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HSC Economics Topic 2: Australia's Place in the Global Economy

Lesson 1

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<u>HSC Economics Topic 2: Australia's Place in the Global Economy</u>

<u>Lesson 1</u>

Syllabus Dot-points covered:

- Value, composition and direction of Australia's trade and financial flows
- Trends in Australia's trade pattern
- Trends in financial flows – debt and equity

Additional content covered:

- *Practice exam questions*
- *Australia's trade and financial flows exemplar essay*

<u>*Value, composition and direction of Australia's trade flows*</u>

<u>*Trends in Australia's trade pattern*</u>

NOTE: When answering questions on Australia's trade pattern, it is important to consider the composition, direction and value of trade flows.

Trends in the composition of Australia's exports (overview)

- The following tables provide a snapshot of Australia's changing export composition:

	1963-64	
	A$m	% share
Total (b)	**2,786**	
Wool	962	*34.5*
Wheat	362	*13.0*
Transport services (c)	258	*6.3*
Beef and veal	154	*5.5*
Sugar, raw	67	*2.4*

Rank	Commodity	2015-16	2016-17	2017-18	% share 2017-18
	Total (b)	**319,721**	**373,740**	**403,241**	
1	Iron ores & concentrates	47,799	62,617	61,357	*15.2*
2	Coal	34,541	54,236	60,356	*15.0*
3	Education-related travel services (c)	24,145	28,093	32,434	*8.0*
4	Natural gas	16,576	22,308	30,907	*7.7*
5	Personal travel (excl education) services	20,669	21,628	21,580	*5.4*

- In the 1960's, Australia relied heavily on agricultural products such as Wool, Wheat, Beef and Sugar, hence the phrase "Australia rode to prosperity on the sheep's back"

- As of 2020, Australia's export composition reflects a shift towards mining products (iron ore and coal) and services (education and travel).

Trends in the composition of Australia's exports (by sector)

- Decline of **agricultural** sector (23%-12% of exports from 1989-2019)
  - Due to changes in world prices reducing export revenue from agricultural commodities (Agricultural trade involves commodity items to which little extra value is added in processing)

- Increase of **minerals and metals sector** (33%-50% of exports from 1989-2019) because of:
  - Resources boom (Mark I & Mark II)
  - 2000s to early 2010s: price and investment boom
  - 2012 to 2016: volume boom
  - Mining exports have increased in 2017-2020 as a result of an increasing ToT (from 70 to a predicted 101 for 2021).

- Growth of **manufacturing** in the 1990s and subsequent decline in the 2000s-2010s (12% in 2019)
  - Growth of manufacturing prompted by microeconomic reforms in the 1980s (floating of exchange rate; labour market decentralisation).
  - As a high income economy, Australia couldn't compete with low-cost Asian manufacturers.

   - Personal motor vehicle (PMV) industry shut down from 2013-2017 as a result of low international competitiveness and the refusal of the government to increase protection levels.
   - Food and beverage, and machinery & equipment sectors growing in 2017-19 as a result of recent depreciation of AUD.

- **Service industry** expected to provide sources of future exports growth. Three-quarters of workforce is in service industries, but they make up only around 20% of exports.
   - Significant growth potential in tourism, finance, education – in large part due to the rising middle class of China, Australia's largest trading partner (24% of two-way trade).

Practice Exam Question:

1. Propose how recent changes Australia's export pattern may influence Australia's economic performance. (4)

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Trends in the composition of Australia's imports (overview)

	1963-64	
	A$m	% share
Total (b)	3,054	
Transport services (c)	411	13.5
Motor vehicles, parts & accessories	247	8.1
Petroleum and shale oils	233	7.6
Motive power machinery (d)	129	4.2
Cotton piece-goods (e)	72	2.4

Rank	Commodity	2015-16	2016-17	2017-18	% share 2017-18
	Total (c)	357,496	362,889	395,400	
1	Personal travel (excl education) services	36,426	37,731	42,496	10.7
2	Passenger motor vehicles	21,542	21,782	23,299	5.9
3	Refined petroleum	16,228	17,389	21,655	5.5
4	Ships, boats & floating structures	922	4,801	14,897	3.8
5	Telecom equipment & parts	11,781	11,969	13,412	3.4

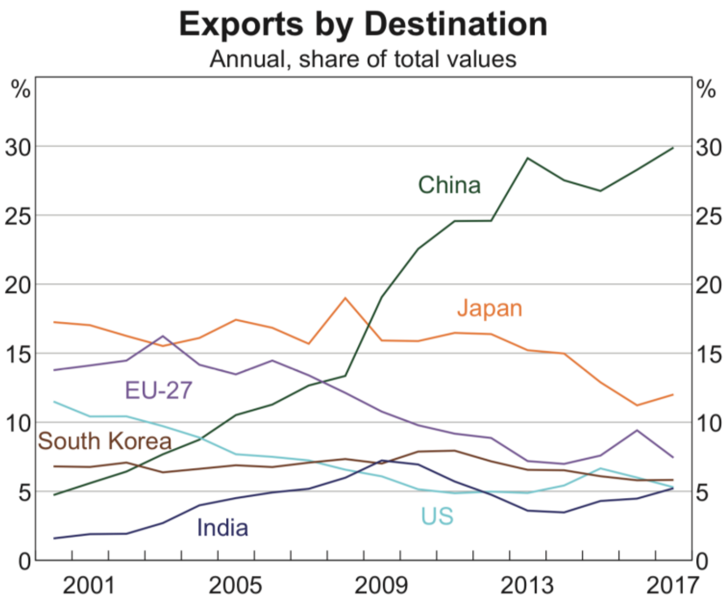
Trends in the composition of Australia's exports (by sector)

- Australia has historically had an inelastic demand for **manufactured goods** and new technology due to lack of specialisation in these sectors (small population size and high wages).
- However, the share of part-finished **intermediate goods and service imports** have recently declined; meanwhile the % of imported **consumer goods** have recently increased.
  - This has been due to the reduction of Australia's protective barriers (especially tariffs down from 20% in 1990 to 1.2% in 2019).

Trends in the direction of Australia's exports

- Australia's export strategy has evolved dramatically over the past 50 years to reflect changing demand from the global economy.
- In the 1960s, most of Australia's trade took place with Europe and North America. Both our export markets and import sources have now shifted geographically towards Asia.
    - Asia now accounts for over 60 per cent of Australia's two-way goods and services trade.

The charts below provide a snapshot of Australia's trade direction.



Source: ABS

Australia's top two-way trading partners

Rank		2015-16	2016-17	2017-18	% share of total	% growth 2016-17 to 2017-18	% growth 5 year trend
1	China	152,061	174,242	194,620	24.4	11.7	7.8
2	Japan	60,553	68,519	77,595	9.7	13.2	0.8
3	United States (c)	70,672	66,599	70,177	8.8	5.4	4.3
4	Republic of Korea (d)	34,130	38,616	52,303	6.5	35.4	8.3
5	India	19,963	25,733	29,116	3.6	13.1	12.9
6	New Zealand	25,431	26,403	28,275	3.5	7.1	5.0
7	United Kingdom	28,363	27,585	27,793	3.5	0.8	5.3
8	Singapore	23,281	24,679	27,773	3.5	12.5	-2.6
9	Thailand	21,555	21,819	24,688	3.1	13.2	4.3
10	Germany	20,039	20,914	22,355	2.8	6.9	6.2
11	Malaysia	18,500	19,793	21,506	2.7	8.7	2.6
12	Hong Kong (SAR of China)	15,706	19,704	18,820	2.4	-4.5	5.7
13	Indonesia	16,138	16,556	16,775	2.1	1.3	1.6
14	Taiwan	12,474	14,717	15,926	2.0	8.2	4.8
15	Vietnam	10,549	11,763	13,051	1.6	11.0	10.3
	Total all countries	**677,217**	**736,629**	**798,641**		**8.4**	**4.1**

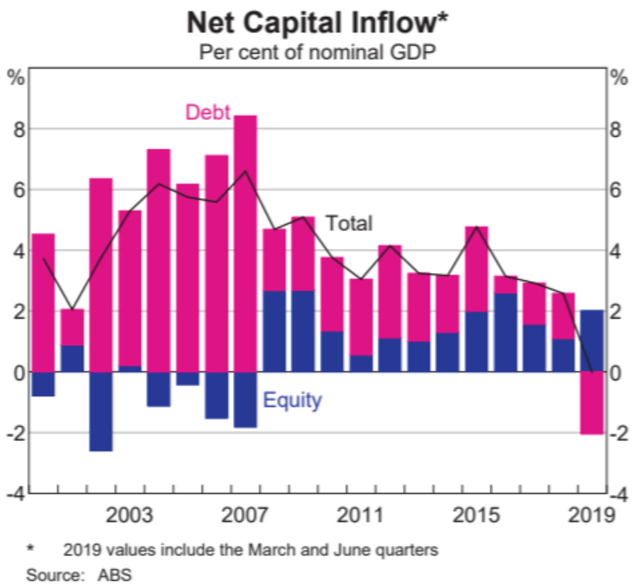
Trends in the direction of Australia's imports

- 1950s: Trade mainly with the UK and Europe due to colonial ties
- 1960s: Shift to Japan due to its sustained rapid economic growth (leading to higher demand for Australian commodities and greater industrial output for Australia to import)
- 1973: Decline of exports/imports from EU due to creation of European Economic Community Trading Bloc (EEC) in the 1970s (which later became the EU), where European nations imposed barriers to trade with Australia along with the rest of the world.
- 1980s: Shift to Asian economies but away from Japan due to slowed economic growth (The Lost Decade)
- 1990s-2000s: Shift to China, South Korea and ASEAN. China is now by far Australia's largest individual two-way trading partner.
- 2018-: China accounts for 24% of total trade; ASEAN members account for 14% of total trade; EU accounts for 13% of total trade.

<u>Trends in financial flows – debt and equity</u>

Financial Flows consist of both debt and equity:

- **Debt:** A sum of money lent out to a borrower with a specified maturity and interest rate.
- **Equity:** Ownership stake in a company which entitles you to a proportion of the company's profit



This figure shows Australia's Net Capital Inflows over time. Note that Australia consistently has positive net capital inflows due to the national Savings-Investment gap (covered in detail in Week 2)

Revision: Direct investment vs. Portfolio investment

Direct investment (FDI): Purchase of a company, or the purchase of a substantial proportion of shares in a company (10%+). Investors intend to play a *role* in long term management *e.g. Nike setting up a subsidiary factory in Vietnam or PayPal acquiring a fintech start-up in Brazil to expand geographic operations.*

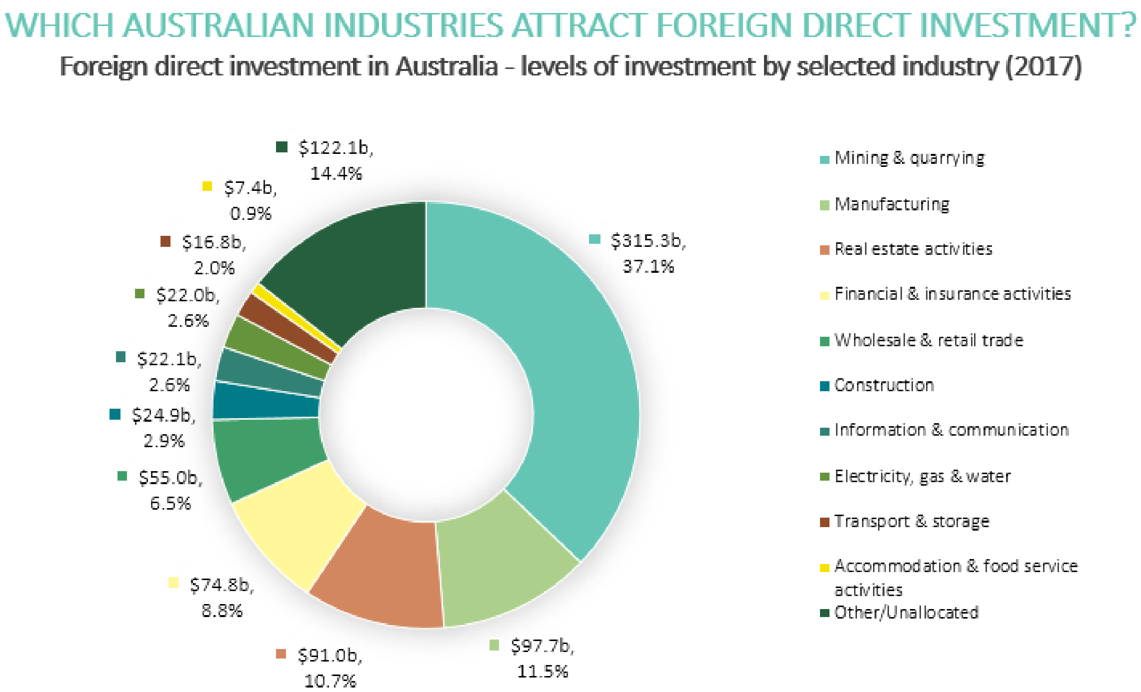
Portfolio investment: Includes loans, other securities (that can be easily sold), property and smaller shareholdings in companies (<10% of shares). Investors do not intend to play a role in managing a business. e.g. Purchasing shares on the NYSE or buying bonds from a foreign company (this is the same as lending them money). Most portfolio investment is in the form of cross border loans.

Trends in the Australia's Financial Flows

- 1970s: Floated exchange rates/removed capital restrictions and technological changes increased financial flows (easier to shift finance).
- 1980s: Level of foreign investment doubled (as Australian dollar was floated and financial markets opened)

- 2018: Investment abroad grew to 90 times its amount in 1980. **Portfolio** investment is higher than direct investment and has grown faster
- 2020: Foreign investment in Australia is significantly more than financial investment abroad (**net capital importer**). Reliance on overseas financial flows to make up for the shortfall between savings and investment (Australia has a low level of domestic savings at 2.4% of national income)
    - Stats: $3.3 trillion invested in Australia (2019) and $2.3 trillion abroad (2019)
    - Much of Australia's capital inflow in the 2010s has been in the mining sector, which is highly capital intensive.
    - NOTE: Australian businesses have substantial assets overseas and Australia has significant shorter-term overseas investments such as overseas loans and shares on overseas stock markets (Australian residents more actively pursued investment opportunities as overseas capital markets are open to investment)

Composition of Foreign Direct Investment



Answers

1. Propose how recent changes Australia's export pattern may influence Australia's economic performance. (4)

In the last 20 years, Australia's export pattern has shifted significantly, with the mining sector increasing to 50% of exports, while the agriculture and manufacturing sectors have each declined to 12% of exports. These shifts in Australia's export pattern will induce structural change in the Australian economy that reflect Australia's comparative advantage in the mining and service industries brought about by its abundant natural resources and skilled workforce. This shift in production towards Australia's more productive industries will result in higher levels of allocative efficiency and ultimately higher economic growth, higher incomes and improved material living standards.

However, changes in our export pattern are associated with structural change, which results in structural unemployment – for example 50,000 jobs were lost in the car manufacturing industry as a result of its downsizing (since Australian car exports were not competitive on the world market). The rise of the mining sector as the dominant sector in Australia's exports has narrowed the export base which makes Australia more vulnerable to commodity price shocks and demand shocks in our trading partners, especially China which has become Australia's largest trading partner (24% of two-way trade). Since the price of commodities on the world market is highly volatile, a decrease in economic growth in Australia's trading partners could result in significantly lower economic growth, and higher cyclical unemployment.

Sample Essay

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

As a small open economy, Australia has been heavily reliant on the global economy to support its economic performance. The Australian economy primarily interacts with the rest of the world through dynamic trade and financial flows. Global factors such as the international business cycle, trade tensions, interest rates and exchange rates have influenced trends in Australia's trade and financial flows. In particular, the commodities boom of 2003- 2007 and 2011-2012 led to a significant increase in natural resource exports to the Asia pacific region. The trend has continued to persist in 2019. Currently, 65% of Australia's exports are in the natural resources sector, with 66% of total exports headed to Asian economies. Likewise, Australia's financial flows, in both foreign portfolio investment and foreign direct investment, have been heavily influenced by developments in global capital markets.

In the 1960's, most of Australia's trade took place with Europe and North America, reflecting Australia's colonial ties. The emergence of the EU trading bloc, which imposed protectionist policies on Australian exports, and subsequently Japan's industrialisation in the 1980s led to a pivot in Australia's trade strategy. Due to its rich resource endowments, Australia was well positioned to fulfil Japan's demand for iron ore and coal over this period, providing resources crucial for infrastructure development. Since the 1980's Australia has continued to strengthen its relationship with emerging Asian economies through trade agreements such as the China – Australia FTA and the recently enforced "Comprehensive and Progressive Trans-pacific Partnership multilateral trade agreement", which provides Australian exporters access to Japanese, Malaysian and Vietnamese agricultural markets. While Asia today accounts for over 66% of Australia's two-way goods and services trade, it is in fact China that dominates the conversation, making up 30% of Australia's total trade.

As Australia's export markets have shifted, so too have the commodities that are exported. During the 1970's, Australia relied heavily on exporting agricultural products due to its competitive advantage in the industry. During this time over 60% of Australia's exports were in rural commodities, hence the phrase that "Australia rode to prosperity on the sheep's back". Today, over 65% of exports are in the natural resources sector with iron and coal making up a combined 30%. From 2013 to 2019, Australia's structural transition to a service-based economy has seen the rise of exports such as tourism, professional services and education, which together comprise 15% of total exports. On the other hand, the composition of Australia's imports has remained relatively steady, comprising mostly of capital machinery goods and fuel (oil).

The international business cycle has played a significant role in shaping the direction and composition of Australia's trade flows. During the early 2000s, strong economic growth in rapidly industrialising Asian economies including China, Asia and Vietnam led to a high level of demand for natural resources – noticeably, iron ore and coal which were necessary inputs for steel production and infrastructure development. As demand exceeded supply at the time, commodity prices soared. The price of iron ore rose from $32/ton in 2003 to $145/ton by the peak of the commodities boom in 2008. Australia took advantage of rising commodity prices and its natural endowment in minerals by prioritising their export base towards resource commodities.

To take advantage of increased profit opportunities, mining companies such as Rio Tinto and BHP Billiton undertook significant infrastructure investment to expand their productive capacity. To fund their capital expenditure, they relied on a mix of internally generated cash flows and offshore debt (foreign portfolio investment). As these mining companies were 80% foreign owned on average, their reinvestments constituted foreign direct investment inflows. By 2008, foreign debt had grown to 8% of nominal GDP relative to only 3% in 2003.

While the GFC crisis in 2008-09 did not alter Australia's trade flows - due to strong ties with the resilient Chinese economy- the structure of Australia's financial flows was dramatically altered. Driven by the precautionary motive, households increased their savings from a savings ratio of 0% in 2000 to 10% by 2009. The increased national savings and institutional aversion to debt led to a slowdown in the demand for offshore funds. As a result, net foreign debt decreased to less than 1% of nominal GDP by 2019. From 2016 to 2019, APRA introduced new regulatory measures that required financial institutions to strengthen their balance sheets by using more long term debt. This altered Australia's financial flows as preference for short term foreign debt decreased (27% GDP in 2007 to 7% in 2019) and long-term foreign debt increased (30% in 2007 to 55% in 2019).

In 2011 to 2012, China's strong economic growth and continued demand for resource exports prompted a rebound in economic activity. During this period, commodity prices increased to a record high of 155 on the commodity price index. In contrast, the index had peaked at 135 in 2008. With 60% of Australian exports in the natural resources sector, the higher commodity prices meant a greater demand for the $AUD in the Forex market as foreign firms required AUD to purchase Australian exports. This caused an appreciation in the AUD to a record high $1.1 USD by 2011. However, the strong exchange rate further eroded the international competitiveness of non-resource exports such as manufacturing and agriculture in a phenomenon known as the Dutch disease. Australia's manufacturing industry was already under significant pressure as a result of Australia's increasing minimum wage laws and high labour costs. The Dutch Disease led to a subsequent hollowing out of the manufacturing sector, effectively reducing its share in Australia's export base. For example, Australia no longer produces and exports electrical goods.

From 2013 to 2016, the global economy entered a period of slow economic growth and highly expansionary monetary policy. Growth in China had slowed down, resulting in falling commodity prices and lower demand for Australian exports. As foreign investors no longer saw the need to increase productive capacity in Australia's mining sector, mining investment spend declined from 9.5% of GDP in 2012 to 3.5% of GDP in 2017. However, increasing global demand for fuel drove increases in FDI to Australia's LNG export industry. To stimulate global economic growth, interest rates were reduced to zero in the US and the EU. On the other hand, Australia was able to maintain a relatively high interest rate of 2.5% in 2013, as the economy remained buoyed by its exports to China. The interest rate differential between Australia and the global economy made Australian assets more attractive on a risk adjusted basis. As a result, Australia was able to attract a significant amount of financial inflows over this period.

In more recent times, from 2016 to 2019, the recovery of the international business cycle has again shifted Australia's trade and financial flows. Rising global interest rates, characterised by the Federal Reserve's decision to increase rates from 0.75% in 2016 to 2.5% by 2019, have narrowed Australia's interest rate differentials with other economies. This has prompted investors to withdraw their capital from Australia and invest in economies that can provide higher returns. While China's demand for commodities has recovered slightly, it is the emergence of China's consumerist middle class that has had a greater impact on Australia's exports, particularly in the tourism and education sectors. The middle class is expected to be a $600 billion market. The combined expectations of improved living standards and a westernisation of Chinese livelihoods has driven demand for Australian and tourism services. China is now the destination for 18% of total Australian service exports, with the figure expected to grow into the future. Australian service exports now account for 15% of all exports.

In conclusion, Australia's trade and financial flows have changed significantly over time due to both domestic and international influences. As a small open economy, factors such as the international business cycle, exchange rates and interest rate differentials can have a significant impact on the value of both trade and financial flows. In the short-term future, the COVID-19 crisis may imperil much of the improvements witnessed in the 2019-19 period. Moving ahead, however, Australia's export industry is expected to remain resource dominated. However, demand from China's middle class may see both a resurgence in agricultural exports such as meat and milk and an increasing role for service exports. On the other hand, the lack of domestic investment opportunities and rising global interest rates may see further decreases in financial inflows. In fact, the accumulation of household savings in superannuation funds, may lead to greater financial outflows as Australians seek higher returns by investing abroad.