4

The Balance of Payments

Chapter concepts

- *the structure of Australia's balance of payments*
- *the concept of the current account balance*
- *recent trends in Australia's current account*
- *structural and cyclical reasons for Australia's current account balance*
- *the significance of Australia's current account balance*

Introduction

The balance of payments is a systematic record of all economic transactions between the residents of Australia and the residents of the rest of the world. The residents of a country include individuals, firms and the government. The balance of payments is in fact not concerned with just international payments but with all international transactions. An economic transaction occurs when something of value is provided by one party to another. Most transactions involve an exchange, for example, a good or service is traded for foreign exchange (money). Economic transactions include:

- exports and imports of goods, such as iron ore, coal, gold, wheat, wool, computers, motor vehicles, machinery and clothing;
- exports and imports of services such as shipping, freight, insurance, expenditure by tourists and overseas students;
- income flows, such as dividend and interest payments associated with foreign investment;
- transfers, such as foreign aid and funds brought by migrants; and
- financial flows, such as investment in shares and securities and loans.

Whenever a transaction occurs involving any one of these categories between a resident of Australia and a non-resident, then it will be recorded in the balance of payments. Australia's balance of payments is divided into two broad accounts - the current account and the capital and financial account. Figure 4.1 shows the structure of the two accounts. The two most important parts of the balance of payments are the current account and the financial account. The current account is concerned with transactions involving trade in goods and services as well as income flows. The financial account includes transactions concerned with foreign investment and international lending. The capital account is rather small and insignificant and records capital transfers and the acquisition/disposal of non-produced, non-financial assets, for example, copyrights.

The Australian Bureau of Statistics (ABS) records transactions in the balance of payments by using the internationally accepted convention of the double entry recording system. Each transaction in the balance of payments is recorded as consisting of two equal and opposite entries, reflecting the inflow and outflow element to each exchange. For each transaction, there is a matching credit and debit entry:

- credit (positive entry) - exports of goods and services, income receivable, increase in foreign liabilities, export of currency
- debit (negative entry) - imports of goods and services, income payable, increase in foreign assets, import of currency

Since for each transaction there is a matching credit and debit entry, the overall record of payments must always balance. This means that the sum of all credit entries will be exactly offset by the sum of all debit entries. But each of the accounts can record

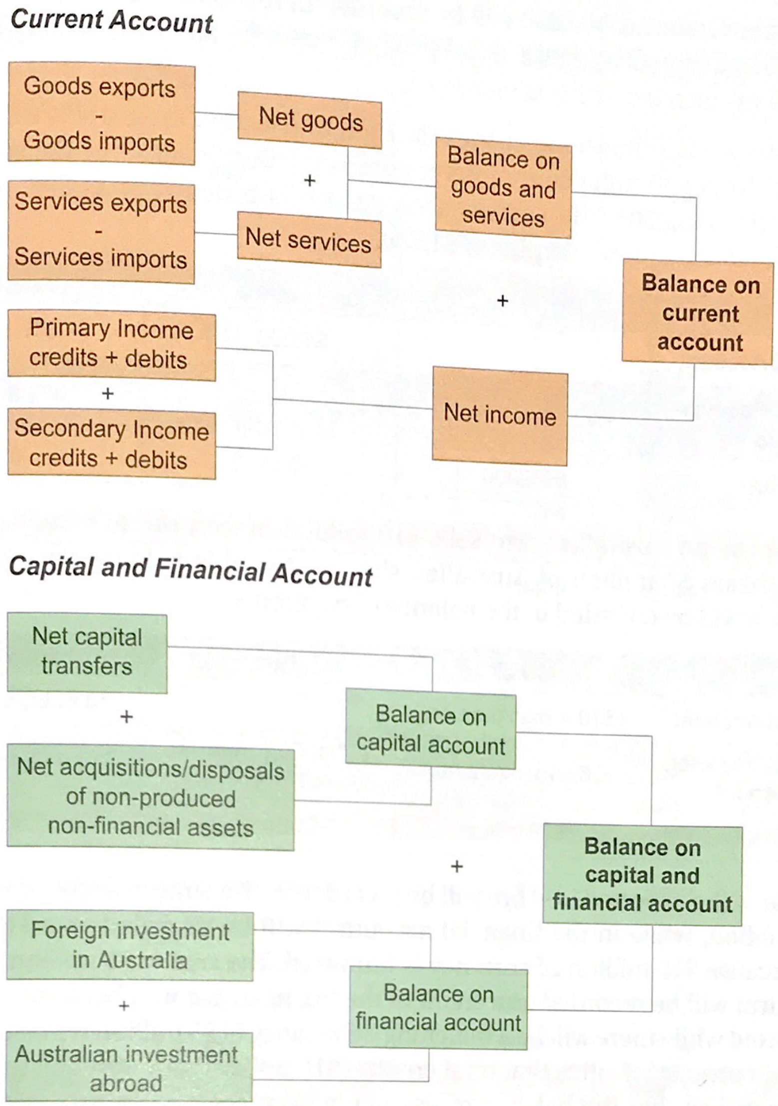

Figure 4.1 The structure of the balance of payments accounts

either a deficit or a surplus. For example, if the current account recorded a deficit of $10 billion, the capital & financial account would show a surplus of $10 billion.

To illustrate, imagine an Australian resident purchasing a TV set from Japan for AUD1,000 and a Japanese resident buying an Australian government bond for AUD5,000. How will these transactions be recorded in Australia's balance of payments? Remember for each transaction there are two offsetting entries. The value of the imported TV will be recorded in the current account as a debit of $1,000, while in the financial account it will be recorded as a $1,000 credit, because $1,000 of Australian currency is exported to Japan. When the Japanese resident purchases the

Australian government bond, it will be recorded in the financial account as a credit entry of $5,000 representing the bond which is exported and a debit entry of $5,000 of Australian currency which is imported.

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

	Credit	Debit	Balance
Current Account		-$1,000 (TV)	**$1,000 Deficit**
Capital/Financial Account	+$1,000 (currency) +$5,000 (bond)	-$5,000 (currency)	**$1,000 Surplus**
Total	+$6,000	-$6,000	**0**

Now suppose an Australian firm sells $10 million of iron ore to China and a US firm purchases $5 million of Australian shares. The table below shows how each transaction will be recorded in the balance of payments.

	Credit	Debit	Balance
Current Account	+$10 million (iron ore)		**$10 million Surplus**
Capital/Financial Account	+$5 million (shares)	-$10 million (currency) -$5 million (currency	**$10 million Deficit**
Total	+$15 million	-$15 million	**0**

The value of the exported iron ore will be recorded in the current account as a credit of $10 million, while in the financial account it will be recorded as a $10 million debit, because $10 million of currency is imported. The sale of $5 million of shares to a US firm will be recorded as a credit in the financial account because the shares are exported while there will be a matching debit entry of $5 million representing the import of currency. Notice that total credits ($15 million) are offset by total debits ($15 million) so that the balance of payments balances. But in this example, the current account records a surplus of $10 million, while the capital/financial account records a deficit of $10 million. It is important to note that the offsetting transaction – the movement of currency – is always recorded in the financial account.

The structure of the balance of payments

Figure 4.2 provides a breakdown of the components in the balance of payments for Australia – note that the data refers to the June quarter of each year. For each year, the balance on current account is equal and opposite in value to the balance on the capital and financial account plus the net errors and omissions item. This means that if the current account balance was +$10 billion, then the capital/financial balance would equal -$10 billion (assuming that the net errors figure was zero). Normally Australia records a current account deficit and a capital/financial account surplus. This has been the case for most of Australia's history.

CURRENT ACCOUNT			$ million (June quarter, original)		
			2020	**2021**	**2022**
	Goods		19777	33037	53658
		Credits	91662	115505	158934
		Debits	-71885	-82468	-105276
	Services		4321	1838	-6067
		Credits	15757	14673	16471
		Debits	-11436	-12835	-22538
Balance on goods and services			**24098**	**34875**	**47591**
	Primary Income		-4827	-7023	-23119
		Credits	14198	15788	21446
		Debits	-19026	-22810	-44565
	Secondary Income		-871	-1711	-1308
		Credits	2313	2342	2861
		Debits	-3184	-4053	-4169
Net Income			**-5698**	**-8734**	**-24427**
BALANCE ON CURRENT ACCOUNT			**18400**	**26141**	**23164**

CAPITAL AND FINANCIAL ACCOUNT		2020	2021	2022
Capital Account	Net Capital transfers	-218	-218	-267
	Net acquisition/disposal of non-produced, non-financial assets	0	-42	56
Balance on capital account		**-218**	**-260**	**-211**
Financial Account	Direct investment	7725	5752	-6956
	Portfolio investment	1929	-29047	42449
	Financial derivatives	-450	2471	-1726
	Other investment	-49747	-1539	-51977
	Reserve assets	23063	754	-462
Balance on financial account		**-17481**	**-21610**	**-18672**
BALANCE ON CAPITAL & FINANCIAL ACCOUNT		**-17699**	**-21870**	**-18883**
Net errors and admissions		-701	-4271	-4281

Source: ABS 5302.0

Figure 4.2 Australia's balance of payments

However, since June 2019 , Australia has recorded successive quarterly current account surpluses, mainly due to very large trade surpluses.

The current account

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

Goods June 2022	$ million
Exports (credits)	
Rural	18505
Mining	120585
Manufacturing	18799
Other	1045
Total	158934
Imports (debits)	
Consumer goods	-30622
Capital goods	-23559
Intermediate	-49109
Other	-1986
Total	-105276

Services June 2022 $ million	Exports	Imports
Transport	1432	-8155
Travel	6588	-5085
Tourism expenditure	7029	-6581
Other	1422	-2717
Total	16471	-22538

- goods
- services
- income (primary & secondary)

Trade in goods includes exports and imports of raw materials, manufactures, minerals and fuels, food and rural products. Australian exports are concentrated in the agricultural and mining sectors, while imports consist mainly of intermediate and capital goods used by industry and consumer goods.

In terms of absolute size, trade in goods is the largest item in the current account. Goods exports in the June quarter of 2022 (see sidebar) amounted to $159 billion. The dominance of mining exports is clearly evident - accounting for 76 per cent of total goods exports. Australia's largest mining exports are iron ore, coal, natural gas and gold. Goods imports totaled $105 billion of which 69 per cent comprised capital & intermediate goods with consumer goods comprising 29 per cent. The merchandise trade account recorded a record surplus of $54 billion for June 2022.

Trade in services consist of transactions in the transport of goods (freight/shipping), transactions involving travel by students and tourists, tourism related services, and other business services such as ICT (information, computer and telecommunications) and financial services. Australia's service exports are around one tenth the size of goods exports and is dominated by education and tourism. In June 2022, services exports amounted to $16.5 billion. The export of education has become an important industry for Australia and is now Australia's fourth largest export. Australia's services imports are relatively larger and are around one fifth the size of goods imports. Australia normally records a net services deficit due to freight costs and Australian tourists travelling overseas. In June 2022, services imports amounted to $22.5 billion - $6 billion more than service exports. In 2020 and 2021, Australia actually recorded a surplus in net services due to the impact of the Covid pandemic on overseas travel.

The income category of the current account is divided into primary and secondary income. Primary income is the largest and most important of the two and is mainly associated with foreign investment flows into and out of Australia. Primary income consists of two categories: compensation of employees (for the use of labour) and investment income (for the use of capital). Compensation of employees is simply the payment of wages and salaries to workers and is relatively small compared with the flow of investment income. Investment income accounts for more than 95 per cent of all income transactions.

Primary Income June 2022 $ million		
	Credits	Debits
Compensation of employees	425	-1567
Investment income - Equity - Interest	21021 18623 1503	-42997 -35961 -5349
Total	21446	-44565
Primary Income balance	-23119	

Australian residents receive income payments from overseas investments (credits) and income payments are made to foreign investors (debits). There are two main types of investment income – dividend payments associated with equity investment and interest income associated with loans. An example of an investment income credit would be if an Australian resident received a dividend payment from an overseas company. An example of an investment income debit would be the payment of interest by an Australian firm to an overseas bank. In the June quarter of 2022, Australia received $21 billion of investment income from overseas countries, but paid out $43 billion to overseas residents. The main reason for the difference is that total foreign investment in Australia exceeds Australian investment abroad, resulting in a net outflow of investment income in the current account.

The net balance in primary income for the June quarter 2022 was a deficit of $23 billion. This net outflow was much larger than previous years because the Australian economy had recovered from the recession in 2020. A stronger economy meant that outflows of profits and dividends to overseas investors increased. Notice in the sidebar that most of the income payments in 2022 were associated with equity investment rather than debt.

The secondary income category involves transactions where real or financial resources are provided (goods, services or financial assets) but nothing of economic value is received in return. Secondary income includes transactions in foreign aid, gifts, donations and pensions. An example of a debit transaction would be foreign aid given by Australia to Indonesia, while an example of a credit transaction would be gifts received by Australian residents from residents in a foreign country. The size of secondary income transactions is relatively small and insignificant - the secondary income balance for the June quarter 2022 was a deficit of around $1.3 billion and is always much smaller than the primary income deficit.

To obtain the overall balance on current account, the balance on goods and services is added to the income balance (primary plus secondary). For the June quarter 2022, the goods and services balance was a record surplus of $47.6 billion while the income balance was a deficit of $24.4 billion. This meant that the balance on current account was equal to a record surplus of $23.2 billion.

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

The capital and financial account

Capital Account June 2022	$ million
Net Capital transfers	-267
Net acquisition/ disposal of non-produced, non-financial assets	56
Total	**-211**

Financial Account June 2022	$ million
Direct investment	-6956
Portfolio investment	42449
Financial derivatives	-1726
Other investment	-51977
Reserve assets	-462
Total	**-18672**

The capital account comprises capital transfers and the acquisition and disposal of non-produced, non-financial assets. Capital transfers include migrants' funds and types of aid funds related to fixed capital formation. Non-produced, non-financial assets refer to intangible assets such as patents, copyrights and trademarks. The size of transactions in the capital account are small and insignificant and the balance is always less than $1 billion. The much larger financial account comprises transactions associated with changes in the ownership of Australia's foreign assets and liabilities – in other words net foreign investment. Australia normally records a large financial account surplus because it offsets the usually large current account deficit. The financial account records the export and import of currency associated with transactions involving both trade and foreign investment.

When foreign residents are purchasing more Australian assets than Australian residents are purchasing of foreign assets, the financial account will record a surplus. A financial account surplus means that a country draws on the savings (foreign investment) from the rest of the world. A financial account deficit means that a country lends its excess savings to the rest of the world (capital outflow). In the June quarter 2022, Australia actually recorded a financial account deficit of over $18 billion.

Transactions in the financial account are classified by type of investment:

- direct investment;
- portfolio investment;
- other investment; and
- reserve assets.

The main forms of foreign investment that are of interest to economists are direct and portfolio investment. Direct investment is undertaken with the objective of obtaining a lasting interest in a foreign enterprise and exercising a significant degree of influence in its management. If a resident investor obtains 10 per cent or more of the equity of a foreign enterprise, then this is deemed to be direct investment. Direct investment enterprises include branches, subsidiaries and other businesses where the foreign resident has significant shareholding. In 2022, there was a net outflow of direct investment of $7 billion.

Portfolio investment consists of international equity and debt securities (mainly bonds and notes) not classified as direct investment. Portfolio investment is more short term in nature and speculative – the investor is not assumed to have any influence in the operation or decision-making of the enterprise (less than 10 per cent equity). In 2022, there was a net inflow of portfolio investment of $42 billion. This is fairly typical and reflects the recovery of the Australian economy after the pandemic years. Other types of foreign investment include financial derivatives and reserve assets which are financial assets controlled by the Reserve Bank of Australia. Reserve assets include monetary gold and foreign exchange.

The overall balance of payments must always sum to zero. This means that if the current account is in surplus, then the capital and financial account will be in deficit and equal to the current account in absolute value (plus any net errors & omissions). In the June quarter 2022, Australia's current account surplus was $23.2 billion, the capital and financial account deficit was -$18.9 billion, which meant that net errors and missions was $4.3 billion.

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

The balance of payments is an important set of accounts that summarise a country's transactions with the rest of the world. Changes in the balance of payments reflect changes in both the world economy and the Australian economy. The balance of payments is an important economic indicator providing information on a nation's trade account and its financial position with the rest of the world. Both the government and the financial markets use the balance of payments as a guide to analyse the relative performance of the economy. Changes in economic growth, inflation, the terms of trade and exchange rates will all have an impact on a nation's balance of payments. Traditionally the focus of analysis has been on the current account in the balance of payments. This reflects the nation's trading performance which directly impacts on GDP (remember the equation: $GDP = C + I + G + X - M$).

But equally changes in consumption, investment and government spending will also have an impact on the current account. For example, an increase in consumption and/or investment will increase imports which, ceteris paribus, will decrease the current account balance. An increase in foreign investment into Australia will result in an increase in income payments which will decrease the current account balance.

Trends in the current account

Figure 4.3 shows the trends in the various categories of the current account since 2012. The figures represent annual data. Notice that the current account balance has fluctuated from a deficit of $77 billion in 2016 to a surplus of $64 billion in 2021. The net goods balance in the current account can fluctuate considerably from year to year. For example in 2016 it recorded a large deficit of $27.5 billion, whereas in 2022, Australia's goods balance was a record $147 billion surplus. The goods balance is mainly driven by changes in commodity prices and changes in domestic economic activity. Australia mainly exports commodities, such as iron ore; coal; LNG; gold; wheat; and wool. Commodities account for around 85 per cent of Australia's goods

Year	Goods	Services	Trade balance	Primary income	Secondary income	Net Income	Balance on current account
2012	9077	-11598	-2521	-45604	-3015	-48619	-51140
2013	-2447	-17581	-20028	-38210	-3302	-41512	-61540
2014	10035	-14495	-4460	-41730	-3225	-44955	-49415
2015	-13507	-10631	-24138	-32981	-2846	-35827	-59965
2016	-27534	-10230	-37764	-39000	-613	-39613	-77377
2017	13584	-4596	8988	-47740	-1372	-49112	-40124
2018	12665	-6082	6583	-57666	-784	-58450	-51867
2019	53501	-4954	48547	-65028	-733	-65761	-17214
2020	72256	5556	77812	-44508	-1225	-45733	32079
2021	76371	13674	90045	-23060	-3034	-26094	63951
2022	147447	-11505	135942	-83187	-3049	-86236	49707

Source: ABS 5302.0 *All figures in $million (original)*

Figure 4.3 The current account (annual)

exports. Commodity prices have a positive relationship with global economic growth - if world growth increases, then commodity prices will increase. This increases the value of Australia's exports and Australia's trade balance.

The rate of economic growth in Australia also has a significant impact on the trade balance. When domestic economic activity in Australia increases, the demand for imports increases. Why? Because both investment and consumption increase. An increase in investment requires imported capital goods such as machinery, transport equipment and computers. High levels of economic activity increases national income which increases household consumption. A rise in consumption will increase the demand for imported consumer goods. When economic activity contracts, the reverse happens – net exports increase because imports fall. This was especially evident in the COVID affected years of 2019-21 when the Australia economy contracted and experienced a recession.

The services balance normally records a deficit due to Australia's large imports of travel and transport services. Australia is relatively isolated from the rest of the world which results in transport services, such as freight, being a relatively large debit item. Outbound tourism is also normally Australia's largest import. Australia recorded a deficit in net services between 2012 and 2019. Between 2020-2021, net services relatively large surpluses. This was due to the travel restrictions imposed by the Australian government during the COVID pandemic. Travel services are also becoming an important export earner for Australia. In 2021, education was Australia's fifth most important export (behind iron ore, coal,LNG and gold), earning $22 billion.

The last important item in the current account is income. Primary income is by far the larger and more important of the two. The main components of the primary income deficit have been interest payments on foreign debt and the payment of dividends to overseas investors. The primary income deficit normally results in Australia recording a current account deficit – every year in the table except for the period 2020-2022. The growth in the primary income deficit over time has paralleled the build-up in Australia's foreign liabilities or the stock of foreign investment. An increase in foreign investment into Australia will increase the income payments to foreign investors. Many people don't realise that whenever the Australian economy is growing strongly, company profits and dividends will also increase, contributing to the increase in the primary income deficit. During 2020-21, the Australian economy contracted and there was a large decrease in foreign investment into Australia. This resulted in a large fall in the income deficit and helped to contribute to Australia's large current account surplus.

The balance on current account is derived by summing the balance on goods and services with net income. Notice that Australia recorded a current account deficit for eight of the 11 years shown in figure 4.3. This was because in each of those years, the income deficit exceeded the trade balance resulting in a current account deficit. Up until 2020, Australia had only recorded a current account surplus once in the past 50 years! So that makes the period 2020-22 quite unique. Of course 2020 was the year of the COVID pandemic which caused the Australian economy to experience its first recession since 1991. With both investment and consumption spending falling, there was a large decrease in imports which was a major reason for the large trade surplus. Combined with the significant fall in the income deficit, it resulted in record current account surpluses.

Figure 4.4 shows changes in the current account on a quarterly basis, rather than annual. The graph reveals a number of important characteristics:

- the trade balance is more volatile than the income balance;
- the trade balance fluctuates from deficit to surplus responding to changes in domestic and global economic activity;
- the income balance is normally in deficit due to Australia's reliance on foreign investment;
- the trade and current account balance have a strong positive relationship;
- in 2020, Australia records its first current account surplus in over 50 years.

Explaining the current account balance

What causes the current account balance to change over time? There are both cyclical and structural reasons for Australia's current account balance. Cyclical factors are temporary and subject to frequent change. A structural factor on the other hand is more permanent and only changes gradually. Cyclical factors help explain the fluctuations in the trade balance while structural factors are associated with the primary income balance. By examining figure 4.4 it is evident that the trade balance and the current account balance exhibit a positive relationship. Whenever there has been a decrease in the goods and services balance (e.g. between 2014 and 2015) the current account balance has also decreased. Likewise, whenever there has been an increase in the goods and services balance (e.g. between 2018 and 2021) the current account balance has also increased.

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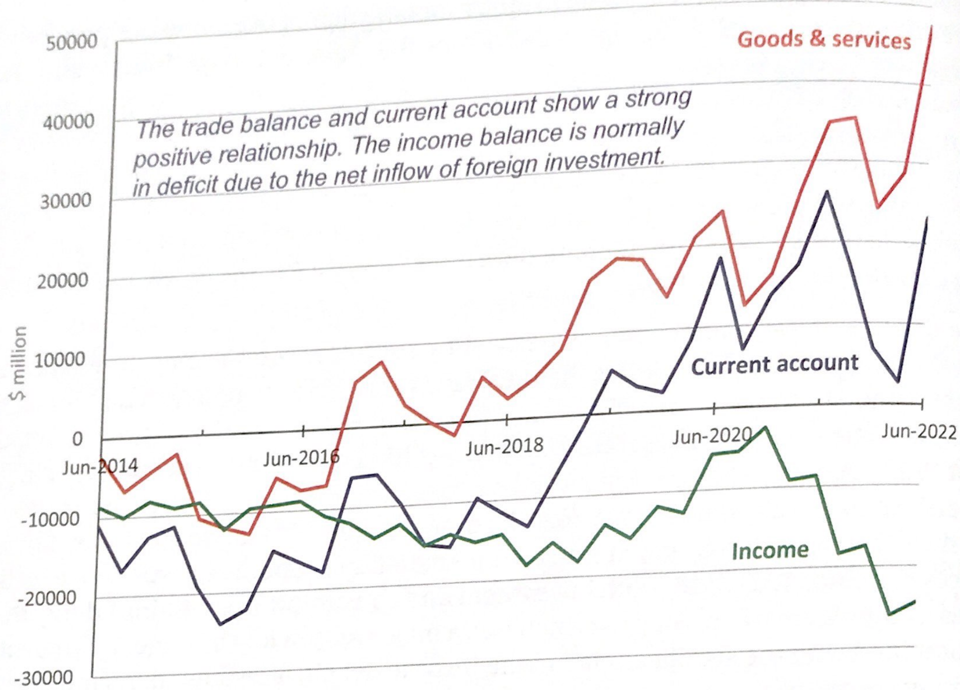

Figure 4.4 The current account (quarterly)

The trade balance is relatively volatile and is very much influenced by both Australia's business cycle and the world business cycle. Notice how the trade balance has fluctuated between -\$12 billion and +\$48 billion during the period shown in the graph. Whenever the economy expands at a rapid rate, the current account balance will decrease due to increased spending on imports - both consumption and investment goods. When the economy slows or contracts, the current account balance will increase because spending on imports will fall relative to exports.

Influences on the current account balance
Cyclical Factors – temporary factors that mainly affect the trade balance: • domestic business cycle • world business cycle • exchange rate • commodity prices/terms of trade • relative inflation
Structural Factors – fundamental factors that mainly affect the income balance: • investment–savings gap • foreign investment • foreign liabilities

Business cycle trends in Australia's main trading partners also have a major impact on Australia's trade and current account balance. If the Chinese economy expands, world commodity prices rise, boosting Australia's export income and increasing the trade and current account balance. Changes in Australia's export and import prices are measured by the terms of trade (see chapter 5) which has a direct influence on the trade balance. Factors that affect Australia's level of international competitiveness such as relative wage levels and inflation rates are also important in causing cyclical changes in the current account balance.

Movements in the exchange rate (see chapter 6) can also affect the demand for exports and imports. A fall in the value of the Australian dollar (depreciation), for example, will decrease the price of Australia's exports and increase the price of imports. This will lead to an increase in exports and a decrease in imports, increasing the trade balance.

The income balance in the current account has been far more stable, compared to the trade balance, fluctuating between –$3 billion and –$26 billion. While the trade balance can fluctuate between deficit and surplus, the income balance is always in deficit. This is because Australia traditionally relies on foreign investment (net capital inflow) to fund Australia's investment–savings gap. Australia has throughout its history been an importer of financial capital to develop its economy. Without foreign investment, Australia would not have a mining sector. Foreign investment is recorded in the financial account. The trade–off for this use of other countries savings is the payments of interest and dividends to foreign investors which is recorded in the primary income account. The result is that the income balance will record a deficit, and is the structural cause of the current account balance.

The savings – investment gap

There are several different ways of viewing a current account balance. Firstly, the current account balance is equal to the trade balance of goods and services and the income balance between Australia and the rest of the world. Basically a current account surplus will occur if a nation's exports and income received from overseas residents exceeds the value of its imports plus income paid to overseas. Analysing the current account balance in terms of international trade focuses on the factors that affect a nation's exports and imports. This includes factors that affect a country's international competitiveness. For example, an increase in a country's inflation rate (ceteris paribus) will decrease net exports and decrease the current account balance. A rise in commodity prices will (ceteris paribus) increase a country's net exports and lead to a rise in the current account balance.

Analysing the current account balance from just a trade perspective only provides a micro viewpoint. To get a more complete understanding of what the current account balance means, we have to explore the link between the balance of payments and the national accounts. This is set out in figure 4.5. Remember the current account balance is equal to the difference between exports and imports plus net income. Gross Domestic Product (GDP) is the total value of a country's production and is equal to the sum of consumption, investment, government spending and net exports (C + I + G + X - M). By adding net income from overseas to GDP we get gross national income (GNI). Notice from equation 4, that GNI also equals the sum of consumption, investment, government spending and the current account balance. To obtain a nation's level of saving, we subtract consumption and government spending from income (equation 5). This reveals that a country's savings is equal to its investment plus the current account balance (equation 6). This is very important, because we can now show that the current account balance is equal to the difference between a country's total savings and its total investment: CAB = S – I (equation 7).

(1)	CAB = X - M + NI
	The current account balance equals exports of goods and services (X) minus imports of goods and services (M) plus net income from foreign residents (NI).
(2)	GDP = C + I + G + X - M
	Gross domestic product (Y) equals the sum of consumption expenditure, investment, government spending and net exports.
(3)	GNI = C + I + G + X - M + NI
	Gross national income equals GDP plus net income from foreign residents
(4)	GNI = C + I + G + CAB
	Gross national income equals the sum of consumption, investment, government spending plus the current account balance
(5)	S = GNI - C - G
	Gross savings (S) equals gross national income minus consumption minus government spending
(6)	S = I + CAB
	Gross savings equals investment plus the current account balance
(7)	**CAB = S – I**
	This shows that the current account balance is equal to the difference between a country's saving and investment. A current account surplus (or financial account deficit) will occur when total saving (S) > total investment (I). A current account deficit (financial account surplus) will occur when I > S.

Figure 4.5 The savings investment gap

This is referred to as the country's 'saving – investment gap'. What this means is that if a country's saving exceeds its investment (S > I), then it will have a current account surplus. If a country's investment is greater than its savings (I > S), then it will have a current account deficit. Up until 2019, Australia's investment had exceeded its savings resulting in a current account deficit. But in 2019, there was a rise in savings and a fall in investment which created a positive S – I gap. This resulted in Australia recording its first current account surplus in over 50 years. Figure 4.6 shows Australia's annual saving, investment and current account balance as a proportion of GDP since 2012. Notice that between 2012 and 2019, Australia's investment exceeded its savings – in other words a negative savings-investment gap which resulted in a current account deficit. For 2020-22, saving exceeded investment and this resulted in a current account surplus.

The current account balance is equal to the difference between a country's saving and its investment (S - I gap).

We now have a very useful and simple framework to understand the factors that drive the current account balance. All we need to do is to analyse what is happening to a country's saving and investment. Normally Australia's investment is greater than its saving and is the reason why Australia usually records a current account deficit. Does this mean that Australia is a 'low saving' country? The answer is no! Australia's saving rate is actually similar to other OECD countries. Australia, being a small economy in terms of population (26 million), is usually not able to generate

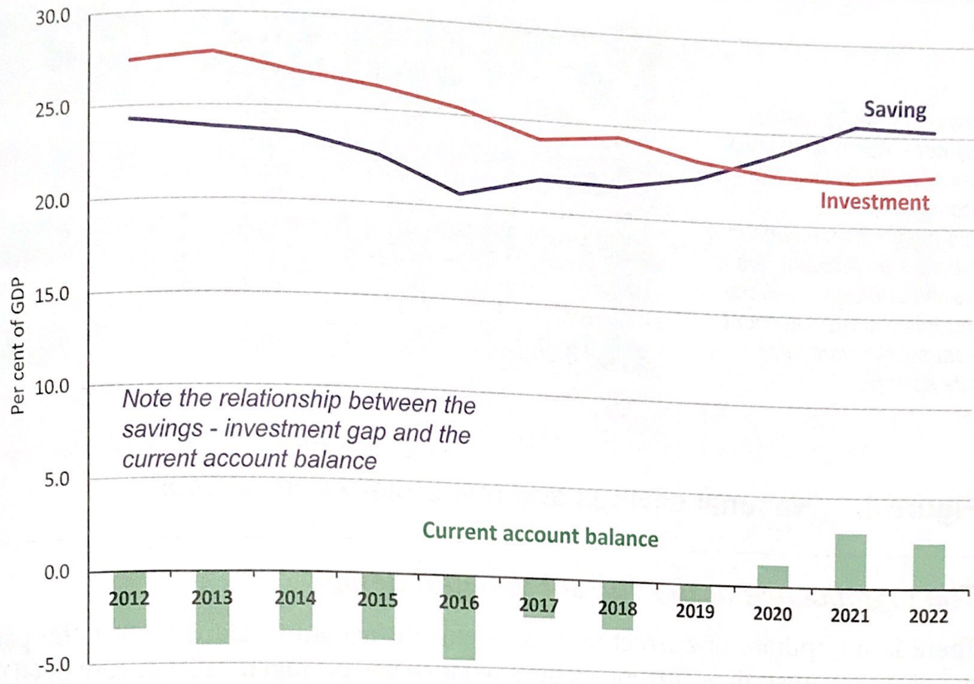

Figure 4.6 Australia's savings-investment gap

enough savings to finance the investment needed to develop its growing economy. Remember that Australia is a large country in terms of geographical area – it is similar in size to the United States. Australia is also endowed with vast natural resource wealth. Developing these resources requires large amounts of capital investment. Drawing on foreign savings enables Australia to achieve a higher rate of investment and economic growth than would otherwise be possible. A current account deficit should not be construed as being inferior to a current account surplus. It simply means that the economy's investment exceeds its savings and therefore it must borrow from other countries to make up the 'gap'.

A current account deficit will occur when a country's investment is greater than its saving (I > S).

One often hears the statement that Australia is a low savings nation and that this is the main cause of the current account deficit. But this is actually a myth! Figure 4.7 compares Australia's saving and investment against other economies (measured as a per cent of GDP) over the past decade. Australia's gross national saving has averaged around 23 per cent of GDP. Notice that Australia's savings rate is very similar to the average of the OECD economies and is considerably higher compared to the United States and the United Kingdom.

What makes Australia different to other economies is its very high investment rate – averaging 25 per cent of GDP. This is much higher than the average across all OECD economies (22%). When a country has a higher rate of investment relative to saving, then it will record a current account deficit. Notice that the current account balance equals the difference between each countries savings and investment.

Is Australia a low saving nation? Absolutely not – Australia's saving rate is similar to the average of the OECD economies.
Is Australia a high investing nation? Yes - Australia's investment rate is well above the average. Australia usually records a current account deficit because its investment exceeds its savings.

Country	National Savings	National Investment	Current Account Balance
Australia	23.2	25.2	-2.0
Canada	20.5	23.7	-3.2
Germany	28.3	20.9	7.4
Japan	27.4	24.9	2.5
United Kingdom	13.5	17.2	-3.7
United States	19.1	20.6	-1.5
Average OECD	22.1	22.0	0.1

Figures are % of GDP 2011-21 *Source: World Bank*

Figure 4.7 National savings and investment comparison

The significance of the current account deficit

There is no optimal or correct size for a current account balance. Over the past twenty years, Australia's current account balance has averaged –3.2 per cent of GDP. This means that the capital and financial account balance must have averaged +3.2 per cent of GDP. In June 2022, Australia recorded a current account surplus equal to +3.2 per cent of GDP. Is it better to have a current account surplus or a current account deficit? Is it better to have a financial account surplus or a financial account deficit? The simple answer is neither - whether the current (or financial) account is in surplus or deficit depends on whether it has a positive or a negative savings investment gap. And this gap is determined by both structural and cyclical factors. A fast growing economy is likely to experience a current account deficit since its investment will exceed its savings. This is what occurs when the Australian economy is in the expansion phase of the business cycle. When the economy contracts or experiences a recession, then investment will fall and savings will rise which will cause the current account balance to increase.

If a country's current account balance decreases, this does not necessarily mean that it represents a weakness in the economy - it could be a response to changes in the world economy, to changes in domestic economic activity or to changes in national savings and investment. For example, Australia's current account balance will decrease if one or more of the following events occurs:

- a fall in the terms of trade - if export prices fall relative to import prices, then ceteris paribus, export receipts will fall and import payments will increase, decreasing the trade balance;
- a decline in international competitiveness - if productivity levels decline or if real wages rise more than productivity then a country's exports will be less competitive in overseas markets. A rise in inflation will also reduce a nation's competitiveness by increasing the prices of domestic goods relative to foreign goods;

- a higher rate of economic growth – this will lead to an increase in national income and an increase in both consumption and investment spending boosting the demand for imports and decreasing the trade balance;
- an increase in foreign investment will increase the financial account balance. If the rate of return on investment is higher in Australia than the rest of the world, then there will be a large capital inflow into Australia. This will increase the primary income deficit due to the outflow of investment income (dividends and the interest payments);
- a decline in national savings – if savings by either households, firms or the government fall, then, ceteris paribus, the current account balance will decrease. When national saving is less than investment, the current account will record a deficit;
- an increase in investment – if investment increases by either the private or public sector, the current account balance will decrease. Stronger economic growth will increase investment and result in a decrease in the current account balance.

The above factors illustrate the many different ways the current account balance can decrease. It is important to understand that a decrease in the current account balance should not necessarily be labeled as a deterioration - which is the fault of many media commentators. How often have you heard comments such as: *"Australia's trade and current account balance deteriorated in the past quarter".* This shows a lack of understanding of basic economics. Rather, the comment should be: *"Australia's trade and current account balance decreased"*. If a strong economy and increased investment contribute to a lower current account balance, then this is a positive change. If the current account balance decreases because of a decline in competitiveness, then this may be a cause for concern. The current account balance is an indicator of changes in the economy – it reflects changes in spending, savings, investment, productivity and external shocks.

Multiple choice 1

Choose the best alternative in the following questions.

1. Which of the following would be a credit item in the current account?
   a. an Australian tourist's spending while on holiday in Singapore.
   b. an Australian firm hires a non-resident Indonesian citizen.
   c. an Australian firm invests overseas.
   d. an Australian firm sells computer software overseas.

2. If a country records a current account deficit, it must be because
   a. exports exceed imports.
   b. imports exceed exports.
   c. foreign currency received from exports and income receipts is more than the foreign currency needed to pay for imports plus income payments.
   d. foreign currency received from exports and income receipts is less than the foreign currency needed to pay for imports plus income payments.

3. The financial account of the balance of payments shows the
   a. value of net foreign investment.
   b. interest repayments on borrowing from overseas.
   c. inflow of pensions and migrant funds.
   d. net trade in capital goods.

4. In the balance of payments
   a. exports of capital goods are recorded in the current account.
   b. imports of capital goods are recorded as a credit item.
   c. the value of exports less the value of imports must always equal the value of net services.
   d. the balance of merchandise trade plus net services equals the balance on current account.

5. Of the following, which is the largest item by value in Australia's current account?
   a. the value of goods imported.
   b. the value of services exported.
   c. the interest payments associated with foreign debt.
   d. the value of direct foreign investment in Australia.

6. Which of the following is included in the financial account of the Australian balance of payments?
   a. dividends paid to foreign investors.
   b. expenditure by Australian tourists overseas.
   c. expenditure by Japanese tourists in Australia.
   d. purchases of shares in Australian companies by foreign residents.

7. If the balance on merchandise trade is $600m, net services are -$350m, income credits are $150m, income debits are $800m and foreign investment into Australia is $450m, then the balance on current account is:
   a. $250m.
   b. -$350m.
   c. $100m.
   d. -$400m.

8. Usually, the largest component of Australia's current account deficit is the:
   a. trade deficit.
   b. goods and services deficit.
   c. net income deficit.
   d. financial account deficit.

9. Which item is not included in the current account of a country's balance of payments?
   a. Exports of services.
   b. Interest on foreign loans.
   c. The inflow of foreign capital.
   d. Profits from foreign investments.

10. If Australia's saving-investment (S – I) gap is positive, then:
    a. the Australian economy will contract.
    b. the Australian dollar will depreciate.
    c. Australia's net foreign investment will be positive
    d. Australia's current account balance will be positive.

11. In a country's accounts with the rest of the world, a surplus on the current account must be offset by
    a. a deficit on the capital and financial account.
    b. a surplus on the current account.
    c. increased borrowing on the capital and financial account.
    d. an appreciation of the domestic currency.

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12. When the level of economic activity __________ there will be a tendency for the trade balance to increase as imports ___________.
    a. increases, increase..
    b. falls, increase.
    c. increases, fall.
    d. falls, fall.

13. Refer to the table of data:

Balance of payments items	$ billion
Exports	400
Imports	430
Net services	–20
Net income	–20

Which of the following statements is correct?
    a. The capital and financial account has a deficit of $70 billion.
    b. The current account has a surplus of $70 billion.
    c. The trade balance is a deficit of $30 billion.
    d. The capital and financial account has a surplus of $70 billion.

14. When a Swiss company purchases an Australian company for $50 million, the value of that transaction is recorded in the:
    a. income account.
    b. current account.
    c. financial account.
    d. investment account.

15. If a global contraction resulted in fewer tourists from other countries visiting Australia, how would this be recorded in Australia's current account of the balance of payments?
    a. A decrease in services exported.
    b. A decrease in services imported.
    c. An increase in services exported.
    d. An increase in services imported.

Worksheet 1

1. What is recorded in a nation's balance of payments.
2. List the different types of economic transactions.
3. Distinguish between credit and debit entries in the balance of payments.
4. Explain why the balance of payments balances.
5. What are the different categories that comprise the current account?
6. The table records transactions between the country of Ecoland and the rest of the world. Record each transaction using the double entry recording system. Note for each transaction there will be a credit and a debit entry.
7. Calculate the following balances for the economy of Ecoland: merchandise trade; goods and services; current account; financial account.
8. Explain why Australia normally records a current account deficit.
9. Fill in the missing values for the table

Ecoland Transactions	$ m
foreign investment to overseas countries	200
coal exports	260
wheat exports	140
spending by overseas tourists in Ecoland	10
interest payments on Ecoland's's foreign debt	40
dividend payments to overseas residents	20
foreign investment in Ecoland	140
computer imports	90
machinery imports	100
car imports	150
wine exports	50
profits received from overseas	10
education exports	30
borrowing from overseas residents	60
loans to overseas residents	100

opposite showing hypothetical balance of payments data (assuming balancing item is zero).

10. What types of transactions are recorded in the financial account?
11. Why does Australia normally record a capital and financial account surplus?

Category	Year 1	Year 2	Year 3
Merchandise exports	3000	1000	4000
Merchandise imports	1500	2000	1000
Net goods	1500	-1000	3000
Net services	-500	-300	-400
Trade balance	1000	-1300	2600
Primary income	-500	-1500	-1400
Secondary income	250	200	100
Current account balance	750	-2600	1300
Balance on capital and financial account	-750	2600	-1300

Articles for analysis

Read the two articles and answer the questions below.

Australia's current account balance (1)

For most of its history Australia has recorded a current account deficit (CAD). This reflects high levels of investment that have consistently exceeded national saving (I > S), even though Australia's saving rate has been around the OECD average. During the mining boom, increased profits in the resources sector led to a surge in mining-related investment. As the current account balance (CAB) is the difference between a country's total saving and total investment, this large increase in investment would have resulted in a large current account deficit in the absence of a matching increase in saving. Indeed, this is what happened in the initial phase of the mining boom.

Period	CAB (% 0f GDP)
Mining boom (2002–2012)	-5.0
End mining boom (2013–2018)	-3.2
Current - including Covid (2019–22)	+2.2

The mining boom in Australia ended in 2012. Since then, Australia's current account balance has averaged -1.3 per cent of GDP. Why did the current account deficit narrow? Investment, especially in the mining sector, fell relative to savings and this reduced the gap between Australia's investment and savings. During 2019-22, Australia recorded successive current account surpluses - the first time in 50 years. During this period, Australia's saving rate increased to exceed its investment rate (S > I). The economy was weak with continued falls in investment. At the same time the Covid pandemic caused an increase in household saving. The combination of falling investment and rising saving resulted in a current account surplus.

Article 1 questions

1. What was Australia's average current account balance during and after the mining boom?
2. Why did the mining boom increase national investment?
3. What effect did the end of the mining boom have on Australia's current account balance?
4. What impact did the Covid pandemic have on Australia's current account balance?
5. Explain the link between Australia's current account balance and its S - I gap.

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Australia's current account balance (2)

The current account of the balance of payments comprises the 'trade balance' (exports less imports) and the 'net income balance' (interest, dividends and transfers received by Australians less interest, dividends and transfers paid to foreigners). Australia has experienced a deficit on the current account for nine years in every ten since European settlement, and for all but three of the last 50 years. By definition, it has also run a surplus on the capital & financial account in all these years, attracting net capital inflow which indicates investment opportunities in Australia continue to be attractive to overseas investors. Over the past twenty years, the current account balance (CAB) has fluctuated between +4 and -7 per cent of GDP. Most of the fluctuation has been a reflection of changes in the trade balance, since the net income deficit has been relatively stable.

The trade balance tends to move with the business cycle. When domestic demand grows faster in Australia than in the rest of the world, import volumes tend to rise more than export volumes and so the trade balance falls. During the Covid pandemic in 2020, import volumes were hit hard and the trade balance was correspondingly larger. Fluctuations in the current account balance are not a bad thing. They are a means by which Australia 'smoothes' consumption in the face of income shocks.

That is, the CAB, like the exchange rate, acts as a buffer or shock absorber between domestic demand and global developments. The deficit on the net income balance largely reflects past current account deficits. These have been funded by borrowing from the rest of the world. As a result, Australia's foreign liabilities exceed its foreign assets. The interest and dividend flows on these net foreign liabilities generally lead to an income deficit.

Article 2 questions

1. Distinguish between the 'trade balance' & the net income balance'.
2. Why does Australia have a large income deficit in the current account?
3. Explain why the trade balance tends to move with the business cycle.
4. 'Fluctuations in the current account balance are not a bad thing'. Explain this statement.
5. How does a strong world economy impact on Australia's current account?

Worksheet 2

1. Why does Australia's trade balance fluctuate?
2. What is the main component of the primary income deficit?
3. Why is Australia's primary income balance always negative?
4. Explain how events in the world economy can affect Australia's current account balance.
5. How is the current account balance affected by Australia's rate of economic growth?
6. Explain why the current account balance follows a cyclical pattern.
7. Explain which category in the current account is more volatile - the trade balance or the primary income balance.
8. What factors can lead to a fall in the current account balance?
9. What are the structural reasons for Australia's recording a current account deficit?
10. Explain how the financial account is linked to the current account.
11. Show that the current account balance is equal to the difference between a country's saving and its investment.
12. Explain what would happen to Australia's current account balance for each of the following:
    - a mining boom
    - an increase in savings
    - a decrease in investment
    - a global recession.

Multiple choice 2

1. When an Australian purchases a New Zealand financial asset
   a. Australia's balance of goods and services deteriorates.
   b. Australia's capital and financial account surplus is reduced.
   c. Australia's current account deficit increases.
   d. Australia's capital and financial account surplus is increased.

2. A decrease in the current account balance
   a. can be directly caused by an increase in the country's GDP.
   b. is likely to appreciate the country's currency.
   c. will be offset by a deficit on the capital and financial account.
   d. will lead to a fall in the terms of trade.

3. An increase in the trade surplus in Australia is most likely to result from
   a. higher economic growth in China.
   b. an appreciation of the $A.
   c. an increase in Australia's inflation rate.
   d. a decrease in domestic interest rates.

4. If the rate of economic growth in Australia decreased while for China it increased, then
   a. both Australia's exports and imports would increase.
   b. both Australia's exports and imports would decrease.
   c. Australia's exports would increase and imports would decrease.
   d. Australia's exports would decrease and imports would increase.

5. Which of the following usually contributes most to Australia's CAD?
   a. Net primary income.
   b. Net services.
   c. Net secondary income.
   d. Net goods.

6. A positive balance of trade in a country's balance of payments necessarily implies that
   a. the volume of imports is less than the volume of exports.
   b. an improvement has occurred in the terms of trade.
   c. the value of imports is less than the value of exports.
   d. the balance on the current account will also be positive.

7. A current account deficit could be reduced by
   a. increasing aggregate demand.
   b. increasing the flow of foreign investment.
   c. increasing domestic savings.
   d. decreasing unemployment.

8. An increase in a country's current account deficit in the balance of payments
   a. can be caused by an increase in the country's economic growth.
   b. must be accompanied by an equivalent deficit in the capital and financial account.
   c. must eventually lead to a decline in the country's terms of trade.
   d. can be caused by an increase in the country's aggregate saving.

9. An increase in the current account deficit is most likely to be a result of
   a. a decrease in economic growth.
   b. a fall in the exchange rate.
   c. domestic investment being greater than domestic saving.
   d. an increase in exports.

10. An increase in the current account deficit is most likely to be a result of
    a. a decrease in economic growth.
    b. an increase in investment in domestic manufacturing plants.
    c. a positive gap between domestic savings and domestic investment.
    d. an increase in exports.

11. All other things being equal, which of the following is most likely to cause an increase in Australia's current account deficit?
    a. A decrease in national savings
    b. A decrease in Australian overseas aid
    c. An increase in the Federal Government's budget surplus
    d. An increase in the number of overseas students studying in Australia

12. Which of the following statements is correct?
    a. A country will have a current account surplus if it imports more than it exports.
    b. A country will have a capital and financial account deficit if it imports more than it exports.
    c. A country that has a current account surplus will lend savings to the rest of the world.
    d. A current account deficit is an indication that a country has an excessively high level of imports.

13. Refer to the data table opposite.
    The balance on current account is
    a. $400 million.
    b. -$400 million.
    c. $0 million.
    d. $1,100 million.

Balance of Payments	$ million
Goods Exports	6600
Goods Imports	5500
Net Services	−200
Net Income	−500

14. In 2020, Australia recorded a financial account deficit. The reason for this was
    a. foreign investment into Australia was less than Australian investment abroad.
    b. Australia's exports of goods and services exceeded its imports.
    c. Australia recorded a net income deficit.
    d. Australia's net foreign debt decreased.

15. An increase in the current account deficit would most likely be of concern if it was due to
    a. rising investment in an economy undergoing structural change.
    b. rising inflation levels affecting international competitiveness.
    c. higher rate of economic growth boosting demand for imports.
    d. an increase in savings relative to investment.

Article for analysis

Read the articles on page 92 and answer the questions below.

Article 1 questions

1. What was the current account balance for June 2020?
2. Explain why net exports increased when actual exports decreased?
3. Explain why the net income deficit decreased.
4. What effect does a recession have on the current account balance?
5. How does a recession affect the savings-investment gap?

Article 2 questions

1. What was the main reason for the record trade balance in June 2022?
2. What was the main reason for the record primary income deficit in June 2022?
3. For June 2022 determine the value of the trade balance, the income balance and the current account balance.

1. Australia records current account surplus during the COVID recession!

Australia's fifth consecutive record current account surplus in June 2020 was driven by a further increase in net exports. But was it due to rising exports? The answer might surprise you – it was due to rapidly falling imports. Exports actually fell, but imports fell even more! While exports of services fell by 18 per cent in the June quarter 2020, services imports collapsed by 49 per cent. This increased the services balance by a record $7 billion, helping drive a record $18 billion current account surplus. The overall current account surplus was also helped along by the net income deficit falling by $4 billion due to less income being paid to offshore investors due to a collapse in dividend payments.

Why did we suddenly get a record current surplus in the middle of a recession? With high unemployment and falling GDP, both consumption and investment spending fell. This meant that spending on imports collapsed and this helped create a massive trade surplus. Remember that a country will have a current account surplus if national saving is greater than national investment (S > I). What happens to S and I during a recession? Investment falls and savings rise – hence the reason for the increase in the current account surplus. So simple even my pet dog 'Bella' understands it!

2. Australia recorded its 13th consecutive current account surplus in 2022

Australia's current account surplus increased by $16 billion in the June quarter 2022. The balance on goods and services increased to reach the highest balance on record of $43.1 billion, driven by strong export prices. The ABS, said: "The increase in the current account surplus was driven by higher commodity prices. Exports of goods and services increased 14.7 per cent, as global supply constraints increased demand for Australian commodities. Travel services also contributed to the rise in exports as education related and personal travel continued to recover following the reopening of Australia's international borders. The net primary income deficit reached a record level of $24 billion due to increased dividend payments to non-residents as profits remained strong on the back of higher commodity prices. (Source: ABS 5302)

Extended responses

Each of the following questions should be answered in 2-3 pages of writing. Include diagrams and examples where appropriate. Pay attention to the allocation of marks..

1. a. Describe the structure of Australia's balance of payments accounts. Distinguish between transactions in goods, services, income and financial assets. [10 marks]
   b. Explain the importance of the savings – investment gap in understanding Australia's current account balance. [10 marks]

2. a. Distinguish between the two accounts in the balance of payments and explain how the two accounts are linked. [10 marks]
   b. Explain both the structural and cyclical factors affecting Australia's current account balance. [10 marks]

3. a. Distinguish between the trade balance and the income balance. [8 marks]
   b. Explain how each of the following events would impact on Australia's current account balance:
   - a decline in foreign investment
   - Australia's rate of economic growth increases
   - a rise in the terms of trade. [12 marks]