7

Foreign Investment

Chapter concepts

- ***the concept of foreign investment in terms of foreign assets and foreign liabilities***
- ***the concept of foreign liabilities - foreign debt and foreign equity***
- ***the relationship between the current account outcome and foreign liabilities***
- ***the extent of, and recent trends in, Australia's foreign direct investment and foreign debt***
- ***the benefits and costs of foreign direct investment and foreign debt to Australia***

Introduction

In this chapter we investigate the importance of foreign investment to the Australian economy. It is important not to confuse foreign investment with investment spending. Foreign investment is an inflow of money from overseas investors - some of which may turn into investment spending, but only a small portion (around 10 - 15 per cent). Australia has always relied on a net inflow of foreign investment to develop its economy and to supplement its domestic savings. In chapter 4 we noted that Australia normally records a current account deficit and a financial account surplus. This occurs because Australia's total investment exceeds its savings (a negative S - I gap) and we import foreign savings from the rest of the world. This foreign savings is capital inflow, or foreign investment into the Australian economy.

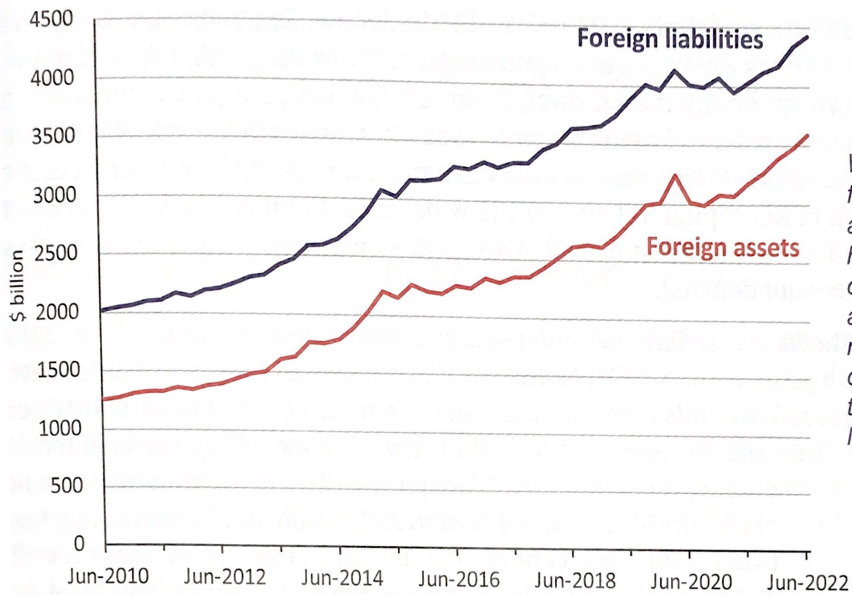
Australia's net international investment position records the stock or level of foreign investment into Australia (FIA) and the level of Australian investment abroad (AIA). The stock of foreign investment into Australia is referred to as foreign liabilities while the stock of Australian investment abroad is known as foreign assets. A liability is something you owe, while an asset is something you own. So if a firm in the United States invests in the Australian share market or invests money into the Australian financial market, this represents an increase in Australia's foreign liabilities - an increase in net capital inflow or inbound foreign investment. If, on the other hand, an Australian firm buys shares in an overseas company or lends money to a foreign bank then this would represent an increase in Australia's foreign assets - an outflow of capital or foreign investment abroad.

In June 2020, the stock of foreign investment in Australia (foreign liabilities) was $4,428 billion. Australia's stock of foreign investment abroad (foreign assets) amounted to $3,594 billion resulting in a net international investment position of $834 billion.

Foreign liabilities and foreign assets

Foreign liabilities are created when Australian residents borrow money from overseas or sell assets such as shares to foreign residents. It is called foreign investment in Australia, and is an inflow of money from overseas. Foreign assets are created when Australian residents lend money to foreign residents or purchase foreign assets. It is called Australian investment abroad, and is an outflow of money. Figure 7.1 shows the growth of Australia's foreign liabilities and foreign assets since 2010. Over this period foreign assets increased from $1,264bn to $3,594bn, while foreign liabilities increased from $2,023bn to just over $4,428bn. It is interesting to note that foreign assets have been increasing at a faster rate than liabilities. Instead of measuring the change in billions of dollars we can compare the growth in assets and liabilities as a per cent of GDP. Since 2010, Australia's foreign liabilities increased from 155 per cent of GDP to 193 per cent. At the same time, Australia's foreign assets have increased at a faster rate from 97 per cent of GDP to 156 per cent.

Foreign investment into Australia increases Australia's foreign liabilities while Australian investment abroad increases Australia's foreign assets



While Australia's foreign liabilities and foreign assets have both increased over time, foreign assets have grown more quickly. The difference between the two is net foreign liabilities.

Figure 7.1 Australia's foreign liabilities and foreign assets

The distance between the two lines in figure 7.1 represents Australia's net foreign liabilities. They have increased from $759 billion in 2010 to $834 billion in 2022 – an increase of 10 per cent. Is this a cause for concern? Not really, because it is important to remember that net foreign liabilities represents net foreign investment into Australia which has enabled the Australia economy to develop and grow over time, increasing our national income and standard of living. Measured as a percentage of GDP, net foreign liabilities have actually decreased significantly – from 58 per cent of GDP in 2010 to 37 per cent in 2022.

Foreign investment can be in the form of borrowing (foreign debt) or in the form of foreign ownership (foreign equity). If Australian residents (households, firms or government) borrow from overseas, then this increases Australia's foreign debt liability. If Australian residents sell assets to overseas residents, then this increases Australia's foreign equity liability. The following table summarises Australia's net international position for 2022.

June 2022	Debt $bn	Equity $bn	Total $bn
Foreign Liabilities	2757	1671	4428
Foreign Assets	1599	1995	3594
Net Foreign Liabilities	1158	-324	834
Per cent of GDP	52	-15	37

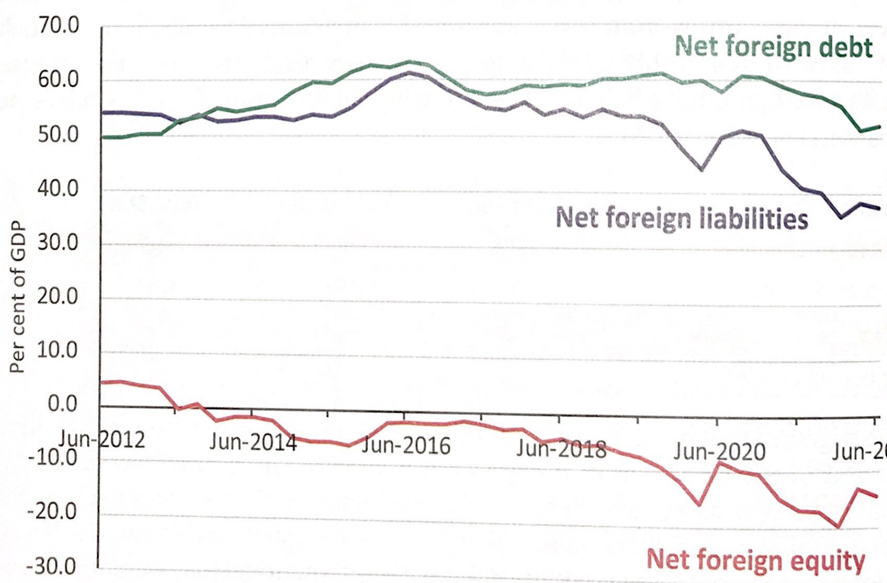
Total foreign investment in Australia (foreign liabilities) amounted to $4,428 billion, comprised of $2,757 billion of foreign debt and $1,671 billion of foreign equity. Australia's foreign assets amounted to $3,594 billion and this comprised $1,599 billion of lending and $1,995 billion of equity. We are interested in the net figures – net foreign debt, net foreign equity and the net international investment position.

Australia's net foreign debt in 2022 was $1,158 billion, while net foreign equity was -$324 billion. Why is the net equity figure negative? This means that Australia now owns more foreign equity than it owes, so in fact net foreign equity is no longer a liability - it is now an asset. Overall, Australia had a net foreign liability of $834 billion. These numbers appear large but it is important to remember that they consist of the accumulation of net capital inflow over many decades. In other words, the stock of foreign liabilities equals the sum of all of Australia's past financial account surpluses (or current account deficits).

All of Australia's net foreign liabilities now comprise foreign debt since Australia's net foreign equity is no longer a liability.

Figure 7.2 shows Australia's net international investment position since 2010 measured as a proportion of GDP. Notice that Australia's net foreign liabilities have actually decreased over this time – falling from 58 per cent of GDP in 2010 to 37 per cent in 2022. Australia has always preferred borrowing over selling assets in terms of foreign liabilities. Net foreign debt has risen from 50 per cent of GDP in 2012 to 52 per cent in 2022, while net foreign equity has fallen from 4 per cent of GDP to –15%. This means that now all of Australia's net foreign liabilities are in the form of foreign debt with net foreign equity no longer being a liability. The reason for this change in foreign equity is that the growth in Australia's superannuation funds has enabled Australia to increase its holding of foreign assets. Is Australia's reliance on foreign borrowing a cause for concern? Not really because it fills Australia's investment – savings gap. Borrowing funds is seen as being a more prudent and flexible approach compared with selling assets. Both types of liability involve an income payment to foreign residents. Foreign debt needs to be serviced with interest payments, while foreign equity involves the remittance of profits and dividends.

Figure 7.2 Australia's net international investment position



Investigating Macroeconomics 7th edition ISBN 978-1-875313-62-4

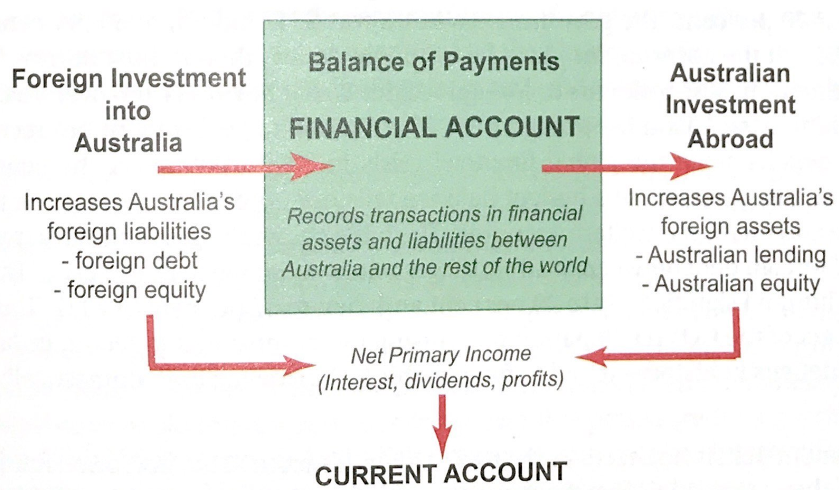
These income payments are recorded in the current account in the balance of payments. Remember that foreign investment flows are recorded in the financial account. Normally Australia would record a financial account surplus each year due to the net inflow of capital, mainly in the form of borrowing. The income payments associated with this foreign investment result in a large net income deficit in the current account.

Foreign liabilities and the current account

Figure 7.3 illustrates the relationship between the financial account and the current account in the balance of payments. The financial account records the flow of foreign investment into and out of Australia. When foreign residents invest in Australia, this increases our foreign liabilities. When Australian residents invest overseas, this increases Australia's foreign assets. Australia's foreign liabilities are greater than its foreign assets, which means that more foreign investment flows into Australia than flows out and most of this capital inflow is in the form of borrowing. A financial account surplus will add to the stock of foreign liabilities.

The income flows associated with foreign liabilities are recorded in the current account. The servicing costs associated with foreign liabilities (interest & dividends) result in a large primary income deficit in Australia's current account. Whether the current account deficit is financed by either equity or debt will result in outflows of income to overseas residents. Some commentators worry that these income payments are a drain on the economy and will cause the current account to record a deficit. But this is incorrect. It is important to remember that the current account balance reflects the gap between national saving and national investment (S – I gap), so a higher level of investment will increase the nation's capital stock. This will expand the economy's productive capacity and provide for future income growth.

Figure 7.3 Foreign investment and the balance of payments



Expressing foreign liabilities as a proportion of an economy's GDP is also not the most relevant measure and in fact, can be quite misleading. Foreign liabilities are a stock variable (accumulated over time) while GDP is a flow variable. Foreign liabilities should be measured relative to the physical capital stock of the country, giving an indication of the proportion of the capital stock being funded by foreign residents. This ratio has been relatively stable in Australia at around 10 per cent. Australia relies on foreign investment not because its national saving ratio is low, but because its investment ratio is high. This creates a savings gap that is filled by foreign liabilities.

Australia's foreign debt

Every time Australia records a current account deficit in the balance of payments, total foreign liabilities increase, either as an increase in foreign debt and/or as an increase in foreign equity. The foreign debt is the amount of money that Australian residents, both public and private, owe to the rest of the world. Foreign equity, on the other hand, represents the extent to which foreign residents own Australian assets. Examples of debt include government securities issued to overseas residents and borrowing by Australian firms from overseas financial institutions. Currently all of Australia's net foreign liabilities are in the form of foreign debt.

An important distinction should be made between gross foreign debt (the total of Australia's overseas borrowing) and net foreign debt (gross debt minus Australian lending to overseas residents). Net foreign debt provides the best view of our debt situation. An example will make this clear. If country A owed country B $100 billion but was owed $60 billion by country C, then country A's gross foreign debt equals $100 billion, but its net foreign debt is $40 billion. In 2022, Australia's gross foreign debt was $2,757 billion but Australia's lending abroad equaled $1,599 billion resulting in a net foreign debt of $1,158 billion.

When people talk of Australia's foreign debt, they think that it is owed by the Australian government - but this is incorrect. Most of Australia's foreign debt is private debt - of a total of $1,158 billion in 2022, private sector debt amounted to $811 billion or 70 per cent. The government's share was $347 billion, or 30 per cent (see figure 7.4). If the government plans for a budget deficit, then it must borrow funds from either domestic residents or foreign residents. If it borrows from overseas, then this will increase Australia's foreign debt. The Australian government has recorded budget deficits since the global financial crisis in 2009. Whenever the economy contracts, the government's budget balance falls due to declining government tax revenue and increased welfare spending. The table shows the government's (public) share of foreign debt between 2013-2019 was relatively stable at 25 per cent. Then in 2019, it jumped significantly to 29 per cent and then to 37 per cent in 2021. This was the impact of the COVID-19 pandemic causing the government to record its largest budget deficits in history - it had to finance this by borrowing both domestically and overseas.

Government debt is not necessarily 'bad.' It depends on how the borrowed funds are used. If they are used to finance government infrastructure, then this will increase future income and will not impose a burden on taxpayers. However, if the funds are

Australia's Net Foreign Debt $billion					
Year	Public $bn	Private $bn	Total $bn	Public %	Private %
2013	205	605	810	25	75
2014	227	652	879	26	74
2015	244	718	962	25	75
2016	252	798	1050	24	76
2017	241	766	1007	24	76
2018	274	818	1092	25	75
2019	300	884	1183	25	75
2020	337	809	1146	29	71
2021	444	751	1195	37	63
2022	347	811	1158	30	70

Most of Australia's net foreign debt is owed by the private sector - however the government's share increased significantly in 2020-21 due to the COVID-19 pandemic.

Figure 7.4 Private and public foreign debt

used for general government spending, then this is a problem. It would be similar to a household taking out a loan to pay for the groceries! This is why private sector debt is usually considered superior to public debt in that it is incurred with the profit motive in mind. Private debt is likely to increase investment which expands the productive capacity of the economy and provides the income stream to service the debt. Many people think that the foreign debt represents a large burden on future generations, but this is also a misconception. It may come as a surprise that a large proportion of Australia's foreign debt is paid within a short period of time. In 2022, one third of the foreign debt had a maturity of less than one year while 62 per cent was to be repaid within five years.

Most of Australia's foreign debt has a relatively short maturity period.

Trends in Australia's net foreign debt are illustrated in figure 7.5. Between 2012 and 2022, net foreign debt increased from 50 per cent of GDP to 52 per cent – a relatively modest increase. It reflects the accumulation of debt over time resulting from continued current account deficits and the fact that Australian firms prefer to borrow funds rather than sell equity. The foreign debt ratio did reach a peak in 2016 of 63 per cent, but has since fallen steadily as Australia's investment-saving gap narrowed.

Part of the issue concerning the size of foreign borrowing is that the interest payments on the debt feed into the current account balance. Figure 7.5 also illustrates the size of Australia's interest payments on its foreign debt measured as a proportion of total export income. The interest payments represent the servicing costs of the foreign debt. One might expect that the growth in interest payments would increase over time, however, this is not the case. In 2012, the interest bill was equivalent to 8 per cent of export income. But notice how the interest burden has fallen dramatically. This is mainly due to world interest rates declining over this period (reducing repayments on loans), and by the fact that Australia's export performance has improved. By 2022, interest payments had fallen to less than 3 per cent of export income.

While net foreign debt has increased as a proportion of GDP, the servicing proportion has fallen. Interest payments as a proportion of GDP have fallen from around 8% in 2012 to 3% in 2022.

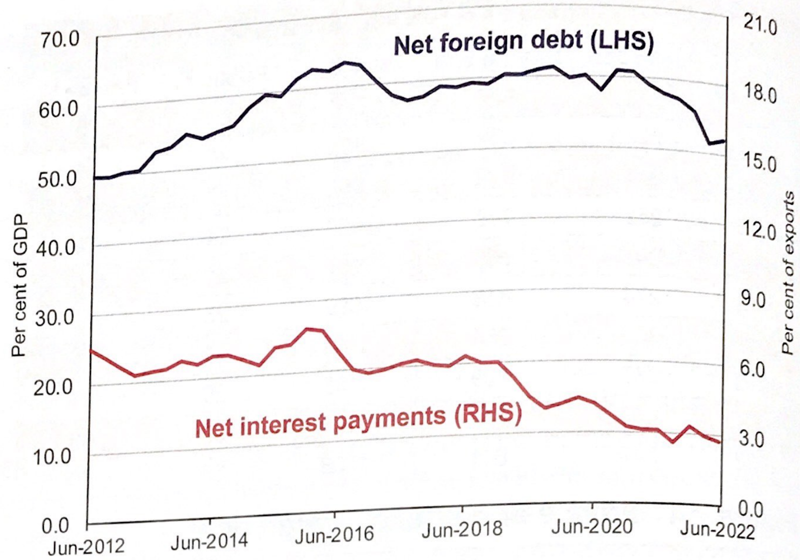


Figure 7.5 Australia's net foreign debt

Is foreign debt a problem?

Borrowing can be of benefit to the individual, the firm and the nation. When borrowing is used for investment, living standards rise. Families borrow for housing, firms borrow for capital equipment and expansion and governments borrow to build infrastructure. The problem is identifying the 'right' amount of borrowing. What is an acceptable level of foreign debt? What should be the size of the current account balance? Many organisations such as the OECD do not even publish figures on foreign debt, believing that it is not that relevant. We know that a current account deficit occurs when a country's total investment exceeds total saving. The difference is equal to net capital inflow. However, there are many journalists in the Australian media who seem to think that a rise in Australia's foreign debt is a national crisis. Perhaps they need to complete a refresher course in basic economics to understand that the buildup in foreign debt mirrors the increase in foreign investment.

Foreign debt is a stock variable and should be measured as a proportion of a nation's wealth or assets rather than GDP.

An important point to be aware of is that foreign debt is a stock variable – it represents the accumulation of debt over time, whereas GDP is a flow variable – it represents the increase in output from one year to the next. Measuring foreign debt as a proportion to GDP is therefore an inaccurate way to measure its relative importance. Foreign debt should be compared with another stock variable such as Australia's total wealth, rather than GDP. It would be similar to comparing a household's total debt with its annual income instead of comparing it to the household's total assets. The ABS now publishes a 'balance sheet' for Australia which details changes in Australia's assets, liabilities and net worth or wealth. What has happened to Australia's wealth during the time that the amount of foreign debt has increased?

Australia's national balance sheet shows that while Australia's foreign liabilities have increased over time so has Australia's assets. These are measured in terms such as buildings, machinery and equipment, land, mineral resources, and financial assets with the rest of the world. The important point to note is that Australia's assets have increased at a faster rate than its liabilities, so that Australia's net worth or wealth has been rising over time. Since 2010, Australia's liabilities increased by $2.4 trillion but total assets increased by $12 trillion. This means that Australia's wealth over this time rose by $9.6 trillion. Not only has the total amount of Australia's wealth increased, but per capita wealth in Australia has also risen. Per capita wealth has increased from $358,000 in 2010 to $675,000 in 2022. This proves that the build-up of Australia's foreign liabilities - both foreign debt and foreign equity - has been used to increase Australia's net worth. Rather than a burden, foreign investment has, over time, enabled Australia to increase its level of real income. This is an apt reminder of not just focusing on a country's level of foreign debt and liabilities. A correct judgment can only be made by comparing a nation's total liabilities with its total assets.

Australia's Balance Sheet

	Assets $billion	Liabilities $billion	Net Worth $billion	Per capita $'000
1990	2211	288	1923	114
2000	3878	783	3095	163
2010	9908	2023	7885	358
2022	21985	4428	17557	675

Source: ABS 5204.0

What are the potential costs associated with a high level of foreign debt? One of the main arguments is that Australia's credit rating may be downgraded which means that future borrowing will be subject to higher interest rates. But if this were to happen, then the higher rates would reduce the amount of foreign borrowing, which is a normal market reaction. A second argument that is raised is that a depreciation in the Australian dollar will increase the value of Australia's debt. But this is incorrect. Most of Australia's borrowing is now denominated in Australian dollars so a change in the exchange rate has minimal effect on the outstanding debt. Australia's foreign assets on the other hand are held in foreign currency, so a depreciation in the AUD actually increases their value. The interest payments on Australia's foreign debt do contribute to the large income deficit in the current account of the balance of payments. But it is important to remember that this represents the servicing cost of using foreign savings to fill Australia's investment-savings gap. Where would Australia be without the mining sector? A rise in the government's share of foreign debt may cause a problem if the government has borrowed to fund recurrent expenditure rather than government investment.

Foreign investment

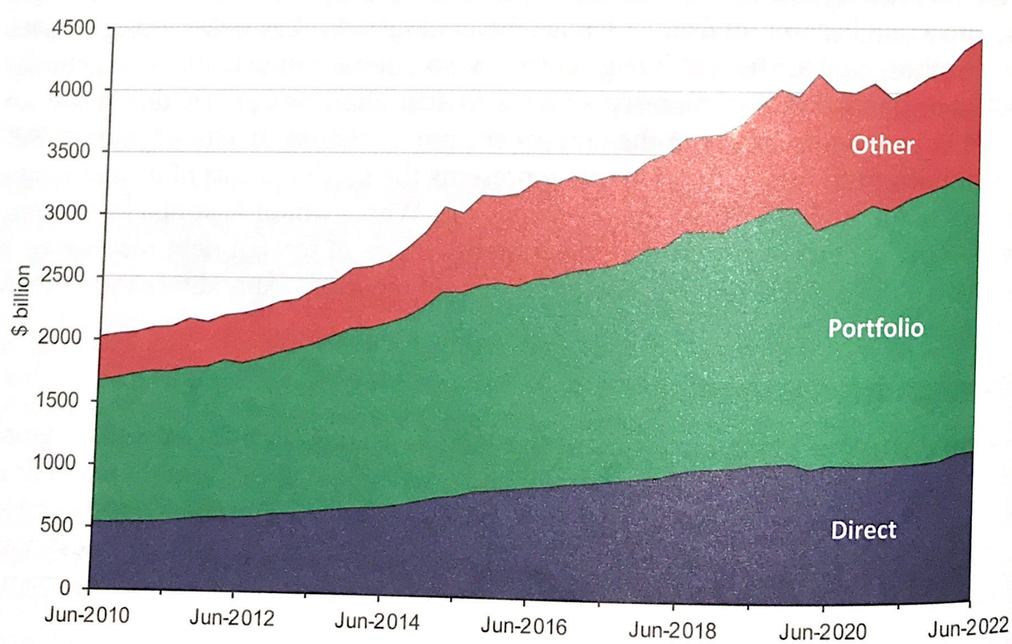
The total stock of foreign investment in Australia is equivalent to Australia's gross foreign liabilities. In 2022, this amounted to $4,428 billion. Every year there is a flow of foreign investment into Australia which adds to this stock. This flow is recorded in the financial account of the balance of payments. If the inflow of foreign investment exceeds the outflow, then there is a financial account surplus. If Australian investment abroad exceeds the inflow, then there is a financial account deficit – this happened in the years 2020 to 2022. In simple terms, foreign investment into Australia occurs when a foreign individual or business decides to establish a new business in Australia or purchases property or shares in an Australian-owned business.

Foreign investment may take the form of borrowing or it may be in the form of equity – the selling of assets (shares of companies, resources) to overseas residents. Australia has, for most of its history, been a financial capital importer. This means that for most of its history, Australia has recorded a financial account surplus. The inflow of foreign capital fills Australia's investment–savings gap. Australia is a small nation in terms of population and it usually does not raise enough savings to fund its investment needs. The inflow of foreign investment has enabled Australia's living standards and rate of economic development to be much higher than they would otherwise have been. Most foreign investment into Australia is in the form of debt securities (62 per cent) with equity comprising the other 38 per cent.

Most foreign investment into Australia is in the form of debt securities (62%) with equity comprising the other 38 per cent.

Figure 7.6 illustrates the growth in the level of foreign investment into Australia, increasing from around $2,000 billion in 2010 to $4,428 billion in 2022. Foreign investment transactions are divided into direct, portfolio, and other (which includes financial derivatives and reserve assets). The two most important categories are direct investment and portfolio investment. Figure 7.6 shows that portfolio investment is the dominant type of foreign investment in Australia, accounting for around one half while direct investment makes up one quarter of the total. Foreign direct investment occurs when a foreign investor establishes a new business or acquires 10 per cent or more of an Australian enterprise.

Figure 7.6 Stock of foreign investment in Australia



The 10 per cent measure provides the foreign investor with a 'significant influence' over that enterprise. Examples of foreign direct investment include the establishment of Australian branches of multinational companies or joint ventures between Australian and foreign companies. Direct investment is thus associated with a degree of ownership and/or influence of Australian enterprises and resources. In this way direct investment is viewed as more long term and stable. While the purchasing of shares is an example of equity investment, other types of direct investment include borrowing and the reinvestment of earnings, although equity securities are the dominant type. The reinvestment of earnings is specific to direct investment and refers to the income retained from after tax profits that would have otherwise left the economy and traveled to the direct investor. Many people are under the impression that all profits and income accruing from foreign investment leave the economy, but this is not the case. A large proportion of this income is retained in the business.

Stock of Foreign investment in Australia 2022

		$billion
Direct investment 26%	Equity securities	894
	Debt instruments	276
	Total direct	1170
Portfolio investment 47%	Equity securities	778
	Debt securities	1321
	Total portfolio	2099
Other foreign investment		1160
All foreign investment		**4428**

Portfolio investment refers to all other foreign investment that is not direct investment - in other words, when an overseas firm purchases less than ten per cent of the shares of an Australian company. This means that portfolio investment does not result in foreign control of Australian enterprises. Examples of portfolio investment include the purchase of property and/or shares in Australian companies as well as the purchase of government bonds by foreign superannuation or pension funds. Portfolio investment is viewed as being more speculative than direct investment. Portfolio investment comprises both equity securities and debt securities (borrowing) such as the issue of bonds and notes. Debt securities form the most important source of portfolio investment accounting for around 63 per cent. This is the opposite case to direct investment where the dominant type is equity capital.

Figure 7.7 shows the inflow of foreign direct and portfolio investment into the Australian economy for the past decade. This inflow adds to the stock of foreign investment (foreign liabilities) and is recorded in the financial account. Usually the inflow of portfolio investment is greater than direct, and this was true for six of the 10 years shown in the graph. In 2019 and 2020, portfolio investment was actually negative which means that it was withdrawn from the economy. This is unusual, but remember these were the years affected by the COVID pandemic which caused the economy to suffer a recession. An important point to note from the graph is the volatility of portfolio investment compared with direct investment. Between 2013 and 2018, direct investment was relatively stable recording an inflow of around $60 billion each year. Over the same period, portfolio investment fluctuated between $30 and $120 billion. In 2019 and 2020, portfolio investment was withdrawn before increasing significantly in both 2021 and 2022.

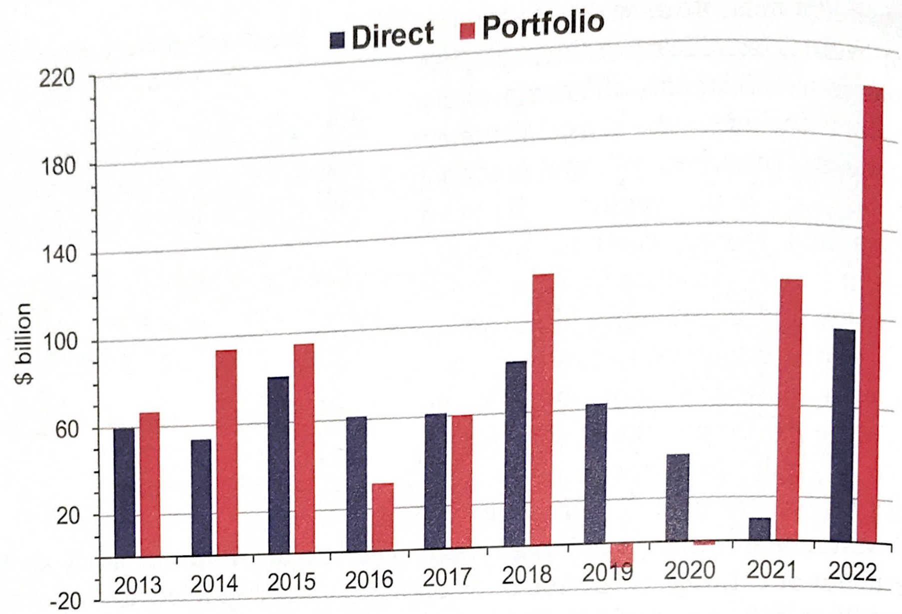
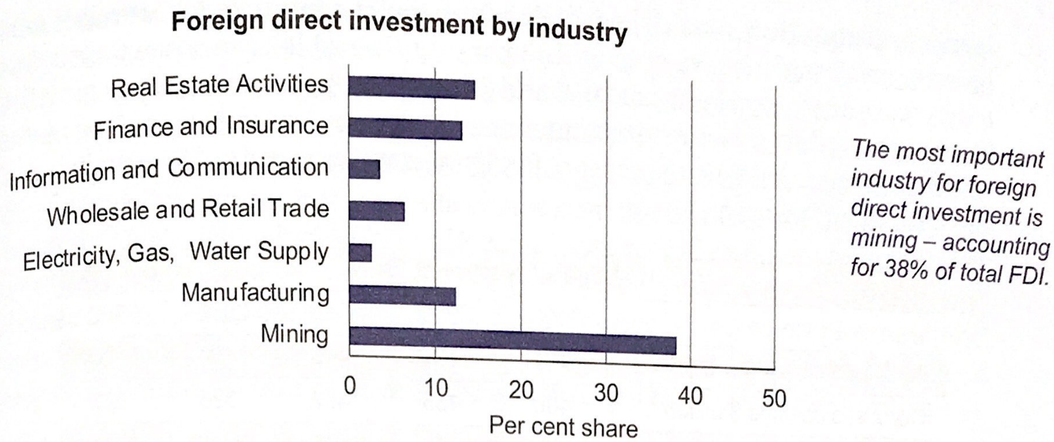


Figure 7.7 Foreign direct and portfolio investment

Foreign investment is influenced by a number of factors. Profit expectations, interest rate differentials and political stability have all been important in attracting foreign investment into the Australian economy. The Australian economy represents a secure and safe haven for financial capital. The Australian economy is also well placed in terms of the fast growing economies of east and south-east Asia. Over the past decade the Australian economy has been outperforming most of the OECD economies which has contributed to the large inflow of foreign investment. Australian interest rates are often relatively higher than most other developed economies which also attracts portfolio investment chasing high returns or yields. Australia has a well developed and regulated financial market which offers investors low risk returns. Australia is a resource rich nation which depends on the inflow of financial capital to supplement its own domestic savings to enable it to develop its vast mineral and energy resources.

Figure 7.8 shows the levels of foreign direct investment in Australia by industry and by source country. The mining industry comprised the largest share of the stock of foreign direct investment (FDI) in Australia in 2022, with 38 per cent of total FDI. Other major industries include real estate activities (15 per cent), finance & insurance (13 per cent) and manufacturing (12 per cent). Most people think that there is a high level of foreign ownership of Australian business firms, but this is incorrect. Australian businesses with foreign ownership greater than 10 per cent accounts for just 3 per cent of all business firms. The industry in which the level of foreign ownership is high is the mining industry, where 28 per cent of mining businesses have foreign ownership of greater than 10 per cent. The three main sources of foreign direct investment are the United States, Japan and the United Kingdom. These three countries account for over 40 per cent of all foreign direct investment in Australia.



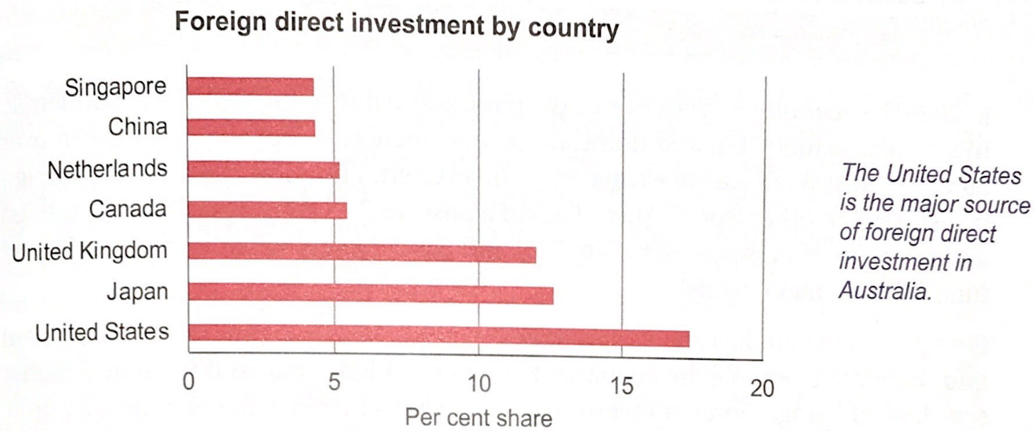


Figure 7.8 Foreign direct investment in Australia

Costs and benefits of foreign investment

It is important to understand that in economics, investment refers to spending on new capital goods such as machinery and construction including new housing. Foreign investment is an inflow of funds into the Australian economy. Most foreign investment is used to purchase Australian assets, such as shares and property. A small percentage of foreign investment does contribute to domestic investment – anywhere from 10-20 per cent. Investment expenditure is a component of GDP and plays an important role in the economy. It increases the level of economic activity, employment and national income. Investment also expands the productive capacity of the economy by increasing the stock of physical capital – in other words it moves the economy's production possibility frontier outwards.

The amount of investment an economy can undertake is determined by the level of savings. If domestic savings are low, then for investment to expand, foreign savings must be used. This has been the situation facing the Australian economy. Australia normally relies on foreign investment because its investment needs exceeds its level of savings. How much does foreign investment contribute to Australia's total investment? Usually between 10 and 15 per cent. The table below shows Australia's total investment flows between 2018 and 2022. In 2018, domestic savings provided 89 per cent of the economy's investment needs with foreign savings making up the other 11 per cent. In 2019, the share of foreign savings required to fill Australia's I - S gap fell to just 4 per cent.

Australia's investment flows

	2018	2019	2020	2021	2022
Total investment flows $billion	449	454	449	464	524
Domestic savings $ billion	400	435	472	528	582
Foreign savings $ billion	49	19	-23	-64	-58
Domestic source (% share)	89	96	105	114	111
Foreign source (% share)	11	4	-8	-14	-11

In 2020 the economy experienced a deep recession due to the COVID-19 pandemic. Investment actually fell and domestic savings increased. For the first time in over 50 years, Australia's saving exceeded its investment and didn't require any foreign investment. In other words, Australia had a positive S – I gap. This is why the foreign savings figure is negative. Between 2020 and 2022, Australia had enough savings to fund its investment needs!

Foreign investment has enabled Australia to fund a much higher rate of investment and therefore to enable the economy to grow at a higher rate and to enjoy a higher standard of living. Foreign investment can help to increase the economy's public and private infrastructure, including transport and communications networks. By increasing the capital-labour ratio it can increase labour productivity lading to higher real incomes . The most important benefit of foreign investment for Australia has been the development of our industries and resources. Without the large amount of foreign investment that has flowed to Australia, the mining and manufacturing sectors would have been much smaller. Inflows of foreign investment have also helped to finance the growth of Australia's stock of housing.

The benefits of foreign direct investment
Helps to fund the I – S gap, allowing Australia to have a high rate of investment
Enables Australia to have higher real incomes & higher living standards
increases employment & economic growth
Enabled the development of Australia's mining & energy sector
Increased net exports in the resources sector
Encourages competition and increased innovation through new technologies
Enhances productivity growth through capital deepening
Increased tax revenue for State and Commonwealth governments

If the funds from foreign investment were to fall, then Australia's standard of living would decline since less goods and services (as imports) could be consumed. Australia's economic growth would decline because there would be insufficient savings to finance the economy's capital needs. Direct foreign investment has the advantage that it can bring with it new technology and managerial expertise. Most of the foreign investment into Australia comes from the countries of the US, the UK and Japan. Their technological know-how and managerial skills can help improve the efficiency of Australian industry and aid the long term growth of the economy. Overseas firms establishing new subsidiaries will directly add to employment and contribute to increased taxation revenue for the government. A large percentage of the profits of these firms are also retained and invested back into the enterprise.

Foreign investment in the form of portfolio investment can be short term and speculative, and therefore may be destabilising. While direct investment has the advantage of being fairly long term, portfolio investment could be withdrawn at any time. This was evident in 2019 and 2020 when portfolio investment was negative. The general state of the economy, the level of interest rates, government stability and the performance of the share market are all factors affecting short term capital movements. Portfolio investment is a function of short term profitability and is highly sensitive to relative interest rates. The interest rate differential between Australia and the rest of the world plays an important role in the movement of portfolio investment in and out of the Australian economy. When interest rates in Australia rise relative to the rest of the world, then capital inflow in the form of portfolio investment increases.

The costs of foreign investment are associated with the supposedly twin 'evils' of foreign ownership and foreign debt. When most capital inflow was in the form of equity, the major concern was the 'selling' of Australian assets. Foreign control, it was argued, might conflict with government economic policy, and profits would be siphoned back to the parent company. Foreign equity investment into Australia has declined in recent decades being replaced by borrowing. Foreign debt has now become one of the media's favourite 'scare bears' but remember that it is the twin side of foreign investment. If foreign investment is seen as a benefit to the economy, then so must foreign debt – they are two sides of the same coin. It is a fact that interest payments on foreign debt have become the largest debit item in the income category of the current account. But as long as the foreign investment boosts Australia's future productive capacity, then the servicing of the debt is not a problem.

Worksheet 1 - foreign liabilities

1. Explain the difference between foreign investment and domestic investment.
2. Explain the link between foreign investment and Australia's I - S gap.
3. Distinguish between Australia's foreign liabilities and foreign assets. Which is larger?
4. Explain what is meant by Australia's net international investment position.
5. What was the size of Australia's net foreign liabilities in 2020?
6. Distinguish between the two types of foreign liabilities.
7. What is Australia's largest foreign liability?

 ISBN 978-1-875313-62-4

8. Explain why Australia's net foreign liabilities have decreased over the past decade.
9. Why is Australia's net foreign equity liability negative?
10. What proportion of Australia's net foreign debt is held by the private sector?
11. Explain the link between the current account and foreign liabilities.
12. Why have the servicing costs of Australia's foreign debt, measured as a per cent of Australia's exports, been falling over time?
13. Why is private debt considered to be superior to public debt?
14. What effect will the COVID-19 pandemic have on the government's share of foreign debt?
15. What has happened to Australia's net worth over time?
16. Discuss three costs associated with incurring foreign debt?
17. Discuss three benefits associated with incurring foreign debt?

Multiple choice 1

Select the best answer to the following questions.

1. In the short term, large amounts of foreign investment into Australia will
   a. increase the current account balance, appreciate the dollar and lower exports.
   b. increase the financial account balance and lower exports.
   c. appreciate the dollar, increase exports and reduce imports.
   d. increase the current account balance by boosting exports.

2. The difference between gross foreign debt and net foreign debt is that
   a. gross foreign debt includes both private and government debt.
   b. gross foreign debt excludes Australian lending to overseas residents.
   c. net foreign debt is the difference between gross debt and gross equity.
   d. net foreign debt excludes government borrowings.

3. One main difference between Australia's level of foreign debt and other countries is
   a. Australia has a higher share of government debt relative to private sector debt.
   b. Australia has a smaller share of government debt relative to private sector debt.
   c. Australia's foreign debt is used to fund government infrastructure.
   d. Australia's foreign debt is used to fund government budget deficits.

4. Most of Australia's foreign debt is owed by
   a. the official sector (government).
   b. private households.
   c. private enterprises.
   d. government enterprises, for example the ABC or Australia Post.

5. The main cause of the surge in Australia's foreign debt can be directly attributed to
   a. the floating of the AUD.
   b. the decline in the terms of trade.
   c. the setting of fiscal and monetary policy by the government.
   d. the increase in the current account deficit.

6. Which one of the following would result from Australian companies increasing their overseas borrowing?
   a both the current account deficit (CAD) and the capital & financial account surplus will fall.
   b both the CAD and the capital & financial account surplus will rise.
   c. the capital & financial account surplus will rise, but the CAD will not be affected.
   d. the CAD will increase, but the capital & financial account surplus will not be affected.

7. To reduce the foreign debt, exports need to increase relative to imports. Which one of the following would not be appropriate?
   a. Increasing the productivity of workers.
   b. Decreasing aggregate demand in the economy.
   c. Increasing government spending in the economy.
   d. Increasing savings in the economy.

8. Which of the following would reduce Australia's foreign debt?
   a. An increase in the Commonwealth budget deficit.
   b. An increase in the level of foreign investment into the Australian economy.
   c. An increase in the current account deficit.
   d. An increase in the rate of domestic saving.

9. The largest component of Australia's foreign debt is
   a. interest payments to overseas lenders.
   b. borrowing by the government sector.
   c. borrowing by the private sector.
   d. borrowing by the household sector.

10. An increase in foreign debt could be viewed as advantageous for an economy if
    a. the borrowing raises the country's level of consumption.
    b. the borrowing is used to retire previous debt.
    c. the borrowing increases a country's productive capacity.
    d. the borrowing is used to pay the welfare costs of a recession.

11. If Australia runs a current account deficit, then this must be financed by
    a an increase in Australia's foreign debt.
    b an increase in Australia's foreign equity liabilities.
    c. either an increase in foreign debt or foreign equity.
    d. an increase in government borrowing.

12. Which of the following will reduce Australia's foreign debt if it is denominated in foreign currency?
    a. An appreciation of the Australian dollar.
    b. A worsening of the terms of trade.
    c. A slowdown in world economic growth.
    d. An increase in Australian interest rates relative to interest rates overseas.

13. Which of the following statements regarding Australia's net foreign liabilities is correct?
    a. Foreign equity is preferred to foreign debt because it is more flexible.
    b. Australia's net foreign liabilities are decreasing over time.
    c. Foreign debt does not require an income payment.
    d. Most of Australia's net foreign liabilities are in the form of net foreign debt.

14. Australia's net foreign debt exceeds its net foreign liabilities because
    a. Australia's net foreign equity has become larger than its net foreign debt.
    b. Australia borrows more funds from overseas than it lends.
    c. Australia records a financial account surplus.
    d. Australia now has a net foreign equity asset position.

15. Which of the following is likely to decrease the level of Australia's foreign debt?
    a. A cyclical increase in the government's budget deficit.
    b. An increase in the domestic savings rate.
    c. A depreciation of the Australian dollar.
    d. An increase in the level of consumption.

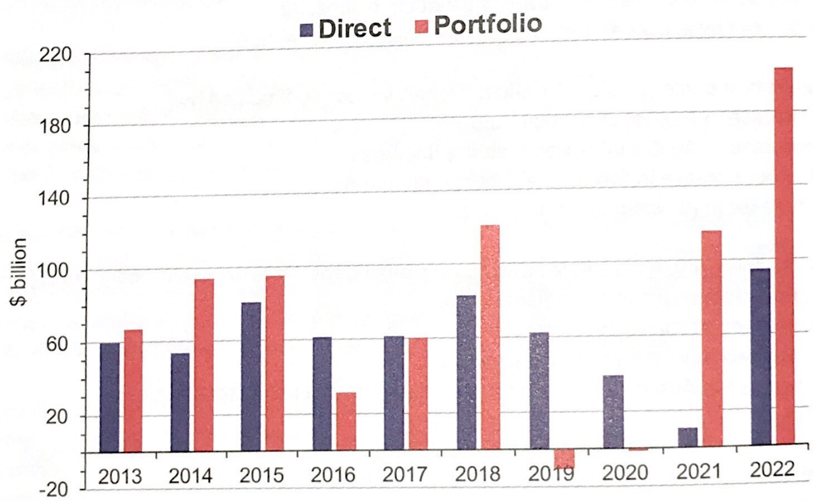
 ISBN 978-1-875313-62-4

Worksheet 2 - foreign investment

1. Define foreign investment and explain how it is different from domestic investment.
2. What forms can foreign investment take?
3. Why is Australia a net importer of capital?
4. Distinguish between direct and portfolio investment. Give examples of each.
5. What are the benefits of foreign direct investment; of portfolio investment?
6. Explain the link between foreign investment, foreign ownership and foreign debt.
7. Explain the difference between the flow of foreign investment in any one year and the level or stock of foreign investment.
8. What proportion of the total stock of foreign investment is made up of borrowing; of equity?
9. Who are the main source countries of foreign investment into Australia?
10. Which industry attracts most foreign direct investment?
11. What factors attract foreign investment to the Australian economy?
12. Outline the benefits and costs associated with foreign direct investment.

Data interpretation

Refer to the graph below showing the flow of foreign investment into Australia.



Questions

1. Distinguish between foreign direct and foreign portfolio investment.
2. Provide an example of direct investment and portfolio investment.
3. What was the value of direct and portfolio investment in 2022?
4. Which type of foreign investment is usually more volatile? Explain why.
5. Outline two factors that would cause an increase in direct investment?
6. Outline two factors that cause an increase in portfolio investment?
7. In which years did direct investment exceed portfolio investment?
8. Describe and explain the change in foreign investment after 2020.
9. Explain why direct investment is viewed as more beneficial to the economy than portfolio investment.

 ISBN 978-1-875313-62-4

Economics in the news

Australia 'better off' with large foreign debt

A Queensland economist says Australia's expanding foreign debt is boosting national income. Griffith University economist Tony Makin says the national debt has been put to good use by helping to expand productive capital stock. Professor Makin says foreign investment has generated billions of dollars over the past decade. "The servicing costs on the foreign debt is less than the extra production (GDP) that it generates, so that's making us better off," he said. "The capital inflow over the past 10 years has generated about an extra $100 billion worth of national income." He says Australia's foreign debt has now increased to over $1,100 billion due to the inflow of foreign investment.

Concerns about growing foreign debt

In 2022 Australia recorded a current account surplus with falling net foreign liabilities. Despite this, Australian was still in hock to the world, with the nation's net foreign liabilities equal to 37 per cent of the economy's yearly output. Foreign ownership ... brings in foreign capital, foreign innovation, foreign management techniques, world's best practice, but ... there's also a negative side - the fact that you always have to pay back profits and dividends to overseas owners and that will increase the income deficit.

Foreign debt & the current account

Why do the media get so excited about Australia's foreign debt? If Australia records a trade deficit (where the cost of imports exceeds the receipts from exports), then when added to the interest and dividends paid to foreigners you will get a deficit on the "current account" of the balance of payments. Although in recent years, Australia has been recording large trade surpluses which has reduced the current account deficit and for the years 2020-2022 actually pushed it into a surplus. When Australia records a current account deficit it has to be financed either by borrowing from foreigners (foreign debt) or by foreigners investing in the ownership of Australian businesses (foreign equity). Foreign savings flowing into Australia equates to the financial account surplus. Over time, the accumulation of current account deficits increases the stock of foreign liabilities. All of Australia's liabilities are now in the form of debt. Who owes this debt? The Australian economy - some of it is owed by individuals, some by the government, but most of it is owed by the business and financial sector – large companies and banks. Should we be worried? No, Because Australia has always 'imported' foreign savings to supplement our small pool of domestic savings. This means that Australia has always relied on foreign investment to develop our resources and industries.

Questions

1. Why is Australia 'better off' with foreign debt?
2. Explain the link between the current account balance and the level of foreign debt.
3. Why does Australia normally record a current account deficit?
4. Why will a current account surplus result in falling net foreign liabilities?
5. Why does foreign investment increase the income deficit in the balance of payments?
6. How is a current account deficit financed?
7. What are the positives of foreign investment?
8. Why do some analysts see an increase in the foreign debt as a problem but others see it as a benefit?
9. Who owes Australia's foreign debt?
10. Australia's net foreign debt is now over $1,100 billion. Should we be worried?

Foreign direct investment

Australia accesses foreign saving through either borrowing (debt) or greater foreign ownership of Australian business (equity). For official measurement purposes, Foreign direct investment (FDI) is regarded as an equity interest of 10 per cent or more in an enterprise. It is important not to confuse FDI with investment. The latter reflects expenditure associated with the creation of new fixed assets (both related to equipment and machinery and to buildings and infrastructure).

FDI can be directed towards the purchase of existing or new assets and the resultant expansion of the physical capital stock. Total foreign investment usually makes up between 10 and 20 per cent of all investment in Australia. Foreign direct investment is a relatively small source of funds - accounting for around 8 per cent of total fixed capital expenditure. The most important characteristic of FDI — which distinguishes it from foreign portfolio investment — is that it is undertaken with the intention of exercising control over an enterprise in another country.

The key benefits of FDI relate directly to the advantages possessed by the foreign direct investing enterprises. Key benefits associated with FDI, apart from the flow of capital itself and the wealth and jobs it creates, include:

- Improvements in management, product design, adoption of new technologies
- Increased likelihood of re-investment
- Improvements to export propensity

As a large, resource rich country with relatively high demand for capital, Australia has, for over two centuries, relied on foreign investment to meet the shortfall of domestic savings against domestic investment needs. Foreign capital has allowed the Australian people to enjoy higher rates of economic growth, employment and a higher standard of living than could have been achieved from domestic savings alone. Foreign direct investment is normally regarded as amongst the most stable forms of capital inflow because it generally involves a substantial commitment from the investor in acquiring business facilities and hiring staff, whereas debt finance and portfolio investment can be recalled relatively quickly. Also the return to direct investment is dependent on profitability unlike debt finance where the capital and interest must generally be repaid, regardless of performance.

FDI brings with it increased competitiveness, through exposing local management to international standards and best practices, and through technological benefits associated with the establishment of new businesses, or the modernisation of old ones.

Article

The questions refer to the excerpt on foreign direct investment above

1. How does Australia access foreign saving?
2. Clearly explain the difference between FDI and domestic investment.
3. What proportion of total fixed capital expenditure is accounted for by FDI?
4. Why does Australia rely on foreign investment?
5. Why is FDI regarded as one of the more stable forms of capital inflow?
6. Outline some of the benefits of FDI.

Multiple choice 2

1. Foreign investment is considered desirable for the Australian economy because it reduces
   a. Australia's reliance on domestic savings.
   b. the stock of investment funds held overseas.
   c. the competitiveness of overseas based firms.
   d. Australia's budget deficit.

2. If the level of foreign investment in Australia increases relative to Australian investment abroad then
   a. the level of Australia's foreign debt must increase.
   b. Australia must sell assets to foreigners.
   c. the capital and financial account surplus in the balance of payments must increase.
   d. the Australian dollar will depreciate.

3. Foreign investment in Australia covers transactions which
   a. increase or decrease Australia's foreign financial assets.
   b. increase or decrease Australia's foreign liabilities.
   c. increase or decrease Australia's foreign debt.
   d. increase or decrease Australia's level of international reserves.

4. Increased direct foreign investment in the Australian iron ore industry would be recorded initially 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.

5. Which of the following is most likely to increase the level of Australia's foreign debt in the short term?
   a. an appreciation of the Australian dollar.
   b. a fall in the proportion of income saved by households.
   c. an increase in the Federal Government budget surplus.
   d. a fall in the current account deficit.

6. One major disadvantage of portfolio investment is that it can
   a. lead to a depreciation of the currency.
   b. result in a deficit on the financial account.
   c. be speculative and destabilising.
   d. reduce the level of direct investment.

7. An important difference in meaning between 'foreign investment' and 'investment' is
   a. investment increases the productive capacity of the economy whereas foreign investment is purely speculative.
   b. foreign investment is a flow of funds which may be used to finance investment.
   c. foreign investment is affected more by interest rates than investment.
   d. investment is the purchasing of capital goods whereas foreign investment is the purchasing of assets.

8. In the short term, a rise in real interest rates in Australia could be expected to, ceteris paribus,
   a. cause increased levels of overseas investment in Australia and an appreciation of the AUD.
   b. cause increased levels of overseas investment in Australia and a depreciation of the AUD.
   c. cause decreased levels of overseas investment in Australia and a depreciation of the AUD.
   d. have no effect on the levels of overseas investment in Australia or the exchange rate.

9. Foreign investment differs from foreign debt as
   a. foreign debt involves a foreign entity gaining greater than 10% of the ownership of an Australian firm.
   b. foreign investment is recorded on the capital and financial account whereas foreign debt is recorded on the current account.
   c. foreign investment is more likely to be associated with the transfer of new technology and management practices.
   d. foreign investment is less likely to result in a loss of ownership of Australian resources.

10. The largest type of foreign investment in Australia is ________ while the most beneficial type of foreign investment is ________ .
    a. portfolio; direct.
    b. direct; portfolio.
    c. portfolio; financial derivatives.
    d. direct; reserve assets.

11. Foreign investment is a benefit to the Australian economy because it
    a. increases the level of net foreign liabilities.
    b. allows Australia to make up the shortfall in domestic savings.
    c. reduces interest payments in the income category of the current account.
    d. leads to a depreciation in the currency.

12. ___________ investment is the flow of funding provided by an investor to establish or acquire a foreign company or to expand or finance an existing foreign company that the investor owns or controls.
    a. International portfolio.
    b. International capital.
    c. Foreign direct.
    d. Foreign indirect.

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 when writing your answer.

1. What are Australia's foreign liabilities? Explain why they occur and how they are linked to the balance of payments. [20 marks]

2. a. Define the term 'foreign investment'. Explain why foreign investment is important to the Australian economy. [10 marks]

   b. Identify and discuss the factors which influence the level of foreign investment in Australia. [10 marks]

3. a. Describe the extent of, and recent trends in Australia's foreign direct investment and foreign debt. [10 marks]

   b. Discuss the benefits and costs of foreign direct investment and foreign debt to Australia. [10 marks]

4. a. Distinguish between Australia's foreign assets and foreign liabilities and explain why Australia has a relatively high level of net foreign liabilities. (10 marks)

   b. What is foreign direct investment? Evaluate the benefits and costs of foreign direct investment to the Australian economy. (10 marks)