

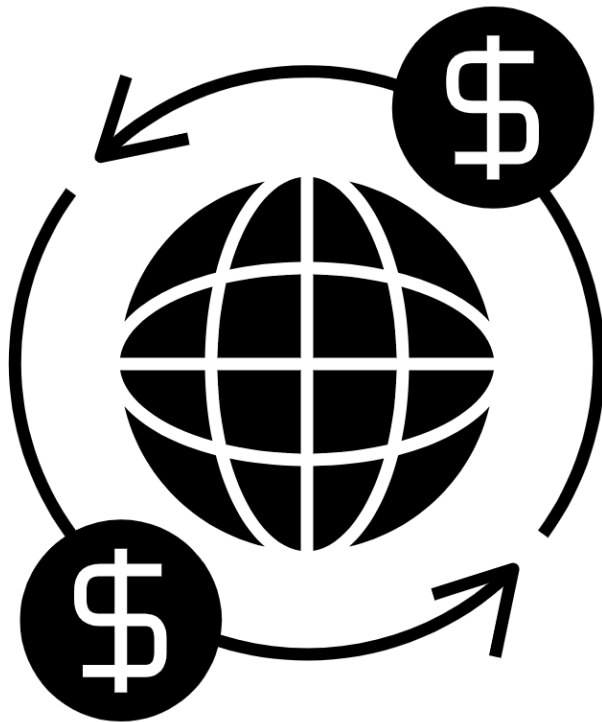


Department of  
Education

# Year 12 Economics

## Unit 3 – Australia and the global economy

### Balance of payments



Except where indicated, this content © Department of Education Western Australia 2020 and released under Creative Commons [CC BY NC](https://creativecommons.org/licenses/by-nc/4.0/). Before re-purposing any third party content in this resource refer to the owner of that content for permission.



<https://creativecommons.org/licenses/by-nc/4.0/>

Year 12 Economics  
Unit 3 – Australia and the Global Economy  
BALANCE OF PAYMENTS

Estimated time to complete this booklet: 10 hours

## Topic - Balance of Payments

The balance of payments is a systematic record of all economic transactions between the residents of Australia and the residents of the rest of the world. You will need to:

- describe the structure of these accounts and be able to distinguish between the various transactions
- explain how the two major accounts are linked and why they must balance.

Also you will learn why Australia usually runs a current account deficit and the significance of this for the Australian economy.

### Syllabus Points

- structure of Australia's balance of payments and the concept of the current account balance
- recent (the last ten years) trends in Australia's current account
- structural and cyclical reasons for Australia's current account deficit
- differing views as to the significance of Australia's current account deficit

### Analysis

- apply mathematical techniques relevant to international trade, including; balance of payments calculations, such as the balance on goods and services, balance on current account, balance on capital and financial account

**Text:** You will need to refer to **Chapter 4** in *Investigating Macroeconomics* by Parry & Kemp 5<sup>th</sup> and 6<sup>th</sup> Ed. as you complete this booklet.

### Balance of payments – Expanded syllabus for teaching and learning

- The concept of the balance of payments
- The structure of Australia’s balance of payments – the current account and the capital/financial account
- The link between the current account balance and the capital/financial account balance
- The current account balance – the goods and services balance and the income balance
- Structural and cyclical reasons for Australia’s current account deficit
- The business cycle and the current account deficit
- Australia’s investment-savings gap and the current account deficit
- The link between the income balance and the financial account
- Changes in Australia’s current account deficit over the past ten years
- The significance of Australia’s current account deficit

Carefully read the materials which follow.  
Complete all questions and activities.  
You will need to refer to your text, as directed.

*Using the relevant chapter in your text, complete the definition:*

The **balance of payments (BOP)** of a country:

---

---

---

---

These transactions are made by i \_\_\_\_\_, f \_\_\_\_\_, and the G \_\_\_\_\_.

Thus the balance of payments includes all external visible and non-visible transactions of a country during a given period, usually a year. It represents a summation of country's current demand and supply of the claims on foreign currencies and of foreign claims on its currency.

Economic transactions include:

		Australian example(s)
1.	Exports and imports of Goods	Export:  Import:
2.	Exports and imports of Services	Export:  Import:
3.	Income Flows	
4.	Transfers	
5.	Financial Flows	

These transactions are recorded in the Balance of Payments. The flow that is recorded is the same as an accounting system, i.e. it is the MONEY flow – an export is recorded as a CREDIT flow. This is because the export is sold and the payment for that export is INCOMING. An import is recorded as a DEBIT flow. Basically, FOLLOW THE MONEY!

### Structure of the Balance of Payments

A record is made of all transactions between residents and non-residents of Australia.

*How?*

The structure of the balance of payments is that it is comprised of two broad accounts, the Current Account and the Capital and Financial Account. We'll get to these shortly.

These accounts record *debit* and *credit* entries.

- Access this link <https://www.rba.gov.au/education/resources/explainers/pdf/the-balance-of-payments.pdf?v=2020-03-19-12-47-01> (copy and paste into browser if it does not open)
- Go to page 4 of the linked information.
- Complete the following, include examples:

**Credits:** What are they?

---

---

---

---

---

---

---

---

---

---

**Debits:** What are they?

---

---

---

---

---

---

---

---

---

---

The ABS (Australian Bureau of Statistics) is responsible for recording all transactions in all accounts using the double entry recording system. Each entry is matched by another of equal and opposite value. This reflects the inflow and outflow element to each exchange. For example, if an Australian resident purchases a \$20,000 car from Japan, it is recorded in the current account, goods section as a debit of \$20,000, but in the financial account it is recorded as a credit of \$20,000 as Australian currency is exported to Japan. You do not need to be an accountant to understand this topic, but a good understanding of the flows, and the direction of the money flows, including currency exchanges, is required for you to understand how it all works.

***The balance of payments always balances – the sum of the current account plus the sum of the capital & financial accounts will always equal zero. If one records a deficit, the other will record a surplus.***

### **The Current Account**

- Access this link: The Balance of Payments: <https://www.khanacademy.org/economics-finance-domain/ap-macroeconomics/ap-open-economy-international-trade-and-finance/the-balance-of-payments/v/balance-of-payments-current-account> (copy and paste into browser if it does not open) to get an introduction to the structure of the accounts. Then continue to the activities in this booklet.

### **The Current Account**

The Current Account is broken down into 3 sub-categories – Goods, Services, and Income (primary and secondary).

Define and explain what each category consists of, and give an Australian example of a credit and debit for each.

#### **Goods**

---

---

---

---

---

#### **Services**

---

---

---

---



**Income**

- **Primary**

---

---

---

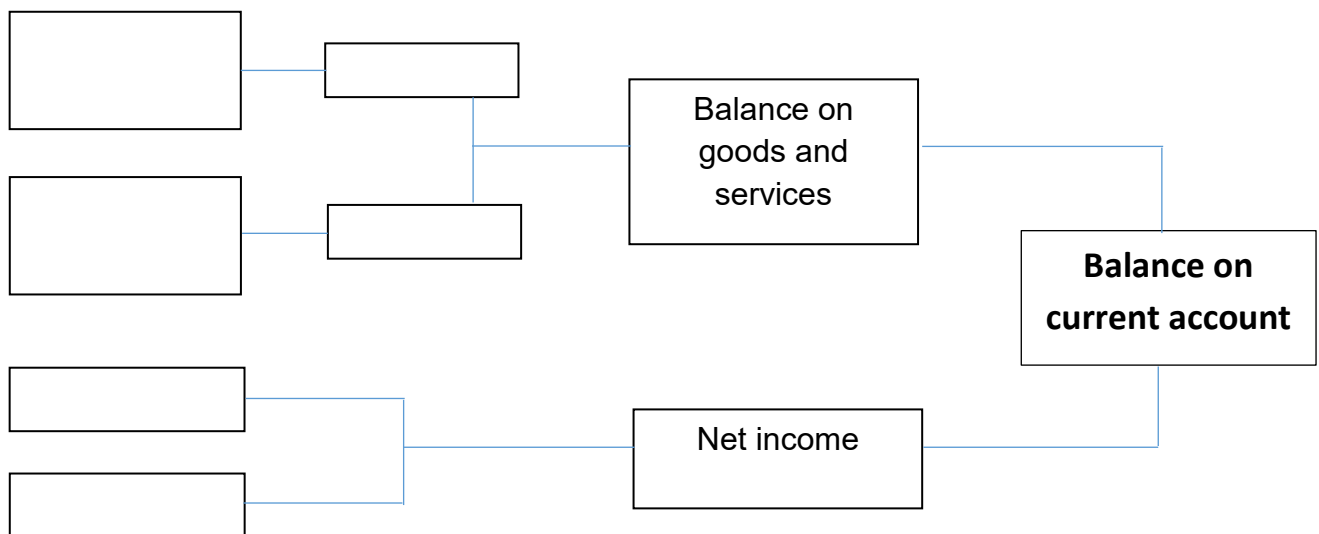
- **Secondary**

---

---

---

*Complete the summary diagram below using your text.*



### Australia’s Balance of Payments 2016 – 18

Complete the table using information from your textbook:

		\$ million original		
CURRENT ACCOUNT		2016	2017	2018
	Goods			
		Credits		
		Debits		
	Services			
		Credits		
		Debits		
Balance on goods and services				
	Primary income			
		Credits		
		Debits		
	Secondary income			
		Credits		
		Debits		
Net Income				
BALANCE ON CURRENT ACCOUNT				

$\text{Balance on Goods and Services} + \text{Net Income} = \text{Balance on the Current Account}$
--

Classify the following according to how they would be recorded on the Current Account in terms of:

- Good, Service, Primary Income, Secondary Income
- Debit or Credit?

Transaction	Classification
A Malaysian tourist visits the new WA museum.	
Ailsa, an Australian resident, goes on holiday to the UK.	
A local noodle cafe sources its ingredients from Indonesia.	
An Australian backpacker earns money by working in London.	
An American shareholder in an Australian company, Wesfarmers, receives a \$450 dividend payment.	
The local Scouts send money they have to aid Vanuatu in recovering from the latest Cyclone.	

## The Capital & Financial Accounts

**The capital account contains the following components:**

Capital transfers includes funds brought into Australia by migrants.

The capital account also records transactions relating to the purchase and sale of non-produced, non-financial assets such as the sale of patents, copyrights, trademarks, intellectual property rights and franchises.

**The financial account shows transactions in foreign financial assets and liabilities.**

Use your text to define and give examples of the following components of the financial account.

### **Direct investment**

---

---

---

### **Portfolio Investment**

---

---

---

### **Other investments**

---

---

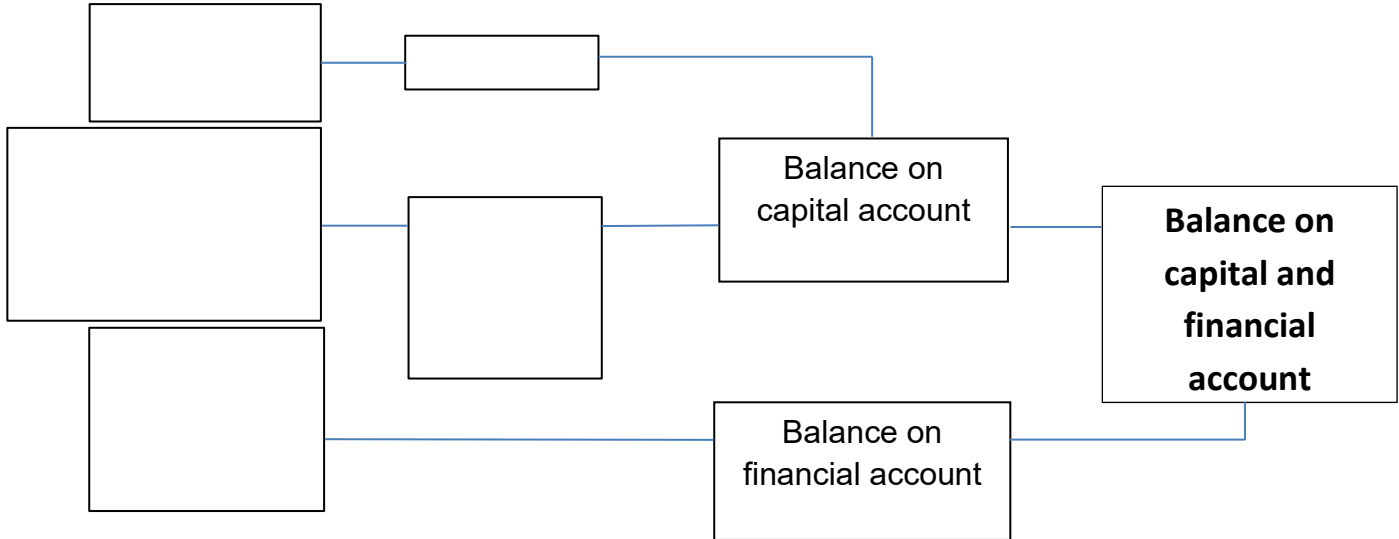
---

**Reserve assets** include the Reserve Bank of Australia's (RBA's) holdings of foreign currencies, gold and special drawing rights (SDRs) position with the International Monetary Fund.

**Net errors and omissions** refer to statistical adjustments made to ensure that the capital and financial account and the current account balance.

**The Capital and Financial Account**

Complete the summary diagram below using your text.



Classify the following transactions according to how they would be recorded in the capital and financial accounts:

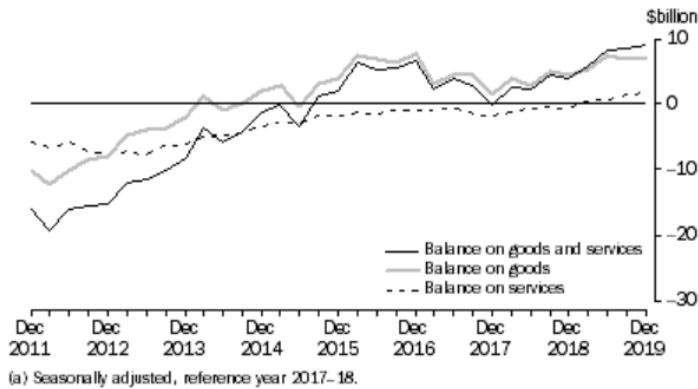
An Australian composer sells copyrights to his symphony to an Italian orchestra	
A Himalayan farmer buys a few shares in a farm in the Wheatbelt	
An Australian investor buys a Taco Bell franchise in the US.	
A UK-based inventor patents his medical grade hand sanitizer in Australia	

### **Changes in the Balance of Payments**

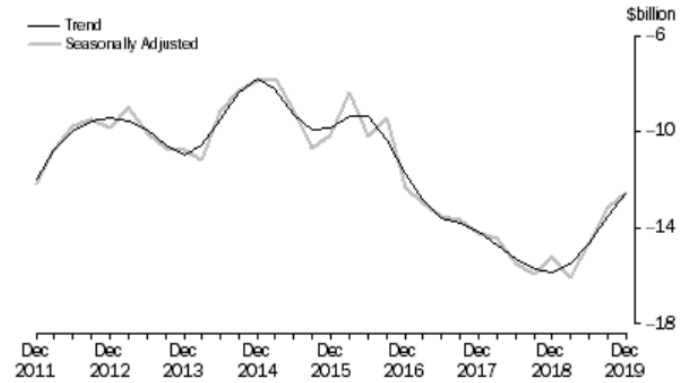
When balances in any of the BoP categories change they are reflecting changes in the overseas and domestic economies.

See the charts below which show trends in sectors of the Current Account since 2011.

**Goods and services , Chain volume measures (a)**



**Net primary income**



[Data sources: Australian Bureau of Statistics. (2019). Current account balance. Used under [Creative Commons Attribution 4.0 International](#) licence.]

**What does a 'negative balance' mean on the Goods and Services chart?**

---

---

---

---

**What is the overall trend on the Goods and Services Account?**

---

---

---

---

## Unit 3–Australia and the global economy: Balance of Payments

---

- Go to the ABS Analysis and comments page  
<https://www.abs.gov.au/AUSSTATS/abs@.nsf/7d12b0f6763c78caca257061001cc588/53986907911474beca256e4a007538bd!OpenDocument> (copy and paste into browser if it does not open)
- summarise briefly the reasons given for the recent trends in Australia's Balance of Payments.

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---





## Causes of the CAD

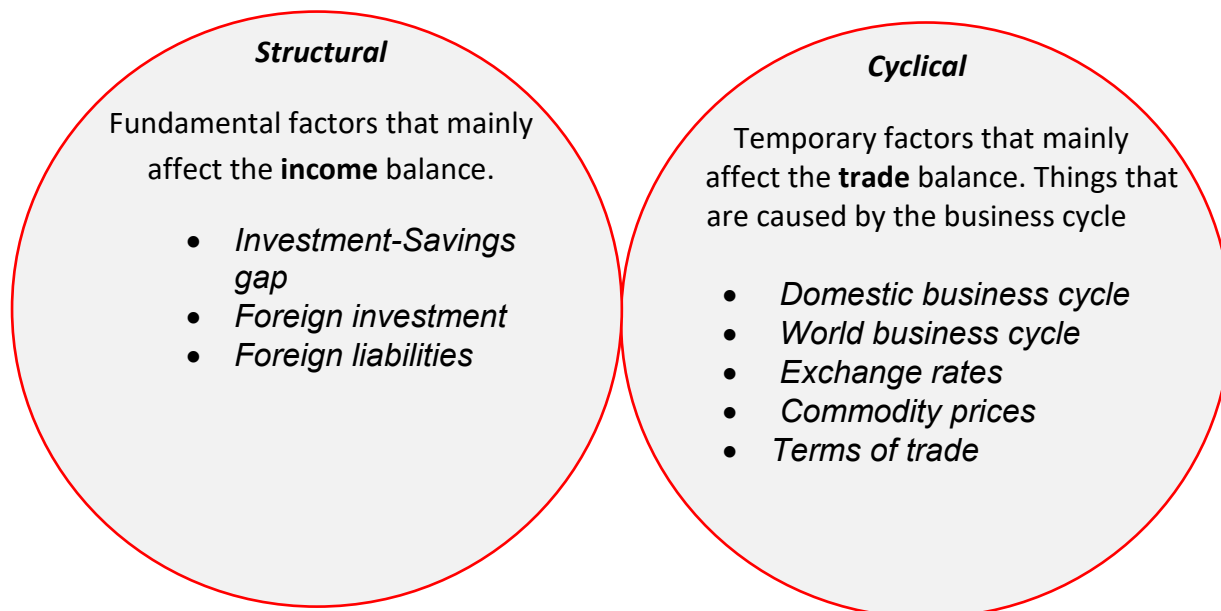
(refer to p.79 of *Investigating Macroeconomics*)

There is no ‘correct’ size for a CAD and its outcome shouldn’t be regarded as ‘good’ or ‘bad’.

Australia’s current account deficit has occurred due to cyclical reasons, such as changes in the level of economic activity in either, or both of, the Australian and global economies, as well as for structural reasons – its savings/investment gap.

If a nation has a CAD, it must be balanced by a surplus on the Capital & Financial Account. Globally, all CADs and surpluses must be balanced. For example, Japan always runs a Current Account surplus. Whether a country has a CAD or a surplus will depend on a number of factors. In the main, countries that rely on foreign investment will have a capital and financial account surplus. Countries that have excess domestic savings will have a capital and financial account deficit as they lend to other nations.

If a country’s CAD increases, it is not necessarily bad. It could be due to a change in a number of factors. These are categorized as either *structural* or *cyclical*.



**Factors with examples**

Use p.79 – 80 in *Investigating Macroeconomics* to elaborate on how the factors impact the Current Account Balance and give a recent example of how it has occurred.

**Structural**

Investment-savings gap

---

---

---

---

Foreign investment

---

---

---

---

Foreign liabilities

---

---

---

---

**Cyclical**

Domestic business cycle

---

---

---

---

Global business cycle (or those of our major trading partners)

---

---

---

---

Exchange rate

---

---

---

---

Commodity prices

---

---

---

---

Terms of trade

---

---

---

---

**Important Note**

An increase in the CAD should be referred to as a 'decrease' in the trade balance and current account balance and not a deterioration. If you hear the phrase a 'deterioration in the CAD' on the news, this is what they mean. However, an increase in the CAD shouldn't be viewed negatively. An increase in the CAD can be due to an increase in investment, which is a good thing and therefore shouldn't be referred to as a 'deterioration'.

### **Interpreting the Current Account Balance**

(refer to p.80 of *Investigating Macroeconomics*)

What does the Current Account Balance (CAB) reflect in regards to the state of the economy? Of course... it depends... We need to identify the links between trends in the domestic economy, the world economy and the level of aggregate expenditure.

Firstly, the CAB reflects the flow of exports, imports and income between Australia and the rest of the world. Secondly, it reflects the difference between total national incomes and total national expenditure.

The national situation is similar to that of an individual. If Flossie spends more than she earns, she can either sell assets to cover her position, or borrow to fund it. Selling stuff means her assets are being depleted – a short term measure. Borrowing is more expensive, but can be advantageous, so long as the repayments can be met by Flossie.

If she continues on this path, however, and continues to borrow only to spend, eventually all her income will be tied up in interest payments. She's bankrupt. However, if Flossie gets her act together and figures out that whilst borrowing is expensive, if she's using her loans to buy profitable shares or investing in a viable business, the earnings will soon cover any interest payments required, and also contribute to paying out the loans. This could also be true of borrowing to pay for education or training – it's an investment in her future earning capacity.

The same applies to a country. If the CAD occurs as a result of investment in productive assets, it is likely to be sustainable.

Finally – the CAB is the difference between a nation's investment and its savings. Australia has a relatively small population and thus savings base. Being able to borrow from overseas means we can invest more and achieve higher rates of growth. Our savings rate has actually improved over the past decade or so, to the point where it is above most OECD countries, but still falls below our investment requirements.

**Apply your learning**

- Access this link to read an article about the current account  
<https://www.abc.net.au/news/2019-09-03/historic-current-account-surplus-banana-republic/11473366>
- Use the article to answer the questions below *in your own words*:

What do you understand by the term ‘a banana republic’?

---

---

---

How much is the current account surplus at the time of writing (Sept 2019)?

---

---

---

What does it mean when the article says ‘Australia’s current account deficit was blowing out’?

---

---

---

During which year was the recent current account surplus recorded?

---

---

---

Since 2015, what events might have been responsible for the decreasing current account deficit?

---

---

---

What does the article highlight about where the revenue earned from commodities actually ends up going?

---

---

---

---

---

---

How have changes in interest rates and the origin of Australia’s debt impacted the balance of payments?

---

---

---

---

---

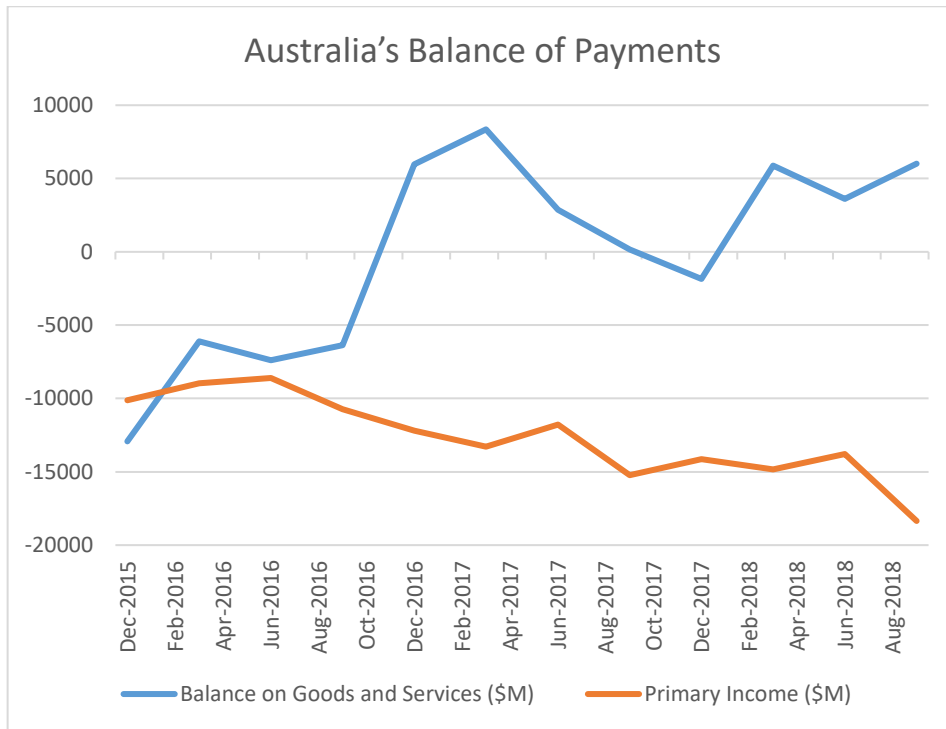
---

**Apply your learning**

**Data interpretation/Short answer**

**(20 marks)**

Refer to the following graph showing Australia’s current account in the balance of payments.



[Data source: Australian Bureau of Statistics. (2019). Current account balance. Used under [Creative Commons Attribution 4.0 International](#) licence.]

1. Identify the year that had the largest monthly trade surplus (1 mark)

\_\_\_\_\_

2. What was the value of the trade balance in December 2017? (1 mark)

\_\_\_\_\_



3. What effect does an increase in China’s economic growth have on the goods and services balance? Provide a reason for this. Looking at the graph, when might this surge in growth have occurred? (3 marks)

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

4. What is recorded in the primary income balance in the current account? Explain why Australia’s net primary income balance is always a deficit. (3 marks)

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

5. Describe the trend in Australia’s primary income balance between December 2015 and August 2018. Provide two reasons for this trend. (3 marks)

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

---

## Test your understanding

### Review questions

## Topic: The Balance of payments

### Practice multiple choice questions from past ATAR exams

All ATAR Examination questions and answers sourced from School Curriculum and Standards Authority, Economics – Past ATAR Course Exams <https://senior-secondary.scsa.wa.edu.au/further-resources/past-atar-course-exams/economics-past-atar-course-exams>

#### 1. (Q8 SCSA 2019 ATAR course exam)

This question refers to the table below, which shows selected economic data for a hypothetical economy.

<b>Balance of payments categories</b>	<b>\$ billion</b>
Export of goods	340
Import of goods	316
Export of services	58
Import of services	61
Net income	-164

According to the information in the table, which of the following statements is correct?

- (a) The balance on goods and services is \$27 billion.
- (b) The goods balance is \$340 billion.
- (c) The current account deficit is \$164 billion.
- (d) The current account deficit is \$143 billion.

#### 2. (Q9 2019 ATAR course exam)

An increase in the current account deficit would most likely be of concern if it was due to

- (a) rising investment in an economy undergoing structural change.
- (b) rising inflation levels affecting international competitiveness.
- (c) a higher rate of economic growth boosting demand for imports.
- (d) excessive domestic savings compared with investment requirements.

3. (Q8 SCSA 2018 ATAR course exam)

The purchasing of shares in an Australian company by an overseas resident would be recorded in Australia's balance of payments as a

- (a) credit in the financial account.
- (b) credit in the net income account.
- (c) debit in the transfers account.
- (d) credit in the capital account.

4. (Q8 SCSA 2017 ATAR course exam)

This question refers to the table below, which shows Australian current account data.

	Sept. quarter 2016 \$m	Dec. quarter 2016 \$m
Balance on goods and services	-3538	4667
Net income	-6663	-8520
Balance on current account	-10 201	-3853

On the basis of the data in the table, what is most likely to have been the cause of the change in the balance on current account over the time shown?

- (a) lower interest payments on Australia's foreign debt
- (b) an improvement in the terms of trade
- (c) a decline in foreign investment
- (d) an appreciation of the Australian dollar

5. (Q9 SCSA 2017 ATAR course exam)

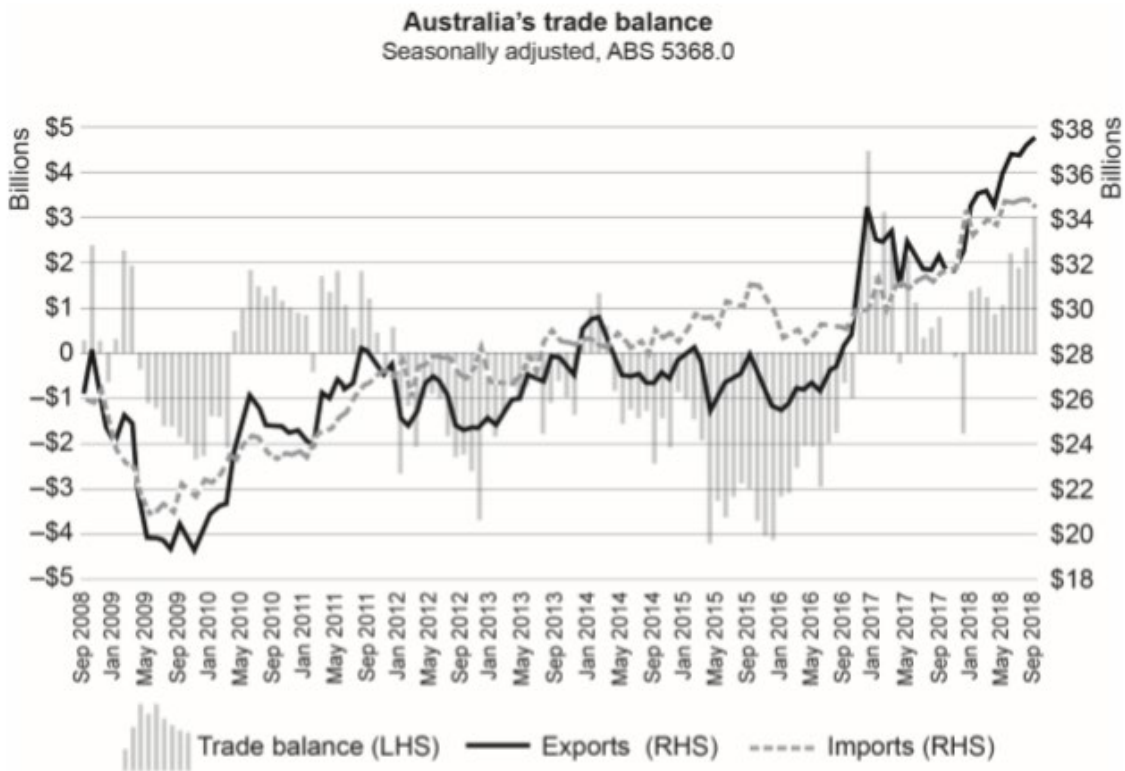
If Australia recorded a current account surplus

- (a) there would be a reduced need for foreign investment.
- (b) net foreign liabilities would begin increasing rapidly.
- (c) Australian residents would need to sell more assets to overseas residents.
- (d) the capital account must record a deficit.

**Practice short answer/data interpretation question**

Question 25 from the 2019 ATAR examination

This question refers to the graph below, which shows Australia's trade balance.



[Data source: Australian Bureau of Statistics. (2019). Australia's Trade Balance. Used under [Creative Commons Attribution 4.0 International](#) licence.]

(a) (i) Identify the year that had the largest monthly trade deficit. (1 mark)

---

(ii) Identify the value of the trade balance in September 2018. (1 mark)

---

(iii) Identify the value of Australian exports in September 2015. (1 mark)

---

b) Identify the trend in the trade balance over the three years up to September 2018 and state two possible reasons for this trend.

(3 marks)

---

---

---

---

---

(c) Discuss the likely effect of the trade balance in 2018 on the following:

(6 marks)

current account balance:

---

---

---

---

---

economic growth:

---

---

---

---

---

Federal Government budget outcome:

---

---

---

---

**Practice extended answer**

Question 28 (2017 ATAR exam)

**20 marks**

- (a) Describe the structure of Australia's balance of payments accounts. Include examples of international transactions that would occur in each category. (8 marks)
- (b) Discuss the structural and cyclical reasons for the deficits that have occurred in Australia's current account balance over the last 5 years. (12 marks)

# Answers

## Topic: Balance of Payments

### Multiple choice

Q1 d

Q2 b

Q3 a

Q4 b

Q5 a

### Data interpretation/short answer question

Check your answer to Question 26 from the 2019 ATAR exam against the marking key [here](#)

[https://seniorsecondary.scsa.wa.edu.au/data/assets/pdf\\_file/0007/592648/2019\\_ECO\\_Ratified\\_Marking\\_Key.PDF](https://seniorsecondary.scsa.wa.edu.au/data/assets/pdf_file/0007/592648/2019_ECO_Ratified_Marking_Key.PDF)

### Extended response question

Check your answer to Question 28 from the 2017 ATAR exam against the marking key [here](#)

[https://senior-secondary.scsa.wa.edu.au/data/assets/pdf\\_file/0018/460521/RATIFIED-Economics\\_Marking\\_Key\\_2017.PDF](https://senior-secondary.scsa.wa.edu.au/data/assets/pdf_file/0018/460521/RATIFIED-Economics_Marking_Key_2017.PDF)