AUSTRALIA’S PLACE IN THE

GLOBAL ECONOMY

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Australia’s Place in the Global Economy
The Link Between Internationalisation and Globalisation

In the 1980s Australia became more internationalised and integrated with the global economy through a series of government policy induced changes. These changes were designed to increase Australia’s trade share of GDP and to modernise the economy by making it more open to international trade and internationally competitive:

• In 1983 the Australian financial system was deregulated and the exchange rate was floated. Financial deregulation led to much greater accessibility of Australian firms to world capital markets and reduced the cost of exporting, although it also increased the volatility of the exchange rate, because of changes in Australia’s international trade and economic performance.

• In the 1980s, 1990s and 2000s the Australian government reduced the levels of protection of Australian industry through cuts to tariffs, subsidies, local content schemes and quotas. This encouraged Australian manufacturers to export to the world market.

• Globally, the Australian government participated in international trade forums such as the Cairns Group of countries to secure better market access for Australian agricultural exports. In the World Trade Organisation (WTO) the USA and EU agreed to cut their agricultural subsidies after the Uruguay Round of GATT was completed in 1994. In the Asia Pacific Economic Co-operation (APEC) forum, Australia played an important role in negotiations with member countries who agreed to reduce their trade barriers by 2020 through the signing of the Bogor Declaration by APEC members in 1994 in Bogor, Indonesia.

Major market induced changes also occurred in the 1990s with a more integrated global economy based on increasing economic integration between countries through greater trade liberalisation leading to rapid globalisation. This was also underpinned by new information and communications technologies (ICT) and the increasing conduct of electronic commerce.

In the 2000s the global resources boom and China’s increasing demand for resources greatly influenced Australia’s trade pattern, its terms of trade and the exchange rate. The Australian government also negotiated bilateral trade agreements with the USA, ASEAN, Korea, Japan and China to strengthen trade relationships and signed the regional Trans Pacific Partnership Agreement (TPP) in 2015.

Trends in the Value and Composition of Australia’s Trade Pattern

The Australian economy has become more internationalised over time, with exports and imports of goods as a percentage of GDP (i.e. the level of trade intensity) rising from 12% of GDP in the mid 1980s to 21% of GDP by 2017-18. The total value of exports of goods was $315,031m in 2017-18. The value of goods exports was 7.8% higher in 2017-18 than in 2016-17 mainly due to a 12% increase in the value of mining exports from $178,978m to $200,358m as commodity prices recovered in the second half of 2017. The value of rural exports in 2017-18 rose by only 1% to $47,075m because of drought. The total value of imports of goods in 2017-18 was -$302,901m consisting of consumption, capital and intermediate goods as shown in Table 1. Australia recorded a large surplus in the goods balance of $12,130m in 2017-18 as the

*Australia’s Place in the Global Economy*
total value of exports ($315,031m) exceeded the total value of imports (-$302,901m). Rural exports were 14.9% of total exports in 2017-18 and mining exports were 63.6% of total goods exports in 2017-18 due to higher commodity prices for coal and iron ore. Manufactured exports were 21.5% of total goods exports in 2017-18. Australia has a diverse export base of rural, mining and manufactured goods in its trade pattern, helping to sustain export income for the Australian economy.

Another feature of Australia’s trade is the strong recovery in service exports between 2012 and 2018. In 2017-18 Australia exported services worth $85,635m, an increase of $16,430m or 21.9%, from 2016-17. Service exports grew between 2012-13 and 2017-18 due to stronger global growth and the impact of a lower exchange rate increasing competitiveness. Service exports include freight, transport, travel, tourism, education, communications, finance, business and insurance.

Imports of services grew strongly in 2017-18 by $16,430m to -$91,546m as domestic growth strengthened to nearly 3%, increasing the demand for imports. Service imports include freight, travel, tourism, education, communications, transport and business. The net services deficit rose from -$1,654m in 2016-17 to -$5,911m in 2017-18 as service exports (16.6%) grew by less than service imports (21.9%).

The total value of exports of goods and services in 2017-18 was $400,666m, consisting of $315,031m of goods and $85,635m of services. The composition of Australia’s exports of goods and services in 2017-18 is shown in Figure 1. Rural exports were 11.7% of the total, with mining’s share a massive 50%, manufacturing’s share at 16.9%, and the services share at 21.4% of the total.

Australia imports consumption (e.g., food, beverages, clothing, footwear and cars), capital (e.g., machinery, industrial and transport equipment and computers) and intermediate goods (e.g., parts, fuels, chemicals, textiles, plastics and paper) used in...
the production of other goods. The total value of imports of goods and services was -$394,447m in 2017-18 (-$302,901m of goods and -$91,546m of services).

The composition of Australia’s imports of goods and services in 2017-18 is shown in Figure 2. Consumer goods were 26% of the total, with intermediate goods at 32.1%, capital goods at 18.7% and services at 23.2%. Australia’s imports of capital goods surged during the mining investment boom as Australia relies on imported capital goods to mine, excavate and transport minerals, coal and iron ore to ports for export to world markets, particularly to Asian countries such as China, Japan, Korea and ASEAN.

Australia recorded a surplus in goods and services of $6,219m in 2017-18 because the value of exports of goods and services ($400,666m) exceeded the value of imports of goods and services (-$394,447m).
Trends in the Direction of Australia’s Trade Pattern

Asian countries accounted for 77.4% of exports in 2017-18 (China 33.5%, Japan 15.3%, ASEAN 10.4%, Korea 6.6%, India 5.1%, Hong Kong 3.6% and Taiwan 2.9%). The Pacific Rim countries of the USA (3.7%) and New Zealand (2.9%) accounted for 6.6% of Australian exports in 2017-18. Together Asian and Pacific Rim countries accounted for 84% of Australian exports in 2017-18, with the EU accounting for a further 5.6% of exports.

China is Australia’s number one export market with 33.5% of total exports in 2017-18, having surpassed Japan (15.3% of total exports) in 2009-10. In third position as an export market in 2017-18 was the Association of South East Asian Nations (ASEAN), with a 10.4% share of Australia’s exports. Korea (6.6%), India (5.1%), the USA (3.7%), Hong Kong (3.6%) and Taiwan (2.9%) were also key export markets in 2017-18.

Figure 3 shows the major destinations for Australia’s exports in 2017-18 according to major region or country:

- North East Asia includes China, Japan, Korea, Taiwan and Hong Kong, which accounted for 61.9% of exports in 2017-18. This is largely due to the recommendations of the Garnaut Report (1989), Australia and the NE Asian Ascendancy, which the Hawke government implemented. For example, China’s export share rose from 14.9% in 2007-08 to 33.5% in 2017-18 because of its large demand for Australian mineral and agricultural resources.

- A further 10.4% of exports went to the ten ASEAN countries; 5.6% to the EU, 5.1% to India, 3.7% to the USA; and 13.3% to other markets in Asia, Europe, the Middle East, South America, Africa and the Pacific.

Source: ABS (2018), International Trade in Goods and Services, Catalogue 5368.0, June. Table 14a
In terms of imports, China (22.5%), the European Union (17.9%) and ASEAN (15.7%) were the most important sources of Australian imports in 2017-18 as shown in Table 2. Singapore, Thailand, Malaysia and Indonesia were the most important export markets and sources of imports in ASEAN for Australia in 2017-18.

Within the EU, Britain, Italy, Germany, Holland and France had the highest trade shares for both exports and imports in 2017-18. Next in importance as sources of Australian imports in 2017-18 were the USA (9.9%), Japan (7.3%) and Korea (7.2%).

Figure 4 shows the major sources of Australian imports in 2017-18 by region or major country. North East Asia (38.6%), the EU (17.9%) and ASEAN (15.7%) were the major sources of Australian imports in 2017-18. China (22.5%) was the single most important country for imports, followed by the USA with 9.9% of imports. China and the ASEAN countries are major sources of low cost Australian manufactured imports. The USA and countries in the EU are major sources of finished consumption goods and capital goods.

### Table 2: Merchandise Trade Shares by Selected Countries and Country Groups 2017-18

<table>
<thead>
<tr>
<th>Annual Australian Exports (% of total)</th>
<th>Annual Australian Imports (% of total)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASEAN</td>
<td>ASEAN</td>
</tr>
<tr>
<td>10.4</td>
<td>15.7</td>
</tr>
<tr>
<td>China</td>
<td>China</td>
</tr>
<tr>
<td>33.5</td>
<td>22.5</td>
</tr>
<tr>
<td>European Union</td>
<td>European Union</td>
</tr>
<tr>
<td>5.6</td>
<td>17.9</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>Hong Kong</td>
</tr>
<tr>
<td>3.6</td>
<td>0.2</td>
</tr>
<tr>
<td>India</td>
<td>Japan</td>
</tr>
<tr>
<td>5.1</td>
<td>7.3</td>
</tr>
<tr>
<td>Japan</td>
<td>New Zealand</td>
</tr>
<tr>
<td>15.3</td>
<td>2.6</td>
</tr>
<tr>
<td>Republic of Korea</td>
<td>Republic of Korea</td>
</tr>
<tr>
<td>6.6</td>
<td>7.2</td>
</tr>
<tr>
<td>Taiwan</td>
<td>Taiwan</td>
</tr>
<tr>
<td>2.9</td>
<td>1.4</td>
</tr>
<tr>
<td>United States of America</td>
<td>United States of America</td>
</tr>
<tr>
<td>3.7</td>
<td>9.9</td>
</tr>
</tbody>
</table>


Figure 4: Sources of Australian Imports in 2017-18

Source: ABS (2018), *International Trade in Goods and Services*, Catalogue 5368.0, June. Table 14b
The growth in Australia’s export and import merchandise trade over time has been due to greater trade intensity (i.e. the ratio of exports and imports to GDP); trade liberalisation within the Asia Pacific region under WTO, APEC, AANZFTA and TPP agreements; and bilateral free trade agreements with Australia’s major trading partners such as the USA, Singapore, Thailand, Korea, Japan and China.

Figure 5 from the Productivity Commission (2017) lists the major recent developments in Australian trade policy including multilateral, plurilateral, regional and bilateral forums and agreements.

Figure 5: Recent Developments in Australia’s Trade Policy
US-China Trade Tensions

Since January 2018, a sequence of US tariff actions on solar panels, washing machines, steel, aluminium and a range of Chinese products plus retaliation by trading partners has complicated global trade relations. In June 2018 the USA announced a 25% tariff on imports from China worth US$50b and China announced retaliation on a similar scale. In September 2018 the USA imposed a 10% tariff on an additional US$200b in imports from China. In response, China announced tariffs on a further US$60b of US imports. Meanwhile the preliminary agreement between the USA and Mexico on some bilateral trade issues has been a step forward. However the future of the trilateral North American Free Trade Agreement (NAFTA) remains uncertain as the United States and Canada work to resolve remaining issues.

Whilst the global economic outlook remains positive, conditions vary across economies. In most advanced economies spare capacity is likely to diminish in 2019 as growth rates strengthen and unemployment rates continue to fall. Some labour markets have tightened and there has been a slight rise in wages growth which will help to underpin consumption spending. This is likely to lead to an increase in global inflation and a gradual tightening of monetary policies. However trade tensions between the USA and some of its major trading partners such as China, the EU, Canada and Mexico will weigh on growth prospects for the global economy.

More US-China tariff measures came into effect in late 2018 and trade restrictions appear to be having a negative effect on export orders for some economies. The possibility of trade tensions escalating further would mean that other economies and business investment decisions are affected. For example, in East Asia growth has been moderate but could be adversely affected in 2019 because the region is important in global supply chains. It is in the interest of all countries that make up the world economy for the USA and China to resolve their trade differences through negotiations rather than by imposing more protection on imports from each other. Refer to the Appendix on pages 21-22 for the latest details.

Chinese growth forecasts for 2019 have been downgraded as the trade conflict with the USA is expected to reduce Chinese export growth. The US government plans further tariff rate increases if trade negotiations with China do not lead to a resolution of the dispute. The US government has already re-negotiated the US-Mexico-Canada trade agreement on more favourable terms to the USA. It is also having trade discussions with Japan and the European Union to resolve policy differences over trade matters.

With Trump dissatisfied with the lack of progress in trade negotiations between the USA and China he announced a further increase in tariffs on $US200b worth of Chinese goods on May 11th 2019. The increase in tariffs was from 10% to 25% covering a wide range of Chinese imports such as pet food, mattresses, soldering irons, chemicals, woven fabrics and bicycles. This would have the following effects:

- Further raising the price of Chinese imports to American consumers
- Raising the cost of imported intermediate goods for US businesses
- Creating further uncertainty over investment in trade
- Forcing some US businesses to shift their production to lower lower cost countries such as Vietnam and Cambodia
- Disruption of regional supply chains

Australia’s Place in the Global Economy
The World Trade Organisation’s forecast for global trade is an expansion of 3.4% in 2019. This is down from 3.8% in 2018 and 5.4% in 2017 (see Figure 6) as US-China trade tensions undermine world output, trade and investment prospects. These forecasts are far below the average 7% annual growth in world trade in goods and services achieved between 1987 and 2006 when globalisation led to faster average growth in world trade compared to the growth in world output or GDP (average 3.7% per annum). Much of this growth in trade was driven by China and other emerging Asian economies which pursued export oriented growth strategies.

However deep uncertainty about short term economic and policy developments particularly in the USA, Britain and Euro Area with a rise in protectionist and anti-immigration sentiment raise risks that this figure may not be achieved. The unpredictable direction of the global economy in the near term and lack of clarity about government action on monetary, fiscal and trade policies raises the risk that trade activity will be stifled. A spike in inflation leading to higher interest rates, tighter fiscal policies and the imposition of measures to curtail trade could all undermine higher trade growth over the next two years. According to WTO Director General, Roberto Azevedo:

"Weak international trade growth in the last few years largely reflects continuing weakness in the global economy. Trade has the potential to strengthen global growth if the movement of goods and supply of services across borders remains largely unfettered. However, if policymakers attempt to address job losses at home with severe restrictions on imports, trade cannot boost growth and may even constitute a drag on the recovery. Although trade does cause some economic dislocation in certain communities, its adverse effects should not be overstated - nor should they obscure its benefits in terms of growth, development and job creation.

Trade is part of the solution to economic difficulties, not part of the problem. In fact, innovation, automation and new technologies are responsible for roughly 80% of the manufacturing jobs that have been lost and no one questions that technological advances benefit most people most of the time. The answer is to pursue policies that reap the benefits from trade, while also applying solutions to unemployment which embrace education and training to help workers compete for the jobs of the future."

Australia’s Place in the Global Economy
Australia’s Balance of Payments

The balance of payments is a record of all transactions between Australian residents and the rest of the world. It consists of three main accounts:

1. The current account records items of a current nature such as exports, imports, net primary income and net secondary income.
2. The capital account records items associated with foreign aid, migrants' funds and workers' remittances.
3. The financial account records items that are long term in nature such as portfolio and direct investment, financial derivatives, other investment, and changes in the Reserve Assets held by the Reserve Bank of Australia.

The Australian Bureau of Statistics (ABS) classifies Australia’s exports of goods into the categories of rural goods (such as meat, cereals and wool), non rural goods (such as mining and manufactured goods), and other goods including non monetary gold. Australia exported goods to the value of $315,031m in 2017-18.

Australia imported goods in 2017-18 valued at -$302,901m. Since imports represent a leakage out of the circular flow of income they are recorded as debits in the balance of payments by the ABS and are given a negative sign. Imports of goods are classified by the ABS in the following three categories:

1. Consumption goods include food, beverages, electrical and transport equipment, textiles, clothing and shoes and other consumption goods.
2. Capital goods include machinery and industrial equipment, all data processing (ADP) equipment and other capital goods.
3. Intermediate goods include parts, fuels, lubricants, plastics and paper used in the production of other goods.

There was a large surplus in the goods balance of $12,130m in 2017-18 as shown in Table 3. Exports and imports of services include freight, travel and tourism, education and business services. The net services balance was deficit of -$5,911m in 2017-18. The goods and services balance is calculated by adding the goods balance to the net services balance and this was a surplus of $6,219m in 2017-18.

| Table 3: Australia’s Goods and Services Balance 2015-16 to 2017-18 |
|-----------------|-----------------|-----------------|
|                 | 2015-16         | 2016-17         | 2017-18         |
| Goods Balance   | -$27,827m       | $13,819m        | $12,130m        |
| Net Services    | -$9,071m        | -$1,654m        | -$5,911m        |
| Goods and Services Balance | -$36,898m | $12,165m | $6,219m |

Net Primary and Secondary Income

Financial flows recorded in the current account of the balance of payments include net primary income and net secondary income. Net primary income is calculated as credits less debits of income received and paid, mainly due to the servicing cost of direct, portfolio and other investment and includes dividends, interest and profits. Australia has a large inflow of foreign investment and therefore the servicing cost of these overseas borrowings in terms of income remitted overseas is larger than the income received from Australian investment overseas.

Therefore Australia tends to have a large net primary income deficit in the current account of the balance of payments. This deficit forms the underlying or structural base of the current account deficit since Australia borrows foreign saving to finance much of its domestic investment. This is especially the case in the mining industry which has a very high level of foreign investment and foreign ownership.

In 2017-18 the net primary income deficit was -$59,064m and accounted for all of the current account deficit of -$54,123m. Net secondary income is calculated as credits less debits associated with government transfers such as foreign aid, the personal transfers of migrants (such as pensions) and workers remittances of wages to their families. In 2017-18 net secondary income was a small deficit of -$1,278m.

The Current Account Balance

The current account balance in 2017-18 was a deficit of -$54,123m which represented -2.5% of GDP. This meant that the current account deficit was largely sustainable and not a constraint to Australia’s rate of domestic economic growth since the growth in national income was sufficient to service the cost of foreign borrowings which is represented by the size of the current account deficit measured as a percentage of GDP. The main components of Australia’s current account in 2017-18 are shown in Table 4 and Figure 7.

The current account deficit tends to increase when domestic growth is higher than world growth leading to increased imports and a trade deficit. This occurred in 2012-13 at the height of the mining investment boom which led to large imports of capital equipment.

<table>
<thead>
<tr>
<th>Table 4: Australia’s Current Account Deficit in 2017-18</th>
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</thead>
<tbody>
<tr>
<td>Goods Credits</td>
</tr>
<tr>
<td>Goods Debits</td>
</tr>
<tr>
<td>Goods Balance</td>
</tr>
<tr>
<td>Net Services</td>
</tr>
<tr>
<td>Net Primary Income</td>
</tr>
<tr>
<td>Net Secondary Income</td>
</tr>
<tr>
<td>Balance on Current Account</td>
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</tbody>
</table>

The current account deficit tends to decrease when world growth exceeds domestic growth and strong export demand leads to higher export earnings and a trade surplus as in 2016-17 and 2017-18 when there was a large goods and services surplus.

**Australia’s Financial Flows**

Australia’s financial flows primarily refer to Australian debt and equity borrowings from foreign residents. Financial flows are associated with direct and portfolio investment flows, financial derivatives, other investment (such as loans) and changes in the Reserve Assets of the Reserve Bank of Australia. Financial flows are recorded in the capital account and the financial account of the balance of payments. They are also recorded by the ABS as changes in the stock of net foreign debt and equity.

The capital account records credits and debits for the acquisition and disposal of non produced and non financial assets such as net capital transfers of foreign aid and net capital brought into Australia by migrants. The capital account balance is usually a small deficit and in 2017-18 it was -$689m.

The financial account records credits and debits for transactions associated with direct and portfolio investment, financial derivatives, other investment (such as loans) and changes in the value of Reserve Assets held by the Reserve Bank of Australia through its foreign currency dealings and its holdings of Special Drawing Rights (SDRs) with IMF.

Since Australia records persistent deficits in the current account they must be financed by recording surpluses in the financial account. Under a floating or flexible exchange rate system, the sum of the current account balance and the capital and financial account balance must equal zero. In other words the current account deficit is financed by a financial account surplus. In 2017-18 Australia recorded a financial account surplus of $52,802m and a deficit in the capital account of -$689m. This resulted in a surplus balance on the capital and financial account of $52,113m.
Net errors and omissions (adjustments made by the ABS for errors and non reporting in the balance of payments) were $2,010m in 2017-18 and when added to the balance on capital and financial account of $52,113m equalled $54,123m which exactly offset the current account deficit of -$54,123m. The capital and financial account balances for 2017-18 are shown in Table 5.

Countries like Australia and the USA which record current account deficits borrow funds from current account surplus countries such as Japan, China and Germany. These countries export capital to deficit countries and record capital and financial account deficits.

**International Account Ratios**

The sustainability of the current account deficit, net foreign debt and net foreign equity are measured by ratios to GDP. The sustainability condition for the current account deficit is that it should be kept to under -5% of GDP so that net primary investment income can be serviced.

If the current account deficit increased to over -5% of GDP this would mean the economy’s growth rate and the rate of increase in national income would not be sufficient to service the net primary income deficit. Therefore more foreign borrowings in the form of foreign debt and foreign equity would have to be undertaken. This would lead to an increase in net foreign liabilities and increase the debt servicing cost on the Australian economy.

In 2017-18 as shown in Table 6 the current account deficit was sustainable at -2.5% of GDP largely because the goods and services balance was in surplus and helped to offset much of the current account deficit. This was due to an improved export performance, especially mining exports.

Net foreign liabilities were $953,430m in 2017-18 consisting of net foreign debt of $1,036,408m and net foreign equity of -$82,978m. Australia’s net foreign equity has

<table>
<thead>
<tr>
<th>Table 5: Australia's Capital and Financial Account Balance in 2017-18</th>
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<tbody>
<tr>
<td>Capital Account</td>
</tr>
<tr>
<td>Financial Account</td>
</tr>
<tr>
<td>- Direct Investment</td>
</tr>
<tr>
<td>- Portfolio Investment</td>
</tr>
<tr>
<td>- Financial Derivatives</td>
</tr>
<tr>
<td>- Other Investment</td>
</tr>
<tr>
<td>- Reserve Assets</td>
</tr>
<tr>
<td>Balance on Financial Account</td>
</tr>
<tr>
<td>Balance on Capital and Financial Account</td>
</tr>
<tr>
<td>Net Errors and Omissions</td>
</tr>
</tbody>
</table>

changed from a net liability to a net asset position in recent years with investment in overseas shares and other assets by superannuation funds and other financial institutions. The stock of net foreign debt represented 55.7% of GDP in 2017-18 and net foreign equity -4.1% of GDP. Net international investment (net foreign liabilities or net debt plus net equity) was 51.6% of GDP.

<table>
<thead>
<tr>
<th>Year</th>
<th>Current Account Deficit</th>
<th>% of GDP</th>
<th>Net Foreign Liabilities</th>
<th>% of GDP</th>
<th>Net Foreign Debt</th>
<th>% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>14-15</td>
<td>$56,979m</td>
<td>-3.6%</td>
<td>$905,996m</td>
<td>56.9%</td>
<td>$976,056m</td>
<td>61.3%</td>
</tr>
<tr>
<td>15-16</td>
<td>$72,828m</td>
<td>-3.8%</td>
<td>$1,035,858m</td>
<td>63.3%</td>
<td>$1,044,505m</td>
<td>63.8%</td>
</tr>
<tr>
<td>16-17</td>
<td>$29,469m</td>
<td>-2.1%</td>
<td>$1,000,264m</td>
<td>59.5%</td>
<td>$990,599m</td>
<td>58.9%</td>
</tr>
<tr>
<td>17-18</td>
<td>$54,123m</td>
<td>-2.9%</td>
<td>$953,430m</td>
<td>52.5%</td>
<td>$1,036,408m</td>
<td>57.1%</td>
</tr>
</tbody>
</table>

**Question 28**  
2018 HSC Examination

Assess the importance of factors that determine the size and composition of Australia’s current account.

- Impact of domestic and global growth on exports and imports
- Terms of trade and competitiveness
- Exchange rate and interest rates
- World interest rates and debt servicing costs
- Savings/investment gap

*Australia’s Place in the Global Economy*
The Exchange Rate

The Australian dollar exchange rate expresses the value of one Australian dollar in terms of other major currencies. These currencies include the US dollar, Japanese yen, euro, Great Britain pound (GBP) and Chinese renminbi (RMB) which are some of the major currencies that make up the Trade Weighted Index (TWI).

The Trade Weighted Index

Aside from bilateral exchange rates such as the $US/$A and euro/$A, the Trade Weighted Index is a measure of the value of the Australian dollar in terms of the trade weighted value of a basket of currencies of Australia’s major trading partners. The value of the TWI and the Australian dollar in terms of the US dollar are calculated and published by the Reserve Bank of Australia each day and are available on its website (www.rba.gov.au).

The weights for the 19 currencies that make up the TWI in 2019 are shown in Table 7. The Chinese RMB has the highest weight (27.71), followed by the Japanese yen (10.92), the European euro (9.73) and the US dollar (9.67). The currencies in the TWI account for over 90% of Australia’s aggregate trade and Asia-Pacific currencies account for the majority of the TWI.

<table>
<thead>
<tr>
<th>Table 7: Weights in the Trade Weighted Index in 2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Japanese yen 10.92</td>
</tr>
<tr>
<td>3. European euro 9.73</td>
</tr>
<tr>
<td>5. South Korean won 5.47</td>
</tr>
<tr>
<td>6. Indian rupee 4.14</td>
</tr>
<tr>
<td>7. New Zealand dollar 4.02</td>
</tr>
<tr>
<td>8. Singapore dollar 3.97</td>
</tr>
<tr>
<td>9. UK pound sterling 3.95</td>
</tr>
<tr>
<td>10. Thai baht 3.52</td>
</tr>
</tbody>
</table>


 Movements in the Australian dollar exchange rate occur daily because the Australian dollar is a freely floating or flexible exchange rate. This means that the market forces of demand and supply determine the value of the Australian dollar against a variety of currencies in the foreign exchange market.

Changes in the TWI basket of currencies is published daily on the Reserve Bank’s website as well as the changes in the value of the Australian dollar against each individual currency in the TWI. This gives a broad and general picture of the Australian dollar’s value or purchasing power each day.

Changes in the Value of the Australian Dollar

Changes in the value of the Australian dollar, especially against the currencies of major trading partners will have an impact on the traded goods sector of the

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Australian economy. This includes the exporters of agricultural and mining products, manufactures and a variety of services such as tourism and education.

The other major part of the traded goods sector are those businesses that compete with imports such as local manufacturers of consumer goods and providers of services such as domestic travel and tourism. The demand for the Australian dollar is largely derived from the demand for Australian exports of goods and services (Xs), and the demand for Australian assets such as Australian equities and bonds and other financial assets such as real estate and derivatives (capital inflow or Ki).

The supply of Australian dollars is derived from the Australian demand for foreign goods and services (imports or Ms) and foreign assets such as equities, bonds and real estate (capital outflow or Ko). In a freely floating or flexible exchange rate system the demand and supply of Australian dollars will determine the equilibrium exchange rate in the foreign exchange market. This is illustrated in Figure 8 where the equilibrium exchange rate of $US0.68 is equal to $A1.00.

For most of 2019 the Australian dollar has been trading at about $US0.70 but more recently has fallen to between $US0.69 and $US0.68 mainly due to lower official interest rates in Australia after the Reserve Bank cut the cash rate to 1.25% in early June 2019. This is the equilibrium point (E) in Figure 8 where the demand for Australian dollars (D$A) equals the supply of $A (S$A) with Q$As traded in the foreign exchange market. In late June 2019 the Australian dollar traded at 4.77 RMB, 74.70 Japanese yen, 0.61 European euro and 59.2 in TWI terms (refer to Table 8). There was a steady depreciation of the Australian dollar against most major currencies and in TWI terms in 2018-19. This helped to support international competitiveness and Australia’s rate of economic growth.

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Appreciation and Depreciation of the Exchange Rate

Movements in the Australian dollar exchange rate in a flexible exchange rate system are known as an appreciation and a depreciation. An appreciation in the exchange rate for example is when the Australian dollar increases in value from US$0.68 to US$0.75 leading to greater purchasing power for Australian consumers in buying foreign imports and cheaper prices for foreign assets by Australian investors.

Although an appreciation of the Australian dollar exchange rate leads to greater purchasing power for Australians in terms of buying foreign goods, services and assets, it also leads to a reduction in international competitiveness. This occurs because Australian exports and assets become more expensive in foreign currency terms and may lead to less foreign demand and lower export earnings for Australian exporters.

At the same time an appreciation leads to foreign imports becoming less expensive for Australian consumers and businesses, who may switch their expenditure from domestically produced goods and services and assets and buy more foreign goods, services and assets. This could lead to lower revenue for Australian businesses that compete with imports. An appreciating exchange rate restricts economic growth because of a lack of competitiveness.

A depreciation in the exchange rate is when the Australian dollar for example decreases in value from US$0.75 to US$0.68 leading to lower purchasing power for Australian consumers in buying foreign imports and assets because they are more expensive in Australian dollar terms.

Although a depreciation of the Australian dollar exchange rate leads to lower purchasing power for Australians in terms of buying foreign goods, services and assets, it also leads to an increase in international competitiveness. This occurs because Australian exports become less expensive or cheaper in foreign currency terms and may lead to greater foreign demand and higher export earnings for Australian exporters.

At the same time foreign imports become more expensive for Australian consumers and businesses who may switch their expenditure from foreign produced goods and services and assets and buy more domestically produced goods, services and assets. This could lead to higher revenue for Australian businesses that compete with imports.

Recent Movements in the Australian Dollar

The most recent movement in the Australian dollar in 2018-19 has been a depreciation. In October 2018 it reached a two and a half year low by trading at US$0.70 after reaching a three year high of US$0.81 in January 2018. This represented a 13% depreciation in the value of the Australian dollar. The Australian dollar fell by around 9% against the US dollar, 5% against the euro and 8% against the Yen in 2018. Overall movements in the value of the Australian dollar between March 2017 and June 2019 are shown in Table 8. In this period there was a trend depreciation in the Australian dollar against the US dollar, Japanese yen, euro, UK pound and in TWI terms. This helped to improve Australia’s competitiveness and

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support domestic economic growth as the economy transitioned to non mining sources of growth such as consumption and services.

Foreign exchange traders view the value of the Australian dollar trading in a narrow band of between $US0.68 and $US0.75 in the future barring any unforeseen shock to the Australian economy from either domestic or global sources. A possible domestic shock could come from a collapse in the housing market and rising household debt. Possible global shocks could occur if China’s growth rate stalls leading to lower demand for Australia’s exports.

So far the Australian dollar’s depreciation has been most noticeable against the US dollar but to a lesser extent against the currencies of our major trading partners. The Australian dollar began to depreciate in early 2018 as the US Federal Reserve began to lift US interest rates and the US dollar began to appreciate against other currencies. Other factors which have contributed to the Australian dollar’s depreciation include the slowdown in Chinese growth and the consequent more pessimistic outlook for Australian exports to China. In domestic terms the Australian economy continues to record positive but below trend growth as wages growth has stalled leading to more subdued domestic demand. At the same time the unwinding of the housing boom and the high level of household debt have constrained domestic spending and growth.

In more detail amongst the major factors contributing to the Australian dollar’s recent depreciation have been the following:

- The release of data on the China’s Purchasing Managers’ Index (PMI) has shown a significant slowing in China’s manufacturing sector. This has implications for imports of iron ore and coal from Australia to China’s large steel industry.

The Chinese government has used an easing in both monetary and fiscal policy to try to sustain Chinese growth but the growth target for 2019 was revised down to around 6.2%, well below China’s average growth of 8% to

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10% over the last decade. Chinese government policies to support growth are in Australia’s interest since they could help to support iron ore and coal prices which would benefit Australian commodity exporters to China.

With a slower projected growth rate and increased trade tensions with the USA, the Chinese RMB has depreciated by about 10% against the US dollar. However the RMB would have depreciated by more if it were not managed by the People’s Bank of China as opposed to a freely floating exchange rate like the Australian dollar. The People’s Bank of China has been selling US dollars and using its foreign exchange reserves to support the RMB to prevent depreciation induced inflation through higher import prices. To some extent the depreciation of the RMB has offset some of the effect of US tariffs on Chinese imports into the USA by maintaining China’s international competitiveness. The RMB has traded at around 7 RMB to the US dollar and 4.77 RMB to the Australian dollar.

- Higher official interest rates in the USA implemented by the Federal Reserve in 2018 were used to dampen inflationary expectations as the US economy recorded above average growth and the unemployment rate fell. This improved economic performance was underpinned by the Trump Administration’s cuts to taxes upon winning office in 2016.

Higher US interest rates have led to higher yields on US Government bonds and this has attracted capital inflow and put upward pressure on the US dollar. A consequence of this has been the depreciation of the currencies of the US’s major trading partners such as the euro, UK pound and Japanese yen.

The Australian dollar as the fifth most traded currency in the world, has also depreciated significantly by around 15% against the US dollar. The Reserve Bank of Australia had held official interest rates previously at 1.5% and the rise in US interest rates widened the interest rate differential between Australia and the USA and other major advanced economies, providing higher returns to investors in US financial assets such as US Treasury bonds.

The widening of the interest rate differential between Australia and the USA has tended to offset the effect of higher commodity prices which would have been expected to result in an appreciating Australian dollar. Since the Australian dollar is heavily influenced by commodity price movements and the terms of trade, these factors have been nullified to a large extent by the widening interest rate differential between Australia and the rest of the world.

- Another factor weighing on the Australian dollar has been the increased trade tensions between the USA and China with the imposition of a 10% increase in US tariffs on $200b worth of Chinese imports and a similar amount on US imports into China. The rise in protectionism has raised import costs in both countries and led to lower export earnings for Chinese and US exporters. It has also started to impact on the growth in world trade and investment by creating uncertainty over the future of free trade.

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Further rises in tariffs could occur if US-China trade negotiations fail to deliver concessions on both sides in resolving trade issues. This especially applies to China as the US is demanding the abandonment of its ‘One Belt One Road’ policy which seeks to project Chinese political and economic power globally and threatens US global economic interests.

The major implication for Australia is the slowing Chinese economy and lower export demand for Australian exporters of commodities, manufactures and services to China. Trade tensions have also impacted on a number of major US technology companies like Apple and Google which rely on China for their supply chains because of manufacturing of components and finished products. Their earnings are projected to fall under Trump’s higher tariff regime.

Overall the recent depreciation of the Australian dollar has been positive in shoring up international competitiveness. The depreciation has been gradual and modest and not led to any upsurge in imported inflationary pressures through higher import prices. There has also been low exchange rate volatility.

Reserve Bank research (2016) suggests that a 10% real depreciation in the exchange rate can lead to a 4% increase in exports in the long run and help to reduce the current account deficit and increase the rate of economic growth.

### HSC Extended Response Questions 2013-18

**Question 25** 2018 HSC Examination

*Assess the extent to which the move towards free trade restricts the Australian Government’s ability to achieve its economic objectives of full employment, distribution of income and external stability. In your response refer to the economic information provided.*

**Question 25** 2017 HSC Examination

Analyse the implications of a decline in global economic activity for Australia’s economic policies. In your response refer to the economic information provided.

**Question 28** 2016 HSC Examination

Analyse the influence of different factors on Australia’s trade and financial flows.

**Question 27** 2015 HSC Examination

Discuss the contributions of international organisations and trade agreements to global economic growth and development.

**Question 27** 2013 HSC Examination

Analyse the effects of domestic AND global free trade and protection policies on the Australian economy.
Appendix: Trade and Technology Disputes between the USA and China Escalate

According to the Reserve Bank (August, 2019):

“The US–China trade dispute has escalated over recent months after negotiations between the two countries stalled. In June, the United States increased tariffs from 10% to 25% on US$200b of imports from China, and China retaliated with higher tariffs on US$60b of imports from the United States. About half of US imports from China are now covered by a 25% tariff rate and most Chinese imports from the United States are covered by 5%–25% tariffs (Graph 1.2); average US tariff rates on Chinese imports are now 12%, which is substantially above those on other US trading partners at around 1%.

More recently, the US administration announced it will impose a 10% tariff on almost all remaining imports from China from 1st September and further tariff increases have been threatened. A decision by the US administration on increasing tariffs on automotive imports from a number of countries has been delayed to November. Trade tensions have broadened in recent months, with some countries using them to address political disputes. For example, the United States threatened, but then suspended, higher tariffs on imports from Mexico in response to a dispute over immigration flows.

The escalation in the trade dispute is weighing on global economic activity. The direct impact of the measures currently in place is relatively small, but the indirect effects of uncertainty on investment have been more significant. The risk of further escalation also poses a major downside risk to global growth, particularly through adverse effects on business investment and confidence more generally, and the potential for amplification through highly integrated global supply chains. Nonetheless, some economies that provide a competitive production alternative to China, such as Vietnam, appear to be benefiting from trade diversion due to the trade dispute.

Graph 1.2
US Tariff Rates on China*
Weighted average bilateral tariff rate

* Excludes steel and aluminium tariffs introduced in 2018
Sources: RBA; World Integrated Trade Solution

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The US–China technology dispute has also escalated in recent months. The United States imposed export and transfer controls that restricted access to key US technologies for certain Chinese entities, particularly targeting advanced semiconductor integrated circuits; the United States is the dominant global producer of advanced circuits. The Chinese Government is reportedly considering controlling exports of rare earth minerals; China is the largest global producer of these minerals, which have various uses in high-technology processes. The economic effects of the technology disputes are uncertain and are likely to play out over a long period."


The reaction of the Chinese government to the latest Trump threat to raise tariffs on more Chinese goods was swift. With Chinese GDP growing by just 6.2% in the June quarter 2019 the weakest growth in nearly 30 years, the People’s Bank of China revealed it was devaluing the yuan or RMB to below RMB7 to the US dollar for the first time. A weaker currency could help China to offset the escalation in tariffs on their imports into the USA. The response of the Trump Administration was this was currency manipulation and unfair. However fears over the escalating trade war in early August (6th - 10th) led to a mass of panic selling on world share markets and the New Zealand government cut interest rates to 1%. On the ASX market capitalisation fell by close to $38b on August 5th when trading opened after the tweet from President Trump about new tariff measures from September 1st 2019.

Former US Treasury Secretary Lawrence Summers said that the world “May well be at the most dangerous financial moment since the 2009 financial crisis.”

The impact on Australia could be profound if China’s growth slows and it demands less resources such as iron ore and coal from Australia as well as tourism and education exports.

**China’s Claims in the South China Sea**

In July 2016 the Permanent Court of Arbitration in the Hague declared that China’s claim to most of the South China Sea was invalid. China has pursued an aggressive policy of building, reclaiming and occupying islands in the Spratly Islands group and claiming sovereignty. The Court found that China’s controversial island building violated neighbouring Philippines’ sovereign rights and the freedom of navigation for other countries in using major commercial shipping lanes in the South China Sea. China rejected the Court’s ruling and has continued its occupation and development of the Spratly Islands including building airstrips and military infrastructure, threatening the security of the region.

In addition it is providing loans to small Pacific island nations to develop their resources and infrastructure. In response the World Bank has cautioned against these small nations from building up foreign debt. China faces the long term challenge of re-balancing its economy away from its previous pattern of investment and export led growth, to more sustainable growth generated by expanding household consumption and the services sector. In order to sustain economic growth of 6.5% to 7% the Chinese government has also pursued a policy of supporting its global SOEs to undertake outward bound foreign investment to secure resource supplies in overseas markets.

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Protests Paralyse Hong Kong

In February 2019 new laws were proposed that would allow the extradition of criminals from Hong Kong to mainland China. Upon the bill’s introduction to Hong Kong’s Legislative Council mass protests involving thousands of people on the streets of Hong Kong began.

Continuing protests by students and young Hong Kongers were met by violence on the part of the police who used pepper spray and batons to disperse crowds. In June 2019 Hong Kong Chief Executive Carrie Lam announced the bill would be suspended but this does not lead to the protests ending. They in fact escalate with occupation of MTR stations and eventually Hong Kong Airport. These actions together with a backlash against the protesters from some Hong Kong residents leads to more violence and the total disruption of Hong Kong’s economy.

Tourists have abandoned Hong Kong in large numbers after weeks of violent protests and the occupation of Hong Kong Airport. The Hong Kong government announced a HK$19b financial relief package for small businesses and households in the hope that increased spending could occur because of lower taxes and fees, government rents and the provision of HK$2,000 to eligible households to help meet their electricity bills. The more the protests go on and are linked to the pro-democracy movement the more of a crisis it becomes. For the Chinese government there is a need to exert control over Hong Kong as a Special Administrative Region (SAR) of China, whilst maintaining its privileged position of having many democratic freedoms. However the ongoing concern is that the Chinese government may use the People’s Liberation Army (PLA) to destroy the protests, arrest and imprison and torture protesters.

The immediate risk to Hong Kong’s economy and the region are the following:

- A breakdown of law and order and the rule of law.
- Disruption of the Hong Kong share market and the Hang Seng Index.
- Disruption of Hong Kong’s transportation system including the MTR, buses, ferries and taxis.
- Disruption of Hong Kong’s leading role in global and regional supply chains.
- Falling numbers of visitor arrivals including tourists with large spending power.
- A large decline in consumer and business confidence and spending on consumption and investment.
- The continuing conflict between pro-democracy demonstrators and the Hong Kong government and Chinese government.

Some have suggested that there is growing opposition to Xi Jinping’s hold on power if he does not reign in the protesters and get Hong Kong functioning as an important trade port and financial capital in the region as well as the world economy.

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