

Keeping up to date

For up-to-date data refer to the Balance of Payments and External Position section of the RBA ChartPack at <http://www.rba.gov.au/chart-pack/balance-payments.html> or to the Trading Economics website at <http://www.tradingeconomics.com/australia/indicators>.

Slideshare and YouTube

You can download a Slide Presentation about the Balance of Payments from www.slideshare.net/AndrewTibbitt or YouTube by searching for Andrew Tibbitt, WACE Economics, Year 12 or using the YouTube URL <https://youtu.be/eiP9gsihlCQ>

Section A: Multiple Choice Questions

1. (2012:06)

Increased direct foreign investment in the Australian iron ore industry would be recorded in Australia's balance of payments as a

- (a) debit in the net incomes account.
- (b) credit in the current account.
- (c) credit in the capital account.
- (d) credit in the financial account.

2. (2013:07)

Which of the following items would be recorded as a debit on Australia's current account?

- (a) a Chinese company purchasing a Western Australian wheat farm
- (b) the sale of Australian wine to the United States of America
- (c) interest paid on Australian Government bonds to overseas investors
- (d) an increase in the number of foreign tourists entering Australia

3. (2014:05)

A fall in the level of Australia's current account deficit is likely to be associated with a

- (a) high rate of domestic economic growth.
- (b) fall in the level of national savings.
- (c) change in the federal budget balance from deficit to surplus.
- (d) fall in commodity export prices.

(2014:08)

4.

The table below shows the balance on current account figures for a nation.

	\$b
Exports of goods	275
Imports of goods	265
Service credits	7
Service debits	6
Incomes — primary	-56
Incomes — secondary	6

Which of the following statements is correct?

- (a) The balance on goods and services is -\$11b.
- (b) The goods balance is -\$10b.
- (c) The current account is in surplus by \$39b.
- (d) The current account is in deficit by \$39b.

(2014:22)

5.

Which of the following is **most** likely to reduce the current account deficit in the short run?

- (a) increased diversification of export industries
- (b) greater restrictions on foreign investment
- (c) increased regulation of the financial sector
- (d) decreased protection of domestic industries

(2015:04)

6.

Australia's current account deficit as a percentage of GDP is approximately

- (a) 3%.
- (b) -3%.
- (c) 5%.
- (d) -5%.

7. (2015:05)
Which of the following factors is **not** a determinant of exchange rates?
- (a) expectations of currency speculators
 - (b) relative inflation rates
 - (c) relative interest rates
 - (d) balance of payments
8. (2015:07)
If a country has a capital and financial account surplus, then it must also have a
- (a) deficit on its merchandise trade balance.
 - (b) surplus on its merchandise trade balance.
 - (c) deficit on its current account balance.
 - (d) surplus on its current account balance.
9. (2016:04)
Australia's recent current account deficit is **not** a problem because
- (a) it is mostly Australian Government debt.
 - (b) it is mostly used for nonproductive consumption by Australians.
 - (c) Australia has a freely floating currency, which will eliminate the deficit.
 - (d) it can be invested in export industries.
10. (2016:06)
A consistently positive component of Australia's balance of payments has been
- (a) net portfolio investment.
 - (b) net primary income.
 - (c) balance on goods and services.
 - (d) the current account balance.
11. (2016:13)
The current account balance is equal to
- (a) net goods + net services + net income + net current transfers.
 - (b) net goods + net services + net income + direct investment.
 - (c) net goods + net services + net income.
 - (d) net goods + net services.

(2017:08)

12.

This question refers to the table below, which shows Australian current account data.

	Sept. quarter 2016 \$m	Dec. quarter 2016 \$m
Balance on goods and services	-3538	4667
Net income	-6663	-8520
Balance on current account	-10 201	-3853

On the basis of the data in the table, what is **most** likely to have been the cause of the change in the balance on current account over the time shown?

- (a) lower interest payments on Australia's foreign debt
- (b) an improvement in the terms of trade
- (c) a decline in foreign investment
- (d) an appreciation of the Australian dollar

(2017:09)

13.

If Australia recorded a current account surplus

- (a) there would be a reduced need for foreign investment.
- (b) net foreign liabilities would begin increasing rapidly.
- (c) Australian residents would need to sell more assets to overseas residents.
- (d) the capital account must record a deficit.

Section B: Data Interpretation Questions

1. [12 marks]

(2012:27)

Components of Australia's current account

Year	Goods credits \$b	Goods debits \$b	Services balance \$b	Balance on goods and services \$b	Net income (primary income plus secondary income) \$b	Balance on current account
2006-07	169.5	-183.5	0.8	-13.2	-45.7	
2007-08	182.9	-204.8	-2.7	-24.6	-48.5	
2008-09	231.4	-222.4	-2.9	6.1	-44.5	
2009-10	201.7	-205.0	-1.4	-4.7	-51.4	
2010-11	247.0	-219.3	-16.7	21.0	-54.2	

Source: Balance of Payments and International Investment Position, ABS (Cat. No 5302)

Note: An addendum was provided by the WACE examiners which changed the 2010-11 Balance on Goods and Services to \$11.0b.

- (a) (i) Calculate the goods balance for 2008-09?

[1]

- (ii) Calculate the current account balance for 2010-11?

[1]

- (b) Describe and account for the significant change that occurred in the Services balance in 2010-11.

[4]

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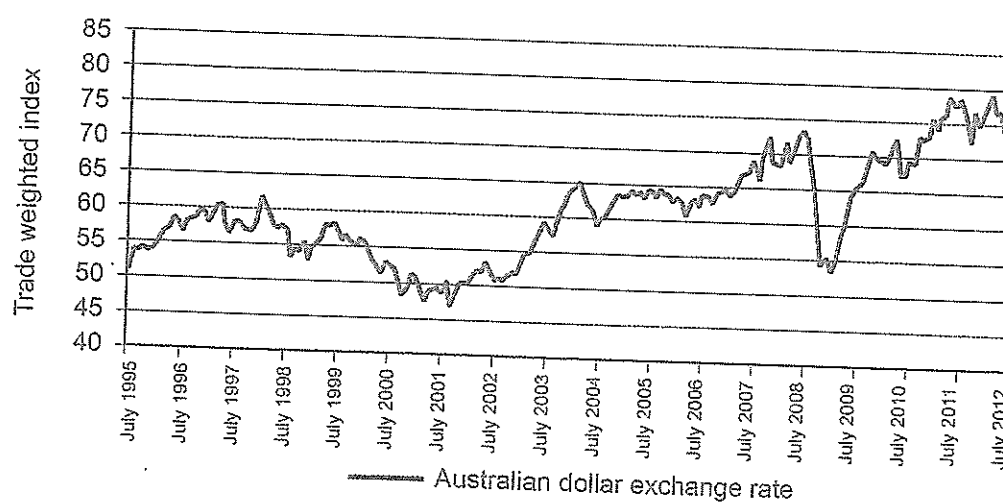
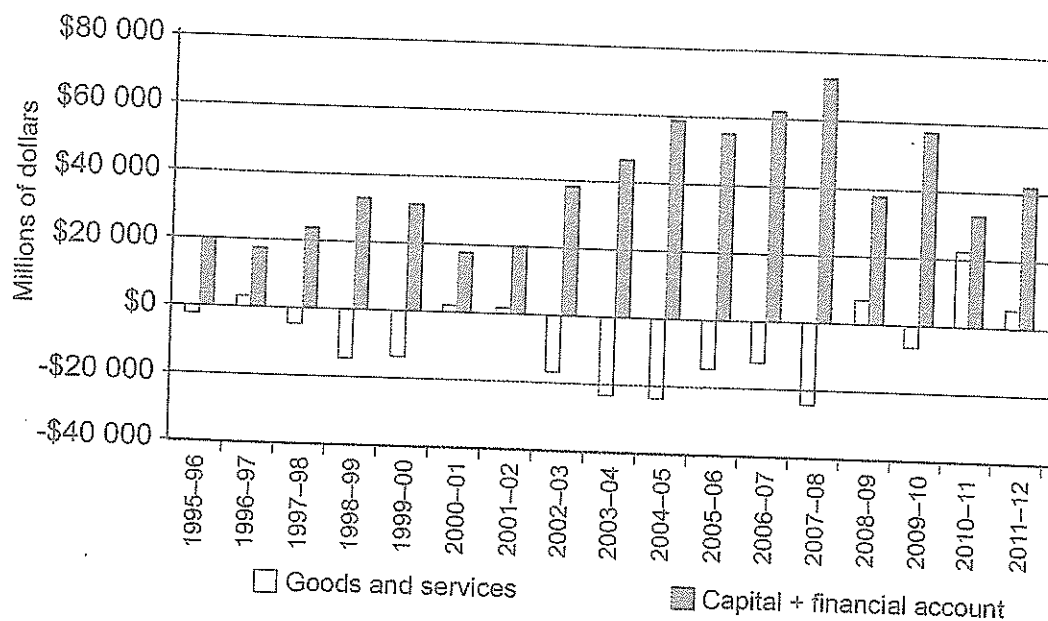
- (c) Explain the likely relationship between the level of domestic economic activity and Australia's current account position. [6]

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2. [12 marks]

(2013:27)

Australia's balance of payments and exchange rate, 1995 to 2012



- (a) (i) What was the value of Australia's current account balance in 2006-07? [1]
- (ii) In 2010-11, both the goods and services balance and the capital + financial account balance were positive. Given that the balance of payments sums to zero, explain how this could occur. [2]

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- (b) Describe and explain the relationship between the change in net capital inflow and the change in the exchange rate from 2000-01 to 2006-07. [4]

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- (c) Explain how changes in domestic interest rates affect the goods and services balance. [5]

This image shows a single sheet of white paper with horizontal ruling lines. The lines are evenly spaced and run across the width of the page. There is no handwriting or other markings on the paper.

Section C: Extended Writing Questions

NOTE: Lined pages are provided for each extended answer in the WACE exam paper. At the end of this section you will find planning grids which you can use in the preparation of a good extended writing answer.

1. (2013:29)
Discuss the causes and effects of Australia's persistent current account deficit. [20]

2. (2017:28)
 - (a) Describe the structure of Australia's balance of payments accounts. Include examples of international transactions that would occur in each category. [8]

 - (b) Discuss the structural and cyclical reasons for recent (the last ten years) trends in Australia's current account. [12]

Essay plan – Focus of question	
Scaffold/Framework	Body paragraphs
Definitions/Key terminology	
Diagrams/Models	
Evaluation/Conclusion	

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should be sufficient but other areas of globalisation could be explained. Gains from trade and foreign investment include:

(i) Australia gets static gains from trade through a better allocation of resources. For example, consumers can buy cheaper products and producers have access to bigger markets.

(ii) Australia also gets dynamic gains from trade, such as efficiency improvements due to economies of scale and increased competition.

(iii) Australia benefits from inflows of foreign investment because, for example, foreign investment closes the investment-savings gap, creates knowledge transfer and introduces different working practices.

2.(2016:25) (a) (i) $19.75\% (63/319) \times 100$; (ii) Education and business related travel and tourism.

(b) The nominal TWI exchange rate depreciated between 2012 and 2016 by about 30% but appreciated again by about 7.5% during 2016. The depreciation of the exchange rate made Australia's service exports more price-competitive in overseas markets and increased the AUD price of service imports. Assuming the demand for services such as tourism and education-related travel, is relatively elastic, the depreciation increased the contribution of net exports to aggregate demand. The AD/AS diagram should show an increase in AD (i.e. a shift of AD to the right), leading to a rise in real GDP and a rise in the price level, other things being equal. The appreciation during 2016 would have reversed these changes.

(c) Products that are internationally competitive are goods and services that meet the test of international markets. Competitiveness reflects the ease or difficulty experienced by a country's producers in selling products overseas. The ability to export successfully depends on price and non-price factors. Prices are affected by; (i) relative inflation rates, (ii) unit wage rates, (iii) labour productivity and (iv) exchange rates. Productivity growth is a key factor. Productivity growth depends on factors such as the level of education and qualities of the workforce (human capital), investment (physical capital), infrastructure (social overhead capital) and innovation (intangible capital). Non-price factors include quality, design, innovation, delivery and after-sales service.

Section C: Extended Writing Questions

No questions in this section.

Chapter 5: Balance of Payments

Section A: Multiple Choice Questions

- 1.(2012:06d) FDI in the iron ore industry is an inflow (credit) and is recorded in the financial account.
- 2.(2013:07c) Money flows out of Australia as a result of the interest payments.
- 3.(2014:05c) Assuming the use of the word 'fall' means 'narrowing', lower government borrowing would reduce financial inflows and hence narrow the current account deficit.
- 4.(2014:08d) Balance on goods and services = +11; Primary incomes outflow = -56; Secondary income inflow = +6.
- 5.(2014:22b) A lower level of foreign investment will narrow the financial account surplus and, therefore, narrow the current account surplus (as the two accounts must add up to zero).
- 6.(2015:04d) The current account balance was -5% (see RBA chart).
- 7.(2015:05d) The balance of payments always balances.
- 8.(2015:07c) The current account balance mirrors the balance in the capital and financial account.
- 9.(2016:04c) The floating exchange rate provides for some automatic correction. Option (d) isn't correct because the CAD is just a number and can't be invested anywhere but it does reflect a financial account surplus which may represent investment in export industries.
- 10.(2016:06a) This contributes to the surplus on the financial account.
- 11.(2016:13c) The components of the current account are financial flows linked to goods, services and income. Current transfers are included in secondary income flows.
- 12.(2017:08b) The table shows a rise in the balance on goods and services. This is consistent with a rise in the terms of trade. The table does not include data about the level of foreign investment which could also have been an explanation.
- 13.(2017:09a) The current account and the capital and financial accounts in the balance of payments must balance.

Section B: Data Interpretation Questions

- 1.(2012:27) (a) (i) Surplus of \$9b; (ii) deficit - \$43.2b (note figure for balance on goods and services for 2010-11 was incorrect on the original exam paper - it should have been \$11b)

(b) Define services - things you can't load on a ship or drop on your foot, such as tourism, education services, transportation, banking and insurance.

Earnings may have fallen because of:

- (i) The high level of the AUD (e.g. overseas holidays became relatively cheap, school and university fees became relatively expensive to overseas students).

(ii) Some overseas students became worried about their security in Australia and this reduced the demand for educational places.

(iii) A drop in the overall level of world trade reduced transportation earnings

(iv) The global financial crisis reduced the earnings of Australian banks

(c) Define 'domestic economic activity' and 'current account position'. Remember that relationships work in two directions – try to explain them both.

(i) Impact of economy on current account – The more growth (and incomes) in Australia the more imports we buy. Given the extent of foreign ownership, more growth might also mean more primary income outflows in the form of dividends and profits.

(ii) Impact of current account on domestic economy. Net exports (X-M) is a component of aggregate demand. An increase in the trade deficit (and hence, other things being equal, the current account deficit) will reduce AD. Draw a diagram to show fall in real GDP as a result.

2. (2013:27) (a) (i) -\$61b (i.e. a deficit of \$61b). The current account deficit is equal to the capital and financial account surplus. (ii) Income outflows of interest dividends, profits and transfers were about \$50b, which offset the goods and services surplus and caused a current account deficit.

(b) During the period 2000–01 to 2006–07 commodity prices rose as a result of an increased demand from growth 'hot-spots' such as China and South Korea. This stimulated net inflows of foreign investment (in the form of both borrowing and equity) to develop capacity in Australia's mineral and energy sector. The inflow of capital created extra demand for the Australian Dollar and contributed to a rise in the exchange rate. Higher commodity prices raised expectations of improved trade outcomes in the future and encouraged people to speculate in the rising Australian Dollar.

(c) Domestic interest rates affect the goods and services balance in two main ways.

(i) A change in cash rates affects the differential between Australian interest rates and overseas rates. This, in turn affects foreign investment flows and hence the value of the Australian Dollar. The change in the exchange affects the balance on goods and services.

(ii) A change in interest rates, after a period of time, affects the level of economic activity in Australia. Higher interest rates, for example, would mean, other things being equal, a lower level of growth. The lower level of growth would reduce the level of imports of, say, consumer and capital goods, and hence affect the goods and services balance.

Section C: Extended Writing Questions

1. (2013:29) Define 'current account deficit'. Comment about the regular occurrence of Australian current account deficits. There are two general explanations of Australia's persistent current account deficits:

(i) The first is Australia's investment-savings gap. As a resource rich nation there is a relatively high need for investment to build capacity and infrastructure for the resources sector. But Australia is also said to be 'capital starved', not because Australians don't save but because our population is relatively small. The investment-savings gap is financed or closed by inflows of foreign investment, involving net direct and portfolio inflows, giving Australia a capital and financial account surplus. Given our floating exchange rate, a capital and financial account surplus must be matched by a current account deficit. The build up of net foreign liabilities leads to relatively large levels of primary income outflows, as a result of interest, dividend and profits payments. The foreign investment inflow also makes the Australian Dollar strong and makes it harder to achieve a trade surplus.

(ii) An alternative explanation is that aggregate expenditure in Australia is greater than aggregate production. The difference between what we buy and what we make has to be imported and hence we have a current account deficit. High spending could be a reflection of low savings and a build up household debt and the fact that Australians are 'import junkies', that is we have a high marginal propensity to import. It could also reflect poor productivity and a consequent lack of international competitiveness.

There are clearly links between these two explanations of Australia's persistent current account deficit. Many resource rich nations suffer from a 'resources curse' because high revenues generated by the strength of the resources sector causes complacency in other less competitive sectors of the economy.

[An alternative scaffold for this part of the answer could be to talk about cyclical factors (i.e. growth rates in Australia and growth rates overseas), structural factors (e.g. productivity, exchange rates and government regulation) and shocks (e.g. droughts and floods)]

There are three main effects of the persistent current account deficit:

(i) The first is that Australian living standards have been higher than the level that would have been possible if the current account had remained balanced. We have been importing and consuming more than we have produced.

(ii) The second effect is the build up of foreign liabilities. These lead to the so-called 'twin evils' of increased foreign debt and foreign ownership. However, these have not been seen as serious problems in the Australian context. Most of

Australia's foreign debt lies in the private sector rather than the government sector. The debt was incurred as a result of commercial judgments of the risks involved. Also, the ability to service and sustain the debt is strong as indicated by our low debt servicing ratios and net debt to GDP ratios. The level of foreign ownership is also relatively low by international standards, although some concern has been expressed because of possible threat to food security.

(iii) The third effect is that the inflow of foreign investment has increased the capacity of the Australian economy to 'pump out' exports. For example, Australia is able to export record amounts of iron ore and coal as a result of building up capacity in the mining sector.

This part of the answer could also include discussion about debt problems, e.g. debt traps and loss of credit ratings. The problem with unstructured questions is that you need to provide your own structure and end up with an appropriate balance of points about the cause and effect of the persistent current account deficits. Even for 20 marks you can't include everything.

- 2.(2017:28) (a) The balance of payments records financial flows between Australia and the rest of the world. There are two main accounts in the balance of payments accounts, the current account and the capital and financial account. The overall accounts must balance or sum to zero.

The current account has four sub-sections, for goods (such as electrical products and food), services (such as education-related travel and tourism), primary incomes (including interest, dividends and profits linked to foreign investment) and secondary income (such as emergency overseas aid and transfers). A sub-total for the balance of goods and services is calculated as well as the overall balance on current account.

The capital and financial account has two main sub-sections, for capital flows (such as foreign aid of a capital nature) and for financial flows (including flows of foreign investment). The financial account is split into a further five sub-sections for portfolio investment, direct investment, financial derivatives, Reserve Bank flows and other financial flows. A balancing item to cover gaps in the payments data as well as errors and omissions is included in the capital and financial account.

In each sub-section inflows are recorded as credits (+ entries) and outflows are recorded as debits (- entries).

- (b) In 2007–08 Australia recorded a current account deficit (CAD) equivalent to about 7% of GDP. Since then the CAD has fluctuated on an irregular basis, but there has been a narrowing trend in the deficit which reduced to about 2% of GDP in 2016–17. This narrowing trend has been caused by both cyclical and structural factors.

Cyclical factors are related to changes in the economic cycle both in Australia and in our major

trading partners. In an economic downturn or period of slow growth, such as that in Australia after the global financial crisis in 2008, imports of consumer goods tend to fall. However, given Australia's important trade links with China and other Asian economies such as South Korea and Japan, our exports continued to be in demand as these economies avoided the worst of the post-GFC downturn.

Structural factors are changes in the basic ways the economy functions or operates, unrelated to the level of economic activity. Important structural factors affecting the current account over the last ten years include (i) the level of commodity prices and the terms of trade, (ii) changes in the exchange rate value of the Australian Dollar, (iii) the end of the mining investment boom, leading to a reduction in the level of capital goods imports, (iv) new regional trade and investment agreements; (v) changes in Australia's international competitiveness e.g. as a result of changes in the level of labour productivity and infrastructure developments; and (vi) natural shocks such as floods, droughts and cyclones.

Underpinning these factors (with exception of the natural shocks) has been the transition from a mining investment boom (reflected in the reduction in the size of the financial account surplus) to a mining export boom (because of an increased capacity to export and, after initial falls, a recovery in commodity prices, the terms of trade and the exchange rate).

Chapter 6: Australia's Terms of Trade

Section A: Multiple Choice Questions

- 1.(2012:09d) The terms of trade is the price of exports divided by the price of imports ($\times 100$). In Year 2 the terms of trade index was 91 but rose in Year 3 to 96.
- 2.(2012:11c) Option 'iv' definitely occurs. The rise in commodity prices also encourages foreign investment increasing the capital and financial account surplus (option 'i').
- 3.(2013:08c) The terms of trade index goes from 100 to 104.5 to 94.8. A fall in the terms of trade means fewer imports can be bought from the money received from a given level of exports.
- 4.(2013:09c) Assuming relatively elastic price elasticity of demand for exports and imports, a rise in the terms of trade narrows the trade deficit and hence narrows the capital and financial account surplus.
- 5.(2016:09c) The fall in commodity prices, such as coal and iron ore, caused a fall in the export price index.

Section B: Data Interpretation Questions

- 1.(2015:25) (a) (i) Fell or worsened from 112 to 89, a fall of 20.5%, (ii) Company tax revenue (royalty receipts were not in the list)