TRENDS IN THE SIZE AND COMPOSITION OF AUSTRALIA’S BALANCE OF PAYMENTS – EFFECTS OF THESE TRENDS

INTERNATIONAL COMPETITIVENESS

Refers to the price and non-price advantages that a domestic firm has over foreign rivals in local or offshore markets. Three major influences impact on our International competitiveness:

- Relative inflation rate.
- Productivity growth link to structural growth and microeconomic reforms.
- Exchange rate fluctuations.

What impact will changes in the international competitiveness of Australia’s firms have on the balance of payments?

TERMS OF TRADE

Relative price Australia pays for its imports and receives for its exports.

- Favourable movement (TOT increase) is when export prices rise faster than imports, thus a country is able to finance larger volume of imports with an existing volume of exports.
- TOT doesn’t take into account volume of exports or imports, just price changes.
- Due to the current commodities boom, price increases via unprecedented demand from China have seen the TOT move to record highs.
- Despite this, volumes have not similarly increased due to infrastructure bottlenecks such as on shipping ports where demurrage costs run into the millions.

Terms of trade = \( \frac{\text{Export Price Index}}{\text{Import Price Index}} \times 100 \)

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<tr>
<th>Year</th>
<th>X Price Index</th>
<th>M Price Index</th>
<th>TOT Index</th>
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<td>1 (base year)</td>
<td>100</td>
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The trend above is similar to Australia’s. Higher demand for commodity X’s fuelled by a booming China is driving X prices higher. The higher dollar and decreased world manufacturing costs has also seen Elaborately Transformed Manufactured M prices fall. With both moving in favourable directions the TOT is rising.

NB: This does not illustrate a change in volumes.
RELATIONSHIP BETWEEN THE TERMS OF TRADE (TOT) AND THE CAD

In the late 90’s the TOT deteriorated, meaning the same volume of exports could buy fewer imports. Unless export volumes improve significantly compared to imports, a larger deficit on the Balance on Goods and Services (BOGS) would in turn increase the CAD and our dependence on foreign funds in KAFAS on the BOP. In recent years this trend has been reversed with demand for commodities from the fast-growing Chinese economy. The pace of Globalisation has also seen the price of manufacturing import goods fall rapidly ensuring cheaper import prices a rising TOT. The same trend with BOGS will continue and affect the CAD adversely. In 2011, Australia’s terms of trade have reached historical highs (highest in the 140 years since records have been analysed) and this is having mainly positive impacts on the size of the CAD. However, if consumer and business confidence return to higher levels, the benefits may be offset by increases in expenditure on consumer and capital goods.

INTERNATIONAL BORROWING

One of the most concerning aspects of our external stability is the nature of our foreign liabilities.

Be careful here, and get your terminology right:

Net Foreign liabilities: Australia’s total financial obligations to other nations, (including assets and borrowings) minus all financial obligations of foreigners to Australians.

Net Foreign Debt: The total borrowings of Australians from foreigners minus the borrowings of foreigners from Australians.

Net Foreign Equity: The total value of Australian assets in foreign ownership, minus the total value of foreign assets in Australian ownership.

Australia’s foreign debt was not a concern until after the deregulation of the financial sector in 1983. By allowing access to international capital markets Australian firms were able to source investment funds from foreign capital markets. In 1980 Australia’s foreign debt was under $7 bill and only 5.8% of GDP. In 2008 it had stabilised at 48% of GDP, representing $331 bill. With the stimulus packages and projected deficits, this is expected to rise.

But, be careful who you blame. This is not a sum that is the responsibility of the government. Approximately 9% of our foreign debt is public debt (accumulated by the government and public enterprises), the rest is all accumulated by the private sector.

Any debt requires interest to be paid on it – servicing. The foreign debt is no different. These payments represent a net outflow from the economy, and represent a source of revenue for those who lend the funds. An accumulation of foreign debt, therefore, requires that a given percentage of our national income be allocated to foreign lenders, placing constraints on our future growth.
NET FOREIGN DEBT

- Total value of money borrowed by government, businesses and individuals from overseas less the equivalent lending to overseas.
- Government debt has been paid off with budget surpluses.
- Foreign debt is private sector debt since the eradication of public sector debt in 2005.
- Australia has insufficient savings to meet the demand for loans. Therefore financial institutions need to borrow overseas savings to lend to households and business. The net foreign debt is essentially the result of the gap between savings and investment. To fund investment opportunities, the savings of foreigners are used.
- 70% of private sector debt has been borrowed by financial institutions to lend to households and businesses.
- National savings may be increased and the foreign debt slowed through government budget surpluses, increasing household savings and superannuation contributions by employers and employees.

FOREIGN INVESTMENT - NET FOREIGN EQUITY

- This is the value of foreign owned assets in Australia less those assets owned by Australians overseas.
- A less significant contributor to NFL although Australian equity overseas and dividend receipts are rising.

**NB:** Foreign Equity is not part of foreign debt but can contribute to the CAD through profits and dividends paid overseas when overseas ownership in Australia exceeds Australian ownership overseas (recorded in the Net Primary Income component)
EXCHANGE RATES

The exchange rate is the price of an Australian dollar expressed in terms of another currency. The two most common measures of the exchange rate used in Australia are:

- The exchange rate against the US dollar. Trading of Australian dollars on the foreign exchange market is predominantly against the US dollar. The US dollar is also the dominant international medium of exchange.

- The trade-weighted index or TWI. This is, in fact, not a price in terms of a single overseas currency, but a price in terms of a basket of currencies. This is often a better measure of general trends in the exchange rate than any one bilateral exchange rate, such as that against the US dollar, since the Australian dollar could be rising against the US dollar but falling against other currencies – in such circumstances, the TWI will give a measure of whether the Australian dollar is rising or falling on average.
FACTORS AFFECTING THE DEMAND FOR AND SUPPLY OF AUSTRALIAN DOLLARS

One important determinant of a country's exchange rate over the long run is whether it has a higher or lower inflation rate than its trading partners. The theory of purchasing power parity suggests that the exchange rate between two countries will adjust such that a unit of each currency has the same purchasing power in both countries, once the exchange rate is taken into account. If a country's inflation rate is persistently higher than that of its trading partners, its exchange rate will tend to depreciate to prevent a progressive loss of competitiveness over time. Graph 4 shows the ratio of the average price level of Australia's trading partners relative to that in Australia and the TWI for the Australian dollar. From the mid 1970s through to the end of the 1980s, prices in Australia rose more quickly than prices overseas. The TWI depreciated over the same period, but a large part of this was doing no more than offsetting the cumulatively higher inflation Australia was experiencing. Much of what appears to be a potential gain in competitiveness due to the lower exchange rate was offset by a poor performance on inflation.

Estimates of real exchange rates adjust for this difference in inflation rates. Between 1970 and 1990, when the nominal TWI fell by about 40 per cent and Australia's inflation exceeded that of its trading partners, the real TWI depreciated by about 20 per cent. The movement in the real exchange rate is a better measure of changes in competitiveness than the movement in the nominal exchange rate, but it is still subject to considerable fluctuations.

One of the strongest influences on the Australian dollar has been the terms of trade. For example, a rise in the terms of trade as a result of an increase in the prices of commodities (which are an important component of Australia's exports) provides an expansionary impulse to the economy through an increase in income. The increased demand for inputs from the export sector also creates inflationary pressure. An appreciation of the exchange rate counteracts these influences to some extent by inducing a substitution of domestic demand towards imported goods and services. However, there is evidence to suggest that this relationship has weakened since the late 1990s/early 2000s (Graph 5). The strong increase in commodity prices that began in 2002 boosted the terms of trade and was associated with an increase in the real TWI, although the rise has been less than what might have been expected given the historical relationship.

A third major influence on the exchange rate is factors that affect capital transactions, such as relative rates of return on Australian dollar assets and changes in investor confidence in Australian dollar assets. Anecdotally, there have been three periods since the currency was floated when relative interest rates were seen as being a major influence. One was in the late 1980s, a period when Australian interest rates were much higher than overseas rates and the exchange rate rose sharply; the second was in the late 1990s, when Australian interest rates fell below US rates and the exchange rate depreciated; the third was in the first half of the 2000s, when Australian interest rates were again higher than overseas rates, as the major economies experienced a downturn.

The importance of relative rates of return is difficult to demonstrate graphically, because it is often expectations about rates of return, rather than current rates, which are important and these expectations are difficult to measure. However, the general tendency is for higher domestic interest rates to be associated with a higher exchange rate when other things are equal.
CHANGES IN EXCHANGE RATES

- **An appreciation of the $A** is an increase in the value of the $A in terms of other currencies. This may be caused by an increase in the demand for the $A (Eg. Due to an increase in demand for exports) in the foreign exchange market (FOREX) and/or a decrease in the supply of the $A (Eg. a decrease in the demand for imports) in the FOREX.

- **A depreciation of the $A** is a decrease in the value of the $A in terms of other currencies. This may be caused by a decrease in the demand for the $A (Eg. Due to a decrease in demand for exports) in the FOREX and/or an increase in the supply of the $A (Eg. An increase in the demand for imports) in the FOREX.

**Determination of exchange rates including fixed, flexible and managed rates**

Between the early 1970s and 1983, exchange rate policy in Australia moved through several regimes. The first major shift occurred in 1971, when exchange rate policy shifted from pegging the Australian dollar to the UK pound to pegging to the US dollar. This was followed by a period of pegging to the TWI, from 1974 to 1976. During each of these regimes, there were occasional revaluations and devaluations. A crawling peg against the TWI was subsequently adopted, until the Australian dollar was eventually floated in 1983. The history is shown below.

Under the fixed-rate and crawling peg arrangements which existed before 1983, the Reserve Bank cleared the foreign exchange market each day of any excess demand for or supply of Australian dollars. If, say, banks in aggregate had acquired US dollar balances in the course of their business and sold Australian dollars, the Reserve Bank would acquire those US dollars from the banks in exchange for Australian dollars at the prevailing exchange rate. As a result, volatile flows across the foreign exchanges would be reflected in matching purchases or sales of Australian dollars by the Reserve Bank. One problem with this was that, through these purchases and sales of Australian dollars, the Reserve Bank was subtracting from or adding to liquidity in the Australian money market. Domestic monetary conditions were therefore affected by the behaviour of international trade and capital flows.

Floating the exchange rate addressed this problem. After the float, the exchange rate was able to adjust to clear any excess demand or supply. The Reserve Bank no longer cleared the market, so foreign exchange flows ceased to have such a large effect on domestic liquidity. One of the final prerequisites for effective domestic monetary policy was achieved (the other, namely that the Government fully finance its budget surplus or deficit in the market at market interest rates, had been achieved in Australia in the early 1980s when the Australian government adopted a tender system for issuing bonds).

But this is not the only reason why there was a case for the floating of the Australian dollar. Economic theory tells us that the choice of exchange rate regime can also influence the way in which economies cope with external shocks. Countries which are susceptible to real external shocks will generally fare better with a floating exchange rate. Take the example, say, of a sharp drop in the terms of trade (the ratio of export prices to import prices). With a flexible exchange rate, the automatic response would be a depreciation, which would tend to cushion the impact of reduced incomes on the domestic economy. This market-driven reaction means, in principle, that there is less pressure to adjust monetary and fiscal policies in response to the initial shock. By contrast, a country with a fixed exchange rate would need to ease fiscal policy or adjust the exchange rate peg to avoid the contractionary effect of such a shock. This is a difficult problem for policymakers and, over the longer term, it would result in domestic policy settings being more volatile.
In summary, the floating exchange rate regime that has been in place since 1983 is widely accepted as having been beneficial for Australia. Such a regime is particularly well suited for the Australian economy, given it is relatively small, reasonably open and subject to sizeable shifts in its terms of trade. The floating exchange rate has acted as a buffer to external shocks, particularly shifts in the terms of trade, allowing the economy to absorb them without generating the large inflationary or deflationary pressures that tended to result under the previous fixed exchange rate regimes. While discretionary changes were made to the value of the Australian dollar in these regimes in response to developing pressures, it was extremely difficult to calibrate the adjustments either rapidly enough or accurately enough to provide an effective buffer against the shocks. Further, the floating exchange rate has contributed to the reduction in volatility of output that has occurred over the past two decades.

THE INFLUENCE OF THE RESERVE BANK OF AUSTRALIA ON EXCHANGE RATES

In simple terms the RBA can influence the value of the Australian dollar against other currencies in TWO main ways:

1. **Direct influence** – the buying and selling of Australian dollars (with foreign reserves) in order to increase (revalue) or decrease (revalue) the value of the Australian dollar. This method has only been used 4 or 5 times in the past decade (including in September 2008 when the Australian dollar plummeted by over 30c against the US Dollar). This is due to the RBA’s general reluctance to affect the value of the floating currency (hence, the float is ‘cleaner’ rather than ‘dirtier’) AND the RBA’s small foreign reserves in relation to the phenomenal $4trillion daily turnover of currency on the FOREX (hence, could not intervene regularly even if they wanted to).

2. **Indirect influence** – the RBA could use domestic market operations (with ‘sterilisation’) to alter the value of the Australian dollar. This could occur by increasing or decreasing the cash rate (and subsequently affecting the demand for Australian securities from foreigners and the demand for the Australian dollar). The RBA argue that they focus on domestic objectives, including inflation, and do not attempt to manipulate the currency in this way.

N.B. It could also be argued that using monetary policy to slow or accelerate the economy could impact the exchange rate by altering the performance of the Australian economy (and hence, influencing the purchasing and selling decisions of FOREX traders).

The exchange rate plays an important part in considerations of monetary policy in all countries. However, the exchange rate has not served as either a target or an instrument of monetary policy in Australia since the currency was floated. The exchange rate is best considered as part of the transmission mechanism. It serves to buffer the economy from external shocks, such that monetary policy can be directed towards achieving domestic price stability and growth.

Since the early 1990s, monetary policy has been conducted under an inflation targeting framework. The inflation target has replaced the exchange rate as the nominal anchor in the economy. Under the inflation targeting regime, monetary policy no longer targets any particular level of the exchange rate. Nor indeed has the Reserve Bank used intervention to defend any level of the exchange rate.
Various measures suggest that exchange rate volatility has been higher in the post-float period. However, output volatility has declined. While this development is not unique to Australia, it is likely that the floating exchange rate has contributed to this decline in output volatility, together with a number of other economic reforms that have occurred in recent decades, including in both the product and labour markets as well as the reforms to the policy frameworks for both fiscal and monetary policy (Gruen and Stevens, 2000). In particular, exchange rate fluctuations have played a particularly important role in smoothing the influence of terms of trade shocks (Gruen and Wilkinson, 1991). Chen and Rogoff (2002) find a similar relationship in other commodity producing countries, but note that the relationship in Australia has been particularly robust.

In addition to counterbalancing the influence of external shocks, particularly those related to movements in the terms of the trade, the other important role of the exchange rate in the transmission mechanism has been in its influence on inflation. Under the fixed exchange rate regimes, the Australian economy directly 'imported' the inflation rate of the country (or group of trading partners) to which the exchange rate was pegged. With the floating of the exchange rate, this was no longer the case. Instead, movements in the exchange rate itself became a direct influence on inflation. However, the extent of this influence has changed over the period since the float. The pass-through of exchange rate changes to consumer price inflation, through changes in the price of tradable goods and services has become more protracted (Heath et al, 2004). This phenomenon is not unique to Australia, having been also found in the United Kingdom, Brazil.
THE EFFECTS OF FLUCTUATIONS IN EXCHANGE RATES ON THE AUSTRALIAN ECONOMY

DEPRECIATION

On tradeables: Should improve International competitiveness. Exports become cheaper and depending on price elasticity of demand for the goods will result in increased total revenue. If demand is non price elastic total revenue will fall and thus our BOP position will worsen. Imports will become less attractive to local buyers causing an improved BOP. Overall tradeables should benefit.

On non-tradeables: Benefits should be gained by producers of non tradeables via increase in local spending.

On employment and investment: Both should rise in tradeable and non tradeable sectors. This may be dampened if monetary policy is tightened to curb depreciation.

On inflation: May rise as many imported goods are included in the CPI basket. Final goods using imported components will also rise.

On government economic activity: Wage-price inflationary spirals will need to be considered in the development of measures in response to depreciation of the currency.

On International competitiveness: Should be improved in import replacement and export oriented industries on the proviso that inflationary pressures can be contained.

On BOP and Foreign Debt: J Curve Economists will state that following depreciation there should be a brief worsening of the CAD but this should level out as demand for imports declines and for exports rises.

The valuation effect – Australia’s currency being denominated against other currencies – may worsen Australia’s obligations and foreign debt.

APPRECIATION

On tradeables: Encourages imports and discourages exports.

On non-tradeables: Demand in the economy should be dampened.

On investment and employment: Depending on inflation, interest rate levels and consumer demand for imports these areas may be adversely affected

On inflation: Cheaper imports will lead to decline in inflation resulting in interest rates being low which ultimately will stimulate aggregate demand, investment and employment.

Government policy will be expansionary (unless the high dollar is accompanied with strong growth as it has done in recent years).

International competitiveness may be reduced.
FREE TRADE AND PROTECTION

AUSTRALIA’S POLICIES REGARDING FREE TRADE AND PROTECTION

Australia pursues a comprehensive and ambitious trade agenda to improve international market conditions for its exporters. The federal government’s top trade priority remains multilateral trade reform through the Doha Round of negotiations in the World Trade Organisation (WTO). A successful outcome to these negotiations offers the greatest opportunity for Australian businesses to increase their access to overseas markets. As well as supporting the WTO multilateral trade negotiations, Australia:

- Works closely with our Asia–Pacific Economic Cooperation (APEC) partners to enhance economic cooperation and encourage liberalisation within our region.
- Seeks to build strategic partnerships through free trade agreements with key trading partners or other mutual agreements for trade facilitation and cooperation.

Overview

All Australians benefit from trade: an increase in trade creates more Australian jobs and delivers more opportunities for Australian businesses.

Australia is party to a broad range of trade agreements that can impact on business operating in international markets.

Existing bilateral trade agreements

Australia has a number of existing Free Trade Agreements (FTAs) with important trading partners and is in negotiations and discussions for further agreements with a number of countries.

An FTA is a contractual agreement between two or more parties under which they give each other preferential market access.

Australia’s FTAs cover trade in goods and services, as well as other non-tariff issues such as the recognition of standards, customs co-operation, the protection of intellectual property rights and the regulation of foreign investment.

Australia has FIVE existing Bilateral Free Trade Agreements:

- The Australia-Chile Free Trade Agreement (ACFTA), in place since 2010.
- Singapore-Australia Free Trade Agreement (SAFTA), in place since July 2003.
- The Australia New Zealand Closer Economic Agreement (ANZCERTA), in place since 1983.
Free trade agreements that are comprehensive in scope and coverage generate new trade and investment opportunities for Australia. These opportunities provide mainly positive impacts, with some short-term negative effects, on *households, firms and the Federal Government.*

- The Closer Economic Relations Trade Agreement between Australia and New Zealand has delivered an increase of over 600 per cent in total trade in goods since it came into force in 1983. Bilateral trade was valued at $15 billion in 2006–07.

- The Singapore–Australia Free Trade Agreement entered into force in July 2003. It offers practical trade and investment benefits for Australia in the professional, financial and education services sectors. In the three years to 2006–07, Australia’s services exports to Singapore increased by 36 per cent to $3 billion in 2006–07.

- The Thailand–Australia Free Trade Agreement came into force in January 2005. As a result, more than three-quarters of current Australian exports receive tariff-free access to the Thai market. Two-way trade grew to $13.7 billion in 2006–07, up from $3.75 billion in 2003–04. Australian exports to Thailand rose from $3.1 billion to $5 billion over the same period.

- The Australia–United States Free Trade Agreement, which came into force in January 2005, aims to boost Australia’s trade relationship with the world’s largest and most dynamic economy. In 2006–07, the United States was Australia’s third-largest two-way trading partner and third largest export market (including services). Two-way goods and services trade grew by 8 per cent to over $48 billion in 2006–07.

- **Australia signed its first true multilateral trade agreement with New Zealand and the ASEAN nations forming the ASEAN-Australian-New Zealand FTA. This agreement includes a population spanning around 500 million people.**

- The Australian Government is engaged in negotiations with China, Malaysia, Japan, the Gulf Cooperation Council and, together with New Zealand, ASEAN (the Association of Southeast Asian Nations). Feasibility studies are under way on free trade agreements with Indonesia, India and the Republic of Korea.
IMPLICATIONS FOR AUSTRALIA OF PROTECTIONIST POLICIES OF OTHER COUNTRIES AND INTERNATIONAL ORGANISATIONS

Australian access to foreign markets is hindered by protectionist policies practiced by other countries and trading blocs, especially in agriculture. The common agricultural policy of the EU has forced alternative markets to be sourced for Australian agricultural products. The GATT achieved some multilateral reductions in protection on manufactured goods.

The WTO provides a rules-based system to manage international trade and resolve disputes between trading partners. The Doha Round of international trade negotiations offers great potential for expanding markets for our world-class farmers, manufacturers, miners and service providers. Successful negotiations will mean:

- More-open overseas markets for Australian goods and services.
- Tougher constraints on subsidies and protectionist practices that distort trade flows.

The Australian Bureau of Agricultural and Resource Economics estimate that a successful outcome to the Doha Round could increase Australia’s agricultural exports by 3 to 15 per cent, worth well over $1 billion a year to farmers.

Sample Short Answer – Exchange Rates

Explain how Reserve Bank operations in the foreign exchange market and the domestic money market can influence the value of the $A. (5 marks)

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| 2  | Sketches in general terms TWO operations used by the reserve bank but does not correctly identify the relationship and the subsequent impact on the value of the $A.  

OR  

Sketches in general terms one operation used by the Reserve Bank and correctly identifies the relationship and the subsequent impact on the value of the $A. |
| 3  | Demonstrates some understanding of the operations used by the Reserve Bank in the forex market and the domestic money market to influence the value of the $A but does not correctly explain the relationship between these operations and the subsequent impact on the value of the $A.  

OR  

Demonstrates a clear and concise understanding of ONE operation used by the Reserve Bank in either the forex market or the domestic money market to influence the value of the $A and explains the relationship between this operation and the subsequent impact on the value of the $A. |
| 4-5 | Demonstrates a clear and concise understanding of the operations used by the Reserve Bank in the forex market to influence the value of the $A.  

AND  

Explains the relationship between these operations and the subsequent impact on the value of the $A. |

Answers can include:

- Dirtying the float by buying or selling $A to influence S and D for the currency and in turn its price.
- Monetary policy decisions via DMOs that will affect interest rates and in turn influence the demand for $A by overseas investors seeking to invest in Aust, in turn affecting the price of the $A.
Hence, the diagram illustrates how a persistent current account deficit will

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Price

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Therefore, as seen in the above Figure, the payment of subsidies to US farmers will