

Balance of Payments:

Causes

1. Internat. competitiveness
2. Terms of Trade
3. Domestic Demand
4. Servicing debt
5. Depreciating AUD
6. Pitchford thesis: savings-investment gap.

Solutions

1. Twin deficits argument: $CAD = (I - S) + PSBR$: tight fiscal policy
2. Monetary: restrict demand growth: decrease spending-output gap
3. Stable wages: external stability & international competitiveness
4. Microeconomic reform - competition to close both gaps -
 - spending-output: protection, deregulation, R&D 150%, privatisation
 - savings-investment: financial markets, superannuation, relaxing of foreign investment guidelines, investment allowances.

Current account:

1. **The balance on merchandise trade** FOB value of exports minus imports
 - **exogenous imports**: subject to government arrangements
 2. **Net services** Credit: flow of money into Australia from overseas Debit: flow of funds from Australia
 3. **Net Income**
 - A) investment income: property income in the form of dividends & interest on investments.
 - B) Other property income: covers receipts (credits) and payments (debits) of royalties.
 - C) labour income: earnings of residents who work for non-resident employers & vice-versa.
 4. **Net Unrequited transfers** unearned, one-way money flows between Australia and the rest of the world
- ⇒ **trends:**
1. Since 1950, Australia has recorded surplus on CA for 4 years. Last time: 1972-73
 2. Dramatic increase in net incomes deficit

billions	M	S	Y	UTs	CAD
1985-86	-3.5	-3.9	-7.9	0.7	-14.6
1994-95	-8.3	-1.4	-18.4	0.5	-27.6
1995-96	-1.9	-0.1	-19.7	1.2	-20.5

⇒ **Reasons for improvement in 1995-96:**

- 1994-95 CAD blow out: trade deficit blew out due to drought & strong growth in investment spending caused strong import growth - particularly capital equipment.
- These factors were reversed in 1995-96: drought ended and we had a bumper wheat crop - our cereal exports almost doubled, accounting for 28% of total increase in value of exports of goods.
 - Strong manufacturing industry growth: 95-96: 15%; now account for 21% of exports of G&S.
 - Net services deficit has been falling since the mid-1980s: 95-96: X grew 15%, I grew 5%.
 - Growth in inbound tourism & 'intelligent exports': education, health & business services.

Effects of a continuing CAD on the economy

1. **Government - Policy mix** - forces the government to take action
 - incentives for exporters - as in mid-1980s
 - demand management policies to restrain consumption - late 1980s
 - higher interest rates the easiest option but not a long-term cure
2. **Employment & Inflation** - consequences from government response to CAD
 - cyclical unemployment through consumption restraint
 - structural unemployment from micro-economic reforms.
 - Contractionary monetary policy likely to restrain inflation to improve competitiveness.
3. **Lower business investment** - due to tight monetary policy - highly sensitive to interest rates.
4. **Increased foreign debt** - significant capital inflow required to balance out deficit → higher CAD
 - formation of a 'debt trap' - borrowing for sole purpose of financing existing debts
5. **Increased vulnerability to external shocks** - high CAD increases reliance on capital inflow
 - \$A becomes more volatile as in mid-1980s & 1993 & 1995.
6. **Less equal distribution of income** - government policy response has more impact on low incomes

Trends in the terms of trade - relationship between prices which a country receives for its exports & prices it pays for its imports - purchasing power of a country's exports in relation to its imports

$$J \text{ TERMS OF TRADE INDEX} = \frac{\text{EXPORT PRICE INDEX}}{\text{IMPORT PRICE INDEX}} \frac{100}{1}$$

- **Demand and supply elasticities - reflects ability to take advantage of terms of trade changes**
 - demand elasticities: extent to which demand for x & i changes in response to change in their prices.
 - supply elasticities: responsiveness of producers in offering goods for sale as prices change.
- è **Australia's terms of trade**: deterioration in Australia's terms of trade over the last two decades
 - Australia's exports are predominantly primary commodities and STMs.
 - Terms of trade affected by excess supply of primary products on world market:
 - developing countries increasing exports of primary products to repay foreign debts.
 - Growth & development have reduced dependence on imported primary products.
 - The United States' Export Enhancement Program and the EC's Common Ag. Policy.
 - The vast majority of our imports are manufactured goods, predominantly ETMs.
- **Effects of a deteriorating terms of trade**
 - Strong relationship between terms of trade & current account balance.
 - By increasing CAD, a deteriorating terms of trade adds to our foreign debt.

Structural adjustment - Structural adjustment involves the decline of industries that are inappropriate and inefficient and the emergence of sunrise industries that have a high growth potential

- can be market induced: (operation of price mechanism) or government induced.
- Microeconomic reform facilitates structural adjustment for export industries.
 - Tariff-reform; Tax-Reform; privatisation; Deregulation; Labour market reform; Education.

è **Structure of Australian economy - our export base**

- Export base heavily weighted towards primary industry commodities.
- Australia promoting manufactured goods:
 - ETMs Elaborately Transformed Manufactures:
 - 1994: Professor Helen Hughes queried claims made by the government that there had been an increase in the contribution of ETMs to Australia's exports.
 - Dr Tim Colebatch refuted this analysis. Australia's market share for ETMs in Asian markets is positive - Singapore, Hong Kong, Japan, Indonesia & Korea.
 - 1980/81: 11.3%, 1993/94 : 22.4%.

è **Potential growth markets**

- **Tourism** - Australia's single biggest export earner
 - Almost half growth in export earnings in 1994-95 - recorded a 16% increase to \$12.3 bn.
 - whilst Australia experienced 11.6% visitor growth, Indonesia experienced 18% & Taiwan 14%.
 - Must become more cost competitive & implement more effective advertising strategies.
- **Services** - almost 80% of Australian jobs & 73% of GDP - retail, finance, education, health...
 - Only 7% of service outputs exported, compared to 69% in Singapore and 10% in France and UK
 - *Intelligent Exports - A national Service Export Strategy* April 1994: 250,000 export-related jobs could be created by 2000: finance & insurance; computers; transport; education.
 - 1990-91, service exports worth \$14 bn, growing to \$19 bn in 1994-95.
 - LEK survey: Asia is the target of service exporters - China & Indonesia. By 1998, LEK projects that service export revenues will more than double to \$33 bn in 1998.
- **Adding value to Primary Products** - Bureau of Industry Economics - \$bns more could be earned
 - Australian Wool Corporation discounting wool to companies establishing domestic processing
 - WTO increases chances of improving agricultural earnings through world protection reductions.
 - Economy could benefit up to \$5bn/year & by up to \$40bn/year through APEC.
- **Manufactured exports** -
 - *McKinsey Report* 1993: 700 businesses, \$8.2 bn "niche" market exports, double exports by 1997.

International competitiveness - advantages that domestic industry has over foreign rivals

- Price & Non-price factors (quality of goods, design, delivery, continuity of supply...)

è **measuring international competitiveness** indices of competitiveness - focusing on cost movements

- Adjusted for exchange rate movements for greater accuracy.
- limitations: fail to take into account the non-price factors.
- inverse relationship between movements in indices & changes in international competitiveness.
- **unit labour costs**: nominal unit labour costs in non-farm compared to major trading partners.
- **GDP Deflator Based Index**: ratio of CPI to weighted average of US, Japan, UK and Germany.
- **Commodity Export Competitiveness (CEC)**: CPI compared with change in CPIs of competitors for primary products - The index represents 20 commodities and includes 28 countries
- **real exchange rates**: price of goods overseas in \$A to price of same goods in Australia.

è **factors influencing Australia's international competitiveness**

- a) inflation: higher inflation rate increases costs of production
- b) wages growth: real wage increases outstripping productivity increases - competitive disadvantage
- c) productivity levels: Poor productivity growth rate over past couple of decades compared to OECD
- d) changes in value of \$A Value of \$A has been rising, reducing debt; but exporters less competitive
- e) proximity to foreign markets: competitiveness is much stronger in the Asia-Pacific region
- f) non-price factors: quantity and quality of goods produced, reliability of delivery, etc...

Servicing External debts

è **Causes**

1. CADs require large capital inflows - KASs
 - CAD leads to larger external debt; interest payments constitute larger part of income debits.
2. Government - through rapid growth of public debt - twin deficits equation; high interest rates
 - high interest rate policy attracted higher volume of capital inflow
3. Consumption & Business investment - low household savings forces other sectors to borrow overseas
 - Fitzgerald inquiry into national savings - 15% of GDP; Households: 4%. Low levels causes:
 - a) excess demand satisfied by increase in imports, financed by overseas borrowing.
 - b) shortfall of investment funds made up by borrowing from overseas.
 - rapid growth of imports: imports to sales ratio: 21.5% 1991/92; 25.8% 1994/95.

è **Consequences**

1. Debt trap - the ultimate consequence of foreign debt is spiralling foreign debt
 - Net interest payments (servicing the debt) are equivalent to 3%+ of GDP
 - Debt Servicing burden (%) = $\frac{\text{Interest Payable on foreign debt}}{\text{Export Income}} \times \frac{100}{1}$
 - Pitchford thesis: debt not a problem while funding projects increases export earning capacity
 - but: inflow has been more related to consumption & to servicing foreign debt interest cost.
2. Instability for the \$A - external problems leads to volatility.
 - Fall in \$A leads to increase in foreign debt since around 60% of debt in foreign currencies.
3. Tighter fiscal & monetary policy - twin-deficits relationship & to maintain capital inflow.
4. Reduced consumption & lower business investment - government contractionary policies.
5. Ownership: equity financing decline (shares in companies & physical assets).
 - equity financing promises to generate the income needed to pay dividends.
 - Borrowing adds directly to external debt, & is generally used to service existing debts.
 - 65% inflow on capital account represents borrowed funds, 35% equity.

Capital Account: international borrowing lending transactions of Australia's public & private sectors

è **recent trends:**

1. Dramatic growth in official borrowing - state government borrowing 1991-93
2. Even greater rise in 'non-official' capital flows from abroad.
3. Rise in Japanese investment -1989, sharp fall since.
4. Dramatic growth in Australian private investment abroad

Official transactions

- General government: all overseas borrowing and lending by all government authorities. Also includes repayments made and received in respect of such borrowing and lending. (Excludes GBEs)
- Reserve bank item measures net change in the central bank's holdings of gold and foreign exchange - Australia's official national reserves - arising from its overseas transactions.

Non-official transactions: implications for foreign debt, ownership & control.

- all overseas borrowing and lending by the private sector as well as by public enterprises.
- Foreign investment often used to describe private capital inflow. Capital inflow involves overseas borrowing, creating a liability. A stake by foreigners in our future production.

è **Two kinds of private foreign investment**

- Direct investment - overseas interests establish new firms & industries. Includes take-overs and expansions. Adds to productive capacity of Australian economy and encourages competition.
 - more desirable than portfolio: adds to economy's productive capacity & less speculative
- Portfolio investment - overseas purchases of shares, debentures and other securities in existing Australian companies. Portfolio investment short term and unstable

è **Advantages of foreign investment**

1. supplement to domestic savings - additional finance available to domestic industries
2. leads to higher growth by contributing to development of Australia's industries and resources,.
3. Knowledge & technology: Multinationals' subsidiaries gain from overseas markets & R&D projects.
4. increases productivity & competitiveness: If into export & import-replacement industries.

è **Disadvantages of foreign investment**

1. ownership: important decisions regarding our resources made by corporations outside Australia
2. transfer pricing by multinationals: less government revenue.
3. Need for debt servicing.
4. multinationals may attempt to reduce competition.

Why the balance of payments must balance

- Floating exchange rate: Value of %A changes to accommodate balance.

$$\begin{aligned} \text{Supply of \$A} &= \text{Demand for \$A} \\ \mathbf{M + K + Y \text{ debits}} &= \mathbf{X + Y + K \text{ credits}} \\ \text{Transposing the equation:} & \\ \mathbf{M + Y \text{ debits} - X - Y \text{ credits}} &= \mathbf{K \text{ credits} - K \text{ debits}} \\ \mathbf{G\&S + \text{net Y} + \text{unrequited transfers}} &= \mathbf{\text{net K transfer}} \end{aligned}$$