Australian firms – e.g. in 2007 and 2008 parts for machinery and equipment totaled $22bn and other processed industrial supplies totaled $46bn. Capital goods (e.g. machinery and equipment) are significant as well as consumption goods (motor vehicles, toys, books and leisure goods, food and beverages) which account for 25% of our imports.

**Trends in Financial Flows**

There have been two major factors influencing the overall growth in financial flows – these are the floating of the exchange rate and the deregulation of financial markets.

Growth in financial flows have been greater than growth in trade flows – international businesses have bought Australian assets and invested in Australian businesses – this has resulted in huge growth in recent years.

- 1970s – exchange rates were floated and restrictions on the movement of capital across borders were removed – this resulted in an increase in financial flows – international capital markets opened + technology allowed capital to move across national borders more easily – FDI flows have doubled since 2000.

There are two types of investment:

- Direct investment involves the purchase of a significant degree of control over foreign assets – when direct investment occurs, it is generally considered long-term and investors tend to play a role in business management.

- Portfolio investment involves purchasing ownership rights (equity) to foreign assets without gaining any significant control over the use of those assets. Portfolio investment has grown much faster than direct investment (as a result of financial market deregulation) and had become the major form of global capital flows by the late 1990s.

Australia is a net capital importer – the level of foreign investment in Australia ($1.7 trillion in 2009) has consistently remained close to twice the level of Australian investment abroad – this partly reflects the lack of domestic savings in Australia.
2.1.2 Australia’s Balance of Payments

Structure of the Balance of Payments

- The **balance of payments** refers to the record of the transactions between Australia and the rest of the world during a given period, consisting of the **current account** and the **capital and financial account**.
  
  - **All money flowing IN = CREDIT** (exports of goods, exports of services, factor incomes (e.g. interest received by Australian firms, profits of Australian firms earned offshore such as dividends/undistributed profits + payments to offshore employees) and current transfers into Australia.
  
  - **All money flowing OUT = DEBIT** (imports of goods, imports of services, factor incomes (e.g. interest paid to foreign firms, profits of foreign firms in Australia such as dividends/undistributed profits + payments to offshore employees) and current transfers out of Australia.

The payments made (debits) and the payments received (credits) are recorded on one of two accounts. These are:

(A) **CURRENT ACCOUNT**

- The **current account** shows the receipts and payments for trade in goods and services (imports and exports), transfer payments and income flows (interest paid and distribution of profits) between Australia and other economies—these are **non-reversible transactions**.

  **BALANCE ON THE CURRENT ACCOUNT = BALANCE ON G&S + NET INCOME + NET CURRENT TRANSFERS**

There are FOUR categories in the current account:

1. **Net goods**: shows the difference between what we receive for our exports and pay out for our imports.
   
   (a) Australia could be in balance (export receipts = import payments)
   
   (b) Australia could be in surplus (export receipts > import payments)
   
   (c) Australia could be in deficit (export receipts < import payments)

2. **Net services**: bought and sold without people receiving tangible goods – e.g. transport, insurance, telephone calls & tourism.

  **BALANCE ON GOODS AND SERVICES = NET GOODS + NET SERVICES**

3. **Net income**: refers to earnings on investment – it covers interest payments on borrowings, and returns on other foreign investment such as foreign-owned companies in Australia or foreign land ownership.

  **NET INCOME = INCOME FLOWS INTO AUSTRALIA – INCOME FLOWS OUT OF AUSTRALIA**
4. **Net current transfers**: occurs when real or financial resources are provided without specific goods or services being provided in return – includes aid to developing nations (unless used to build capital in the nation), pensions received by residents from foreign governments.

(B) **CAPITAL AND FINANCIAL ACCOUNT**

- The **capital and financial account** records the borrowing, lending, sales and purchases of assets between Australia and the rest of the world. Financial inflow has the immediate effect of increasing the supply of foreign exchange to Australia while financial outflow reduces it. These are **reversible transactions**, e.g. borrowings can be repaid; assets which are bought can be sold again.

- The **capital account** consists of THREE main elements:
  - **Capital transfers** from people migrating into or out of Australia.
  - **Capital transfers in the form of foreign investment** to assist other countries to build up their infrastructure or capital stock (such as an Australian donation to build a bridge in the Solomon Islands).
  - **Purchase and sale of non-produced, non-financial assets** – mainly intellectual property such as trademarks, copyrights, patents and franchises.

- The **financial account** shows Australia’s transactions in foreign financial assets and liabilities.

The FIVE categories are:

1. **Direct investment**: the purchase of a significant degree of control over foreign assets – when direct investment occurs, it is generally considered long-term and investors tend to play a role in business management.

2. **Portfolio investment**: purchasing ownership rights (equity) to foreign assets without gaining any significant control over the use of those assets.

3. **Financial derivatives**: the value of these investments is normally derived from the performance of specific assets, interest rates, exchange rates or indices – these have become increasingly important in recent years.

4. **Other investment**: a residual category that captures transactions not classified as direct investment or portfolio investment – this covers trade credits, loans including financial leases, currency and deposits, and other accounts payable and receivable which don’t meet the classification requirements of the above categories.

5. **Reserve assets**: foreign financial assets that are available to and controlled by the central authorities for financing or regulating payment imbalances such as the RBA – includes monetary gold and Special Drawing Rights.

**Balance on Capital & Financial Account**

\[
\text{Balance on Capital & Financial Account} = \text{Capital Account} + (\text{Direct Investment} + \text{Portfolio Investment} + \text{Financial Derivatives} + \text{Other Investment} + \text{Reserve Assets})
\]
(C) NET ERRORS AND OMISSIONS

- **Net errors and omissions** refer to statistical discrepancies.
- These are included because, under a floating exchange rate system, the balance of payments should equal **ZERO**, i.e. a deficit of $38.5 billion on the current account should be offset by a surplus of $38.5 billion on the capital and financial account.

\[ \text{Balance of Payments} = \text{Current Account} + \text{Capital & Financial Account} + \text{Errors/Omissions} = 0 \]

**Links between the Balance of Payments Categories**

- The **balance of payments** is represented by the **SUM** of the current account and the capital and financial account, totalling zero.
- An increase in the current account deficit (CAD) will result in an increase in the capital and financial account surplus.

The reason Australia’s largest current account item (net income) is negative is that for many years, we have attracted more foreign savings than we have sent overseas.

- The Australian dollar (\$A) plays the key role in ensuring that there is a balance in the balance of payments – movements in the value of the components of Australia’s BOP create movements in the value of the currency which will ensure the BOP = 0.

**For equilibrium in the FOREX market:**

**Supply of $A = Demand for $A**

**Supply of $A** is represented by:

- Payments for imports of G&S (M)
- Income/transfers overseas (Y debits)
- Capital and financial outflow (K outflow)

**Demand for $A** is represented by:

- Receipts for exports of G&S (X)
- Income/transfers overseas (Y credit)
- Capital and financial account inflow (K inflow)

\[ M - X + Y \text{ debits} - Y \text{ credits} = \text{K inflow} - \text{K outflow} \]

or

**Current Account Deficit = Capital and Financial Account Surplus**
• In the long-run, a capital and financial account surplus will result in a larger deficit on the net income account – this is because any foreign financial inflow into Australia must earn some kind of return for its owner, and these earnings are recorded as a debit on the net income account.

• High capital and financial account surpluses will result in a widening CAD because of the servicing costs associated with increased foreign liabilities – this can lead to the ‘debt trap’ scenario.

• Australia’s low levels of domestic savings make it necessary to attract a large financial inflow on the capital and financial account.

Trends in the Size and Composition of Australia’s Balance of Payments

The balance of payments is an important indicator of the health of the economy – it reflects the key features of the economic structure, and highlights imbalances in the relationships between Australia and the global economy.

The best measure of the trends in the current account is not in its size in dollars, but the CAD as a proportion of GDP – this allows for accurate comparisons over time and between countries.

In recent years, the Australian economy has witnessed a dramatic widening in the size of the current account deficit.

- In 2001, the CAD of 2% of GDP was the best BOP performance of the Australian economy since the 1980s.
- In 2007, the CAD reached 6.3% of GDP – the largest CAD outcome on record in Australia.
- In 2008, the CAD fell to 4.2% of GDP – and fell as low as 2.2% of GDP in the December quarter of 2008.
- Australia’s CAD has averaged 4.5% of GDP over the past two decades – one of the worst performances in major advanced industrialised economies.

- A key economic issue is whether the CAD is sustainable – this will depend on the reason for the CAD, since a CAD can be the result of high levels of direct investment that would allow for higher economic growth and exports in the long-term.

The main trends in the Australian current account in the last decade have been:

1. Australia has run a persistent CAD (since as far back as 1979 when the CAD was 1.7% of GDP) which has been primarily influenced by the net income deficit and the goods deficit (since Australia imports more goods and services than it exports) – the high net income deficit reflects Australia’s ongoing problem of low national savings and high foreign liabilities. This deficit is offset by the willingness of foreigners to invest in Australia by purchasing shares, businesses and properties, thus resulting in a capital and financial account surplus to mirror the CAD.

2. The CAD has fluctuated between about 3% sand 6% of GDP over the past decade and has been smallest in years of weaker domestic demand and largest in years of strong domestic demand.

The main measurements of the components of the CAD show the following patterns:

1. Net goods have usually recorded a deficit (but have improved recently due to the global resources boom)

2. Net services moved into surplus in 2000 as a result of rising service exports (but they used to record a deficit)

3. The net income deficit accounts for most of the CAD – net current transfers have very little effect on the CAD.
The **main trends in the Australian capital and financial account** in the last decade have been:

1. **Always in surplus** to finance Australia’s persistent CAD – mainly comprised of the **financial account surplus** (which amounted to $47.6bn in 2008) rather than the capital account surplus (which is very small at merely $2.5bn in 2008).

2. **Reserve assets are volatile** (due to the varied effectiveness of the RBA FOREX dealings) and affect the value of the $A, which in turns impacts on the CAD.

**Reasons for the trends in Australia’s Balance of Payments**

(A) **The Balance on Goods and Services**

- Australia’s high CAD (and particularly the balance on goods and services) moves in cycles – it is influenced by **short-term cyclical factors** (domestic and international influences) such as the changes in global demand for commodities, Australia’s terms of trade and the demand for imports from businesses and consumers.

Australia’s CAD fell in 2008-09 because of these CYCLICAL FACTORS – an improvement in terms of trade (driven by the strong growth of China and the NIEs of East Asia) = higher export revenue + depreciation of the currency in late 2008 = international competitiveness, which also led to a significant improvement in the balance on goods and services to -0.3% of GDP in 2008.

**EXPORTS**

Australia’s export performance over the 2000s has been mixed – annual growth in exports averaged 10.8% - up from a 7.2% average over the 1990s. This has been due to a **booming terms of trade**, sending Australia’s commodity prices towards their highest levels on record. Between 2003 and 2008, Australia’s terms of trade rose by 55.8%.

Australia’s **export performance** (and the balance on goods and services) has been influenced by a number of factors:

1. **Booming commodity prices and Australia’s soaring terms of trade** – this has driven the recent boost to export revenue – strong economic conditions in China and other NIEs in Asia has underpinned the strong demand for resource exports.

The balance on goods and services moved into surplus in the September quarter of 2008 and remained in surplus in the December quarter because of increases in 2008/09 prices for iron ore and coal exports – this improved the CAD also.

2. **A period of strong global economic growth over the mid 2000s boosted demand for Australian exports** – the global economy grew at record high rates between 2004 and 2007 driven by booming East Asian economies.

Since late 2007, however, the global growth outlook has deteriorated – the effects of the US subprime mortgage crisis have been pervasive – the turmoil in global financial markets has caused the global rate to be downgraded, and 6/10 of Australia’s ten major trading partners were in recession. Australia’s modest export growth fell due to the financial crisis, worsening the balance on goods and services deficit.

Widespread drought can sharply reduce rural exports, while recent events in China have aided mining exports.

3. **The Australian dollar has been strong in previous years despite falling dramatically in the second half of 2008** – generally, Australia’s balance on goods and services records its best performances during periods when the value of the $A is low – e.g. in 2001, the $A reached its lowest ever value of $US0.48 (and the balance on goods and services recorded a small surplus of 0.7% of GDP).

A weaker $A increases export competitiveness and slows import consumption, improving the balance on goods and services.
IMPORTS

In 2008, Australia’s import spending rose by 19.3% to $283.8 billion.

This rapid increase was caused due to:

- **Higher household incomes** which encouraged households to splash out on imported goods and services.
- **Strong exchange rate** which reduced the price of imported goods and services for Australian firms and households.
- **Improvement in Australia’s terms of trade** which resulted in higher incomes and profits – especially for commodity exporters – encouraging further spending on capital and consumer imports.

The global financial crisis meant that while the Australian economy remained stronger than many other economies, domestic activity was to be inevitably weak which, in combination with the lower Australian dollar and a falling terms of trade, reduced domestic demand for imports.

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Thus, the causes of Australia’s persistent CAD are **CYCLICAL**, **STRUCTURAL** and **SPECULATIVE**.

1. Cyclical Reasons

   - **When the domestic economy grows faster than the global economy**, import demand overtakes export demand – this increases the CAD. This was the situation in 2003-04 – commodity prices for Australian exports ↓, export revenue ↓ and hence the CAD ↑ - therefore when import spending increases faster than export income, terms of trade will deteriorate and the CAD will rise.

   - **When the domestic economy grows slower than the global economy**, export demand overtakes import demand – this was the situation in the 2005-06 global resources boom – commodity prices for Australian exports ↑, export income ↑ and hence the CAD ↓.

2. Structural Reasons

   The major **structural factor** causing Australia’s persistent CADs is the **net income deficit**, which reflects the cost of servicing Australia’s foreign liabilities (total debt and equity borrowings) – it is highly dependent on numerous factors such as FOREX fluctuations, global interest rates and the performance of close major trading partners – the net income deficit is volatile and if not managed correctly can cause major problems for the Australian economy.

   **The size of the net income deficit reflects the extent to which Australia is using foreign savings within its economies – 2008-09 figures reflect the large inflows in recent years and big profits from part ownership of mining companies.**

   The net income deficit has grown in previous years in line with Australia’s mounting borrowing requirements from the rest of the world. It exploded to its largest ever level of 4.4% of GDP in 2007. After falling to as low as 2.7% of GDP in 2001, Australia’s net income deficit has returned to record high levels in recent years - in 2008 the net income deficit fell to 3.9% of GDP.

   **In 2006-07, the net income deficit was 78.9% of the CAD.**

   Though it is considered the structural component of the current account, the recent increase in the net income deficit is largely due to the **strength of Australia’s domestic economy**, which has increased corporate profits and meant that Australia has needed to
send greater dividends to their overseas shareholders in foreign firms who have engaged in direct investment in Australian firms – this is recorded as a debit on net income, which further worsens the CAD.

Australia’s continued net income deficits remain a major cause for concern – the net income deficit represents an ONGOING BURDEN on the Australian economy – one that must be met regardless of domestic economic conditions.

3. Speculative Reasons: The integration of the global economy and global financial market has increased capital flows – as the $A is one of the world’s most traded currencies, speculation has increased the volatility of the Australian economy, thereby potentially rapidly increasing/decreasing the CAD.
2.1.3 Issues Associated with the Trends in the Balance of Payments

Australia’s BOP is influenced by a wide range of domestic and international factors. The trends present in Australia’s balance of payments have created both benefits and problems for the Australian economy. The following are issues associated with the trends in the balance of payments.

1. **The structure of Australia’s export base**

- **Australia’s export base is heavily weighted towards primary industry commodities** – almost 60% of our export earnings come from Australia’s mineral and agricultural commodity exports – in comparison with the overall patterns of trade for advanced economies, this indicates that Australia has an unusually heavily reliance on the exports of primary industries.

- **In the long-term, Australia’s narrow export base contributes to the volatility of the CAD** – if global economic growth slows and global demand for commodities declines, prices will fall, export earnings will decrease and the current account will deteriorate – this was seen in 2009, where Australia’s export prices fell sharply in response to the global recession, reducing growth in X revenues and contributing to an increase in the CAD.

- **Australia has benefited during the past decade from a sustained increase in resource prices** that has only partly reversed during the global financial crisis – however, the **agricultural sector has experienced a long-term decline** as global trade has shifted towards sophisticated manufactured goods and services – due to the high levels of protection in agricultural industries throughout the world, it is more difficult for Australia to sell these exports.

- **Service industries** dominate the Australian economy, employing about 75% of working Australians – but only a small portion of Australia’s service output is exported – given the structure of the Australian economy, an expansion of service exports is essential to diversifying Australia’s export base and improving Australia’s trade performance.

2. **Terms of Trade (TOT)**

- The **terms of trade** shows the relationship between the prices Australia receives for its exports and the prices it pays for its imports – it measures the relative movements in the prices of an economy’s prices and exports over a period of time.

\[
\text{Terms of Trade Index} = \frac{\text{Export Price Index}}{\text{Import Price Index}} \times 100
\]

- **A favourable movement** in the terms of trade (improvement in terms of trade) – when X prices \(\uparrow\) faster than Y prices or \(\downarrow\) slower than Y prices (which would be shown by a rising index number compared to the base year).

- **An unfavourable movement** in the terms of trade (worsening in terms of trade) – when X prices \(\uparrow\) slower than Y prices or \(\downarrow\) faster than Y prices (which would be shown by a falling index number compared to the base year).

- The TOT affects the BOP in that a deteriorating TOT means that the same volume of exports can buy fewer imports, which increases the deficit on the balance on G&S, and increases Australia’s CAD and foreign liabilities, while also reducing Australia’s standard of living because this then implies that our export production is less powerful.

- **Australia is vulnerable to a deterioration in the terms of trade because of its narrow export base** (agriculture and minerals) – the prices of these commodities are volatile, and depend on global supply and demand conditions – a diversification in Australia’s export base would lead to a more stable TOT – and improve the BOP – in general, the long-term deterioration in our terms of trade reflects the experience of nations that rely heavily on exports of non-oil primary products which have shown poor long-term price trends compared to manufactured goods and service industries.

- **The second half of the 20th century saw a long-term downward trend in the prices of commodities**, reflecting the fact that improved technologies and developments have allowed many nations to become self-sufficient in
these goods, slowing the growth in demand for these items – the combination of slower demand growth and rising supply (due to heavy subsidies for farm production in the US and EU) have contributed to a long-term fall in prices for commodity items on global markets.

- Since 1997, there has been a general improvement in Australia’s terms of trade, which reflects the diversification of Australia’s X base, the global resources boom as a result of a surging GWP, strong Chinese demand for resources, the falling prices of manufactured imports due to improved technology and low-cost production (e.g. China), reduced production costs as a result of globalisation, and recently, the appreciation of the $AUD – the price of information and communications technology products has also been falling rapidly recently, helping to improve the terms of trade and reduce inflation.

  o The Australian terms of trade tends to improve when economic growth is strong in the main world economies, and declines when USA growth weakens or when major mineral markets are in recession – due to a diversification in our export base, Australia no longer has the weak terms of trade trends seen during the mid 1950s to the late 1990s (where Australian was different to other high-income nations in that we were unusually dependent on exports of primary products whereas their exports were driven by manufacturing and services).

3. Size of the Current Account Deficit (as a Percentage of GDP)

- The measurement of the CAD as a percentage of GDP is an accurate indication of the relative size of the CAD compared to national output over time, and the trends in the CAD are an important aspect of Australia’s domestic/international stability.

- As previously mentioned, the net income deficit is a major contributor to the CAD – it is fairly stable at approximately 3% - 4% of GDP – this is due to our recent history of attracting and using large amounts of foreign savings.

- If the CAD reaches -5% of GDP, it is considered unsustainable and a threat to external stability – this proportion represents a constraint to domestic economic growth (particularly if the CAD is a result of spending on consumer and not capital goods).

- An ↑ in the size of the CAD relative to GDP will also ↑ the accumulation of external/foreign liabilities to fund some part of the ↑ in the CAD, which not only adds to the existing stock of net external debt and equity, but ↑ the servicing cost of the net foreign liabilities in terms of interest payments on debt.

- The IMF’s rule of thumb is that CADs are a problem when they exceed 4% of GDP – in the long-term a CAD above this level might reduce investor confidence in Australia, potentially triggering massive capital outflow (similar to the situation of the Asian Financial Crisis of 1997) – making it harder to finance domestic investment.

- Reducing Australia’s CAD can be achieved through two main methods: reducing the balance on goods and services by becoming more internationally competitive OR increasing the level of domestic savings in Australia so as to eventually reduce our need for foreign savings and, as a result, begin to reduce the net income deficit.
4. Foreign Debt and Liabilities

Foreign Liabilities

• One of the most important economic relationships relating to the BOP is with the level of net foreign/external liabilities.

A major effect of Australia’s ongoing CAD is that it must be financed by a surplus in the capital and financial account through debt and equity borrowings.

• Net foreign (external) liabilities reflect Australia’s total financial obligations to foreigners, minus the total financial obligations of foreigners to Australia – as of March 2009 net foreign liabilities were $735bn, approx. 6 times more than in 1987.

There are TWO components of foreign liabilities:

1. Net foreign debt (or net external debt): the total stocks of loans owed by Australians to foreigners, minus the total stock of loans owed by foreigners to Australians.

2. Net foreign equity: the total value of assets in Australia such as land, shares and companies in foreign ownership, minus the total value of assets overseas that are owned by Australians.

\[
\text{Net Foreign Liabilities} = \text{Net Foreign Debt} + \text{Net Foreign Equity}
\]

In the past 20 years, there has been much media attention given to the rapid rise in Australia’s net external liabilities and particularly the rise in Australia’s net external debt – these rises followed the increasing foreign investment in Australia associated with the rise in our CAD and the increasing emphasis on borrowing rather than equity investment.

Several factors influence the level of net foreign liabilities:

• The size of the CAD – any deficit on the CA must be matched by a surplus on the capital and financial account, and any such surpluses will add to our foreign liabilities – this has been the major factor driving the growth of Australia’s net foreign liabilities in recent years.

• Strong economic growth influences the size of foreign liabilities – a fast growing economy will suck in more imports (requiring increased financial inflows) and will provide greater opportunities for foreign investment (in the form of borrowed funds or equity) – overall growth in the economy also makes it possible to sustain a higher level of net foreign liabilities.

• Level of national savings – Australia has one of the lowest levels of national savings in the developed world – between the 1970s and 1990s, Australia experienced a decline in household savings and in public savings (because governments tended to run fiscal deficits, which meant that the government was borrowing money to fund government spending) – also, Australia has one of the highest levels of household debt in the industrialised world – by 2009, household debt was equivalent to over 155% of household incomes.

Over time, a lower national savings rate contributes to a higher level of net foreign liabilities and is a major factor contributing to the size of Australia’s foreign debt and high CAD – this is because Australia has to rely more on the savings of foreigners to fund local investment and thus with a low level of national savings, Australia has an insufficient supply of funds for consumption and investment spending.

This problem of a low level of national savings can be addressed by the government implementing policies to increase personal savings (such as compulsory superannuation and encouraging individuals to save through tax incentives), as well as through measures to increase public savings by eliminating the budget deficit and moving the public sector into surplus.
Foreign Debt

- Borrowing adds directly to Australia’s foreign debt – the initial borrowing sum must be repaid and the debt must be serviced (i.e. regular interest repayments must be made) – the servicing of Australia’s debt constitutes an outflow of funds on the current account, and it therefore adds to the overall size of the CAD – the effect of debt servicing on the CAD is very significant and is the largest single cause of Australia’s high CAD.
  
  - Obtaining savings through selling equity has advantages to a nation in that equity does not add directly to foreign debt, repayment of the principal is not normally required and unlike borrowing, equity investment has no definite income flow abroad (i.e. the income debits from equity investment will depend on profitability, therefore there is no automatic increase in income debits to raise the CAD).

- A high foreign debt can create a vicious cycle – the debt trap scenario – this starts with a high CAD, requiring an inflow of foreign funds. With a larger foreign debt, Australia’s interest repayments on that debt become greater, constituting a large part of the income debits that flow out on the CA – this means that current foreign debt will add to future CADs. As Australia finances a large proportion of its CAD by borrowing from overseas, Australia’s foreign debt will continue to grow, creating the risk of being trapped in a cycle of spiraling debt.
  
  - In 2008-09, Australia’s net foreign debt amounted to $633.2bn or 52.9% of GDP (compared to $9.4bn or 6.3% of GDP in 1980-81) and Australia’s net foreign liabilities amounted to $725.9bn or 60.6% of GDP (compared to $33.4bn or 22.3% of GDP in 1980-81. Australia’s net foreign debt has grown dramatically due to globalisation, and continued to rise in the late 1990s largely due to a sharp depreciation of the $A. Foreign debt grew steadily in the 2000s because rising CADs necessitated increased levels of foreign borrowing.

- In the long-term, a growth of Australia’s foreign debt will lead to a debt sustainability problem - this means that it will become increasingly difficult for Australia to service the debt – if the size of the debt is rising faster than the increase in GDP (as it has done for a large portion of the period 1980-2009), the interest repayments take up an increasing proportion of Australia’s GDP, reducing the overall standard of living and the economic growth potential of the domestic economy (but this has not happened so much due to falling global interest rates during the 1990s which reduced the repayments Australia needed to make on its borrowings).
  
  - The servicing costs of foreign debt are lower when overseas interest rates are low.

In 2008-09, Australia paid $28.8bn of interest (net) on its foreign debt, more than double the $12bn paid in 2003-04 – this emphasises the result of currently rising interest rates around the world, which means that the cost of servicing Australia’s foreign debt is again increasing.

- If these situations develop, capital markets may become wary of the risk of bad debts and foreigners may demand even higher interest rates or refuse new loans. Therefore, although virtually of Australia’s external debt is owed by private enterprises, it is possible that severe macroeconomic problems (such as higher inflation, higher unemployment and a depreciation in the currency) could result from the excessive growth of external debt.

- The debt servicing ratio is a common economic measure of a country’s capacity to service its foreign debt and the sustainability of an economy’s foreign debt level – it refers to the proportion of export revenue that is used to make repayments on foreign debt. A country is better able to service its foreign debt when it has a high volume of exports.
  
  - The debt servicing ratio in Australia peaked at just under 20% in the late 1980s, but has since fallen back due to lower global interest rates and Australia’s continued export growth – in recent years, the debt servicing ratio has risen slightly, but in 2009, it was 10.1%, reflecting that fact that the rising foreign debt has been matched by increasing export income from the terms of trade boom in recent years.

- When a country’s net foreign debt rises too far, it is generally considered by international financial markets that it may pose repayment problems for the debtor country – this may undermine Australia’s international credit rating, which would make it more expensive to borrow funds internationally, as lenders demand a higher interest rate because of the increased risk associated with the loan.
Since the late 1980s, the preference for borrowing foreign savings meant that our severe CADs were adding to foreign debt. The rising foreign debt then made it difficult to reduce the CAD (the rising net income burden was difficult to offset through higher goods and services credits – exports). However, a trend towards more equity rather than borrowing assisted in stabilizing our net foreign debt as a percentage of GDP in the mid-late 1990s, allowing it to hover between 5.8% (in 1980) and 33.3% (in 1995) compared to the significant increases evidenced during the twenty-first century (where foreign debt levels have tended from 40.5% in 2000 to 57.1% in March 2009).

It had been feared that deterioration in the CAD will push our external debt closer to the level that could result in a larger debt sustainability problem and make another major collapse in the $A possible.

Reasons for a Rapid Growth in Australia’s Foreign Debt

Some reasons for the rapid expansion in Australia’s foreign debt levels include:

(a) The growth of our current account deficit produces a situation where we have to borrow from overseas to cover some of the excess expenditure, i.e. Australia has tended to spend too much – when we borrow savings, we need to repay interest on these savings, and the cost of servicing past debts is now a major component of the CAD and may absorb more and more earnings from the export of goods and services.

(b) Budget deficits can lead to a rapid increase in governmental borrowing – governments operated with large federal budget deficits in the mid 1980s, in the early-mid 1990s and again in 2009.

(c) The shift in equity-financing to debt-financing, i.e. increased borrowing.
5. International Competitiveness

- In order to be competitive in global markets, Australia needs to be able to match other world producers with the **price and quality** of its exports - however, a major reason Australia has only made limited progress in improving on its trade performance relates to Australia's lack of international competitiveness in major areas of global trade.

- The **promotion of structural change** is the major solution to Australia’s competitiveness issues - in order to increase productivity, Australia must focus on **cost competitiveness** (which is influenced by labour costs and productivity levels, infrastructure costs, the costs of basic services such as electricity and water, transport costs, tax levels and the value of the currency) as well as **non-cost competitiveness** (including the reliability of supply, the effectiveness of marketing efforts and the quality of customer service).

- Australia’s overall international competitiveness **has improved** generally in the last decade as a result of **labour market deregulation, exchange rate depreciation** and **falling inflation** – these have fuelled economic growth in Australia.

- Thus, international competitiveness is **improved** by lower inflation, lower wage growth, higher productivity, depreciation in the $A.

- International competitiveness is **reduced** by higher inflation, higher wage growth, lower productivity, appreciation in the $A.

6. Structural Change in the Australian Economy

- **Structural change** refers to the way that production of goods and services changes over time.

- In order to diversify Australia’s export base and improve the economy’s international competitiveness, **Australian governments have implemented an extensive range of microeconomic reforms** over the past three decades.

- **Australia’s narrow X base negatively affects the CAD** – this is because Australia’s unusual reliance on primary exports makes our resource sector fairly volatile, and our agricultural sector uncompetitive, due to the high levels of protection in foreign markets. When there are downturns in the resources and agricultural sectors, Australia’s X ↓, and this makes it more difficult for Australia to sustain its CAD, causing a further deterioration. A more efficient allocation of domestic resources and the use of new technologies has assisted in the diversification of Australia’s X base and rise in the competitiveness of Australia’s X industries; resulting in an improved G&S balance and a reduced CAD – manufactured and service exports now account for 40% of G&S exports. Between 1989 and 2006, the relative shares of primary industries to GDP, employment and exports now account for 40% of G&S exports. Between 1989 and 2006, the relative shares of primary industries to GDP, employment and exports between the same years. (main structural change)

- **Australia has become a post-industrial economy** – spending on services has been rising at a faster rate than spending on goods since at least the start of the 1960s. Therefore, Australia has experienced significant changes in the composition of its production by sector, with the **tertiary and mining sectors experiencing favourable structural change** and the manufacturing and farming industries experiencing adverse structural change.

Structural change can be seen as coming from many source, and the **microeconomic reforms** the Australian government has initiated to address competitiveness issues have been important. Such reforms include:

1. **Controlling inflation** – if Australia has an inflation rate higher than that of the countries it competes with in international trade, Australian exporters are put at a competitive disadvantage because their costs of production are increased – this was an issue in the 1980s when Australia’s inflation was nearly double the average for OECD countries – **since the early 1990s, Australia has sustained relatively low levels of inflation due to increased competition in Australian industries.**

2. **Sustaining productivity growth** – in order to compete internationally, Australian firms must sustain productivity growth, using their resources and workforce more efficiently. In the 1990s, Australia’s productivity performance improved dramatically, reflecting the impact of extensive microeconomic reforms that changed work practices and production methods – more recently, however, productivity growth has fallen back to below long-term averages.
3. Changing role of government in the economy – since the 1980s, the government’s role in the economy has changed in the pursuit of improved international competitiveness, emphasising a smaller and more efficient public sector – increased privatisation has occurred, and governments have given a higher priority to keeping budget deficits under control, reflecting the view of international investors that greater competitiveness will be achieved in countries with a smaller public sector, lower taxes and minimal levels of government business ownership.

• Structural change can also come from market pressures (such as technological change, increasing global specialisation, resource discovery/depletion and rapid economic development in Asia). Given the increased role of the market in the Australian economy since financial market deregulation in the 1980s, it is clear that market forces have been more active in driving structural change due to the declining government intervention in the economy.

• Structural changes can also have a significant impact on the balance of payments – if a major export sector of the economy is in decline then the balance of payments (specifically the CAD) will deteriorate, especially if the economy has a fixed exchange rate. However, since Australia has a flexible (floating) exchange rate, the $A rises or falls in response to forces such as structural change and thus the impact of structural change is not as severe.

Consequences of a high CAD

Sustaining a high CAD has significant impacts on the Australian economy and on the conduct of economic policy – Australia’s CAD has been above 4% for the last 20 years, exceeding the IMF’s measure of CAD sustainability.

There are clear risks associated with Australia sustaining a high CAD, including:

1. Growth of foreign liabilities – if the CAD reaches an unsustainable level, Australia’s credit rating will fall as domestic firms will be unable to service the debt/borrowing costs, and this will decrease foreign investment.

2. Increased servicing costs associated with high levels of foreign liabilities impose substantial servicing costs, reflected by the large net income deficit on the CAD – higher levels of foreign debt can lead to lenders demanding a ‘risk premium’ on loans, forcing up interest rates and can contribute to the problem of the debt trap in which Australia is borrowing money simply to service its existing foreign liabilities.

3. Increased volatility for exchange rates – high CADs may undermine the confidence of overseas investors in the Australian economy and, by reducing demand for Australian currency, may result in a depreciation of the $A – this will generally worsen Australia’s CAD problem in the short-term, as the prices of imports increase.

4. Constraints on future economic growth – in the longer term, the CAD limits economic growth as high levels of growth generally involve an increase in imports and a subsequent decline in the CAD. The balance of payments constraint is the extent to which an economy’s capacity to grow is constrained by its need to keep the CAD at a sustainable level, and this affects economies with a CAD problem.

5. More contractionary economic policy – governments will use tighter macroeconomic policies (monetary policy + fiscal policy) to reduce economic growth in the short-term and therefore contribute to a lower CAD. Micro-economic reform will be used to help solve the structural problems behind CAD problems – however in the short to medium-term, tighter macroeconomic policies and accelerated microeconomic reform is likely to lead to slower economic growth and development and a rise in unemployment.

6. Loss of international investor confidence – losses in investor confidence can be triggered due to an economy’s inability to sustain itself and will result in rapidly decreasing foreign investment - economic crises (as seen by the major financial crisis triggered in Asia by concerns over Thailand’s high CAD in 1997 and similarly in Argentina in 2002 due to external imbalances) may occur, and it is countries with high CADs that are most vulnerable to shifts in investor sentiment.
Why has the CAD not caused any significant problems for Australia in recent years?

a. Financial markets have been confident that Australia’s natural resource wealth will underpin continued strong export growth in the future, allowing Australia to service its foreign liabilities.

b. Financial markets have also accepted that the CAD often surges in response to short-term factors – such as the sharp fall in commodity prices in 2009.

However, Australia’s BOP difficulties are ultimately an issue of risk. Australia’s CAD and foreign debt levels expose the economy to risk, but this risk has been managed successfully in recent years, and Australia’s high degree of trade and financial integration with the global economy (due to globalisation) has helped it to sustain strong growth in recent years. Nevertheless, this is no guarantee of continued success in the years ahead and, in a time of global uncertainty, these issues are likely to play an increasingly important role in Australian economic debate.
2.2 Exchange Rates

- An *exchange rate* refers to the relative price of two currencies – it is an indication of the relative purchasing power of one currency against another and is an essential market price for determining the basis for international trade transactions such as importing and exporting goods and services.

- Exchange rates are necessary because exporting firms want to be paid in their own currency, meaning importers will need to be able to convert their domestic currency into the foreign currency in order to make payments.

- The currency conversion occurs in the *foreign exchange market* (FOREX market) where the forces of supply and demand (or the government in the case of a *fixed exchange rate*) determine the exchange rate, i.e. the price of one country’s currency in terms of another.

**Measurement of Relative Exchange Rates**

- Measurement to other individual currencies

  - **Bilateral rates** (or cross rates) measure the value of a unit of domestic currency relative to another currency.

  - Changes in exchange rates over time measure the rise or fall in the value of the Australian dollar relative to other currencies.
    - An *appreciation* refers to a rise in the value or purchasing power of the Australian dollar.
    - A *depreciation* refers to a fall in the value or purchasing power of the Australian dollar.

Exchange rates can be quoted in TWO main ways:

1. The *indirect method of quotation* refers to the rate of exchange between a unit of domestic currency and the equivalent amount of foreign currency – e.g. $A1.00 = $US0.68

2. The *direct method of quotation* refers to the number of units of domestic currency needed to purchase one unit of foreign currency - e.g. $A1.47 = $US1.00.

- *Trade Weighted Index* (TWI) is a measure of the Australian dollar against a basket of foreign currencies of major trading partners – these currencies are weighted according to their significance to Australia’s trade flows.

- The TWI is a more accurate and important measure of the $A purchasing power than bilateral exchange rates, as it is *trade weighted* and reflects the changes in Australia’s BOP performance over time.

- Since 1984, the TWI shows that the $A has moved overall in line with global economic conditions – the TWI will generally fall significantly after the world’s richest nations experience recessions and rise when the major advanced economies experience strong economic growth.
**Factors Affecting the Demand and Supply of Australian Dollars**

**A) DEMAND FOR AUSTRALIAN DOLLARS**

- The $A is demanded whenever firms, governments and to a lesser extent individual have foreign currency which they wish to convert into Australian dollars – i.e. represents those wishing to BUY $A.

- The main groups DEMANDING Australian dollars are:
  
  (a) **Foreign savers** who want to either lodge their savings with financial institutions in Australia or directly use their savings to purchase assets or undertake investment within the Australian economy.
    
    These foreign savers may be:
    
    (i) **Offshore financial institutions** such as pension/superannuation funds, foreign banks and fund managers – these firms are attracted by interest rates and dividend opportunities from businesses based in Australia – they typically allocate their savings into shares and government bonds.
    
    (ii) **Offshore firms** seeking to buy assets or establish/expand their existing assets in Australia – their activities are influenced by confidence in profit opportunities in Australia compared to elsewhere.
    
    (iii) **Linked to Australian financial institutions** which borrow foreign savings and wish to make them available within Australia – this group is the most significant to the inflow of loans from overseas and are influenced by the demand for funds in Australia, i.e. the rate of economic growth and business confidence.

  (b) **Exporters of goods and services** usually need to return their offshore earnings to Australia to meet day to day expenses (wages etc.), dividends and other funding requirements (e.g. new investment expenditure) – foreigners who buy Australian exports need to convert their currency into $A (by purchasing $A) to pay Australian exporters.

  (c) **Government receipts of funds** from abroad, e.g. in the form of loans, fees and charges for services – the RBA acts as the agent for such government transactions as well as occasionally trying to influence the value of the $A by demanding $A.

  (d) **Speculators** will demand $A if they expect an appreciation of the $A in the future.

- Demand for $A will be affected by:

  1. **The size of financial flows INTO Australia** from foreign investors who wish to invest in Australia and need to convert their currency into $A.

  a. The **level of Australian interest rates relative to overseas interest rates** has a critical influence on the demand for $A – relatively high Australian interest rates makes Australia a more attractive location for foreign savings and thus increases the demand for $A.

  b. The **availability of investment opportunities in Australia** will also strongly influence the demand for $A – if there are more opportunities for investors overseas to start new businesses or buy into existing businesses via the share market, the demand for $A will increase.

  2. **Expectations of a future appreciation** of the $A will increase current demand for $A by speculators, thus contributing to the expected appreciation.

  3. **Demand for Australian exports**, since the foreigners who buy Australia’s exports need to convert their currency into $A to pay Australian exporters.

  a. Changes in **commodity prices** and in the **terms of trade** have tended to have an immediate effect on the dollar – a rise in commodity prices and an improvement in the terms of trade are generally associated with an increase in Australian exports.
Financial markets will often respond to these changes by increasing the value of the dollar with an expectation that exports will increase over the short to medium-term.

b. The degree of international competitiveness of domestic producers and Australia’s inflation rate will also influence the demand for Australian X – if domestic producers are competitive in world markets and Australia’s inflation rate is relatively low, Australia’s exports will generally be cheaper and more attractive to foreign buyers.

c. Changes in global economic conditions will influence the overseas demand for exports – the demand for Australian commodity X is highly dependent on the growth rates of Australia’s trading partners – when the world economy is on an upturn, demand and prices for Australia’s exports rise and vice versa.

d. Tastes and preferences of overseas consumers will also affect the demand for Australia’s exports.
(B) SUPPLY OF AUSTRALIAN DOLLARS

- The $A is supplied whenever firms, governments and individuals have $A which they want to convert into another nation’s currency – i.e. represents those wishing to SELL $A.

- The main groups SUPPLYING Australian dollars (with an interest in converting to another currency):

  (a) **Australian savers** who wish to lodge their funds with overseas financial institutions or directly use their savings to purchase assets or undertake investment overseas.

  These Australian savers may be:

  (i) **Australian-based firms** that are establishing production facilities offshore.

  (ii) **Offshore financial institutions** redirecting funds from Australia to elsewhere.

  (iii) **Australian financial institutions** lending on offshore projects of Australian firms or foreign firms – fund managers buying overseas shares/bonds are also involved.

(b) **Importers of goods and services** who wish to move funds from the sale of items in Australia offshore to meet expenses such as wages, supplies and dividends.

(c) **Government** loans or aid to foreign nations and any RBA activity to weaken the value of the $A by selling $A and adding to Australia’s official assets overseas.

(d) **Speculators** who expect the value of the $A to depreciate in the future - to obtain profits they convert to another currency now and buy back $A after it has fallen.

- Supply of $A will be affected by:

1. **The level of financial flows OUT of Australia** by Australian investors who wish to invest overseas will need to sell $A and purchase foreign currency.

   a. **The level of Australian interest rates relative to overseas interest rates** will also be a critical factor influencing financial flows out of Australia and the supply of $A – relatively low Australian interest rates will make investing savings overseas more attractive and hence increase the supply of $A.

   b. The **availability of investment opportunities overseas** will also influence financial flow out of Australia – greater opportunities to start businesses overseas or to purchase shares in overseas companies will increase financial flows out of Australia and increase the supply of $A.

2. **Speculation** by speculators in the FOREX market who expect the value of the $A to fall will sell $A, increasing the supply of $A and thus contributing to the anticipated depreciation.

3. **Domestic demand for imports**, since Australian importers who buy from overseas need to sell $A in order to obtain foreign currencies to make import payments.

   a. The **level of domestic income** will influence the demand for imports –output, employment and incomes are rising when the economy is growing and thus at the same time the demand for imports will also rise, increasing the supply of $A.

   b. The **competitiveness of domestic firms that compete with imports** and the **domestic inflation rate** influences import levels – if Australia’s domestic inflation rate is higher and its import-competing firms are relatively uncompetitive, imports will be relatively cheaper than domestic products and demand for imports will be higher.

   c. **Tastes and preferences of domestic consumers** change over time, and an increasing preference for goods and services from overseas will raise the supply of $A on the FOREX market.
How the exchange rate of the $A against the $US can appreciate or depreciate due to changes in supply/demand

**Appreciation of the $A**

This graph shows that any *increase in the demand for $A* (shift in the curve from D1 to D2) will increase the price of $A in terms of $US (i.e. cause an **appreciation in the $A**).

Likewise, any *decrease in supply of $A* (shift in the supply curve from S1 to S2) will also cause a **appreciation in the $A**.

**Depreciation of the $A**

This graph shows that any *decrease in demand for $A* (shift in the curve from D1 to D2) will decrease the price of $A in terms of $US (i.e. cause a **depreciation in the $A**).

Likewise, any *increase in supply of $A* (shift in the supply curve from S1 to S2) will also cause a **depreciation in the $A**.
**Changes in Exchange Rates**

- When a change in the exchange rate occurs, the exchange rate will either **appreciate** or **depreciate**.

- The main factors causing an appreciation or depreciation of the Australian dollar are shown below.

<table>
<thead>
<tr>
<th>Appreciation of the Australian Dollar</th>
<th>Depreciation of the Australian Dollar</th>
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<tbody>
<tr>
<td>• An increase in Australian interest rates or decrease in overseas interest rates.</td>
<td>• A decrease in Australian interest rates or increase in overseas interest rates.</td>
</tr>
<tr>
<td>• Improved investment opportunities in Australia or deterioration in foreign investment opportunities.</td>
<td>• Deterioration in investment opportunities in Australia or improvement in foreign investment opportunities.</td>
</tr>
<tr>
<td>• A rise in commodity prices and an improvement in Australia’s terms of trade.</td>
<td>• A fall in commodity prices and a deterioration in Australia’s terms of trade.</td>
</tr>
<tr>
<td>• An improvement in Australia’s international competitiveness.</td>
<td>• A deterioration in Australia’s international competitiveness.</td>
</tr>
<tr>
<td>• Lower inflation in Australia.</td>
<td>• Higher inflation in Australia.</td>
</tr>
<tr>
<td>• Increased demand for Australia’s exported G&amp;S.</td>
<td>• Increased demand for imported goods and services.</td>
</tr>
<tr>
<td>• Expectations of a currency appreciation based on forecasts of one of the above factors.</td>
<td>• Expectations of a currency depreciation based on forecasts of one of the above factors.</td>
</tr>
</tbody>
</table>

- When an **appreciation** in the value of the currency occurs, it means that the $A can buy **more** of another currency:
  
  (i) **Importers will benefit from an appreciation** – e.g. if $A1 changes from converting into $US0.75 to $US0.80, the importers have the choice of taking higher profits in $US terms or reducing their prices in Australia.

  (ii) **Exporters will be disadvantaged by an appreciation** – they have the uncomfortable choice of accepting lower $A revenues and profits OR risking price rises in the export market and accepting the lower volume of sales that will almost certainly result.

- When a **depreciation** in the value of the currency occurs, it means that the $A can buy **less** of another currency:

  (i) **Imports will be disadvantaged by a depreciation** – e.g. if $A1 changes from converting into US$0.75 to US$0.60, the importers are faced with a major issue: if they raise their Australian prices to prevent the slump in the $US revenue, they risk losing sales to Australian competitors – the alternative is to accept lower profits or even losses on their sales in Australia and hope that the depreciation is soon reversed.

  (ii) **Exporters will benefit from depreciation in the $A.**

So, from the point of view of Australian firms and individuals:

**Depreciation** benefits Australian exports and foreign investors buying assets in Australia.

**Appreciation** benefits importers into Australia and Australians buying assets offshore.
Thus, the value of the $A depends largely on movements in:

- Profit opportunities and interest rate differences between Australia and the other major economies.
- Australia’s terms of trade (especially commodity prices) – the main cause of the recent strength of the $A.
- Australia’s balance on the current account and its components: the BGS, net incomes and current transfers.
- Interest rate differentials between Australia and the nations supplying us with foreign savings have been very significant in recent years.
- Speculators’ views on the likely movements in these matters.
- The RBA’s intervention in FOREX markets has to be limited to occasional interventions, usually when it is sure that the market has over-reacted.
**Determination of Exchange Rates, including Fixed, Flexible and Managed Rates**

- **Flexible exchange rates (under a floating exchange rate system)**

  - The December 1983 decision for Australia to move towards a floating exchange rate system was based on THREE factors:

  1. It was the *most efficient* system that could be used to determine the value of currency.
  2. To expose the Australian economy to *international competitive pressures*.
  3. To pursue a more *independent and effective monetary policy system* in a deregulated financial environment.

(a) **Freely Floating Exchange Rates ("Clean Float")**

  - Under a freely floating exchange rate system, the value of a nation’s currency is determined by the *interaction between supply and demand for the currency* in the FOREX market – this is known as a *‘clean float’*.

  - When there is an *excess of supply or demand*, the RBA intervenes to force the market price up or down – i.e. *‘dirtying the float’*.

**Advantages of a Floating Exchange Rate**

- Achieves a realistic market price for the currency that reflects the trends within the Australian economy (such as inflation, BOP performance, unemployment etc.)

- Pursues a more independent and effective monetary policy, due to more efficient and reduced RBA intervention.

- Provides some protection for the Australian economy from external real and financial shocks, by moving to equilibrium positions.

- Consistent with the floating exchange rates used by major trading partners; allowing for greater global capital market integration, greater capital mobility, and the co-ordination of international monetary policies to control inflation.

**Disadvantages of a Floating Exchange Rate**

- **The prices of the $A will be very volatile under this system** due to increased speculation of exchange rates – this additional risk from exchange rate volatility leads to uncertainty in savings and investment decisions, makes economic and business decision-making uncertain and reduces investor confidence – in the course of any one day, the price may move both upwards and downwards as demand and supply conditions change on the FOREX market, and over a longer period of time, general trends of an *appreciation or depreciation* will occur.

- Exchange rate becomes subject to sudden shifts in market sentiment (risk of currency becoming over-valued or under-valued by the market => potential collapse) - Caused by 'speculative bubbles' which prompts the RBA to 'smooth' or stabilise the changes in market sentiment, through a 'dirty float'.

**Thus, under a freely floating exchange rate:**

- market forces of supply and demand determine the value of the currency of nations.

- the exchange rate will change frequently even with a day as the rates are very volatile.

- significant trends develop in the exchange rate over a short period, and large depreciations/appreciations can occur within a week or month.
(b) Flexible exchange rate system with COVERT INTERVENTION

- Some central banks set out to reduce the volatility of a freely floating exchange rate by trying to alter the short-term balance of market forces – this is known as dirtying the float.

- This action of ‘dirtying the float’ is taken because anxiety can often be created by large exchange rate fluctuations, resulting in importers/exporters making unwarranted decisions.

- The intervention of this central bank is not accounted publicly – it is therefore a concealed or covert intervention.

Thus, dirtying the float involves the central bank either:-

(i) Reducing the extent of the depreciation by buying $A;

OR

(ii) Reducing the extent of an appreciation by selling $A.

- Fixed exchange rates

- Under a fixed exchange rate system, a central bank intervenes in the market to reduce exchange rate fluctuations and to determine the value of a nation’s currency in relation to another currency or basket of currencies. This system was used until 1983 when the Australian dollar was floated.

- The fixed exchange rate system requires the Reserve Bank to have stores of foreign currency or gold available to meet the excess supply, known as foreign reserves.

- The advantage of a fixed exchange rate system: there is certainty about the immediate short-term value of the exchange rate and the exchange rate is stable and not subject to any rapid changes. A stable exchange rate (as developed under a fixed exchange rate system) gives producers and consumers confidence about prices that they can use to make wise business and consumption decisions.

- Disadvantages of a fixed exchange rate system include:

  o Speculation increases (with speculators ‘betting’ on the future direction of the price of the currency) since the exchange rate is not market determined - hence central bank intervention is predictable. Increased speculation creates a cycle of intervention.

  o A fixed exchange rate economy does not react to external structural changes as the exchange rate does not respond directly to changes in market forces (i.e. it does not reach to changes in demand for or supply of the currency) or external real or financial shocks.

  o Fixed exchange rates cause increases and decreases in the domestic money supply, as the bank supplies and withdraws domestic currency to maintain the fixed rate of exchange – in floating exchange rate systems, the international market supplies and sells the currency and there is no need to influence the supply of money in the domestic economy.
- Managed exchange rates

Nations have more options to consider than the extremes of freely floating and absolutely fixed exchange rates, and so a managed exchange rate system attempts to combine features of both systems. Prior to the introduction of the floating exchange rate system in 1983, Australia had a managed rate system.

(a) Managed float – a managed float occurs when the central bank announces its intervention in the market, rather than concealing its action.

(b) Flexible peg exchange rates - under this system, the RBA would ‘peg’ the value of the $A at 9am each day and that price would operate throughout that day, keeping the exchange rate within a ‘target band’ or ‘zone of intervention’ – the central bank would only intervene when the exchange rate appreciates/depreciates out of the target band – the exchange rates were set after analysis of the forces of supply and demand + the interests of the domestic economy.

The Influence of the Reserve Bank of Australia on Exchange Rates

- Although Australia relies primarily on market forces to determine the exchange rate, the RBA sometimes plays a role in influencing the value of the currency – while the RBA cannot change the value of the $A in the long-term, it is able to smooth out swings in the $A relating to short-term factors by ‘dirtying the float’ and through monetary policy intervention.

- The RBA intervenes in the FOREX market for THREE main reasons:

1. **Achieve stability and orderly markets** in the face of excessive volatility.

2. **Influence expectations** (not based on economic fundamentals) that may result in under or overshooting or a misalignment of the exchange rate from its long-run equilibrium path.

3. **Prevent excessive volatility** from threatening the achievement of domestic monetary objectives, e.g. depreciation threatens price stability & appreciation threatens the attainment of economic growth + full employment.

- Intervention by the RBA in the FOREX market can be ‘sterilised’ to offset its effect on domestic liquidity and interest rates, or ‘unsterilised’, with the intervention affecting domestic liquidity and interest rates.

  a. **Sterilisation** involves the RBA selling (or buying) foreign currency, which takes $AUDs out of the financial system, but then buying (or selling) sufficient govt. securities to inject the same amount of $AUDs back into the financial system => no change in the domestic money supply or interest rates

  b. **Unsterilised** FOREX market intervention involves no such offsetting purchase or sale of government securities, and leads to a rise/fall in the money supply and a rise/fall in interest rates

The RBA has always undertaken sterilised intervention in its FOREX dealings, and does this through either buying Commonwealth Government Securities (CGS) or by arranging foreign currency swaps on the futures market.
• Forms of intervention by the RBA are:

1. **Dirtying the float:** when the RBA feels that a large short-term change in the exchange rate (possibly due to excessive speculation) will be harmful to the domestic economy, it may decide to intervene in the FOREX market (as a buyer or a seller) in order to stabilize the $A.

   In order to curb a rapid depreciation of the currency, the RBA will **buy $A**, putting upward pressure on the exchange rate – on the other hand, by **selling $A** the RBA may prevent a rapid appreciation. For instance, in the second half of 2008 when the $A lost one-third of its value against the $US, the RBA purchased $3.3bn of $A to moderate its depreciation and provide support in the FOREX market. The RBA was able to sell $3.4bn of $A in 2009 as the currency recovered in value.

   The RBA’s ability to intervene through buying $A is limited by the size of its foreign currency holdings (i.e. its reserves of foreign currency and gold that can be used to fund such purchases.)

2. **Monetary policy decisions:** monetary policy initiatives are an indirect way of influencing the exchange rate and are rarely used for this purpose – if the RBA wants to curb a rapid depreciation, it may increase the demand for $A by raising interest rates – this policy will generally only be effective for a limited time.

   It is unusual for the RBA to change interest rates in response to movements in the currency, since the primary focus of its monetary policy decisions is to influence the domestic economy, particularly the inflation rate – however, exchange rate movements can sometimes be so volatile that they may affect the stability of the economy or the level of inflation.
The effects of fluctuations in exchange rates on the Australian economy

- Changes in the exchange rate can bring about changes in the balance of payments.

The Economic Effects of Exchange Rate Depreciation

- Exchange rate depreciation has an expansionary impact on domestic economic activity – it increases the domestic price of foreign goods as well as decreasing the foreign price of exports.

### POSITIVE EFFECTS OF EXCHANGE RATE DEPRECIATION

- By decreasing the value of the $A in terms of other currencies, Australia’s exports become cheaper on world markets and therefore easier to sell, leading to an increase in export income and an improvement in Australia’s CAD in the medium-term. Australia’s experience since the late 1990s suggests that depreciation can have substantial positive effects on the CAD because of its boost to export competitiveness and it can also lead to a rise in employment in more internationally competitive industries, e.g. mining and agriculture.

- Imports will be more expensive, discouraging import spending and potentially improving Australia’s CAD – domestic production of import substitutes should also rise. Alternatively, if in the short-term there is import rigidity (inelastic demand for imports), overall import spending will increase and worsen the CAD. In the longer term, however, the CAD should improve due to export growth and as import replacement industries develop. When a depreciating $A leads to long-term improvement in the CAD, after an initial worsening, this is known as the J-curve theory (which states that an exchange rate depreciation leads to a decline in X income and a rise in M expenditure in the short-run [worsened trade balance], but an improvement in a country’s international competitiveness and CAD in the long-term).

- Lower import spending and greater export revenue will increase Australia’s growth rate but this may not happen if Australia is unable to replace its imports with domestically produced goods.

- A depreciation increases the $A value of foreign income earned on Australia’s investments abroad and would cause an improvement in the net income component of the CAD.

### NEGATIVE EFFECTS OF EXCHANGE RATE DEPRECIATION

- Australian consumers suffer reduced ‘purchasing power’ – they can buy fewer overseas produced goods with the same quantity of $A.

- A depreciation increases the interest servicing cost on Australia’s foreign debt because Australia can buy less foreign currency with its domestic currency with which to pay interest – this increases income outflow on the net income component on the CA and thus increases Australia’s CAD.

- A depreciation will also raise the $A level of foreign debt that has been borrowed in foreign currency as expressed in Australian dollar terms – a phenomenon known as the valuation effect.

- Inflationary pressures in Australia will increase as imports would now be more expensive + exports are now cheaper and increased export sales may generate domestic shortages and force up domestic prices of those goods. Overall, this may increase pressure on the RBA to raise interest rates to defend its inflation target, which will lead to falling economic growth and reduced domestic investor confidence.
**A depreciation** will also increase the value of foreign assets in $A dollar terms – a phenomenon known as the **valuation effect** (where an appreciation [or depreciation] of the currency causes an immediate decrease [or increase] in the Australian dollar value of foreign debt that is borrowed in foreign currencies).

- **Depreciation of the exchange rate** increases the cost of imports and lowers the price of exports – this could lead to lower export income from the sale of a given volume of exports and increase the cost of a given volume of imports – lower export income and higher import expenditure will worsen the goods balance and increase the CAD.

**Foreign investors** will find it less expensive to invest in Australia, generally leading to greater financial inflows and thus this may increase the level of foreign direct and equity investment in Australia – however, financial inflows may dry up if foreign investors expect the currency to continue falling.

- **Depreciation of the exchange rate** increases the cost of imports and lowers the price of exports – this could lead to lower export income from the sale of a given volume of exports and increase the cost of a given volume of imports – lower export income and higher import expenditure will worsen the goods balance and increase the CAD.

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**POSITIVE EFFECTS OF EXCHANGE RATE APPRECIATION**

- **Australian consumers** enjoy increased ‘purchasing power’ – they can buy more overseas-produced goods and services with the same quantity of $A.

**NEGATIVE EFFECTS OF EXCHANGE RATE APPRECIATION**

- **By increasing the value of the $A** in terms of other currencies, Australia’s exports become more expensive on world markets and hence more difficult to sell, leading to a fall in X income and a deterioration in Australia’s CAD in the medium-term. The higher prices of exports may mean that these could become less competitive compared with goods from other countries.

- **An appreciation** decreases the interest serving cost on Australia’s foreign debt since Australians can buy more foreign currency with $A – this reduces outflow on the net income component of the CA in future years and helps reduce Australia’s CAD.

- **Higher import spending and reduced export revenue** will reduce Australia’s economic growth rate.

- **Inflationary pressures** in Australia will be reduced as imports become cheaper – this is likely to reduce pressure on the RBA to raise interest rates to defend its inflation target.

- **Imports will be less expensive**, encouraging import spending and worsening Australia’s CAD. Domestic production of import substitutes is likely to fall.

- **Foreign investors** will find it more expensive to invest in Australia, generally leading to reduced financial inflows – however, financial inflows may continue if foreign investors expect the currency to continue rising.

- **An appreciation** reduces the $A value of foreign income earned on Australia’s investments abroad and would cause a deterioration in the net income component of the CAD.

- **An appreciation will also reduce the value of foreign assets in $A terms** – a phenomenon known as the **valuation effect**.
How does the balance of payments influence the exchange rate?

- Under a floating exchange rate system, the quantity of $A supplied = the quantity of $A demanded (i.e. the net outflow of funds on the CA [supply of $A] must = the net inflow of funds on the CFA [demand for $A]).

- Any disequilibrium on the balance of payments is only temporary and is automatically corrected by exchange rate movements.

- How the current account influences the exchange rate and the CFA - If the value of imports increases while exports remain unchanged, a deterioration in the CAD would result – it would cause an increase in the supply of $A (since importers would be selling more $A in order to buy foreign currency), resulting in a depreciation in the currency. Because of the depreciation, a given level of financial inflow would be able to buy more $A – thus the positive balance on the CFA would increase in terms of $A to match the bigger deficit on the CA.

- The effect of the balance of payments on the exchange rate also depends on perceptions of the financial market – if financial markets are concerned that an increase in the CAD is not sustainable, they may be less willing to purchase Australian assets – this would reduce the value of the dollar due to reduced capital inflow.

- If financial market participants believe that a rise in the CAD is justified by some other factors, the high CAD may not have a significant impact on the currency – e.g. the $A appreciated to over $US0.95 in mid 2008, a time when the CAD was large, but investors believed that Australia CA problems did not pose a short-term risk to the economy and expected that high commodity prices would eventually reduce the CAD.

- Experiences of recent years suggest that the most significant influence on the value of the exchange rate is how financial markets perceive developments in the balance of payments, not the actual BOP figures themselves – this results in greater instability in FOREX markets because market sentiment can change quickly.
The impacts of the recent depreciation in the Australian dollar (2008-09)

- The Australian dollar started to depreciate sharply in August 2008 after the collapse of major financial institutions in the US – the $A depreciated against all major currencies and in TWI terms fell by 20% between August and November 2008 (the largest fall in any three-month period since the currency was floated in 1983).

The large depreciation reflects a number of important factors:

1. A rapid deterioration in the global economic outlook especially for world growth and world demand for commodities.
2. The sharp fall in commodity prices with major implications for Australia’s export prices, terms of trade and the CAD.
3. The narrowing of the interest rate differential between Australia and the rest of the world as major central banks cut their official cash rates by substantial increments.
4. The general scaling back of international investments as investors withdrew capital profits and dividends from their international investments.
5. Widespread selling of commodity-driven currencies such as the $A and the purchase of safer or less risky investments such as gold and government securities.

The exchange rate depreciation had a number of significant effects flowing through the Australian economy:

1. The depreciation boosted prices of imported goods and services which put upward pressure on consumer price inflation feeding through rapidly into the prices of some goods such as petrol.
2. The depreciation had impacts on businesses with foreign currency denominated assets and liabilities and foreign currency income streams or servicing obligations – but Australian financial institutions and large corporate with overseas currencies typically hedge their foreign exchange exposures to insulate themselves from the effects of exchange rate changes on their balance sheets.
3. The depreciation benefited import-competing an export industries which experienced an improvement in their international competitiveness – exporters such as the tourism and education industries where prices are set in $A benefitted from increased foreign demand, given that their prices fell relative to suppliers in other countries.

The effects of a depreciation will be stimulatory for economic growth and will show up in the national accounts as increased contribution to growth from net exports (and a reduction in the CAD – however the depreciation was occurring in an environment of slowing global growth, lower commodity prices and a reduction in Australia’s income and growth prospects, which worked in the opposite direction to the stimulatory effects of the depreciation.

During the post-float period, the exchange rate has acted as a form of shock absorber for the Australian economy – the recent depreciation follows a period when the exchange rate appreciated substantially in line with the large increase in the terms of trade. The recent appreciation was contractionary for the economy but helpful in that it contributed to holding down inflation and reducing pressures on resource utilization at a time of strong growth in domestic incomes.
2.3 Free Trade and Protection

- Australia was historically **one of the most highly protectionist countries** in the world – governments felt it was necessary to protect Australian manufacturers who for many years found it difficult to compete because of the relatively small population and low production runs in Australia.

- The 1970s saw a shift away from this protectionist strategy and in the 1980s Australia phased out almost all tariffs and other non-tariff trade barriers (such as subsidies and quotas) which has benefited the Australian economy overall.

- Australia is **one of the least protectionist economies in the world today**.

The **government's main aims** in reducing protection are:

1. To force domestic industries to become internationally competitive by exposing them to competition from imported goods.

2. To encourage resources to move away from industries and firms that cannot improve their competitiveness to those that can become more competition – i.e. to focus on areas of the economy where Australia has a comparative advantage.

3. To allow Australia to benefit from greater integration with the global economy, by giving consumers and businesses access to goods and services available on global markets at the lowest possible price.

4. To promote structural change in the economy, with the long-term aim of encouraging efficient firms to produce what the global economy demands.

**Australia’s Policies Regarding Free Trade and Protection**

- Australia’s transition from a highly protected economy to an economy with relatively low trade barriers has occurred over decades – the gradual **decline in average tariff levels** since the 1960s demonstrates this.
  
  - In 1968-69 the average tariff level in Australia = 36%; 1977-78 = 23%; 1994-95 = 9%; 2005 = 3%; 2007 = 1.8%.

- **First initiative to reduce protection** was made by the Whitlam Govt. in 1973—a 25% across the board tariff cut was announced in order to stimulate greater industry efficiency - over the subsequent decade **Australia reduced its tariffs at the second fastest rate globally** (after NZ). However it was not until 1988 that Australia commenced a comprehensive program of trade liberalization.

- The change in government industry assistance policy in the 1980s and 1990s in order to move towards greater free trade:
  
  - Increased the competitiveness of Australian industry.
  
  - Increased economic growth through structural reform - improved technical, allocative, and dynamic efficiency and reduced cost structures of Australian Industries.
  
  - Increased export shares of Australian firms in foreign markets due to higher productivity.

- **Australia’s reductions in protection levels have exceeded international trade agreement requirements** as Australia has pursued a general strategy of phasing out protection – this means that even with a successful conclusion of the Doha Round of the trade negotiations, Australia would be unlikely to face additional obligations to reduce protection.
The Implications of Australia’s Policies for Individuals, Firms and Governments

- Australia’s decision to abandon protectionism has been one of the most significant structural changes in the economy in recent decades and is central to Australia’s integration with the global economy.

Effects on firms/businesses

- Individual firms that operate in marginal, import-competing industries will shrink unless they are able to improve their competitiveness – entire industries/sectors of the economy may die out completely, e.g. the manufacturing of consumer electronics products such as televisions has almost ceased entirely in advanced economies such as Australia due to relatively low-skilled labour that is required for the manufacturing of these products - advanced economies cannot compete with lower wage costs of industrialising economies like China.

- Some businesses may restructure their operations with the aim of staying in business by focusing on one area of production and eliminating less profitable product lines as well as finding new opportunities in exporting due to decreased access and a declining share of the domestic market.

- The aim of removing protection for local industries is to force them to develop the innovation and efficiency that is necessary to compete on the world stage – research by the Productivity Commission has concluded that productivity growth and export performance have improved in sectors where tariff reductions have been greatest.

- Lower tariffs = lower input costs – this makes exporting firms more internationally competitive.

- During the 1990s, a reduction in protection levels (combined with other microeconomic reforms) contributed to changes in and a diversification of Australia’s export base including a significant growth in manufacturing exports – there has been substantial overall growth in export volumes, suggesting Australia is becoming more integrating with the world economy (a higher proportion of Australia’s production is exported and equally, a higher proportion of the G&S Australians consume are imported).

  - In 1989-90, total exports = $61bn and exports accounted for 14% of GDP – 33% minerals and metals, 23% rural/agriculture.
  - In 2008-09, total exports = $286bn and exports accounted for 26% of GDP – 49% minerals and metals, 10% rural/agriculture.

Effects on individuals

- Individuals can experience substantial dislocation in particular through increased unemployment associated with the restructuring of industries and cuts in local production – this can have a harsh impact on individuals who have worked in these industries for a long time and have limited alternative job opportunities due to unemployment being concentrated in regions where there are few sources of employment growth.

  - Many of the jobs lost in the manufacturing sector because of lower protection levels are relatively low-skilled, production-line jobs – limited skills developed in these jobs are not easily transferrable to other work places, resulting in structural unemployment – it then becomes necessary for these people to retrain to develop work skills relevant to the current needs of the economy.

- Provided the process of structural change promotes internationally more competitive firms in the future, the loss of employment should be recouped by the growth in those sectors of the economy that are more efficient and internationally competitive – e.g. while Australia has experienced the decline of manufacturing industries in recent decades, it has experienced enormous growth in service industries such as tourism and education.
• One way for consumers to benefit from lower levels of protection is in their role as consumers – lower trade barriers have resulted in consumers being able to buy more goods and services at lower prices – the increased level of competition has also contributed to improved customer service from firms in some sectors – increased choice is likely to improve living standards.

Effects on the government

High and moderate protection levels produce, in most circumstances, unfavourable effects which governments are aware of, such as: an inefficient allocation of resources, a redistribution of income, higher prices (in the form of tariffs and quotas) and it may provoke retaliation from trading partners (who may also engage in tit-for-tat protection increases).

Impacts on governments due to reductions in protection include:

• Cutting tariffs will lead to a reduction in government revenue since tariffs provide indirect tax revenue to the government – the importance of tariff revenue has declined throughout the 20th century (whereas at the beginning of the 20th century it was the largest source of revenue for the Commonwealth Government) – in 2009-10, the $3bn in tariff revenue collected by the government accounted for only 1% of its total revenue.

• A program of reducing protection levels may also have effects on the levels of government spending – governments may be required to assist the structural adjustment process through increased expenditure on unemployment benefits and retraining programs to aid individuals who have lost their jobs – the government may also provide financial support to certain industries to assist with the adjustment process.

• Governments may be affected by the political consequences of tariff reductions – despite the general consensus among economists that cutting protection will benefit the economy, this policy is generally unpopular with the wider community since the costs of lower protection levels are visible (e.g. structural unemployment and the closure of well-known businesses) and the benefits are often seen in the long-term – meanwhile, governments can lose votes by pursuing policies to reduce protection, thus justifying why governments in many countries are reluctant to reduce protection.

Other economic effects

Phasing out protection has further impacts on the Australian economy:

1. The CAD is likely to deteriorate due to a rise in imports in the SHORT-RUN because some imports will be cheaper (due to lower tariffs and quotas) or of higher quality than local products – however, lower protection levels should improve international competitiveness and reduce the CAD in the LONG-RUN.

2. Australia’s trade liberalisation policy between 1988 and 2008 increased GDP by 3.4% and increased average family income by up to $3900 per year according to recent modeling by the Centre for International Economics.

Other economic benefits for Australia included:

- Employment: + 0.5%
- National Income: +2.7%
- Exports: +15.2%
- Imports: +11.2%
Implications for Australia of Protectionist Policies of Other Countries and International Organisations

The impact of international protection levels on Australia

- Overall, international protectionism reduces the output of the Australian economy, leading to exports becoming less competitive and less able to penetrate foreign markets. In 2009 it was estimated by the Centre for International Economics that a 10% increase in global tariffs would reduce GWP by 0.2% (A$110bn) and Australia’s GDP by 0.13%.

- The use of protectionist policies in other countries has resulted in significant costs to the Australian economy, in particular the loss of potential export revenue as a result of lower export prices and reduced access to overseas markets.

- As a small economy with a high level of agricultural trade, Australia suffers particular hardships as a result of the protectionist policies of other nations and trading blocs – the EU has for several decades heavily subsidized agricultural production and farmers receive significant subsidies in the US, Japan, Korea and Switzerland – therefore Australian farmers are competing in global markets at a significant disadvantage to their counterparts in the rest of the industrialised world.

- Progress towards reducing agricultural protection has provided disappointing in recent years – many of the most highly protectionist agricultural nations have taken advantage of complex loopholes in the WTO’s regulations to avoid genuinely freeing up agricultural trade – if global trade liberalisation is achieved by the WTO’s Doha Round, it could boost Australia’s agricultural exports by US$9bn by 2020.

- Australian firms exporting non-agricultural goods generally face FEWER trade barriers compared with the agricultural sector – the mining and resources sector, whose exports (including coal, natural gas, oil and iron ore) contribute the largest share of Australia’s exports, face very few barriers to trade and are highly demanded globally.

- Australia’s manufacturing industries generally face FEWER trade barriers because of the substantial reduction in industrial tariffs in recent decades that have been negotiated through multilateral trade agreements – most industrialized economies in the world have low manufacturing tariffs like Australia – however Australian exporters also face non-tariff trade barriers such as technical restrictions and licensing which make it difficult for Australian exporters to penetrate foreign markets, e.g. health restrictions/regulations for processed food products.

- Australia’s service industries arguably face the most prohibitive barriers to international trade – most of these are not the result of protectionist policies in other economies, but natural barriers caused by geography and transport costs, language and cultural differences, and local tastes and preferences.

Protectionism also plays a role in reducing services trade in the global economy, however:

- Many countries’ banking sectors are protected from foreign competition by regulations and foreign ownership restrictions, thus preventing the growth of Australia’s financial services industries in overseas markets.

- Competitive Australian firms in the electricity, recycling and postal industries face many overseas markets that are dominated by monopoly government providers or procurement arrangements that favour local providers.
The future of Australian industry in the global economy

- It seems that the next phases of globalisation will make resources industries more central to the Australian economy, especially for trade flows – to the extent that high commodity prices sustain a high value of the Australian dollar, this is likely to make Australia’s manufacturers less competitive in both global and domestic markets – consequently, the overall outlook for the Australian economy in the medium term at least is for resources industries to play a greater role, to some extent at the expense of other sectors.

- **Mining and energy industries** now account for about half of Australia’s export earnings and with major projects coming into production in the coming years, the strong growth is expected to continue – in 2010, earnings from resources exports will reach almost $150bn.

- In contrast, Australia’s **agricultural industries** are likely to face significant challenges in the coming years – the lack of progress in reducing global protectionist barriers, the impact of climate change on weather patterns and agricultural output, growing water shortages and increasing levels of agricultural efficiency in other economies will probably mean that the relative share of Australia’s export revenue from rural produce will continue to decline, as it has in recent decades.

- **Manufacturing growth** is expected to continue as specialised manufacturers expand their markets by producing high quality goods aimed at specific market niches – however manufacturers may face difficulty in competing in global markets if high commodity prices result in an overvalued exchange rate.

- **Services industries** will continue growing as a proportion of the economy in line with global trends – future growth is anticipated in such sectors as health care, education, financial services, business services and tourism. As countries try to reduce their emissions of greenhouse gases, there will be greater business opportunities to supply renewable energy, energy-saving devices, and other environment-related services.

- Australia’s **approach of phasing out protection is likely to lead to an economy that is more integrated with the global economy in the future, with a higher proportion of production and consumption going to imports and exports, fuelled further by globalisation and increasing trade flows.**