TOPIC 2

AUSTRALIA'S PLACE IN THE GLOBAL ECONOMY

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Focus

The focus of this topic is an examination of Australia's place in the global economy and the effect of changes in the global economy on Australia.

Issues

By the end of Topic 2, you will be able to examine the following economic issues:

- Assess the impact of recent changes in the global economy on Australia's trade and financial flows
- Examine the effects of changes in trade and financial flows on Australia's economic performance
- Analyse the effects of changes in the value of the Australian dollar on the Australian economy
- Discuss the impact of free trade and protection policies on the quality of life in Australia
- Propose likely changes to the structure of industry within Australia as a result of current trends in the global economy

Skills

Topic 2 skills questions can ask you to:

- Calculate the main components of Australia's balance of payments
- Analyse the relationship between the balance of the capital and financial account and the net income balance
- Explain the relationship between the current account balance and the balance of the capital and financial account
- Use supply and demand diagrams to explain how the value of a currency is determined under different exchange rate systems
- Analyse the impact of changes in the components of the balance of payments on the value of the Australian dollar

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Topic 2

Introduction

Australia is a big country in terms of its physical size, yet its economy is relatively small compared to the rest of the world, and it is geographically isolated compared to most other economies. Yet Australia is, in many ways, deeply integrated into the global economy. Despite being geographically isolated, global economic forces have changed the Australian economy and the lives of Australians dramatically in recent decades, and those changing global forces are likely to shape Australia's economic future.

Chapters 1 to 3 covered Year 12 Topic 1 – *The Global Economy* and reviewed some of the main features of the global economy. It was noted that economies have become far more integrated in recent years because of flows of trade, finance, investment, technology and labour. International institutions have become more important as economies have become more closely linked to each other. There has been significant progress in recent years to remove trade barriers between nations. Yet with the integration of the global economy, there remains an extraordinary gap in wealth between rich and poor nations.

This topic – *Australia's Place in the Global Economy* – will focus on examining where Australia fits into the global economy and the impact of changes in the global economy on Australia's internal and external stability.

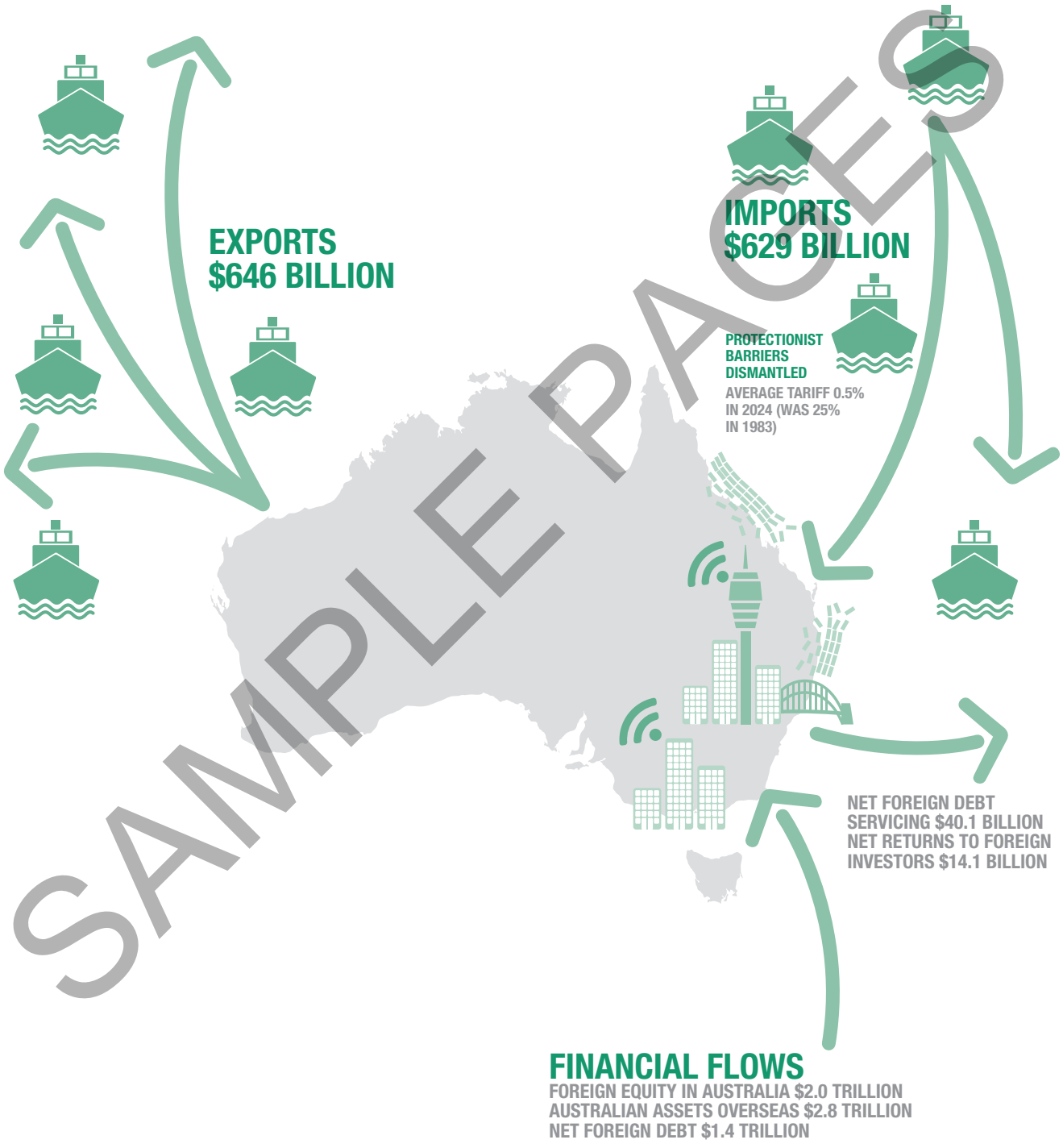
Chapter 4 outlines Australia's trade and financial flows. It looks at how Australia's trade patterns have changed over time, and how Australia's trading partners have also changed. Chapter 4 also examines the key topic of the balance of payments. The balance of payments tracks Australia's trade and financial relationships with the global economy. Chapter 4 sets out the structure of the current account and the capital and financial account, along with links between key balance of payments categories. This chapter also analyses recent trends in the size and composition of Australia's balance of payments.

Chapter 5 explains the role that Australia's exchange rate system plays in Australia's relationship with the global economy. It gives an overview of how exchange rates are determined, and looks at the influences on the demand for and supply of Australian dollars. This chapter also examines the role of government policy in influencing the exchange rate, and the effects that exchange rates can have on other economic outcomes.

Chapter 6 examines free trade and protection with a particular focus on Australia's trade and protection policies, which have changed significantly in the past three decades. These changes have had impacts for many participants in the economy. The chapter concludes with a look at the implications for Australia of the free trade and protectionist policies of other countries and international organisations and the future of Australian industry in the global economy.

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AUSTRALIA'S PLACE IN THE GLOBAL ECONOMY



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Source: ABS *Balance of Payments and International Investment Position, Australia*, Tables 10, 11, 16, 29, 30), *International Trade: Supplementary Information*, *International Investment Position, Australia: Supplementary Statistics*

4 Australia's Trade and Financial Flows

4.1 Understanding Australia's place in the global economy
4.2 Trends in Australia's trade patterns
4.3 Trends in Australia's financial flows
4.4 The balance of payments
4.5 Trends in Australia's balance of payments
4.6 The consequences of a high CAD

4.1 Understanding Australia's place in the global economy

In the first section of this book we examined the key features of the global economy, including the trends towards greater integration among countries, trade and financial linkages, trade policies, important global institutions, and the income gap between advanced and developing economies. This section focuses on where the Australian economy fits into the global economy, particularly the nature of Australia's trade and financial links with the rest of the world.

By global standards, Australia is large in some respects and small in others. On size alone, the Australian economy usually ranks 13th in the world – placing it in the middle rank of advanced economies, alongside Mexico and South Korea. This means that the Australian economy is larger than most other countries. But if it is compared to the giants of the world economy, such as the United States, China, the EU or Japan, Australia is relatively small, only making up less than 2 per cent of the Gross World Product.

Measures of the size of the economy only provide a snapshot comparison between economies. To really understand the **impacts of changes in the global economy on the Australian economy**, we must understand the linkages between Australia and the global economy. This requires an analysis of Australia's trade patterns and trade policies, Australia's financial relationships with overseas countries, and the influence of the exchange rate on the **structure and performance of the Australian economy**.

4.2 Trends in Australia's trade patterns

Despite Australia's geographic isolation from the rest of the world, trade has always represented a high proportion of Australia's economic activity. In part, this is because there have always been overseas markets for Australia's primary commodities, such as minerals and agricultural products, and because Australia's high level of development has made it an exporter of services such as tourism and education (tourism and education are considered exports because even though the transaction happens within our borders, they still bring foreign income into Australia). It is also partly because Australia has needed to trade in

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order to obtain new technology and goods that are not produced in Australia because of its relatively small population.

Trade is central to the Australian economy. Australia exports more than one-quarter of what is produced and imports the equivalent of almost one-quarter of Gross Domestic Product (GDP). As a result, although the Australian economy is small by international standards and does not have much influence on the global economy, world economic developments have significant impacts on Australia.

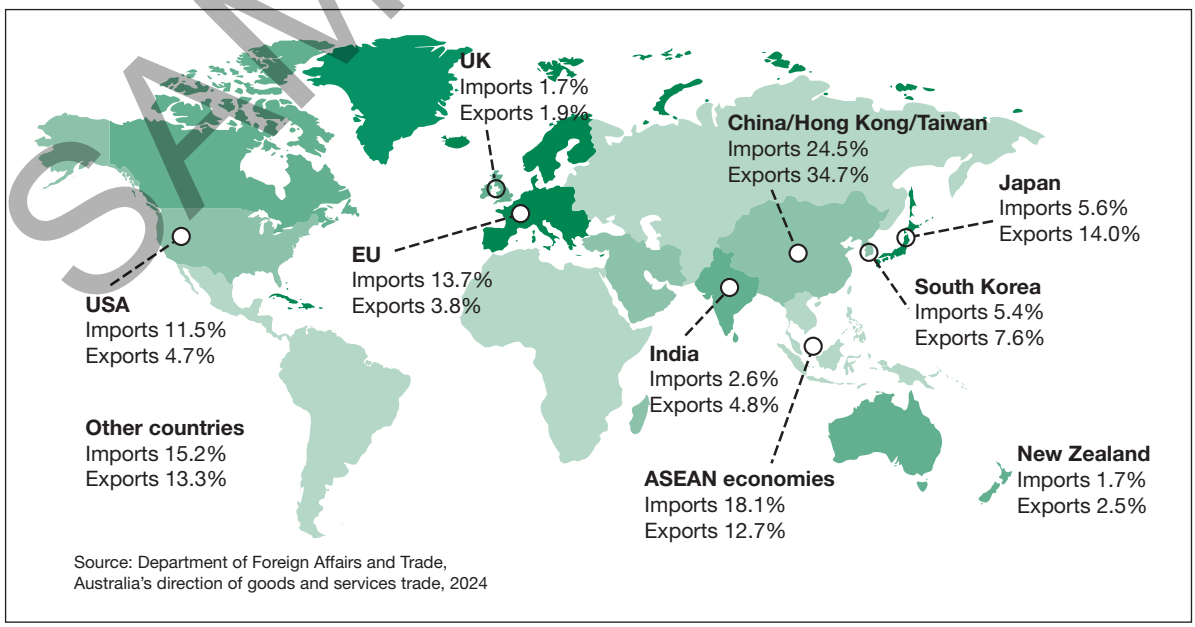
The changing direction of trade

The direction of Australia's trade has changed considerably over recent decades. China has become Australia's dominant trading partner in the past decade, while India and Southeast Asian countries have also become more important. Meanwhile, the key export markets for Australia in previous decades – the United Kingdom and Europe – have declined in importance. Figure 4.1 illustrates the importance of each of these regions to Australia's merchandise trade (which includes trade in goods but not trade in services).

There was a historic shift in the direction of Australian trade after the United Kingdom joined the European Economic Community (EEC) trading bloc, now known as the European Union (EU), in 1973. The United Kingdom had been Australia's major trading partner prior to this period, reflecting the historic ties going back to when Australia was a colony of Britain. Once the United Kingdom joined the European trading bloc, it was required to impose the same barriers to trade with Australia as with other countries, in effect giving a preference to trade from European countries. Australia shifted its exports, particularly of agricultural products, to Japan and other economies – many of which were faster-growing and geographically closer.

When Australian exporters found it more difficult to gain access to European markets, their focus shifted to other areas, particularly the Northeast Asian and Southeast Asian (ASEAN) countries, for trade opportunities. In the 1960s, the Japanese economy was growing strongly and its demand for minerals and energy increased rapidly. Australia responded to this opportunity and Japan was, for several decades, our largest export market.

China's extraordinary economic growth from the 1990s onwards created huge export markets for Australian commodities such as iron ore and coal. As China became the world's leading supplier of low-cost manufactured goods, it also became one of Australia's main sources of imports, surpassing all other countries since 2016. Since 2007, China has been **Australia's**



Source: Department of Foreign Affairs and Trade, Australia's direction of goods and services trade, 2024

Figure 4.1 – Australia's major goods trading partners

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largest trading partner (calculated by adding imports and exports together). This reflects both China's increasing significance in the global economy and Australia's role as a major commodity supplier. China is the dominant export market for Australia, with more than twice as many exports as the next largest market, Japan. In 2024, China accounted for 34.6 per cent of Australia's exports, after peaking at 37 per cent in 2019. Figure 4.2 shows the rapid growth in exports to China (together with Hong Kong and Taiwan) in the past quarter century.

Figure 4.2 also shows that the trends in the direction of Australia's exports and imports differ. Although Australia does not sell a high proportion of its production to other advanced economies, it still buys a substantial amount from these economies, in particular Europe and the United States. These imports are typically complex manufactured items likes cars and aircraft that Australia does not produce, as well as sophisticated consumer items such as pharmaceuticals.

Southeast Asia is now the fastest growing region in the world. With many large companies such as Apple diversifying their production out of China, ASEAN countries such as Vietnam have expanded manufacturing, becoming larger sources of imports to Australia. ASEAN economies will only grow as important trading partners for Australia, reflected in the Albanese Government's launch of a major strategy to boost trade and investment with Southeast Asia over the long term.

With increased geopolitical tensions and severe conflict in the US/China trade relationship, many economies are seeking to reduce the risks of depending too heavily on Chinese suppliers. Concerns about Australia's dependency on China were highlighted in 2020 when it imposed very large tariffs on several Australian exports, wiping out those export markets overnight.

Country/region	Annual share of exports (%)				Annual share of imports (%)			
	1990–91	2000–01	2010–11	2023–24	1990–91	2000–01	2010–11	2023–24
China/Hong Kong/Taiwan	2.4	13.2	23.7	37.9	2.4	9.7	15.5	20.6
Japan	24.9	17.1	16.4	12.2	15.0	11.3	6.8	5.4
ASEAN	12.1	13.6	11.1	12.7	7.7	14.7	18.1	18.1
South Korea	5.1	8.2	8.2	6.4	2.0	3.2	2.7	4.7
United States	11.7	11.1	4.8	5.7	23.1	18.7	13.1	14.6
India	0.6	1.7	6.1	5.2	0.6	0.7	1.0	2.6
European Union	14.2	7.8	8.8	3.8	25.1	14.6	18.6	13.7
New Zealand	5.7	6.2	3.7	2.9	3.6	4.1	3.6	3.0
Other countries	23.3	21.1	17.2	13.2	20.5	23.0	20.6	17.3

Source: Department of Foreign Affairs and Trade, Australia's direction of goods and services trade 2024, Australia's trade performance 1990–91 to 2010–11, World Bank

Figure 4.2 – Trends in the direction of Australia's goods and services trade by country and region

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The changing composition of Australia's trade

Primary industries have always been the main focus of Australian exports, as Australia has a comparative advantage in commodities due to its vast natural resources. Australia has exported high volumes of agricultural products such as wheat, wool and beef, and minerals such as coal, iron ore, gold and lithium. During the past two decades, mineral resources have accounted for around half of Australia's export earnings. Australia has been less competitive in manufacturing due to its small size, distance from major markets and high costs. The competitiveness of manufacturing has also been undermined by the strong terms of trade for commodity goods, which led to an appreciation of the Australian dollar. Manufacturing is now an even smaller proportion of Australia's exports than in the past, as shown in figure 4.3. Australia imports large quantities of capital goods and manufactured consumer goods.

Several factors have contributed to the decline of agricultural exports as a proportion of Australia's trade over recent decades. Large fluctuations in world prices as well as the trade protection policies of other countries make it harder for Australian farmers to compete internationally. Most of Australia's agricultural exports are also bulk commodities with little value-adding in production. There is much less scope for expanding agricultural output, because of finite supply of arable land, and the erosion of soils. In recent years, natural disasters such as floods and bushfires have become more frequent and more severe, reducing the output and productivity of the agricultural sector.

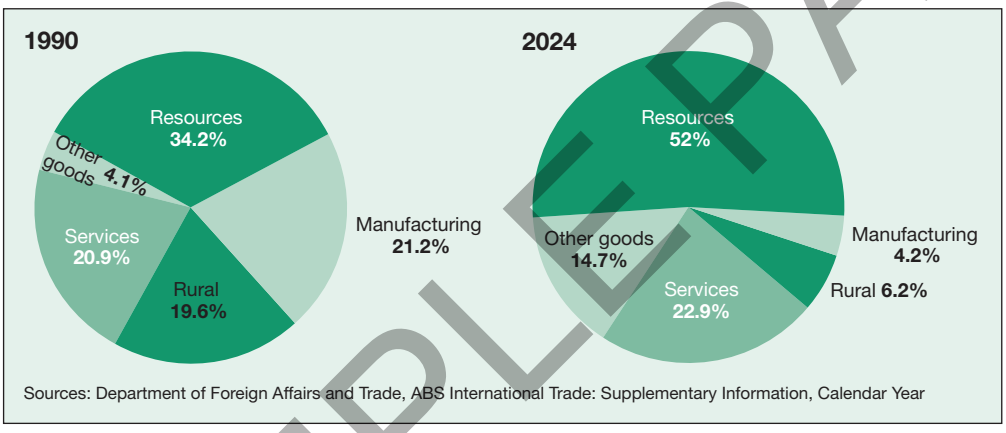


Figure 4.3 – Australia's composition of exports

Since the start of the global resources boom there has been debate about whether Australia can continue to rely so heavily on commodity exports. Some economists argue that the prospects for high commodity prices will last over the long term as China, India and ASEAN economies continue to grow rapidly.

However, others point out the risk of Australia's reliance on commodity exports, and especially its reliance on China, which accounts for almost four in every ten export dollars. In 2020, China imposed restrictions on the import of some Australian goods as a result of political tensions with the Australian Government. Alongside tariffs of over 100 per cent on wine, barley and other items, its unofficial ban on the import of Australian coal resulted in the overnight loss of a $14 billion annual trade. This underscored the risk of being too exposed to the Chinese market. Foreign policy specialists warn that the impact of a more serious dispute with China would be much greater.

While resource exports have been lucrative for the past two decades, they also create volatility for the Australian dollar and trade. Falling commodity prices were the main factors that caused the value of Australia's exports to drop from $688 billion in 2022–23 to $646 billion in 2024–25. Australia also relies heavily on coal and gas exports, whose global markets are likely to decline as economies transition to clean energy. Australia could also face carbon tariffs from other economies (such as the EU) if it continues to export large volumes of fossil fuels that contribute to global warming.

Australia's Department of Foreign Affairs and Trade publishes information about Australia's top 25 exports and imports on the Trade, Investment and Economic Statistics section of its website.

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One area of export growth that involves diversification from fossil fuels but builds on Australia's existing strengths in resources is in critical minerals and clean energy fuels. In 2024, the Albanese Government launched the Future Made in Australia package. This included a $22.7 billion investment in new export industries such as renewable hydrogen, green metals and critical minerals processing. Australia also has sophisticated service industries and a highly skilled workforce, nearly three-quarters of which is employed in service industries. In recent decades, Australia has grown substantial export markets for education services, financial services, insurance and tourism, as well as smaller markets for transport, health and communications services. These services, along with Australia's premium agricultural produce, will see greater demand from the rising middle class population across Asia.

> "Given our critical and abundant natural endowments and skilled workforce, Australia is well positioned to strengthen priority supply chains and become an indispensable part of the net zero global economy. … The Government is making targeted investments in clean energy technology manufacturing capabilities … that best align with Australia's comparative advantages and capabilities."
>
> – Australian Government, Budget 2024–25, A Future Made in Australia Fact Sheet

Figure 4.4 illustrates trends in the composition of Australia's imports as a percentage of total import expenditure. During this time, the composition of Australia's imports has remained relatively constant, even as the volume and value of imports have grown substantially, doubling in value between 2012–13 and 2024–25. With the shift away from large-scale manufacturing, Australia has become more reliant on imports for the four categories of finished consumer goods, machinery, part-finished manufactured goods and services.

Year	Capital goods (%)	Consumer goods (%)	Intermediate goods (%)	Services (%)
1999–00	18	21	36	24
2009–10	18	25	33	23
2014–15	17	23	30	30
2019–20	16	22	27	34
2020–21	17	24	25	34
2021–22	17	22	32	29
2022–23	18	23	32	28
2023–24	18	23	31	28
2024–25	18	24	30	28

Source: ABS *International Trade in Goods, Balance of Payments and International Investment Position* (accessed September 2025)

Figure 4.4 – Australia's composition of imports

reviewquestions

1. Identify the key changes in the direction and composition of Australia's trade over recent decades.
2. Discuss whether Australia's reliance on commodity exports is beneficial or harmful for the Australian economy.

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4.3 Trends in Australia's financial flows

While Australia's trade flows have increased substantially over recent years, the rate of growth in financial flows has been faster and greater, as international businesses have bought Australian assets and invested in Australian businesses, and as Australian companies have increased their overseas investments.

During the early 1970s the international system of fixed exchange rates came to an end. Exchange rates around the world were floated and restrictions on the movement of capital across national borders were removed. Financial flows began growing rapidly and technological changes made it easier to shift finance between countries. The level of foreign investment in Australia and investment overseas by Australians has grown rapidly during the era of globalisation, and has more than doubled in the last decade.

Figure 4.5 shows a change in the composition of financial flows between **direct investment** and **portfolio investment**. Direct investment includes the establishment of a new company, or the purchase of a substantial proportion of shares in an existing company (10 per cent or more). When a business undertakes direct investment, it is generally considered to be a longer-term investment and the investor normally plays a role in managing the business. This is different from portfolio investment, which includes loans and smaller shareholdings in companies. Businesses and individuals that undertake portfolio investment generally do not play a role in running the business.

Direct investment includes financial transactions to fund the establishment of a new company, or the purchase of a substantial proportion of shares in an existing company (10 per cent or more).

Portfolio investment refers to the short-term movement of funds between economies for loans or the purchase of small share holdings (less than 10 per cent of the total value of a company).

Year	Foreign investment in Australia ($m)			Australian investment abroad ($m)		
	Direct	Portfolio	Total	Direct	Portfolio	Total
1990–91	106,636	145,942	**309,330**	44,715	22,702	**115,583**
1995–96	156,172	256,288	**482,952**	84,786	49,964	**204,281**
2000–01	253,467	475,407	**888,811**	218,371	150,145	**516,419**
2005–06	386,425	831,380	**1,456,020**	352,019	314,393	**918,882**
2010–11	557,154	1,192,146	**2,116,789**	458,567	496,556	**1,338,477**
2015–16	877,179	1,642,290	**3,304,726**	624,395	865,905	**2,255,207**
2020–21	1,094,382	2,075,541	**4,091,045**	898,502	1,439,815	**3,167,968**
2021–22	1,188,407	2,085,677	**4,506,040**	995,642	1,461,602	**3,610,389**
2022–23	1,218,361	2,177,770	**4,649,348**	1,030,622	1,617,229	**3,816,812**
2023–24	1,258,611	2,376,798	**4,644,493**	1,194,057	1,843,463	**3,983,587**
2024–25	1,350,927	2,614,834	**5,026,720**	1,298,709	2,110,782	**4,362,005**

Source: ABS *Balance of Payments and International Investment Position, Australia, Table 27*
Note: direct and portfolio investment differ from calculations of foreign debt and equity

Figure 4.5 – The changing pattern of Australia's financial flows

Before the financial sector was deregulated, most capital entering Australia came through direct investment, which governments favoured for its potential to create jobs and bring new technology. Portfolio investment played a smaller role, as foreign share purchases were limited and overseas loans were uncommon under the regulated system. This changed after Australia's deregulation of the financial sector and the floating of the Australian dollar in the 1980s. These opened the door to increased financial flows and allowed Australia to benefit from foreign investment through both loans and share purchases, boosting local companies' access to international markets for capital.

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This trend has been sustained for the past four decades. The rate of growth of portfolio investment into Australia has been significantly faster than the growth in longer-term foreign direct investment. Similarly, Australian investment overseas has grown at an average of 7.3 per cent a year in the 2020s. Much of this has gone to Asia, including a 56 per cent increase in Australian investment in Japan. The level of Australia's portfolio investment abroad is significantly higher than the level of direct investment.

Another significant feature of the financial flows between Australia and the global economy is the imbalance between investment in Australia and Australian investment overseas. Australia has always been a **net capital importer**, with the level of foreign investment in Australia consistently well above the level of Australian investment abroad. In part, this reflects the historically **low level of domestic savings** within Australia. Australia has historically relied on financial flows from overseas to make up for the shortfall between savings and investment in Australia, and this remains a feature of financial flows between Australia and the global economy today. However, it is important to note that these flows are not all one-way – even though foreign investment in Australia added up to $5 trillion in 2025, Australia also invested $4.4 trillion overseas (87 per cent of that invested in Australia). One reason for this is that as overseas capital markets have become more open to international investors, Australia's large superannuation funds have increasingly pursued investment opportunities overseas.

review questions

1. Explain the difference between direct and portfolio investment flows.
2. Identify TWO factors that have influenced financial flows into and out of Australia in recent years.
3. Discuss the impact of globalisation on Australia's financial flows.

4.4 The balance of payments

Balance of payments is the record of the transactions between Australia and the rest of the world during a given period, consisting of the current account and the capital and financial account.

The **balance of payments** is the single most important economic indicator of the relationship between Australia and the global economy. The balance of payments summarises all transactions that Australia has with the rest of the world over a given period of time. It shows the trade and financial flows in and out of the Australian economy. All money that flows in is referred to as a **credit**, and all money that flows out is referred to as a **debit**. For example, if Australia exports goods to Indonesia, the money we receive for these exports is an inflow, and thus a credit on the balance of payments. On the other hand, if Australia imports goods from Indonesia, the money paid out for these imports is a debit. In these accounts, credit entries are considered positive transactions, while debit entries are negative (denoted with a minus sign).

The balance of payments figures are presented in two accounts – the **current account** and the **capital and financial account**. These accounts are compiled according to a set of international accounting standards, which make it easier to compare balance of payments outcomes between countries.

Current account is the part of the balance of payments that shows the receipts and payments for trade in goods and services, transfer payments and income flows between Australia and the rest of the world in a given time period. These are non-reversible transactions.

The current account

The **current account** shows the money flow from all goods exports and imports of goods and services, income flows and non-market transfers for a period of one year. In effect, the current account covers external transactions that are not reversible (once commenced, these transactions cannot be undone). Figure 4.6 shows a simplified current account for the Australian economy.

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In order to analyse the information in this table, one must understand the meaning of the items that appear on the current account:

Component	2023–24 ($bn)	2024–25 ($bn)
Goods		
Exports	535.4	513.0
Imports	–443.3	–457.2
Net goods	92.2	55.8
Services		
Service credits	124.2	132.5
Service debits	–160.4	–171.7
Net services	–36.2	–39.2
Balance on goods and services	55.9	16.6
Primary income		
Credits	102.1	112.4
Debits	–189.4	–185.1
Net primary income	–87.3	–72.6
Secondary income		
Credits	14.2	15.1
Debits	–15.1	–15.6
Net secondary income	–0.8	–0.5
Balance on current account	–32.2	–56.6

Source: ABS *Balance of Payments and International Investment Position, Australia*, Table 30

Figure 4.6 – Structure of the current account

Net goods

This refers to the difference between what Australia receives for its goods exports and what it pays out for its imports of goods. As with all accounts on the balance of payments, there are three possible outcomes: Australia could be in balance (where export receipts equal import payments), Australia could have a surplus (where receipts exceed payments), or Australia could have a deficit (where payments exceed receipts). Figure 4.6 shows that net goods recorded a surplus of $55.8 billion in 2024–25.

Net services

This refers to the difference between what Australia receives for its service exports and what it pays for services from overseas. Service exports that Australia sells are inflows (credits), such as a course fees for overseas students studying in Australian universities or tourists visiting Australia. Services that Australia buys are outflows (debits), such as overseas travel, insurance policies or online gaming. The $39.2 billion net services deficit in figure 4.6 shows Australia imports more services than it exports.

Balance on goods and services

The balance on goods and services (BOGS) is the amount that is derived by adding net goods and net services together. Figure 4.6 shows a surplus of $16.6 billion in 2024–25.

Net primary income

This refers to earnings on investments – that is, income that is earned as a return from a factor of production. It covers interest payments on borrowings and returns on other foreign investments, such as foreign-owned companies in Australia or foreign land ownership. When foreigners invest in Australia, income in the form of rent, profits, interest and dividends flows overseas (debits). When Australians invest overseas, there is a flow of income back to Australia (credits). Figure 4.6 shows a deficit in the net primary income account of $72.6 billion in 2024–25.

Net secondary income

This refers to non-market transfers – that is, income not earned through a factor of production. These occur when products or funds are provided without a specific good or service in return. This small account has little impact on the overall balance of payments. Net secondary income includes payouts on insurance claims, workers' remittances (for example, foreigners working in Australia and sending money overseas) and funds taken out of Australia in the form of unconditional aid to developing nations (such as funds given as a gift to a foreign government without a specified purpose). These are each examples of debits. On the other hand, pensions received by Australian residents from foreign governments would be a credit on net secondary income. Figure 4.6 shows a deficit in the net secondary income account of $0.5 billion in 2024–25.

Balance on current account

This refers to the addition of the BOGS, net primary income and net secondary income. Figure 4.6 shows that in 2024–25 the balance on the current account was a deficit of $56.6 billion.

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The capital and financial account

Capital and financial account records the borrowing, lending, sales and purchases of assets between Australia and the rest of the world.

The other side of the balance of payments is the capital and financial account. This is concerned with financial assets and liabilities – the money flows that result from international borrowing, lending and purchases of assets such as shares and real estate for a period of one year. The major feature of the capital and financial account is that these transactions are reversible – that is, they can be undone in the future. For example, borrowings can be paid back, and purchased assets can be sold again.

Component	2023–24 ($bn)	2024–25 ($bn)
Capital account		
Capital transfers	–0.5	–1.0
Net acquisition/disposal of non-produced, non-financial assets	0.2	0.5
Total capital account	**–0.3**	**–0.5**
Financial account		
Direct investment	66.7	54.4
Abroad	–12.6	–19.6
In Australia	79.3	73.9
Portfolio investment	66.5	15.9
Abroad	–108.8	–127.3
In Australia	175.3	143.2
Financial derivatives	–55.9	–32.5
Other investment	–29.3	28.7
Reserve assets	–4.1	2.9
Total financial account	**44.0**	**69.4**
Balance on capital and financial account	43.7	68.9
Net errors and omissions	–11.5	–12.3

Source: ABS *Balance of Payments and International Investment Position, Australia*

Figure 4.7 – Structure of the capital and financial account

Figure 4.7 shows a simplified capital and financial account for the Australian economy. The main features of the capital and financial account are as follows:

Capital account

The **capital account** consists of two main components. The first item is capital transfers, mainly in the form of "conditional" foreign aid grants (which are linked to specific capital projects) and debt forgiveness. This often takes the form of contributions from Australia for infrastructure in countries in the Pacific region. It would also include the financial support that the Australian Government is providing to help Papua New Guinea establish an NRL team from 2028. The second item is the purchase and sale of non-produced, non-financial assets – mainly intellectual property rights such as patents, copyrights, trademarks and franchises (such as an Australian company paying a South African company for the rights to operate a Nando's outlet in Australia). Figure 4.7 shows a capital account deficit of $0.5 billion.

Financial account

The **financial account** records transactions of financial assets and liabilities by Australians and foreigners. It is categorised into five different types of investment: direct investment, portfolio investment, financial derivatives, reserve assets and other investment. The size of the financial account can change substantially from one year to the next. This is because it can include very large one-off financial transactions (such as Australian skincare brand Aesop being acquired by French company L'Oreal for $3.7 billion).

Credits in the financial account represent net inflows. These come about because of either an increase in foreign investment in Australia or a reduction in Australian investment overseas. Debit entries represent net outflows. Until recent years, Australia has consistently recorded a positive financial account balance. This meant Australia's liabilities to the rest of the world were higher than the liabilities of the rest of the world to Australia. When that happens, Australia has effectively drawn on the savings of the rest of the world to finance a deficit on its current account.

The five main financial account components are:

- **Direct investment**: Direct investment covers foreign financial transactions to fund new investment in Australia or overseas or to buy at least 10 per cent of shares in an existing company. This might include a South Korean company bringing in funds to build a motorway in Sydney or BHP sending funds to Indonesia to fund the construction of a copper mine. Figure 4.7 shows a direct investment surplus of $54.4 billion.
- **Portfolio investment**: Portfolio investment refers to the buying of land, shares and other marketable securities (that is, securities that can be easily sold) in existing companies. This is also where most foreign debt is recorded. Portfolio investment usually has the largest volume of transactions on the capital and financial account. Figure 4.7 shows a $15.9 billion surplus in portfolio investment in 2024–25, down

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from a $66.5 billion surplus in 2023–24. This means that the value of Australian portfolio investment overseas was less than the value of overseas portfolio investment in Australia.

- **Financial derivatives**: Financial derivatives are a category of complex financial assets that became widely known for their role in the Global Financial Crisis in 2008. The value of these investments is normally derived from the performance of specific assets, interest rates, exchange rates or indices. Figure 4.7 shows a $32.5 billion deficit in financial derivatives.
- **Reserve assets**: Reserve assets refer to those foreign financial assets that are available to and controlled by the central authorities for financing or regulating payment imbalances. Reserve assets include foreign currencies and gold held by the Reserve Bank, as well as reserve positions (similiar to an equity stake) in the International Monetary Fund. Figure 4.7 shows a surplus of $2.9 billion in reserve assets.
- **Other investment**: Other investment captures transactions not classified in the other four categories. Other investment covers trade credits, loans including financial leases, currency and deposits. Figure 4.7 shows a $28.7 billion surplus for this category.

Balance on capital and financial account

The overall balance of the capital and financial account is determined by adding the categories together. The outcome should be approximately equal to the deficit on the current account. Figure 4.7 shows a $68.9 billion surplus in 2024–25.

Australia's balance of payments figures are derived in the following way:

The current account is calculated as:

net goods + net services
(the balance on goods and services)
+
net primary income + net secondary income

The capital and financial account is calculated as:

capital account + direct investment + portfolio investment
+
other investment + reserve assets + financial derivatives

The balance of payments is calculated as:

current account + capital and financial account
+
net errors and omissions = 0

The final part of the balance of payments is the category of **net errors and omissions**. These are statistical discrepancies. They are included because under a floating exchange rate system, the balance of payments always balances to zero (that is, a deficit of $56 billion on the current account would be offset by a surplus of $56 billion on the capital and financial account). For convenience, the balancing item is often added on to the capital and financial account figure to ensure the balance of payments sums to zero. It is therefore often reported with the capital and financial account. In 2024–25 the net errors and omissions item was the largest ever recorded at $12.3 billion.

Links between key balance of payments categories

An important relationship exists between the current account and the capital and financial account on the balance of payments. Firstly, the two accounts add up to zero – together, they represent a "balance of payments". The deficit on the current account is equal to the surplus on the capital and financial account (allowing for the small category of net errors and omissions). On the other hand, an increase in a current account surplus results in a larger capital and financial account deficit.

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In theory, the floating Australian dollar plays the key role of ensuring that there is a balance in the balance of payments. Under a freely floating exchange rate, equilibrium occurs where:

Supply of A$

The supply of A$ is represented by:

- Payments for imports of goods and services (M)
- Primary & secondary income/transfers overseas (Y debits)
- Capital and financial outflow (K outflow)

=

Demand for A$

The demand for A$ is represented by:

- Receipts for exports of goods and services (X)
- Primary & secondary income/transfers from overseas (Y credits)
- Capital and financial inflow (K inflow)

Therefore, for equilibrium in the foreign exchange market:

Supply of A$ = Demand for A$

Which in turn implies:

M + Y debits + K outflow = X + Y credits + K inflow

Rearranging the equation:

M – X + Y debits – Y credits = K inflow – K outflow

OR

Deficit (or surplus) on the current account = Surplus (or deficit) on the capital and financial account

The strongest link between the current account and the capital and financial account can be seen on the net primary income part of the current account. In the longer term, a capital and financial account surplus will result in a larger deficit on the net primary income component of the current account. This is because any foreign financial flow into Australia must earn some kind of return for its owner, and these earnings are a debit (or an outflow) recorded on the primary income account. Financial inflows create debits on the primary income category of the current account in two main ways:

- **International borrowing** (that is, foreign debt) will require regular interest repayments. These interest payments, or servicing costs, are not recorded on the capital and financial account; they are recorded as debits on the net primary income part of the current account. Only the repayment of the principal (the original amount borrowed) is recorded on the financial account. Australia's high level of borrowing from overseas has contributed significantly to the net primary income deficit due to the servicing costs of foreign debt.
- **Foreign investment** (that is, foreign equity) will require returns on the equity investment. Equity financial inflows are related to the foreign purchase of Australian assets such as land, shares or companies. Foreign owners of Australian land will receive rent, owners of shares will receive dividends, and owners of companies will receive profits. These returns on investment flow back to the overseas investor, and are also recorded as debits on the net primary income part of the current account.

Over time, larger capital and financial account surpluses will result in a greater current account deficit because borrowing from overseas or selling assets to foreigners creates ongoing costs such as paying interest or dividends to foreign investors. In extreme cases this may lead to a "debt trap" scenario, in which an economy borrows from overseas merely to pay the interest-servicing costs on its existing foreign debt.

The link between savings and investment on the balance of payments is an important part of understanding the balance of payments. Australia's historically low savings has meant that the economy has required large quantities of foreign investment, which are represented by financial account inflows. This suggests current account deficits are not only the result of trade imbalances and a lack of international competitiveness. They are also the result of a savings–investment gap which has been a long-term driver of Australia's external imbalances. The growth of superannuation savings has helped to reduce the savings–investment gap in recent years, making the balance of payments less of a concern to economists.

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reviewquestions

1 Identify the main components of the balance of payments.
2 Explain the main components of the capital and financial account.
3 Explain the relationship between the TWO sides of the balance of payments.

4.5 Trends in Australia's balance of payments

The balance of payments is an important indicator of the health of the economy and the ability for Australia to make good on its obligations to the rest of the world. It reflects key features of the structure of the economy, and it highlights any imbalances in the relationship between Australia and the global economy. Figures 4.8 and 4.9 highlight the trends in Australia's balance of payments.

Australia's current account balance moves in cycles, reflecting a mix of short- and longer-term domestic and external influences. The size and movements on the BOGS and primary income account are influenced, to varying degrees, by both cyclical and structural factors. Cyclical factors are those that vary the level of economic activity – such as changes in global demand for commodities, Australia's terms of trade and the value of the exchange rate. On the other hand, structural factors are those that are underlying or persistent influences on the balance of payments – such as the structure of Australia's export base, the international competitiveness of Australia's exports, and the level of national savings.

The most-analysed trend in the balance of payments is the current account deficit, and in particular, its main components, the balance on goods and services and net primary income. In the decades prior to the 2010s, calculated as a percentage of GDP (which provides the most accurate comparison across time and between countries), the current account was

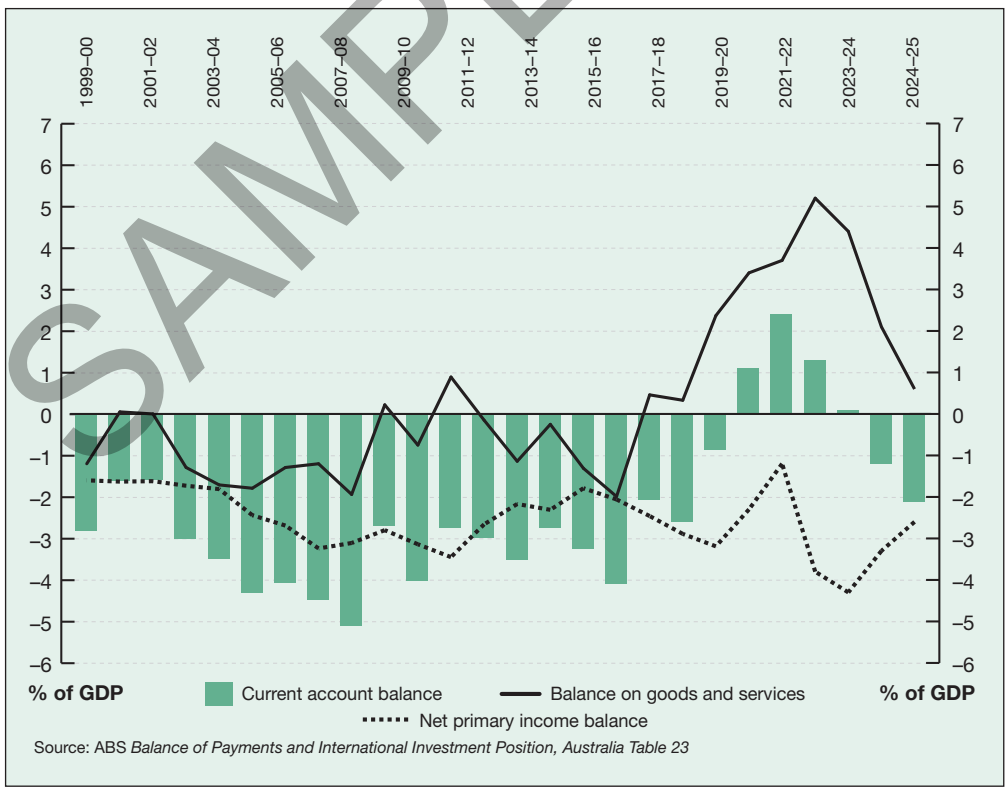


Figure 4.8 – The current account balance

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Year	Balance on goods & services ($bn)	Net primary income ($bn)	Net secondary income ($bn)	Balance on current account ($bn)	Current account balance (deficit/surplus) as % of GDP	Capital and financial account ($bn)
1990–91	–0.6	–16.8	0.6	–16.7	–4.0	16.0
1995–96	–2.4	–18.7	0.4	–20.7	–3.9	19.1
2000–01	0.6	–19.8	–0.4	–19.6	–2.8	16.9
2005–06	–18.5	–38.8	–1.0	–58.3	–5.8	55.7
2010–11	14.5	–57.0	–3.0	–45.5	–3.2	45.8
2015–16	–40.1	–39.4	–0.6	–80.0	–4.8	85.8
2020–21	79.5	–23.4	–3.3	52.8	1.3	–62.0
2021–22	122.1	–88.3	–3.1	30.8	0.1	–35.9
2022–23	112.3	–110.0	–0.9	1.3	0.1	–7.2
2023–24	55.9	–87.3	–0.8	–32.2	–1.2	43.8
2024–25	16.6	–72.6	–0.5	–56.6	–2.1	68.9

Sources: ABS *Balance of Payments and International Investment Position, Australia*, *Australian National Accounts: National Income, Expenditure and Product*

Figure 4.9 – Australia's balance of payments performance

consistently in deficit, at a level averaging around 4 per cent of GDP. After reaching a record level of 6.6 per cent of GDP in 2007–08, the current account has shown a sustained improvement. The current account recorded surpluses in the four years to 2022–23, before returning to deficit in 2023–24. These were the first current account surpluses since 1975 and were driven by strong commodity prices, low global interest rates and a contraction in imports during the COVID-19 recession. The surpluses were prolonged by a surge in commodity prices that ended in 2023. However, the short-term nature of these factors was reflected in the return to a current account deficit in 2023–24, with weaker commodity prices and higher debt servicing costs due to rising interest rates.

The balance on goods and services

The balance on goods and services (BOGS), also sometimes referred to as the trade balance, has recorded strong surpluses in recent years. It has been in surplus since 2016–17, averaging around 3 per cent of GDP. This reflects the strong growth in income from Australia's resources and energy exports. The BOGS surplus of $16.6 billion (or 0.6 per cent of GDP), down from $55.9 billion in 2023–24, reflected elevated commodity prices due to the war in Ukraine, strong activity in the travel and tourism sectors, and the return of international students to Australian cities after COVID-19 border closures.

Cyclical factors

The BOGS is affected by a range of cyclical factors, including the exchange rate, the terms of trade, and the rate of economic growth in the Australian and global economies.

- **Exchange rate**: Movements in the exchange rate affect the international competitiveness of Australia's exports and the relative price of the goods and services that Australia imports. A depreciation decreases the foreign currency price of Australia's exports, increasing the international competitiveness of Australian exports on world markets. At the same time, a depreciation increases the Australian dollar price of imports and discourages consumers from purchasing imports, also improving the BOGS account.
- **Terms of trade**: The greatest influence on Australia's balance of payments in recent years has been changes in Australia's terms of trade. The terms of trade shows the relationship between the prices Australia receives for its exports and the prices it pays for its imports. An improvement in the terms of trade means that the same volume of exports can buy more imports. All things being equal, this would lead to an improvement on the BOGS (either a larger surplus or a smaller deficit), and a decrease in the current account deficit.

Terms of trade measures the relative movements in the prices of an economy's imports and exports over a period of time. The terms of trade index is calculated as export price index divided by import price index multiplied by 100.

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CALCULATING THE TERMS OF TRADE

The **terms of trade** is expressed as a number known as the terms of trade index. It shows the ratio of the export price index to the import price index. The export price index shows the proportional change in the level of export prices, while the import price index shows the proportional change in the level of import prices. If export prices are increasing relative to import prices, Australia's terms of trade will improve. On the other hand, if import prices are increasing relative to export prices, then the terms of trade will deteriorate.

It should be noted that, as with all index numbers, the proportional change is relative to a base year, or starting point, which is given an index number of 100. (**Note**: You are not required to make calculations of the terms of trade index for the NSW Year 12 syllabus but understanding the terms of trade is important for analysis of recent trends in Australia's balance of payments.)

$$\text{Terms of trade index} = \frac{\text{Export price index}}{\text{Import price index}} \times \frac{100}{1}$$

The following example, based on the information in figure 4.10, demonstrates how to calculate the terms of trade.

Year	Export price index	Import price index	Terms of trade index
1	100	100	100
2	115	105	109.5
3	120	130	92.3

Figure 4.10 – Hypothetical terms of trade index figures

In this example, the terms of trade have improved in Year 2 and deteriorated in Year 3 (shown by the falling index number), with import prices rising faster than export prices.

$$\text{Year 3 terms of trade index} = \frac{120}{130} \times \frac{100}{1} = 92.3$$

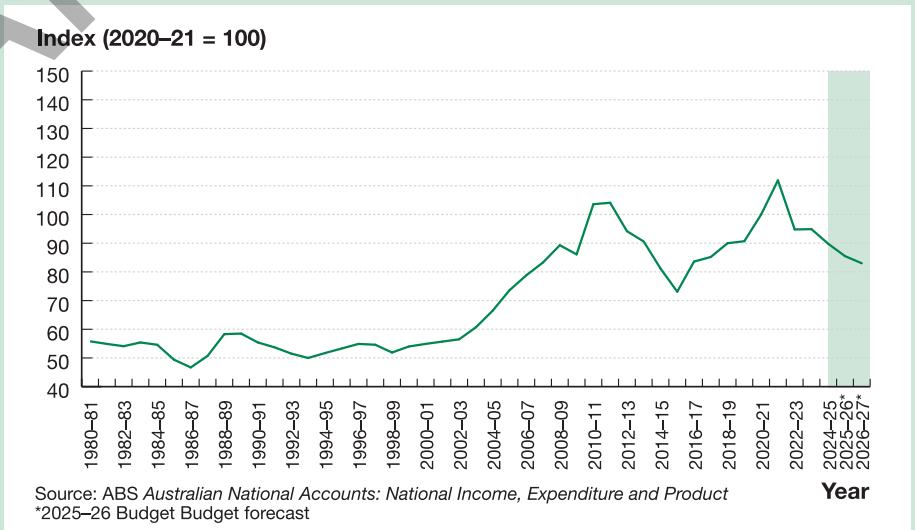
THE LUCKY COUNTRY: AUSTRALIA'S RECORD TERMS OF TRADE

Since 2003, Australia has experienced the largest sustained terms of trade boom in its history. This reflects the impact of a long boom in the prices for global commodities. As most of Australia's exports are commodities, Australian exporters have received higher prices for their exports, increasing the value of Australian export revenues. At the same time, the rise of China and other low-cost emerging economies also flooded world markets with low-cost manufactured goods, reducing import prices. Both of these factors helped to improve the BOGS.

After the beginning of the boom in global commodity prices in 2003, Australia experienced a doubling of its terms of trade. As figure 4.11 shows, the terms of trade have emained well above historic averages since then even with periods of decline in the early 2010s and mid-2020s.

The terms of trade reached a peak in mid-2022, as the recovery from the COVID-19 pandemic increased demand for Australia's commodity exports, and global energy prices soared following Russia's invasion of Ukraine and its threat to cut off gas supplies to Europe. Slower growth in China between 2023 and 2025 prompted a fall in commodity prices.

In 2025, the Treasury forecast a 9 per cent decline in the terms of trade over the next two years, stabilising at around its average of the last 15 years by 2025–26. This assumes that commodity prices, including for iron ore and coal, will fall to around their long-run levels in the coming years.



Source: ABS *Australian National Accounts: National Income, Expenditure and Product*
*2025–26 Budget Budget forecast

Figure 4.11 – Terms of trade

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- **Economic growth rates**: The level of domestic economic growth influences the BOGS balance by affecting demand for imports. An upturn in the domestic business cycle results in increased business investment and higher disposable income, which leads to higher consumption. Higher levels of business investment and household consumption spill over into higher imports, worsening the BOGS. If economic growth is driven by investment that increases productivity and output, exports will grow, and this should reduce the BOGS deficit, or increase the surplus. This helps explain why, after the onset of the mining boom in 2003, the BOGS worsened for several years before its turnaround in the 2010s.

  Changes in the international business cycle impact the BOGS by affecting the demand for Australia's exports. A slowdown in global economic growth, particularly in Australia's key regional trading partners, reduces demand for Australia's exports, worsening the BOGS. A key feature of Australia's economic successes in recent decades is that our economy has been more closely integrated with faster-growing economies than many other developed countries.

Structural factors

Over the long term, Australia's BOGS has tended to remain in deficit. This reflects two key structural factors on the BOGS: Australia's narrow export base and a lack of international competitiveness.

- **Narrow export base**: Australia's export base is narrow, in the sense that Australia's exports are heavily weighted towards a small number of commodities. Australia's comparative advantage lies in products that do not involve a large value-added component, such as minerals and agriculture, which together account for around two-thirds of Australia's export earnings. Australia is highly exposed to movements in prices and demand in these markets. This volatility contributes to large fluctuations in the BOGS from year to year.

  For much of the second half of the 20th century commodity prices were on a long-term downward trend, worsening Australia's external position. While the increased global demand for commodities made commodity exports more valuable over the last 25 years, Treasury forecasts a continuation of recent declines in the terms of trade through to 2026–27.

  In recent decades there has also been an upturn in the prices for many agricultural exports, although the increase has been smaller than for the mining sector. The Reserve Bank's index of rural commodity prices rose from an average of 47 in US dollar terms in the 2000s, to an average of 90 between 2020 and 2025. The increase in agricultural prices reflects growing global food demand, rising incomes in the developing world, rising prices for agricultural inputs such as oil and fertilisers, the effect of the war in Ukraine and the impacts of climate change reducing agricultural productivity, such as through natural disasters.

  While the boom in commodity prices has benefited Australia during the first quarter of the 21st century, economists agree on Australia's need to reduce its dependence on fossil fuel exports. As economies across the world accelerate their shift away from carbon-intensive fossil fuels, Australia will not be able to rely on carbon-intensive exports such as coal and gas. In addition, agricultural practices will need to change as output is affected by changing weather patterns and natural disasters.

- **Lack of international competitiveness**: Australia lacks international competitiveness in manufacturing and relies heavily on imports of value-added products such as consumer goods and capital goods, while relying on the export of bulk commodities to which little value is added. As a result, BOGS has historically tended to be in deficit because import payments often outstrip export revenues.

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Many economists argue that in the long run Australia must diversify its exports towards high-growth, high value-added sectors of global trade, including digital and other services, clean energy and elaborately transformed manufactures (ETMs). This is one of the goals of the Future Made in Australia policy announced by the Albanese Government in 2024, which provides industry support for the manufacture of solar cells, batteries and clean energy technology.

Services exports also provide a strong growth opportunity, given Australia's close proximity to emerging economies in Asia. Continued growth in services exports is essential to diversifying Australia's export base since Australia is chiefly a service-based economy. Following double digit growth for much of the 2010s, and strong recovery from the COVID-19 recession, Australia's trade in service exports in 2024–25 rose to a record level of $132.5 billion.

Australia's international competitiveness is also affected by infrastructure for transport and information, such as the capacity at the nation's ports, road and rail networks, and broadband networks. Significant recent infrastructure investment has helped alleviate infrastructure capacity constraints and facilitated export growth.

The primary income account

The primary income account plays a central role in the trends in Australia's current account balance. It is composed mainly of payments of interest and dividends on Australia's net foreign debt and equity. Between 2004–05 and 2019–20, the net primary income account typically recorded a deficit between 2 and 3 per cent of GDP. In 2024–25, the net primary income deficit was 2.6 per cent of GDP.

Cyclical factors

The net primary income deficit reflects Australia's net servicing costs for its foreign liabilities. These can take the form of interest repayments on foreign debt or dividend payments and profits on foreign equity. The three main cyclical factors that drive these servicing costs are domestic economic growth, the exchange rate and interest rates.

- **Domestic economic growth:** When the domestic economy experiences strong growth, company profits rise, and these profits are redistributed to shareholders as dividends. In Australia, approximately 40 per cent of the Australian public share market is foreign-owned. As a result, a large proportion of dividends flow out of Australia as payments to overseas shareholders. This means that higher domestic profits tend to increase equity servicing costs in the form of dividend outflows, which then increase the net primary income deficit. Since Australia's mining sector is mostly owned by foreign companies, a high level of profits in the mining sector results in a significant dividend outflow from Australia. This had a major influence on the size of the net primary income deficit during the mining boom.
- **Exchange rate**: Movements in the exchange rate alter the Australian dollar value of debt denominated in foreign currencies. This is known as the "valuation effect". An appreciation decreases the Australian dollar value of debt denominated in foreign currencies, decreasing Australia's debt servicing costs (in Australian dollar terms), reducing the value of net primary income outflows and reducing the net primary income deficit. On the other hand, a depreciation of the Australian dollar results in the opposite impact.

  However, the valuation effect on the net primary income account is limited, particularly in the short term. Approximately 75 per cent of Australia's foreign debt is denominated in Australian dollars, and is thus not affected by exchange rate movements. Further, much of the remaining amount is "hedged" in some way, meaning that the business will enter into a forward contract or other agreement to offset any change in the exchange rate over the life of the loan.

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- **Changes in interest rates**: Australia's overseas loans can be taken out with overseas interest rates (when borrowed in foreign currencies) or an Australian interest rate (when borrowed in Australian dollars). When interest rates change, the cost of servicing foreign debt also changes. Australia's sensitivity to global interest rates was reflected in the cost of debt servicing, due to a sharp increase in global interest over the two years to 2023–24, which doubled to $38 billion in net terms, reflecting the rising cost of servicing debt in both Australian dollars and foreign currencies.

Structural factors

The main reason for Australia's long-term net primary income deficit is an underlying structural feature of the Australian economy: a gap between savings and investment. Australia is a relatively small economy with a historically low level of national savings. At the same time, the Australian economy requires high levels of capital investment for its economic growth. In particular, Australia's major export industry, minerals and resources, requires substantial investment in exploration, capital equipment for extraction and transport infrastructure from remote locations.

Since Australia is an open economy, firms are able to look to foreign sources of finance to fund their investment. This means that Australia tends to fund a large part of its investment through overseas borrowing (which increases foreign debt) or selling ownership stakes in Australian businesses (which increases foreign equity). This increases Australia's foreign liabilities and creates future servicing obligations in the form of interest repayments (on debt) and dividends (on equity). These servicing costs are recorded as outflows on the net primary income account and are the major reason why the current account remained in deficit until recent years even as Australia sustained trade surpluses.

On the other hand, the growth in Australia's overseas investments (which has been led by Australia's large volume of superannuation funds) results in inflows of earnings on those investments, which improve the net primary income balance. This contributed to the trend towards a lower primary income deficit since the 2010s and was aided by a lower exchange rate.

Historically, Australians have had low levels of household and public savings. Australian households are highly leveraged compared to other countries, with twice as much debt (as a proportion of their household income) as two decades ago. As shown in figure 4.12, household savings increased dramatically during the COVID-19 recession in 2019–20, as households had fewer opportunities to spend. However, the increase in savings was not sustained, and by 2024 the household savings ratio had fallen to a 17-year low of 0.6 per cent of household income (although it is important to note that this low household savings ratio does not include superannuation savings). The fall in household savings reflected the impact of rising interest rates over previous years and cost of living pressures. Australian governments have also substantially increased their borrowings during the past decade, detracting from the overall level of national savings.

Governments can increase Australia's national savings through policies to increase the level of personal savings (such as increasing the rate of compulsory superannuation, and reversing incentives in the tax system that encourage increased debt to encourage increased savings). Governments can also increase public savings by reducing budget deficits and moving the budget into surplus through fiscal consolidation. A budget deficit is a form of negative public savings, whereas a budget surplus makes a positive contribution to the level of national savings. With Australia facing long-term spending pressures, in particular for age and disability care and for defence, a key issue for economic debate in the 2020s is the speed of deficit reduction, which will have a long-term influence on the savings/investment gap and therefore on the balance of payments.

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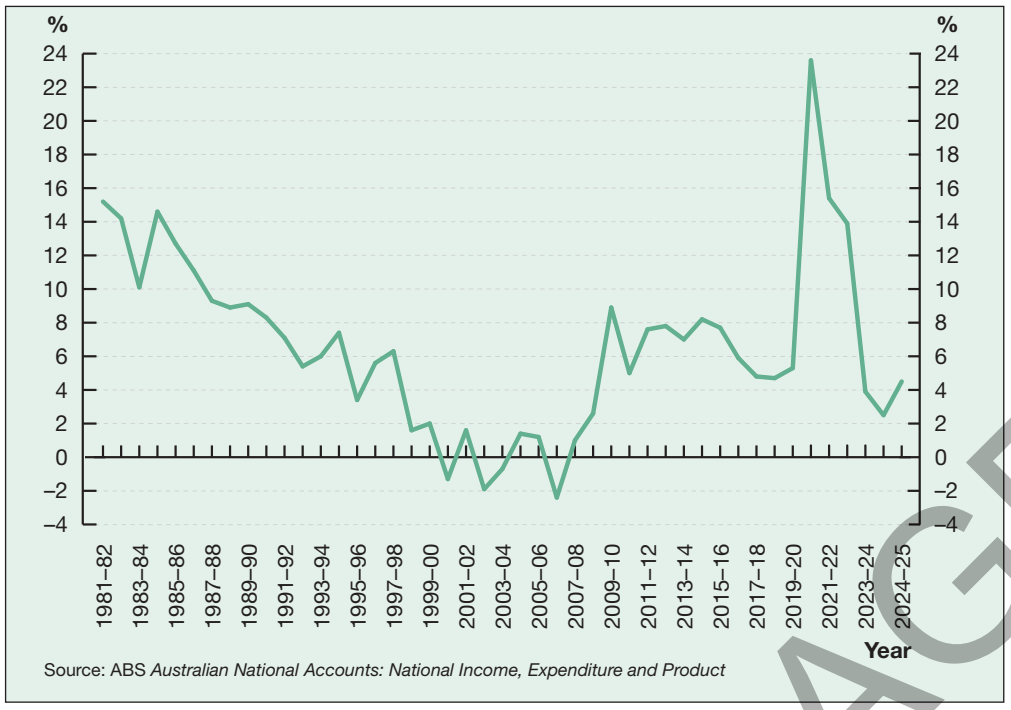


Figure 4.12 – Household savings ratio

reviewquestions

1. Discuss THREE trends in Australia's balance of payments performance in recent years.
2. Explain how changes in commodity prices have influenced Australia's terms of trade and the current account in recent years.
3. Analyse the relationship between the level of national savings and imbalances on the current account.
4. Evaluate recent influences on the current account.

4.6 The consequences of a high CAD

Economists differ over their level of concern about Australia's historic pattern of high deficits on the current account and foreign liabilities. Some argue that if the government is not borrowing money (that is, the budget is in surplus), any external imbalances are simply the result of normal market transactions. Some also argue that a current account deficit and foreign debt can be beneficial because this signals a high level of investment, which helps the economy to grow faster. The International Monetary Fund has generally considered a current account deficit to be too high if it averages over 4 per cent in the medium to long term or above 6 per cent in the short term.

There are several risks associated with a sustained high current account deficit. These include:

- The growth of **foreign liabilities** – over time, a high CAD will contribute to increased foreign liabilities. This is because a CAD requires financial inflows – either through borrowing from overseas (foreign debt) or selling assets such as property and companies (foreign equity). As these liabilities grow, foreign lenders and investors may become more cautious about lending to or investing in Australia.
- Increased **servicing costs** – high foreign liabilities increase servicing costs, leading to increased outflows on the net primary income account, further worsening the current account deficit. Foreign debt must be serviced through interest payments that vary

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according to the level of interest rates in Australia and overseas, and profits must be returned on foreign equity investment. As debt grows, lenders may demand a "risk premium", pushing interest rates higher.

- Increased volatility for **exchange rates** – high CADs may undermine the confidence of overseas investors in the Australian economy and, by reducing demand for Australia's currency, may result in a depreciation of the Australian dollar.
- Constraint on future **economic growth** – in the longer term, a high CAD may become a speed limit on economic growth. Higher levels of economic growth generally involve an increase in imports and a deterioration in the CAD. Economies with a CAD problem are therefore forced to limit growth to the level at which the CAD is sustainable. This is known as the **balance of payments constraint**.
- More **contractionary economic policy** – if they find it necessary to reduce a high CAD in the short term, governments may use tighter macroeconomic policies and accelerate the implementation of microeconomic reform. In the short run, tighter fiscal and monetary policies will reduce economic growth and contribute to a lower CAD.
- A sudden **loss of international investor confidence** – economic crises can sometimes be triggered by a sudden shift in the attitude of global markets towards a country whose external imbalance appears unsustainable. In recent years such crises have been seen in Sri Lanka and Argentina. Countries with high CADs and foreign debt are more vulnerable to sudden shifts in investor confidence.

Concerns about Australia's high CAD have decreased in recent years. This was especially the case as the scale and persistence of the mining boom became clearer. During the era of globalisation, financial markets have also become more willing to accept external imbalances, and have been confident that Australia's natural resource wealth will underpin continued strong export growth in the future, allowing Australia to service its foreign liabilities.

Some economists warn, nevertheless, that the current account may still re-emerge as a long-term risk for Australia. Changes in economic conditions, such as a loss of Chinese export markets or a rise in global interest rates, could see a return of high current account deficits. They argue that while Australia's current account has not been a problem in recent years, this is due to favourable external conditions that could change in the future.

reviewquestions

1. Describe THREE consequences of a persistently high current account deficit.
2. Explain how a high current account deficit might affect the exchange rate.
3. Discuss why Australia's current account has not caused significant problems for Australia in recent years. Explain whether you think this might change in the future.

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chapter summary

1 The **direction** of Australia's exports has shifted considerably in recent years from the United States, Japan and Europe towards China, Hong Kong, South Korea, India and the ASEAN economies.

2 Historically, agricultural products such as wheat, wool and beef comprised a large share of the **composition** of Australia's exports. These have declined in relative importance, while mineral and energy exports, and to a much lesser degree services, have increased in relative importance.

3 The **balance of payments** summarises all transactions between Australia and the rest of the world over a given period of time. The balance of payments consists of the current account and the capital and financial account.

4 The **current account** shows the money flowing from all of Australia's exports and imports of goods and services, income and transfer payments for a period of one year. The main feature of current account transactions is that they are not reversible.

5 The **capital account** consists of Australia's capital transfers, such as those from conditional foreign aid and the purchase and sale of intellectual property rights. The **financial account** shows Australia's transactions in financial assets and liabilities. The main feature of capital and financial account transactions is that they are reversible.

6 The current account and the capital and financial account are closely linked. A deficit on the current account corresponds to a surplus on the capital and financial account. These surpluses, which cause rising foreign debt or the sale of Australian assets, result in longer-term outflows on the primary income component of the current account.

7 The long-term effect of running a current account deficit (CAD) is the growth of **foreign liabilities**. This may occur in the form of foreign debt or foreign equity (the sale of Australians' assets such as land, companies and shares).

8 The **terms of trade** is an index showing changes in the prices of Australian exports relative to changes in the price of imports. Australia has experienced a long period of above-average terms of trade since 2003, with far-reaching consequences for the balance of payments and the economy.

9 The current account is influenced by a combination of **cyclical and structural factors**. The BOGS is the major cyclical component and is influenced by the exchange rate, terms of trade and the international and domestic business cycles. The net primary income deficit is the main structural cause of Australia's pattern of current account deficits and is the result of a savings-investment gap.

10 A persistently high current account deficit may increase foreign liabilities, debt servicing costs, exchange rate volatility and interest rates, resulting in slower economic growth. However, financial markets have tolerated deficits for several decades and, more recently, Australia experienced a series of current account surpluses.

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chapter review

1 Outline recent changes in the direction and composition of Australia's trade flows.

2 Explain why foreign direct investment might be preferable to portfolio investment.

3 Briefly explain what is meant by the *balance of payments*. Outline the structure of the two main accounts of the balance of payments.

4 Explain the relationship between the current account and the capital and financial account.

5 Examine Australia's recent balance of payments performance, distinguishing between short-term and long-term factors influencing the current account.

6 Discuss the impact of movements in the exchange rate on the current account.

7 Discuss the role of cyclical and structural factors in influencing the net primary income account.

8 Explain how movements in the terms of trade impact on the current account, with reference to recent Australian experience.

9 Examine the role of savings in Australia's balance of payments problems.

10 Discuss the possible problems associated with a high current account deficit.

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Exchange Rates 5

5.1 Introduction

5.2 Australia's floating exchange rate system

5.3 Reserve Bank intervention in the foreign exchange market

5.4 Fixed exchange rate systems

5.5 Exchange rates and the balance of payments

5.1 Introduction

Exchange rates play a central role in the relationships between individual economies and the global economy. All trade and financial relationships between countries are mediated through the exchange of currencies. For this reason, exchange rate movements have a significant impact on international competitiveness, trade flows, investment decisions, inflation and many other factors in the economy. Chapter 2 examined how global foreign exchange markets operate. This chapter will examine more closely where Australia fits into global foreign exchange markets, and what influences the value of the Australian dollar.

The exchange rate is the price of Australia's currency in terms of another country's currency. It is the price at which traders and investors can swap Australia's currency for another currency. Exchange rates are necessary because exporting firms want to be paid in their own currency, which means importers need a mechanism to convert their domestic currency into a foreign currency so they can make payments. For example, a South Korean firm exporting to Australia wants to be paid in South Korean won (the local currency). The Australian importer must convert Australian dollars into won in order to make the payment. To do so, they must know how many won they can buy with their dollars.

This currency conversion occurs in the **foreign exchange market** (also referred to as the forex market) where the forces of supply and demand or, in the case of a fixed exchange rate, the government or its representatives, determine the price of one country's currency in terms of another (that is, the exchange rate).

THE AUSTRALIAN DOLLAR IN THE GLOBAL ECONOMY

- The Australian dollar is the world's sixth-most traded currency after the US dollar, European euro, Japanese yen, British pound and Chinese renminbi.
- The Australian dollar is used in 6.4 per cent of all daily currency trades in foreign exchange markets.
- The Australian dollar and US dollar currency pair comprises 41 per cent of total turnover in the Australian forex market.
- Activity in Australia's forex market has increased over time, but the value of the currency can still go through large upswings and downswings in any given year.
- Turnover from foreign exchange transactions averaged US$182 billion per day in Australia in October 2024.

Sources: Triennial Survey of Foreign Exchange and OTC Derivative Markets, Bank for International Settlements 2022 (accessed May 2025), Semi-Annual Report on Foreign Exchange Turnover, Australian Foreign Exchange Committee 2024 (accessed May 2025)

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Countries can use different systems for determining the exchange rate of their currency. These include a floating system (clean or dirty float), a fixed-rate system and a flexible peg. Another option for countries with similar regional interests is a currency union (also referred to as a monetary union) with major trading partners, such as the euro, which is the currency of 20 European Union members, known as the eurozone, as well as four non-EU countries.

5.2 Australia's floating exchange rate system

Floating exchange rate is when the value of an economy's currency is determined by the forces of demand and supply in foreign exchange markets.

In December 1983 Australia switched from a managed flexible peg to a **floating exchange rate** system. This is regarded as one of the most important structural changes in Australia's economic history because it opened up the economy to global financial flows. Under a floating system, the exchange rate is determined by free market forces and not government intervention. Supply and demand intersect to establish an equilibrium price for the Australian dollar (A$) in terms of another country's currency. This is demonstrated in figure 5.1, which shows how the exchange rate for A$ in terms of US dollars (US$) is determined.

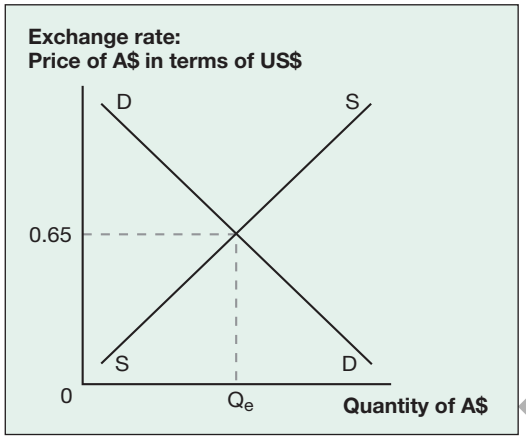


Figure 5.1 – Exchange rate determination under a floating exchange rate system

Just as market forces establish the equilibrium price for a good, they can also determine the equilibrium price of the A$ in terms of another country's currency. Figure 5.1 reveals that market forces have determined the value of the A$ in terms of US$ at US$0.65 (that is, A$1 will buy US65 cents or alternatively US$1 buys A$1.54). This equilibrium will change regularly (hour by hour, or even minute by minute) as supply and demand in the foreign exchange market change.

Demand for Australian dollars is represented by all those people who wish to **buy** that currency. Demand for Australian dollars is affected by:

- The size of **financial flows** into Australia from foreign investors who wish to invest in Australia and need to convert their currency into A$.
  - The level of Australian interest rates relative to overseas interest rates. Relatively higher Australian interest rates make Australia a more attractive location for foreign savings and thus increase the demand for A$.
  - The availability of investment opportunities in Australia. If there are more opportunities for investors overseas to start new businesses or buy into existing Australian businesses via the share market, the demand for A$ will increase.
- **Expectations** of future movements of the A$. For instance, expectations of a future appreciation of the A$ will increase current demand for A$ by speculators, as they wish to purchase the A$ at a lower exchange rate in order to gain if the A$ appreciates. This increased demand will thus contribute to the expected appreciation.
- The demand for Australian **exports**, since the foreigners who buy Australia's exports need to convert their currency into A$ to pay Australian exporters.
  - Changes in **commodity prices** and in the **terms of trade** have tended to have an immediate effect on the dollar. A rise in commodity prices and an improvement in the terms of trade are generally associated with an increase in the value of Australian exports. Financial markets will often respond to these changes by increasing the value of the dollar with an expectation that the value of exports will increase over the short to medium term.
  - If domestic firms are **internationally competitive** and Australia's inflation rate is relatively low, Australia's exports become cheaper and more attractive to foreign buyers, causing increased demand for the A$.

International competitiveness is a measure of the ability of Australian producers to compete with overseas producers in both local and world markets.

SAMPLE PAGES

  - Changes in global economic conditions will also influence the overseas demand for exports. The demand for Australia's commodity exports is highly dependent on the growth rates of Australia's trading partners – when the world economy is in recession, demand and prices for Australia's exports fall, and vice versa.
  - Tastes and preferences of overseas consumers will also affect the demand for Australia's exports.
- **Protectionist policies**, such as tariffs, can also affect the demand for exports from Australia. An increase in tariffs reduces demand for Australian exports and hence A$.

Supply of Australian dollars is represented by all those people who wish to **sell** the currency. The supply of Australian dollars is determined by a number of factors:

- The level of **financial flows** out of Australia by Australian investors who wish to invest overseas and who will need to sell A$ and purchase foreign currency.
  - The level of Australian interest rates relative to overseas interest rates influences financial flows out of Australia and the supply of A$. Relatively lower Australian interest rates will make investing savings overseas more attractive and hence increase the supply of A$.
  - The availability of investment opportunities overseas influences financial flows out of Australia. Greater opportunities for Australians to start businesses overseas or to purchase shares in overseas companies will increase financial flows out of Australia and increase the supply of A$.
- **Speculators** in the foreign exchange market who expect the value of the A$ to go down will sell A$, increasing the supply of A$ and thus contributing to the anticipated depreciation.
- The exchange rate will be affected by the **domestic demand for imports** since Australian importers who buy from overseas need to sell A$ in order to obtain foreign currencies to make import payments.
  - Demand for imports will be determined by a range of factors within Australia. One of the most important is the level of domestic income. Strong economic growth and rising incomes and employment will result in the demand for imports also rising, increasing the supply of A$.
  - The domestic inflation rate and the competitiveness of domestic firms that compete with imports will also influence import levels. If Australia's inflation rate is higher and its import-competing firms are relatively uncompetitive, imports will be relatively cheaper than domestic products and demand for imports will be higher.
  - Tastes and preferences of domestic consumers change over time and an increasing preference for goods and services from overseas will raise the supply of A$ on the foreign exchange market.
- **Protectionist policies**, such as tariffs, can also affect the demand for imports by Australians. An increase in tariffs reduces demand for imports and raises the supply of A$.

In section 5.3, we discuss how governments may intervene in foreign exchange markets to affect demand and supply and the value of the dollar. In addition, **government policy measures** may also indirectly affect the value of the currency. For example, in 2020 when the Reserve Bank of Australia (RBA) purchased bonds in the bond market (to increase liquidity and put downward pressure on interest rates), it also had the effect of increasing the supply of Australian dollars, which the RBA estimated resulted in a 1 to 2 per cent depreciation of the exchange rate in November 2020. In February 2022, the Reserve Bank ended its bond purchase program. In 2024, the RBA decided to reduce its bond holdings over time by letting the bonds mature naturally (rather than selling the bonds), contributing to a gradual appreciation of the Australian dollar.

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Figures 5.2 and 5.3 show how the exchange rate of the A$ against the US$ can **appreciate** (increase) or **depreciate** (decrease) due to changes in supply and demand.

Figure 5.2 reveals that any increase in the demand for A$ (shift in the demand curve to the right, from D_1 to D_2) will increase the price of A$ in terms of US$ (that is, cause an appreciation of the A$).

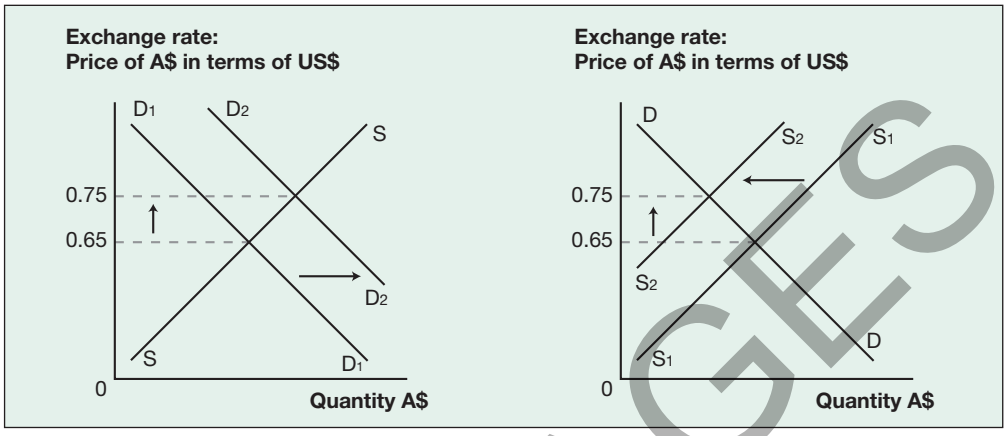


Figure 5.2 – An appreciation of the Australian dollar

Likewise, any decrease in supply of A$ (a shift in the supply curve to the left, from S_1 to S_2) would also cause an appreciation. The appreciation shown in both cases is an increase in the value of the A$ from US65 cents to US75 cents.

Figure 5.3 reveals that any decrease in the demand for A$ (shift in the demand curve to the left, from D_1 to D_2) will decrease the price of A$ in terms of US$ (that is, cause a depreciation of the A$).

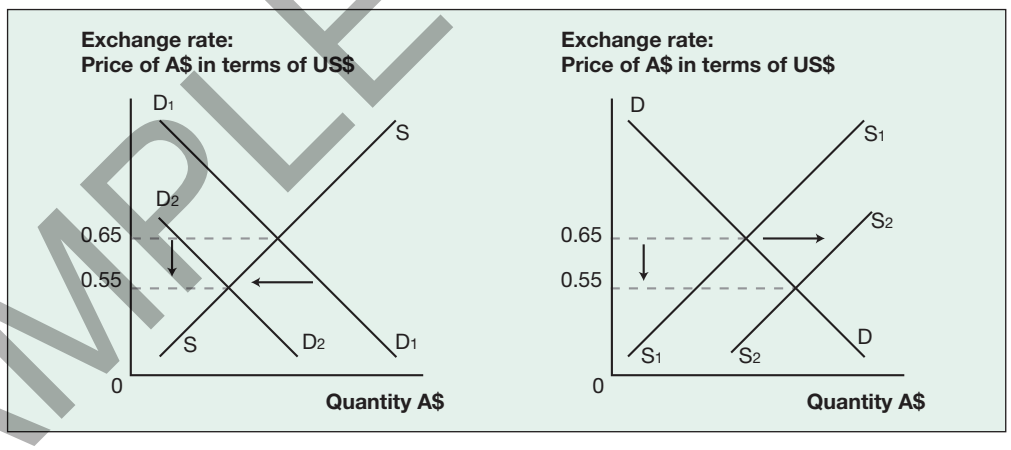


Figure 5.3 – A depreciation of the Australian dollar

Likewise, any increase in supply of A$ (shift in the supply curve to the right, from S_1 to S_2) would also cause a depreciation. The depreciation shown in both cases is a decrease in the value of the A$ from US65 cents to US55 cents.

A floating exchange rate does not just allow market forces determine the value of a currency. It also acts as an "automatic stabiliser" to help protect the economy from external booms or busts. A prime example of this took place during the mining boom in Australia from the mid-2000s to the early 2010s. The increase in demand for Australian resources pushed commodity prices up, causing the dollar to appreciate. As a result, other industries saw their costs increase and demand for output fall. The appreciation of the dollar helped the economy to re-allocate labour and capital to the booming mining sector, therefore reducing inflationary pressures and maintaining a stable employment level within the economy.

Australia has many exchange rates – one for each of the currencies of the countries for which foreign exchange transactions are required. Thus, it is possible that at any given time

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APPRECIATION ▲	DEPRECIATION ▼
• an increase in Australian interest rates or decrease in overseas interest rates • improved investment opportunities in Australia or deterioration in foreign investment opportunities • a rise in commodity prices and an improvement in Australia's terms of trade • an improvement in Australia's international competitiveness • lower inflation in Australia • increased demand for Australia's exported goods and services • expectations of a currency appreciation based on forecasts of one of the above factors	• a decrease in Australian interest rates or increase in overseas interest rates • deterioration in investment opportunities in Australia or improvement in foreign investment opportunities • a fall in commodity prices and a deterioration in Australia's terms of trade • a deterioration in Australia's international competitiveness • higher inflation in Australia • increased demand for imported goods and services • expectations of a currency depreciation based on forecasts of one of the above factors

Figure 5.4 – Main factors causing an appreciation or depreciation of the Australian dollar

Australia's exchange rate may be appreciating against some currencies and depreciating against others. For example, in April 2025, the Australian dollar appreciated against the US dollar but depreciated against the euro.

A comparison of the value of the dollar against a single currency, such as the US dollar, can create a misleading impression of trends in the Australian dollar's value. This is because just as there are unique factors influencing the Australian dollar, there are also unique factors influencing the value of the US dollar. For example, on average against other currencies, the US dollar depreciated in the first half of 2025 by over 10 per cent. If we only examined the exchange rate between the Australian and US dollars, and did not make other comparisons, we would think that the Australian dollar had appreciated on its own by 5 per cent. In fact, the Australian dollar was falling but the US dollar was falling further, creating the impression of a rise in the A$ against the US dollar. The value of the Australian dollar actually fell against most other currencies in the same period.

The **Trade Weighted Index** (**TWI**) gives an indication of how the value of the A$ is moving against all currencies in general. The TWI is calculated by measuring the value of the A$ against the currencies of Australia's major trading partners compared with a base year. The currencies of the countries that are more prominent in Australia's trade are given a higher weighting so that they have a greater influence on the TWI.

Trade Weighted Index (TWI) is a measure of the value of the Australian dollar against a basket of foreign currencies of major trading partners. These currencies are weighted according to their significance to Australia's trade flows.

Currency	Trade weights (%) from 10 January 2025	Currency	Trade weights (%) from 10 January 2025
Chinese renminbi	29.5	Indian rupee	4.5
United States dollar	11.3	Singapore dollar	4.3
Japanese yen	10.1	New Zealand dollar	3.4
European euro	8.6	United Kingdom pound sterling	3.1
South Korean won	6.3	Thai baht	3.1
Source: Reserve Bank of Australia 2025			

Figure 5.5 – Trade Weighted Index: the currency weightings of Australia's top 10 trading partners

Figure 5.5 indicates how the TWI is calculated. Each year, the Reserve Bank amends the measurement of the TWI based on the volumes of trade for the previous financial year. The total number of countries included in the TWI must cover at least 90 per cent of Australian trade (in 2025, 18 countries were included in the TWI calculations). During the last two decades, the relative significance of the exchange rates with the Japanese yen and the US dollar have declined, while the exchange rate with the Chinese renminbi has become more important.

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For the latest statistics and analysis of exchange rate movements, visit the website of the Reserve Bank of Australia

An important limitation of the TWI exchange rate measurement is that the weighting is only based on volumes of trade regardless of the currency in which exports and imports are invoiced. In fact, Australia often sells its commodities in US dollars even when trading with another country such as Japan or South Korea; almost 90 per cent of Australia's merchandise exports and more than half of imports are priced in US dollars. As a result, the A$/US$ exchange rate is far more important than the weight it receives in the TWI calculation. This is important when analysing the impact of movements in the A$ against the US$ and TWI on Australia's trade and financial flows.

Figure 5.6 shows exchange rate movements since 2000–01 for the currencies of some of Australia's major trading partners as well as the TWI. It shows that while there are often sustained trends, such as the overall depreciation of the Australian dollar over the last decade, there are also years that break the trend, such as the appreciation in 2020–21.

Year	US dollar	Euro	Japanese yen	Pound sterling	Chinese yuan	TWI
2000–01	0.54	0.60	61.47	0.37	4.45	50.3
2010–11	0.99	0.72	82.02	0.62	6.54	73.9
2016–17	0.75	0.69	82.25	0.60	5.14	64.8
2017–18	0.78	0.65	85.55	0.58	5.05	64.5
2018–19	0.72	0.63	79.51	0.55	4.88	61.5
2019–20	0.67	0.61	72.57	0.53	4.72	58.5
2020–21	0.75	0.63	79.55	0.55	4.94	62.6
2021–22	0.73	0.64	85.11	0.55	4.68	61.7
2022–23	0.67	0.64	92.49	0.56	4.68	61.6
2023–24	0.66	0.61	97.76	0.52	4.74	61.5
2024–25	0.65	0.59	96.03	0.50	4.66	60.7

Source: Reserve Bank of Australia (accessed July 2025)

Figure 5.6 – Average daily exchange rates 2000–25

AUSTRALIAN DOLLAR: RECENT MOVEMENTS AND OUTLOOK

The Australian dollar experienced a sustained appreciation during the 2000s and then a trend depreciation since around 2011. After hitting a low in 2001 (of US47 cents), from 2003 it began appreciating strongly as commodity prices increased. The dollar fell sharply in 2009 as the global financial crisis destabilised international currency markets, losing one-third of its value against the US dollar. But it swiftly recovered, peaking at US$1.10 in 2011. The dollar then began to depreciate, falling during the mid-2010s into a range between US70–80 cents. The COVID-19 pandemic saw the dollar briefly depreciate even further to just US55 cents in March 2020. It recovered by early 2021 to almost US80 cents, before depreciating again to averages of around US64–66 cents in the following years.

Commodity prices have played a critical role in the volatility of the exchange rate. As a significant commodity exporter, with mineral and metal resources comprising half of all exports, Australia's terms of trade and long-term export performance are strongly influenced by the prices of those commodities. During the resources boom, commodity prices soared to over three times their pre-2003 value, fuelling demand from trade as well as speculative investment in the Australian dollar. More recently, in response to the war in Ukraine (beginning in 2022), many countries imposed sanctions on Russia, a large commodity exporter. This caused an increase in demand for Australia's commodity exports, such as coal, gas and iron ore, which contributed to a 7.5 per cent appreciation of the Australian dollar from January to March 2022.

Australia's interest rate relative to other advanced economies has also influenced exchange rate movements. When Australia's cash rate is greater than that of other advanced economies, foreign investors are incentivised to invest in Australia. This is known as "carry trade" and supported the Australian dollar throughout the 2000s and 2010s. Despite a sharp

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increase in interest rates after the COVID-19 pandemic, Australian rates remained below those of most other advanced economies. When Australian interest rates were lowered in 2025, this put further downward pressure on the Australian dollar as some investors moved their funds overseas.

Global economic uncertainty has also weakened the Australian dollar. Slowing global economic growth, combined with the threat of global tariffs from the United States, reduced demand for the Australian dollar in the first half of 2025, reflecting its status as a "risk-sensitive" currency.

> "When the outlook for global growth weakens, the Australian dollar typically depreciates (falls in value) as investors expect our economy to be buffeted by the global headwinds, and the RBA to respond with cuts to the cash rate. This makes our exports cheaper in foreign currency terms, which offsets some of the effect of weaker global demand.
>
> An additional driver of the Australian dollar in times of uncertainty is its status as a 'risk-sensitive' currency. When global investors are worried, they tend to focus on reducing risk exposure, moving their capital to low-risk assets in countries like the United States, Switzerland and Japan. This means the Australian dollar tends to lose value against these currencies, over and above the depreciation linked to weaker growth and expected cuts in the cash rate."
>
> – Sarah Hunter, RBA Assistant Governor (Economics), address to Economics Society of Australia, 3 June 2025

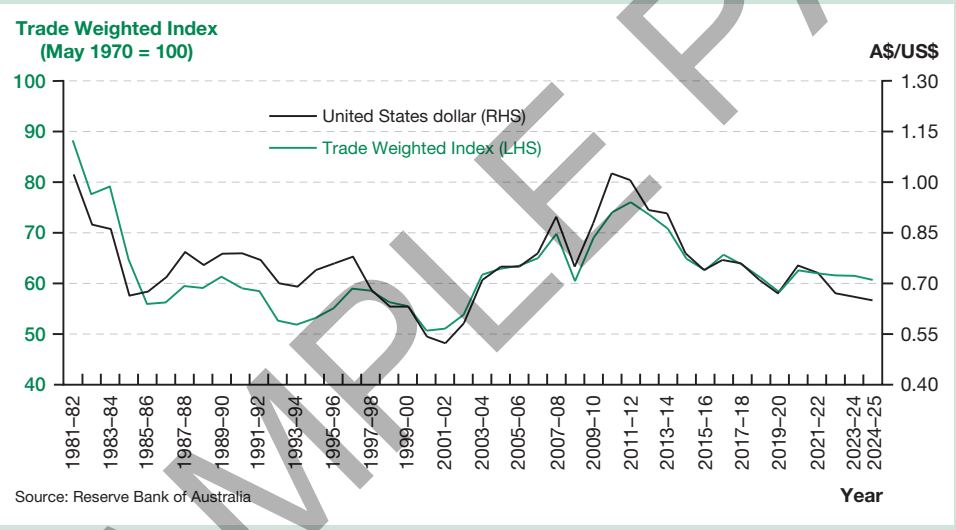


Figure 5.7 – Recent movements in the Australian dollar

reviewquestions

1. Define the term *exchange rate*.
2. Describe how the Trade Weighted Index (TWI) is calculated and explain why it is a better measure of the value of the Australian dollar than the US$/A$ exchange rate.
3. Account for recent movements in the Australian dollar.
4. Outline the possible impact of the following scenarios on the Australian dollar:
   - **a)** an increase in commodity prices and Australia's terms of trade
   - **b)** protectionist policies are imposed on Australian exports
   - **c)** speculators believing that the Australian dollar will soon appreciate
   - **d)** an increase in Australia's economic growth rate
   - **e)** an increase in interest rates overseas.

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5.3 Reserve Bank intervention in the foreign exchange market

Although Australia relies primarily on market forces to determine the exchange rate, the Reserve Bank of Australia (RBA) sometimes plays a role in influencing the value of the currency. While the RBA cannot change the value of the Australian dollar in the long term, it is able to smooth out swings in the dollar relating to short-term factors. It can do so by **dirtying the float** and through monetary policy intervention.

Dirtying the float

When the Reserve Bank feels that a large short-term change in the exchange rate (possibly due to excessive speculation) will be harmful to the domestic economy, it may decide to step into the foreign exchange market, either as a buyer or a seller, in order to stabilise the A$.

In order to curb a rapid depreciation of the currency, the RBA will buy A$, putting upward pressure on the exchange rate by increasing demand. On the other hand, by selling A$ the RBA may prevent a rapid appreciation by increasing supply. The RBA last intervened significantly in the foreign exchange market in 2007–08 during the global financial crisis. When the A$ lost one-third of its value against the US$, the RBA bought $3.3 billion of A$ to stabilise its depreciation. The RBA was able to sell $3.4 billion of A$ in 2009 as the currency recovered in value. In addition to stabilising the currency, the forex interventions also generated profits that contributed to the RBA's dividend payment to the government.

Nevertheless, the RBA's ability to intervene through buying A$ is limited by the size of its foreign currency holdings (that is, its reserves of foreign currency and gold that can be used to fund such purchases). In reality, the sum total of the RBA's foreign currency reserves is relatively small – it is not even equal to one day's total transactions in the currency.

Monetary policy decisions

Monetary policy initiatives are an indirect way of influencing the exchange rate and are rarely used for this purpose. If the RBA wants to curb a rapid depreciation, it may increase the demand for A$ by raising interest rates. Higher interest rates relative to overseas countries will attract more foreign savings, which must be converted into A$. This will increase the demand for A$ and put upward pressure on the exchange rate. However, this policy will generally only be effective for a limited time.

It is unusual for the RBA to use monetary policy in response to currency movements, as its primary focus is to influence the domestic economy – particularly inflation. However, exchange rate movements can sometimes be large enough to affect economic stability and inflation. Reserve Bank research in 2014 estimated that a 10 per cent depreciation leads to a 0.25 to 0.5 per cent increase in inflation over two years. In 2025, while there were concerns that lower interest rates could cause a depreciation and add to imported inflation, the RBA nevertheless began reducing interest rates once inflation had returned to the RBA's target band.

reviewquestions

1. Explain how the Reserve Bank of Australia could directly intervene in the foreign exchange market to prevent a rapid depreciation of the Australian dollar. Discuss the limitations of this method of intervention.
2. Explain the impact of a decrease in Australian interest rates on the Australian dollar.
3. Explain what is meant by a *dirty float* of a currency.

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5.4 Fixed exchange rate systems

Since December 1983, Australia has had a floating exchange rate system. In previous decades, however, it operated on a range of fixed exchange rate systems. Prior to November 1976, Australia had a fixed exchange rate system in which the A$ was pegged, at different times, to the UK pound sterling, the US dollar and the Trade Weighted Index. From November 1976 to December 1983, Australia had a variation of the fixed exchange rate known as the **managed flexible peg**.

GOVERNMENT PARTICIPANTS IN GLOBAL FOREIGN EXCHANGE MARKETS

In recent decades, governments and their central banks have played a much smaller role in global foreign exchange markets. The power of governments to influence the exchange rates of currencies has been reduced as private sector participants in forex markets, especially currency speculators with very large quantities of funds under management, have become more dominant. Central banks rarely play more than a residual role as a buyer or seller of a country's currency, mainly to stabilise its value.

Some countries, however, attempt to influence the value of their currency against another currency and therefore play a much larger role in that foreign exchange market. The value of the Chinese yuan, also known as the renminbi, is largely set by the People's Bank of China (PBC). Between 1994 and 2005, the PBC fixed the exchange rate at 8.27 RMB to the US dollar. After 2005, it adopted a crawling peg exchange rate system, intervening to prevent the value of the yuan from deviating more than 0.5 per cent (in either direction) against the US dollar on any given day. This daily trading band was gradually widened, reaching its current rate of 2 per cent in 2014.

By mid-2025, the yuan was valued at around 7.2 to the US dollar. To maintain the exchange rate around this level, Chinese authorities must be willing to purchase a US dollar for 7.2 RMB and be willing to purchase 7.2 RMB for a US dollar. If there is too much demand for renminbi at this "price" in US dollar terms, the Chinese central bank will accumulate US dollar "reserves" as it sells more renminbi. China's foreign exchange reserves soared to almost US$4 trillion by the mid-2010s, before stabilising above US$3 trillion, still around 20 times their level in 2000. While it is difficult to calculate the fair value of the yuan without government intervention, most estimates in recent years suggest it it undervalued by around 20–25 per cent.

However, the Chinese Government is gradually reducing its influence over day-to-day currency movements. This gradual internationalisation of the renminbi can be seen in the moderate fall of China's foreign reserves since 2014 (see figure 5.8). This move towards a more flexible exchange rate will contribute to the diminishing role of central banks in global foreign exchange markets. This position was challenged during the US/China 'tariff war' in April 2025, when the yuan depreciated to 7.35 against the US dollar before quickly appreciating back to its pre-tariff level of around 7.25. This confirmed the Chinese Government's ongoing objective of currency stabilisation.

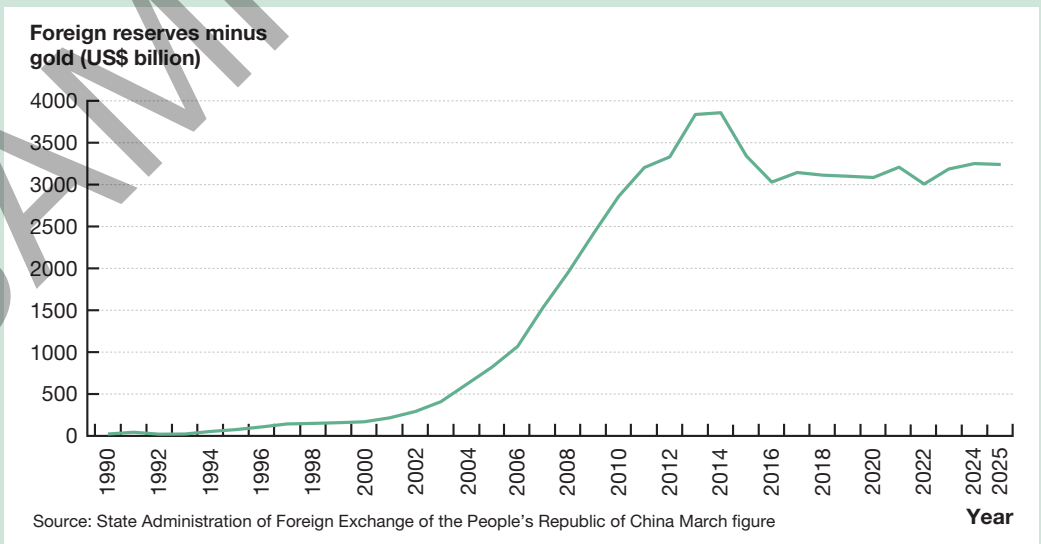


Figure 5.8 – China's foreign exchange reserves since 1990

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Fixed exchange rates

Under a fixed exchange rate system, the government, or the central bank, officially sets the exchange rate (that is, it would not be left up to the forces of supply and demand). A fixed exchange rate regime is depicted in figure 5.9. In this case, the official rate has been set at A$1=US75 cents (above the US65 cents rate that would apply if it was left up to market forces).

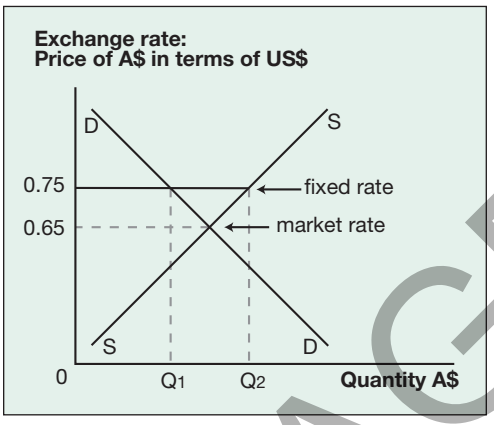


Figure 5.9 – A fixed exchange rate system

The government can attempt to maintain a fixed exchange rate by either buying or selling foreign currency in exchange for A$. In this case it would be buying the excess supply of A$ (that is, Q_1Q_2) at a price of US75 cents.

Thus, in order to intervene in the foreign exchange market under a fixed exchange rate system, the government would need **foreign reserves** of foreign currency and/or gold.

When Australia operated under a fixed exchange rate system, the RBA obtained the necessary foreign reserves by insisting that all foreign exchange holdings be lodged with them. Even so, the risk with this system is that in order to prop up the value of the A$, the RBA could exhaust its foreign reserves by continually exchanging them for the excess supply of A$, which could lead to a complete collapse of trade in the currency.

The other avenue open to the government would be to change the exchange rate "officially", so that it was closer to the real market value. It would **devalue** the A$ when it officially lowered the exchange rate and **revalue** the A$ when it increased the exchange rate. Another problem of fixed exchange rates is that it limits the ability of the central bank to influence interest rates, which are used for monetary policy, as discussed further in chapter 15.

The managed flexible peg

A variation of the fixed exchange rate is the managed flexible peg. This system operated in Australia from November 1976 to December 1983. Under this system, the Reserve Bank would "peg" the value of the A$ at 9:00 am each day and that price would operate throughout that day. A flexible peg system provides more flexibility than the fully fixed rate, but it can still allow the official rate to drift away from that which would exist under pure market forces. For example, many economists have argued that Australia had an overvalued exchange rate under the managed flexible peg system in the early 1980s.

reviewquestions

1. Explain, using graphs, how the Reserve Bank of Australia can influence the exchange rate by buying and selling Australian dollars.
2. Outline the risks of operating a fixed exchange rate system.
3. Distinguish between a fixed exchange rate and a managed flexible peg.

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5.5 Exchange rates and the balance of payments

In an open economy such as Australia's, the value of the exchange rate can change substantially in response to economic developments. One of the most important influences on the exchange rate is the performance of the balance of payments. But just as the balance of payments influences the value of the dollar, the value of the dollar can also influence the balance of payments – as well as several other areas of the economy.

How the balance of payments influences the exchange rate

Under a floating exchange rate, the quantity of Australian dollars supplied must always equal the quantity of dollars demanded. In other words, the net outflow of funds on the current account (supply of A$) equals the net inflow of funds on the capital and financial account (demand for A$). (Note, however, that in reality, allowance has to be made for statistical mistakes through the net errors and omissions item on the balance of payments.) If there is any disequilibrium on the balance of payments, it is only temporary and is automatically corrected by a movement in the exchange rate.

The following example demonstrates how a change in the current account can influence the exchange rate and the capital and financial account. If the value of imports increased, while exports remained unchanged, this would result in a deterioration in the current account. It would also cause an increase in the supply of A$ (importers will be selling more A$ in order to buy foreign currency), resulting in a depreciation of the currency. Also, because of the depreciation, a given level of financial inflows would be able to buy more A$. Therefore, the positive balance on the capital and financial account would increase in A$ terms to match the bigger deficit on the current account.

Likewise, any other increased outflow of funds on the current account (for example, payment of services, income payments or current transfers) would cause an increase in supply of A$, causing a depreciation and an increase in the surplus on the capital and financial account. On the other hand, an improvement in the current account would result in an appreciation of the A$ and a decrease in the surplus on the capital and financial account.

The effect of the balance of payments on the exchange rate also depends on the perceptions of financial markets. If financial markets are concerned that a current account deficit is not sustainable, they may be less willing to buy Australian assets and so the value of the dollar is likely to fall further as capital inflow is reduced. On the other hand, the dollar may appreciate despite increases in a current account deficit if financial markets believe the external position is sustainable and they have confidence in Australia's future economic prospects. For example, the COVID-19 recession showed that an improvement in the balance of payments is often not the largest influence on the exchange rate in any one year. Although Australia recorded a current account surplus from 2019 to 2023, the exchange rate still depreciated at times over this period (because of other factors). Similarly, despite the move back to a current account deficit since 2023, the value of the dollar remained relatively stable.

Recent years indicate the most significant influence on exchange rate movements is how financial markets choose to react to developments in economic indicators (such as the balance of payments), and sometimes those reactions are difficult to predict. This results in greater instability and volatility in foreign exchange markets because market sentiment can change quickly. Investors can follow the actions of others, known as "herd mentality". This speculation can cause large currency falls and rapid depreciation.

SAMPLE PAGES

CENTRAL BANK DIGITAL CURRENCY

The Reserve Bank of Australia issues the Australian dollar in two forms: physical money in the form of banknotes and digital money in the form of balances held by commercial banks and other financial institutions. Only 4.5 per cent of Australia's money takes the form of banknotes or coins.

The Reserve Bank recently explored a third option of issuing the dollar as a central bank digital currency (CBDC). A CBDC is digital money, denominated in the national unit of account and issued by a central bank. The difference between a CBDC and existing forms of digital money is that a CBDC represents a claim on a central bank, rather than a claim on a private financial institution. There are two types of CBDC: a retail CBDC for use by both the public and financial institutions, and a wholesale CBDC limited to financial institutions.

After a small-scale pilot in 2023, the RBA assessed the safety and privacy of digital currency relative to commercial banking in 2024. The RBA found that the average Australian consumer would not value the added safety of a CBDC relative to bank deposits, which are already considered safe. While the privacy benefits of a CBDC were found to be a more compelling reason for their introduction, the RBA concluded that the establishment and ongoing costs would make it difficult to justify a CBDC in Australia.

Despite this, the RBA is still open to the idea of CBDCs, having committed to a three-year research program on the future of digital money in Australia starting in 2024. There are several reasons why central banks are interested in CBDCs. First, a CBDC could make payment systems more efficient, particularly for sending money overseas. Second, CBDCs can improve access to digital payment services, particularly in emerging market economies, which tend to be more reliant on physical money.

The global economy is at a crossroads in the development of CBDCs. China is expanding its CBDC network, while in the United States, the Trump Administration in 2025 issued an executive order banning a US "digital dollar". Australia's future stance on CBDCs may be influenced by international positions.

Sources: Reserve Bank of Australia, BIS Innovation Hub and Central Banks of Australia, Malaysia, Singapore and South Africa, IMF 2024

The effects of a change in the exchange rate

Changes in the exchange rate can also bring about changes in the balance of payments as well as several other areas in the economy. The effects of appreciations and depreciations can be both good and bad for the economy.

An appreciation

NEGATIVE EFFECTS

- An appreciation causes Australian exports to become more expensive on world markets in terms of other currencies. Therefore, exports are more difficult to sell, leading to a decrease in export income and a deterioration in Australia's current account deficit (CAD) in the medium term.
- Imports will be less expensive, encouraging import spending and worsening Australia's CAD. Domestic production of import substitutes is likely to fall as imported goods are cheaper.
- Higher import spending and reduced export revenue will reduce Australia's economic growth rate.
- Foreign investors will find it more expensive to invest in Australia, generally leading to lower financial inflows. However, financial inflows may continue if foreign investors expect the currency to continue rising.
- An appreciation reduces the A$ value of foreign income earned on Australia's investments abroad and would cause a deterioration in the net primary income component of the CAD.
- An appreciation will also reduce the value of foreign assets in Australian dollar terms – a phenomenon known as the **valuation effect**.

Valuation effect is where an appreciation (or depreciation) of the currency causes an immediate change in the Australian-dollar value of foreign debt that is borrowed in foreign currencies or foreign assets held by Australians.

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POSITIVE EFFECTS

- Australian consumers enjoy increased purchasing power – they can buy more overseas produced goods with the same quantity of A$.
- An appreciation decreases the interest servicing cost on foreign debt because Australians can buy more foreign currency with Australian dollars. This would reduce outflow on the net primary income component of the current account in future years and help reduce Australia's CAD.
- An appreciation will also reduce the A$ value of foreign debt that has been borrowed in foreign currency – a phenomenon known as the valuation effect.
- For Australian investors looking to purchase overseas assets, an appreciation will reduce the price of those assets.
- Inflationary pressures in Australia will be reduced as imports become cheaper. This is likely to reduce pressure on the RBA to raise interest rates to defend its inflation target.

A depreciation

NEGATIVE EFFECTS

- Australian consumers suffer reduced purchasing power – they can buy fewer overseas produced goods with the same quantity of A$.
- A depreciation increases the interest servicing cost on Australia's foreign debt because Australia can buy less foreign currency with its domestic currency with which to pay interest. This increases income outflow on the net income component on the current account and thus increases Australia's CAD.
- A depreciation will also raise the A$ level of foreign debt that has been borrowed in foreign currency as expressed in Australian dollar terms – a phenomenon known as the valuation effect.
- A depreciation will raise the price of overseas assets that are being purchased by Australian investors.
- Inflationary pressures in Australia will increase as imports would now be more expensive. This may increase pressure on the RBA to raise interest rates to defend its inflation target.

POSITIVE EFFECTS

- A depreciation causes Australian exports to become cheaper on world markets in terms of other currencies. Therefore, exports are easier to sell, leading to an increase in export income and an improvement in Australia's CAD in the medium term. A weaker A$ following the end of the commodities boom is largely credited with helping the Australian economy adjust to reduced income from mining by increasing the international competitiveness of other sectors.
- Imports will be more expensive, discouraging import spending and potentially improving Australia's CAD. Domestic production of import substitutes should also rise.
- Lower import spending and greater export revenue will increase Australia's growth rate, but this may not happen if Australia is unable to replace its imports with domestically produced goods.
- A depreciation increases the A$ value of foreign income earned on Australia's investments abroad and would cause an improvement in the net primary income component of the CAD.
- A depreciation will also increase the value of foreign assets in Australian dollar terms – a phenomenon known as the valuation effect.
- Foreign investors will find it less expensive to invest in Australia, generally leading to greater financial inflows. However, financial inflows may diminish if foreign investors expect the currency to continue falling.

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The impact of exchange rate movements on the value of Australia's foreign assets and liabilities (and consequently, the balance of payments) ultimately depends on the currencies in which they are denominated. Recent analysis of Australia's liabilities reported in the RBA Bulletin made the surprising conclusion that a depreciation of the Australian dollar may reduce rather than increase Australia's net foreign liabilities because of the composition of those liabilities. Australia's liabilities are largely denominated in Australian dollars while our assets are largely denominated in foreign currencies. The article concluded therefore that "the Australian economy overall is well protected from vulnerabilities associated with a depreciation of the exchange rate, despite its net foreign liability position".

Given the positive and negative effects of both depreciations and appreciations, we might ask the question: do economists and policymakers favour a higher or lower exchange rate? The answer is that economists generally believe that, as far as possible, the exchange rate's value should reflect the true forces of supply and demand. These "true" supply and demand forces would result from the exchanges of goods, services and finance between Australia and the rest of the world, but would not include exchange rate changes due to speculation. Speculative traders who buy or sell A$ with the aim of making profits from short-term price movements distort exchange rate movements and increase exchange rate volatility by exaggerating upwards and downwards cycles.

One of Australia's challenges, as a small economy that is integrated into global trade and financial markets, is that it is more vulnerable to speculators than many other advanced economies. Excessive speculation and volatile currencies are significant concerns for many countries, because of how large currency movements can destabilise domestic economies.

reviewquestions

1 Critically evaluate whether the value of the A$ is likely to be higher or lower against the US$ by the end of this year. Justify your forecast. (*Hint:* check the currency forecasts on the websites of any of the major Australian banks.)

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chapter summary

1 The **exchange rate** is the price of Australia's currency in terms of another country's currency.

2 Under Australia's floating exchange rate system, the value of the currency is determined by the interaction of the forces of demand and supply in the marketplace, which determine an equilibrium value for the currency. This equilibrium changes regularly (the levels of minute by minute) as supply and demand change.

3 **Demand** for the Australian dollar is determined by the perceptions of speculators about future movements in the dollar, changes in interest rates and the demand for Australian exports, which are in turn influenced by the level of economic growth in Australia's trading partners, protectionist policies and commodity prices.

4 **Supply** of the Australian dollar is determined by the perceptions of speculators about future movements in the dollar, changes in interest rates and the demand for imports, which are in turn influenced by the level of economic growth and consumer spending within Australia.

5 The two main exchange rates are the Australian dollar against the **United States dollar**, the world's leading currency, and the **Trade Weighted Index**, which is a basket of currencies weighted according to their significance to Australia's trade patterns.

6 The Reserve Bank of Australia (RBA) can influence the value of the dollar by intervening directly in foreign exchange markets through buying or selling the dollar with the aim of influencing its value, which is known as **dirtying the float**.

7 The RBA can also influence the currency's value indirectly through **monetary policy** decisions. For example, an increase in the level of interest rates will tend to attract financial flows into Australia and raise the value of the currency.

8 Under a **fixed exchange rate system** the value of the currency is normally determined by the central bank, either for the longer term or on a day to day basis through a flexible peg system.

9 Changes in the **balance of payments** can influence the currency's value, although the extent to which the balance of payments impacts on the currency depends on the response of foreign investors. In general, a deterioration in the current account is likely to result in a depreciation, and an improvement in the current account is likely to result in an appreciation.

10 Movements in the value of the exchange rate can have an impact on the level of inflation, international competitiveness, the level of exports and imports, foreign debt servicing costs, the current account and the rate of economic growth.

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chapter review

1 Describe what is meant by the *exchange rate*.

2 Outline the factors that affect the demand for Australian dollars.

3 Outline the factors that affect the supply of Australian dollars.

4 With the aid of a diagram, explain what is meant by a *fixed exchange rate system*. Outline the problems that the RBA could experience when maintaining a fixed exchange rate.

5 Explain what is meant by a *depreciation* of the dollar. With the aid of a diagram, describe how a depreciation may occur.

6 Outline what is meant by the *Trade Weighted Index*. Identify why it is useful for analysing movements in the value of the Australian dollar.

7 Explain how, under our present floating exchange rate system, the Reserve Bank can influence the exchange rate:
   a) by dirtying the float
   b) through changes in monetary policy.

8 Examine how the exchange rate will be influenced by a deterioration in the current account.

9 Discuss the positive and negative impacts of an appreciation of the Australian dollar.

10 Discuss how speculation can influence the value of the Australian dollar.

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Protection in Australia

6

6.1 Introduction

6.2 Government initiatives to reduce protection

6.3 Australia's free trade agreements

6.4 Implications of a reduction in protection levels for the Australian economy

6.5 The impact of international protection levels on Australia

6.6 The future of Australian industry in the global economy

6.1 Introduction

Trading relationships have always been important to the Australian economy. Australia's distance from the rest of the world, and relatively high reliance on both exports and imports, mean that barriers to trade have a significant effect on the economy – whether these barriers are within Australia or in overseas markets. Over the past 50 years, the Australian economy has benefited from the gradual removal of trade barriers. Although global momentum towards freer trade has faltered in recent years, Australia remains a vocal advocate for further trade liberalisation. Protectionist sentiments around the world have gathered strength over the past decade, with the second Trump Administration making protectionism a central instrument of its foreign policy since 2025. Even before then, the COVID-19 pandemic and the war in Ukraine sparked broader debates about whether globalisation has left economies too dependent on vulnerable global supply chains that might fail in a time of crisis.

Australia was once one of the most highly protectionist countries in the world. During the first half of the 20th century, governments believed it was necessary to protect Australian manufacturers, who found it difficult to compete because of Australia's relatively small population and low production levels (in other words, because manufacturers in larger economies overseas benefited from greater economies of scale). However, from 1973 Australia began to shift away from protectionism, and throughout the 1990s and 2000s it phased out almost all tariffs. Australia is now broadly recognised as one of the most open economies in the world.



For further information on Australian trade rules and agreements, visit the websites of the Department of Foreign Affairs and Trade (DFAT), the Productivity Commission and the Bureau of Agricultural and Resource Economics and Sciences.

Using the DFAT website, identify current negotiations being undertaken by the Australian Government for future bilateral and regional trade agreements.

THE GOVERNMENT'S MAIN AIMS IN REDUCING PROTECTION

- Make domestic industries more internationally competitive by exposing them to competition from imported goods.
- Encourage resources to move away from industries and firms that cannot improve their competitiveness to those that can become more competitive – in other words, to concentrate the economy on areas where Australia has a comparative advantage.
- Allow Australia to benefit from greater integration with the global economy by giving consumers and businesses access to goods and services available on global markets at the lowest possible prices and highest possible quality.
- Promote structural change in the economy, with the long-term aim of encouraging efficient firms to produce what the global economy demands.

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6.2 Government initiatives to reduce protection

Australia's transition from a highly protected economy to an economy with relatively low trade barriers has occurred over a number of decades. As shown in figure 6.1, **the average tariff level** in Australia has declined significantly since the late 1960s. Over the same time period, other "non-tariff barriers" to trade, such as quotas and subsidies, have also gradually been phased out in Australia.

1968–69	1977–78	1982–83	1986–87	1994–95	2004	2014	2024
36%	23%	25%	19%	9%	3.7%	1.9%	0.5%

Sources: Productivity Commission, World Development Indicators, Commonwealth of Australia data (Budget 2024–25 papers)

Figure 6.1 – Average tariff rates in Australia

Protectionist policies came under sustained attack from the early 1970s. Organisations such as the Productivity Commission (then called the Industries Assistance Commission), the Commonwealth Treasury and the National Farmers' Federation argued that domestic trade barriers fostered inefficiency, increased prices, misallocated resources, made Australia less internationally competitive, damaged our trading performance and reduced living standards over the long run.

The first significant push to reduce protection was made by the Whitlam Government, which in 1973 announced a 25 per cent across-the-board tariff cut. However, it was not until 1988 that Australia commenced a comprehensive program of trade liberalisation. Over the subsequent decade, Australia reduced its tariffs faster than any other advanced economy (other than New Zealand).

Today, about 90 per cent of all imported goods are tariff free, with the remainder, mostly manufactured goods, subject to a general tariff rate of 5 per cent or less. Historically, some manufacturing industries, such as motor vehicles and the clothing and textiles industry, were protected by higher tariff levels. However, these arrangements have been significantly reduced over time, with the most recent cuts occurring in 2015. Most remaining tariffs do not apply to imports from countries with which Australia has a free trade agreement (FTA), such as South Korea, Japan and India.

In 2024, the Australian Government removed tariffs on almost 500 imported products, including toothbrushes, toasters and refrigerators (which had a combined import value

THE BIRTH OF mRNA MANUFACTURING IN AUSTRALIA

In 2022, the Australian Government and Moderna, a pharmaceutical and biotech company, finalised a deal to establish an mRNA research and vaccine manufacturing facility in Australia – one of the first ever to be built in the Southern Hemisphere. The 10-year arrangement is worth billions of dollars, expected to create hundreds of jobs and see Australia produce up to 100 million mRNA vaccine doses a year from 2025. A substantial government investment was needed to persuade Moderna to make the investment.

Such government intervention could be characterised as a form of trade protection. Australia has sourced mRNA vaccines from other countries since 2021 to protect its citizens from COVID-19. There is no independent evidence that Australia has a comparative advantage in making them locally.

Despite that, the deal was not controversial and not considered to be a harmful example of protectionism. This reflects a shift in policymakers' thinking about the limits of free trade in the era of globalisation. During the pandemic, other countries prioritised their own needs which meant that countries such as Australia who were relying on vaccine imports were forced to wait in line for vaccines to arrive. Establishing an mRNA manufacturing facility in Australia improves health security and should mean that, in the event of future pandemics, Australia will be better placed to access new vaccines and treatments.

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of around $8.5 billion a year). These tariffs were called "nuisance tariffs" because they raised little revenue and Australia no longer produced them in material quantities anyway. The Productivity Commission described it as Australia's most substantial reform to tariffs in two decades. In addition to lowering costs for importers, this also reduces the cost of collecting tariff revenue, which is often a very complex task for government given the different tariff rates for different products, from different markets. In 2024, the Productivity Commission estimated that for each dollar of received from tariffs, it can cost up to $1.90 to collect the revenue. This means tariffs sometimes cost more to implement than they make.

Australia's **average tariff level** (weighted by the most traded products) was most recently calculated as 0.5 per cent – lower than that of most advanced economies, including the United States (2 per cent). Further, less than 0.5 per cent of Australia's tariffs exceed 15 per cent (the World Trade Organization's threshold for high tariffs) compared to about 10 per cent in other nations.

Over the last 50 years, Australia has also phased out non-tariff barriers to trade, including quotas and subsidies. Overall, this has led Australia to become **one of the least protectionist economies in the world**. Australia provides far fewer subsidies for domestic producers compared with North America, Western Europe and East Asia, where they play a significant role in boosting the competitiveness of these countries' agricultural sectors. In 2024, Australia had among the lowest levels of agricultural protection in the OECD, with subsidies accounting for around 2 per cent of farm income. By comparison, subsidies accounted for 10 per cent of farm income in the US, 20 per cent in the EU and 43 per cent in South Korea.

While protection and direct assistance for producers has been substantially reduced during recent years, some export assistance programs still exist. Governments often say these programs are not protecting specific industries because they grow the broader economy, citing research which suggests companies that export employ more people, pay higher wages and are more productive. These programs are administered through **Austrade** (the Australian Trade and Investment Commission). Austrade's assistance for exporters includes financial assistance, information on potential export markets and marketing advice. The main program that Austrade administers is the **Export Market Development Grants (EMDG)** scheme, which since 1974, has supported more than 51,000 small- and medium-sized exporters in promoting their exports in over 180 countries. It has been estimated that each dollar of assistance generates roughly $14 of exports.

Australia's reductions in protection levels have gone well beyond those required by **international trade agreements**. While some other countries have only reduced protection levels to the extent required by their trade agreements, Australia has pursued a general strategy of phasing out protection. A Trade Policy Review of Australia by the WTO in 2025 commended Australia's trade policies and highlighted only a few examples where policy changes could further liberalise trade. These included complexities for foreign companies competing for government contracts, certain foreign investment restrictions, and ensuring support for small and female-led businesses is accessible. The report also called for greater environmental considerations in trade policy. This echoes research published by the Department of Agriculture, Fisheries and Forestry in 2025, highlighting how lower protectionism in agriculture leads to lower greenhouse gas emissions through shifting food production to the most efficient producers and products that lead to the least waste. Previous WTO reports have called out Australia for overzealous use of anti-dumping restrictions on trade. This followed changes to Australian laws in 2017 making it easier for governments to keep enforcing anti-dumping measures after the related dumping activity stopped.

WHY DID CHINA SLAP TARIFFS ON AUSTRALIA IN 2020?

In 2020, the Chinese Government imposed tariffs of 80 to 200 per cent on Australian exports of wine, barley, a type of grain used to make beer and to feed livestock. China also restricted other Australian exports – such as cotton, coal, lobsters and timber – through unofficial channels, by instructing importers not to buy from Australia, or by imposing overly strict customs and regulatory barriers targeted at Australian products. The Chinese Government said these were "anti-dumping" and "anti-subsidy" penalties.

Most economists saw the tariffs as retaliation against Australia for policy decisions perceived as anti-China. These included restricting major Chinese investments in Australia (such as the construction of Australia's 5G mobile network) and advocating for an international inquiry into the origins of COVID-19. The measures could also have been partly motivated by Australia's own anti-dumping measures against Chinese steel and aluminium products, which the WTO ruled were inconsistent with anti-dumping rules in 2024. As a result of the trade bans, exporters sought to grow sales in other markets, including India, Japan and South Korea. Improving Australia's relationship with China has been a priority of the Albanese Government, and between 2023 and 2025, China removed all of these tariffs trade restrictions. Most exports had been successfully diverted to other markets, but diversification proved difficult for the wine industry, whose exports fell by 30 per cent between 2020 and 2022. Its recovery is expected to take several years.

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reviewquestions

1 Outline trends in Australia's protection levels over recent decades.
2 Explain the government's main objectives in reducing protection levels.

6.3 Australia's free trade agreements

In addition to reducing their own levels of protection, governments pursue free trade by accessing overseas markets through trade agreements. Australia has secured free trade agreements with key trading partners like China and Japan, as well as other economies in the Indo-Pacific region, including Malaysia and the US (see figure 6.2). Australia has both multilateral agreements and bilateral agreements.

TRADE AGREEMENTS

Bilateral agreements

ANZCERTA (New Zealand–Australia)
SAFTA (Singapore–Australia)
TAFTA (Thailand–Australia)
AUSFTA (Australia–United States)
ACI–FTA (Australia–Chile)
IA–CEPA (Indonesia–Australia)
A–HKFTA (Australia–Hong Kong)
MAFTA (Malaysia–Australia)
KAFTA (Korea–Australia)
JAEPA (Japan–Australia)
ChAFTA (China–Australia)
PAFTA (Peru–Australia)
ECTA (India–Australia)
A–UKFTA (United Kingdom–Australia)

Multilateral agreements

APEC forum (Asia-Pacific Economic Cooperation forum)
AANZFTA (ASEAN–Australia–New Zealand)
CPTPP (Australia and 10 other regional countries)
PACER Plus (Australia and 9 other Pacific countries)
RCEP (Australia and 14 other Indo-Pacific countries)

Figure 6.2 – Trade agreements that affect the Australian economy

Bilateral trade agreements

Bilateral agreements involve just two nations. They are the easiest trade agreements to negotiate because they only need to factor in the interests of the two participants. The most comprehensive bilateral agreement for Australia is the 1983 Australia–New Zealand Closer Economic Relations Trade Agreement (ANZCERTA). This agreement has led to free trade between the two countries, and increased standardisation of laws, business practices and commercial structures.

Bilateral trade deals are an important focus of trade policy in Australia. Since 2020, Australia has entered into bilateral agreements with Hong Kong, the UK, Indonesia, India, and most recently, with the United Arab Emirates in 2024–25. In addition, the Australian Government is negotiating agreements with the European Union and the Gulf Cooperation Council (covering the economies of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates). Negotiations have for several years been underway to conclude a more complete agreement with India.

While bilateral trade agreements reduce protection for Australian industries, they only do so on a country-by-country basis. As a result, they generate fewer economy-wide benefits than broad trade liberalisation involving multiple countries. Increasingly, bilateral deals operate less as a means of unlocking new trading opportunities and more as a means of maintaining free trade in a time of rising protection.

One of the challenges of the proliferation of bilateral trade agreements is that they create a complex web of overlapping and inconsistent trade rules for exporters and importers. For instance, an exporter may have to comply with very different rules in order to sell the same product in different foreign markets. These complex rules can create inefficiency and businesses often need to engage expert advisers to understand detailed tariff requirements.

Multilateral trade agreements

Multilateral trade agreements provide for free or preferential trade between many countries, usually on a regional basis. This category of agreements includes those administered by the WTO, which are global in nature. At other times, this category can refer to regional trade agreements that involve a select group of countries, such as the European Union and the United States–Mexico–Canada Agreement (USMCA). These agreements deliver greater trade liberalisation than bilateral ones, but they are much harder to negotiate and often take a long time to implement after they are signed.

Australia has several key multilateral trade agreements. The first one enacted was the **ASEAN–Australia–New Zealand Free Trade Agreement (AANZFTA)** with New Zealand and the Association of South-East Asian Nations (ASEAN), which came into effect in 2010. This agreement covers around 15 per cent of Australia's trade in goods and services,

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The **Australia–United States Free Trade Agreement (AUSFTA)**, in operation since 2005, provides significant tariff reductions on a number of goods, especially in agriculture and manufacturing. In particular, automotive tariffs were eliminated immediately, and tariffs on all goods were eliminated from 2015. Between 2005 and 2022, two-way trade between Australia and the US tripled, while two-way investment flows have more than tripled since the agreement has been active. The US is currently Australia's third-largest trading partner. Details on the impacts of the increase in US tariffs in 2025 on Australia can be found in Chapter 2.





The **Korea–Australia Free Trade Agreement (KAFTA)**, in operation since 2014, sees Australia's tariff-free exports rising from 84 per cent to 99 per cent of exports over a 20-year period. The agreement also facilitates more services trade in legal, financial, engineering and education services. Two-way trade between the countries increased by over 40 per cent in the five years following the conclusion of KAFTA. Moreover, South Korea's investments in Australia nearly tripled from 2011 to 2023. Australia's Department of Trade and Foreign Affairs (DFAT) considers KAFTA to be one of Australia's most comprehensive trade agreements. South Korea has become Australia's third-largest export market.





The **Australia–UAE Comprehensive Economic Partnership Agreement (CEPA)** was signed in November 2024, coming into force in late 2025. Like many CEPAs, this aims to go beyond trade alone, to improve cooperation on investment, intellectual property and regulation. The agreement will eliminate tariffs on over 99 per cent of Australia's exports to the UAE, making this the most liberalising trade agreement the UAE has signed to date. Independent modelling estimates a potential annual increase in Australian goods exports to the UAE of around $678 million. While the UAE is not one Australia's top trading partners, investment is already valued at $20 billion and is expected to grow.



and effectively creates a free trade area of about 700 million people with a combined gross domestic product (GDP) of over US$6 trillion. ASEAN economies are also growing rapidly; by 2050 the entire group is projected to be the fourth-largest economy in the world. Australia and the ASEAN economies are complementary economies. This means that the type of goods that Australia can export – namely commodities, particularly in resource-based industries – are in heavy demand in the industrialising nations of South-East Asia. Conversely, South-East Asia can export to Australia those goods that we cannot produce competitively, such as simply transformed manufactures produced in labour-intensive industries. In November 2022, negotiations to deepen the AANZFTA were concluded, with new provisions covering areas including e-commerce, trade facilitation, and co-operation on the environment and climate change.

Australia and New Zealand are just two of the six countries that have multilateral trade agreements with ASEAN (the others being China, India, South Korea and Japan). In 2020, after eight years of negotiations, ASEAN and all of these countries (except India) signed the Regional Comprehensive Economic Partnership (RCEP), a China-led trade grouping that brings all of these countries together with a single multilateral trade agreement. RCEP covers around 30 per cent of global GDP and population, making it the world's largest free trade agreement. Under the agreement, which came into effect in 2022, exporters and importers only need to use a single set of rules and regulations to access preferential trade treatment in any of the 15 RCEP countries. The agreement also provides greater investment certainty and a common set of rules on intellectual property.

The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) is a separate multilateral agreement currently in force for Australia, Canada, Japan, Mexico, New Zealand, Singapore, Vietnam, Peru, Malaysia, Chile, Brunei Darussalam, and the United Kingdom. The agreement increases market access across borders for businesses by lowering tariff barriers, simplifying compliance requirements in order for businesses to access preferential trade treatment, reducing foreign investment restrictions and imposing rules around the conduct of state-owned enterprises. While a significant free trade area, the CPTPP is less ambitious than the original plan for a Trans-Pacific Partnership Agreement

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(TPPA), which had also included the United States (before its withdrawal under the Trump Administration in 2017). As chair of the CPTPP in 2025, Australia worked on strengthening regional economic integration and encouraging members to maximise the benefits of the agreement.

During the 1990s, Australia's multilateral trade negotiations focused on the **Asia-Pacific Economic Cooperation (APEC) forum**. In 1994, the APEC forum set a target of free trade by 2020. This goal was never formalised in a trade agreement, and for most of its history the annual meeting of APEC forum leaders each November has focused on other priorities such as economic crises, terrorism and climate change. APEC has therefore receded over the years from the centre of Australia's trade policy. A 2020 analysis by the APEC Policy Support Unit nevertheless argued that, even without binding commitments, the forum has indirectly supported trade liberalisation among its members. Since 1994, average tariff levels have fallen from 17 per cent to around 5 per cent, the proportion of tariff-free goods has increased to over 60 per cent, and over 150 free trade agreements have been implemented involving APEC members.

review questions

1. Distinguish between a bilateral trade agreement and a multilateral trade agreement.
2. Explain the key features of TWO of Australia's bilateral trade agreements.
3. Compare and contrast TWO of Australia's multilateral trade agreements.

6.4 Implications of a reduction in protection levels for the Australian economy

Australia's decision to phase out protectionism has been one of the most significant structural changes in the country's economic history. It has significantly increased Australia's integration with the global economy. It has also had far-reaching effects in its impact on the structure of the economy and the nature of Australia's trading relationships.

Effects on firms

While the long-run effect of reduced protection on businesses may be beneficial, as shown in figure 6.3, reducing protection creates winners and losers, particularly in the short run.

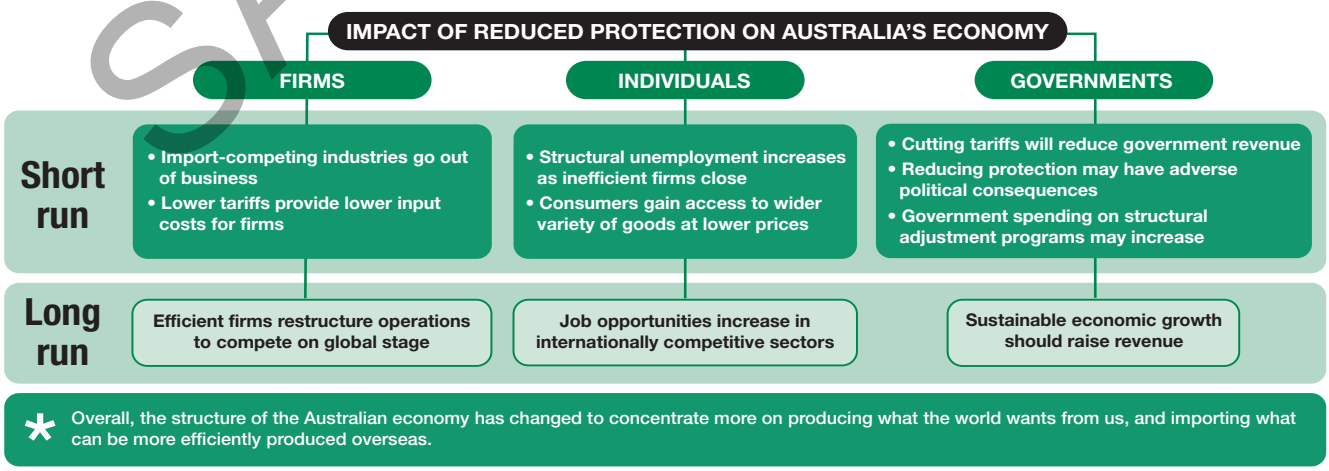


Figure 6.3 – The impact of reduced protection on the Australian economy

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Individual firms that operate in marginal, import-competing industries will shrink unless they are able to improve their competitiveness. In some cases, production in certain sectors ceases entirely. For example, Australia has largely ceased manufacturing consumer electronics like televisions and microwaves, with car manufacturing also ending in 2017. This is due to the high-volume, labour-intensive nature of production, which favours lower-wage economies such as China and Vietnam that produce these goods in very largely quantities.

Some businesses will respond to a phasing out of protection by restructuring their operations to improve competitiveness with the aim of staying in business. This restructuring may involve moving production offshore, consolidating manufacturing operations down to a single plant, eliminating less profitable product lines, finding export opportunities to replace lower domestic sales, adopting new production technologies to reduce production costs, or reducing staffing levels.

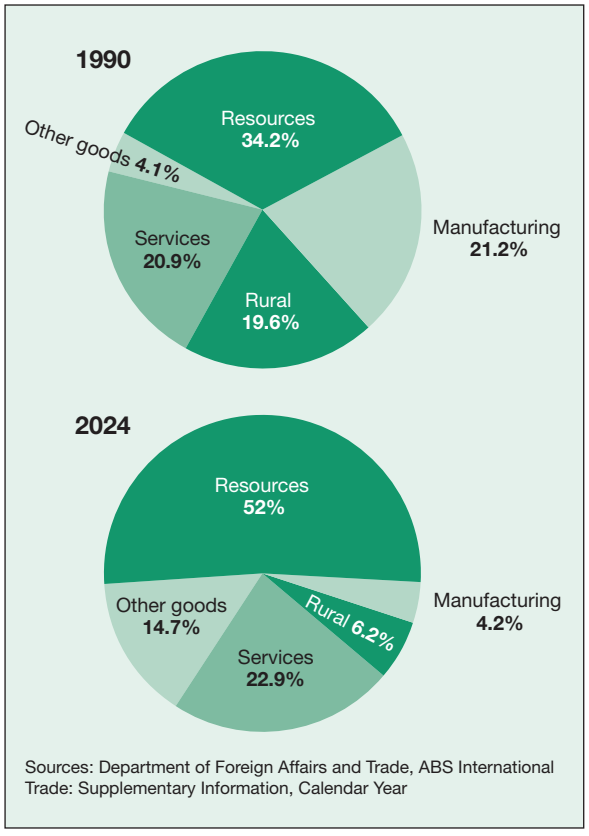
Where businesses struggle to compete against cheaper imports, firms often merge so they can work together, and more efficient companies acquire less efficient (but still useful) ones. For example, Byron Bay Cookies went into voluntary administration in 2013 after international brands like Oreo and Biscoff became more popular in Australia. It was taken over by major pasta and snack company Rinoldi, which focused on only the most popular cookie varieties and manufacturing them on a larger scale, remaking Byron Bay Cookies into a competitive brand.

Productivity Commission research shows that reducing tariffs spurs innovation and productivity growth through increased competitive pressures. In a globalised world economy, Australian firms, by operating in a competitive domestic market, should also be able to compete in global markets. This generally results in higher levels of investment for those firms that survive, as Australian businesses invest in improving their technology or expanding their business.

Lower tariffs can also generate benefits for firms by reducing the price of imports that they use as inputs in their production processes. For example, mining companies in Australia rely on machinery produced overseas to extract commodities such as coal and gas. Eliminating tariffs on those machines reduces mining companies' input costs, lowering their overall production costs and making them more internationally competitive when selling commodities.

By creating winner firms and loser firms, changes to trade protection have affected the overall composition of Australia's exports. During the 1990s, the reduction in protection, along with other microeconomic policies, contributed to changes in Australia's export base, including a significant growth in manufacturing exports. However, the global resources boom of the 2000s saw Australia shift back to a heavily commodity-focused export base, as shown in figure 6.4. This pattern is expected to remain in place for at least the medium term, with natural gas and critical minerals like lithium expected to be strong drivers of export growth in the coming years.

In addition to the changing composition of exports during this period, there has also been substantial overall **growth in export volumes**, suggesting that Australia is becoming more integrated with the world economy. A higher proportion of Australia's production is being exported, and equally, a higher proportion of the goods and services that Australians consume are imported.



Sources: Department of Foreign Affairs and Trade, ABS International Trade: Supplementary Information, Calendar Year

Figure 6.4 – Changes in Australia's export profile in the past decades

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Effects on individuals

Individuals can experience substantial dislocation as a result of reduced protection levels, in particular through the **increase in unemployment** associated with the restructuring of industries, and cuts in local production. The impact of these job losses can be particularly harsh on individuals who have worked in these industries for a long time and have limited alternative job opportunities.

- The import-competing industries that were most affected by reductions in protection have been concentrated in particular regions, such as the manufacturing areas of Victoria and South Australia, where there are fewer alternative sources of employment. With reductions in protection, unemployment rates in these areas climbed dramatically and it was difficult for people who lost jobs in these areas to find alternative employment.
- Many of the jobs lost in the manufacturing sector because of lower protection are relatively low-skilled, production-line jobs. The limited skills that workers develop in these jobs are not easily transferred to other workplaces, especially at a time when the overall number of people employed in many of the manufacturing industries has been declining.

People who lose jobs as a result of tariff cuts are usually categorised as **structurally unemployed**, because they often find that their skills do not match the job vacancies in the economy. It may then become necessary for these workers to retrain to develop work skills that are relevant to the current needs of the economy. State and federal governments have funded many adjustment programs, such as the NSW Government's Future Jobs and Investment Authority which received $27 million of funding in 2025–26 to secure employment opportunities in communities that will be impacted as demand for coal declines in the future.

However, the effects of reduced protection on employment patterns are not entirely negative. While unemployment is likely to increase in the short term due to cuts in protection, in the longer term, employment levels may increase. Provided the process of structural change promotes internationally competitive firms in the future, the lost employment opportunities should be more than recouped by the growth experienced in other sectors that are efficient and internationally competitive. For example, while manufacturing industries declined in recent decades, new export industries such as liquefied natural gas (LNG) have grown. Before 1989, Australia did not export any LNG at all. Australia is now one of the world's largest LNG exporters. The problem with reducing protection in overall terms is less that it raises the total level of unemployment, and more that the gains and losses from protection cuts are distributed unevenly throughout the population, with some communities and individuals winning while others lose out.

One way in which all individuals can benefit from lower levels of protection is in their capacity as **consumers**. Lower trade barriers have resulted in consumers being able to buy a wider variety of goods at lower prices. For example, research by the Centre for International Economics found that, overall, prices in Australia were 3.4 per cent lower in 2016 because of reductions in trade protection that have been implemented since 1986 (see the box on the left for more details of the research). Increased competition has also contributed to improved customer service from firms in some

CLOTHING TARIFF CUTS

The reductions in tariffs on clothing goods from 17.5 per cent to 10 per cent in 2010 were strongly opposed by manufacturing industry employees. Campaigners argued the decision would create unemployment. A report by the Productivity Commission estimated that the lower clothing tariffs would reduce industry employment by over 5 per cent – the equivalent of over 1500 jobs. However, the government decided to proceed with the cuts because there would be overall economic benefits, including lower prices for consumers, a view strongly supported by the Productivity Commission. A number of the 'nuisance' tariffs eliminated in 2024–25 also related to clothing and textiles.

ECONOMIC BENEFITS OF TRADE

Australia's trade liberalisation policy between 1986 and 2016 increased GDP by 5.4 per cent and increased average family income by up to $2670, according to modelling by the Centre for International Economics. Overall benefits included:

Gross Domestic Product	+ 5.4 %
National income	+ 5.1 %
Exports	+ 28.5 %
Imports	+ 28.6 %
Prices	– 3.4 %
Real wages	+ 7.4 %

Source: Centre for International Economics (2017), "Australian Trade Liberalisation", prepared for the Department of Foreign Affairs

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LESSONS FROM COVID-19: DOES AUSTRALIA NEED INDUSTRY PROTECTION TO MAKE ITS SUPPLY CHAINS MORE RESILIENT?

Australia grappled with supply shortages for essential medical and other items during the COVID-19 pandemic, including vaccines, face masks, cars and smart televisions. The shortages of goods occurred when transport networks and overseas producers were disrupted or could not expand production to meet demand during the pandemic. These shortages stoked debate about whether the phasing out of protection left Australia vulnerable to global supply chains that fail in times of greatest need.

The Productivity Commission (PC) evaluated these issues in its 2021 report *Vulnerable Supply Chains* and concluded that free trade policies actually make supply chains more resilient. The report argued that with fewer barriers to trade, there are more suppliers. In other words, diversification of suppliers, rather than "onshoring" production, is the best way to make supply chains more resilient. Overall, the PC estimated that only around 5 per cent of goods imported by Australia come from vulnerable supply chains. Roughly two-thirds of these imports come from China. The PC rejected the case for increased industry protection.

In 2023, with the United States and other economies increasing production subsidies and local content rules, the Productivity Commission's *Advancing Prosperity* report recommended that government intervention should be a last resort, and should only support high-risk and critical supply chains. It also recommended that any supply chain assistance should be subject to an assessment by the Australian Government's Office of Supply Chain Resilience, with public reporting on the justification, benefits and costs of any intervention.

sectors. Figure 6.5 shows how the removal of tariff protection lowers the *domestic price* of products (from P_T to P_W), and increases the amount of foreign products available (from Q_2Q_3 to QQ_1).

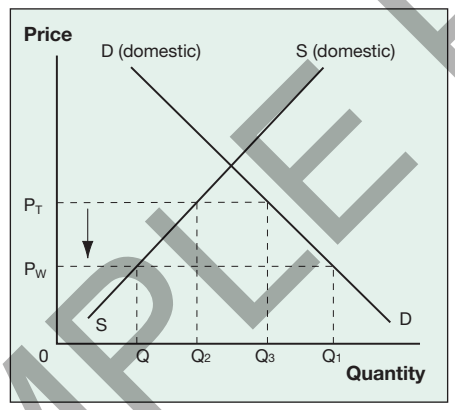


Figure 6.5 – The effect of tariff reductions

The phasing out of trade barriers and the opening up of the Australian economy to global markets is intended to **improve living standards** for individuals. The quality of goods and services is higher because globally competitive businesses enter Australian domestic markets, forcing domestic firms to lift their game. Highly competitive markets also tend to encourage greater innovation as firms seek to differentiate themselves from competitors. The domestic presence of many firms that operate in global markets also ensures that innovations in other markets are brought into Australia more quickly.

Effects on governments

Cutting tariffs leads to a reduction in **government revenue**, since tariffs provide indirect tax revenue to the government. In the early years of Australia's nationhood at the beginning of the 20th century, tariffs provided the largest source of revenue to the Commonwealth Government. Indeed, the two largest political parties were the Protectionist and Free Trade parties. In contrast, in recent decades there has been general agreement about free trade among Australia's major political parties, and tariffs are now only a minor source of revenue. The approximately $2.1 billion in tariff revenue collected by the government in 2024–25 accounted for about 0.3 per cent of its total revenue.

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A program of reducing protection levels may also have effects on the levels of **government spending**. This can be seen in two ways, the first being less spending on subsidies. On the other hand, governments may be required to assist the structural adjustment process through increased expenditure on unemployment benefits and retraining programs to aid individuals who lose their jobs.

Governments can also be affected by the **political consequences** of tariff reductions. Despite the general consensus among economists that cutting protection will benefit the economy, this policy is generally unpopular with the wider community. The costs of lower protection are highly visible: structural unemployment, the closure of factories and well-known businesses, and the damage to the economy of regional Australia. The benefits are less visible, because they are spread out across the economy, and they may take a long time to arrive. In the meantime, governments can lose votes by pursuing policies to reduce protection. This explains why governments in many countries are reluctant to reduce protection levels, and why some, including the United States, have recently increased them.

Other economic effects

Phasing out protection also has an impact on Australia's economic growth and **standards of living**. In the short term, lower levels of protection may lead to increased levels of imports. Because imports are produced overseas and do not create jobs or income in Australia, reducing protection can be negative for living standards in the short term. In the long term, however, as resources such as labour and capital move to more productive areas of the economy – with higher rates of return – economic growth and living standards should improve. While many other factors have also been important, low protection levels in recent decades have generally been viewed as one of the critical factors for Australia's strong economic performance.

In the short term, the phasing out of protection can have significant effects on Australia's trade performance and **current account**. The current account balance is likely to worsen as imports rise, because some imports will be cheaper due to lower tariffs and less restrictive quotas, or if the imports are of a higher quality than locally made products. However, lower protection should improve international competitiveness and improve the current account over the longer term as more competitive exporters grow. In fact, government reports have argued that Australia's failure to reduce tariffs until the late 1980s contributed to a less competitive export sector and higher current account deficits.

The benefits of reduced protection grow over time, and this influenced Australia's decision to adopt a process of phasing tariffs out over a 30-year period rather than with a small number of large cuts. Many trade liberalising measures implemented through free trade agreements are also phased in gradually over a period of time instead of being activated immediately. Implementing these changes gradually can help industries plan for the best long-term investment decisions and adjust to changing business conditions. Most economists would agree that the short-to-medium-term problems of reducing protection are far outweighed by the long-term benefits, but a gradual phasing out makes it easier to manage the structural changes that occur as a result.

reviewquestions

1. Outline the impacts of reduced protection on economic growth, unemployment, and external stability in the Australian economy.
2. Outline how reducing protection creates winners and losers in the Australian economy.
3. Assess the effect of reducing tariffs on government revenue and expenditure.

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6.5 The impact of international protection levels on Australia

Just as domestic policies to protect Australian industries have an impact on the Australian economy, so do the policies of other nations to protect their industries. When other countries put tariffs on Australian goods and services, Australian exports become less competitive in those overseas markets. When other countries subsidise their exports, they raise the supply and reduce the price of those goods on global markets. The result is that countries like Australia that compete to sell similar products on global markets experience a reduction in their income.

Australia can also be a "second-hand" victim of tariffs. When our major trading partners are subject to tariffs from other countries that cause their economies to contract, their demand for Australian exports decreases. This was a major concern in 2025 when the US and China imposed tariffs of over 100 per cent on each other's exports. Analysis by the Reserve Bank in 2025 noted that the increased international protection levels implemented by the Trump Administration would create greater uncertainty for investors, leading to lower investment, output and employment. It is difficult to calculate the specific impacts on Australia because it depends on how consumers and businesses respond to higher tariffs. Economists mostly expect negative effects on the demand for Australian exports, especially to China. But the Productivity Commission estimated in July 2025 that lower prices for imports would have a greater impact alongside a shift of investment out of the US, with the overall effect of actually boosting the Australian economy by 0.37 per cent of GDP. Overall, international protectionism reduces the output of the Australian economy. On the other hand, a reduction in global protection levels would increase Australia's national income. A 2018 report by the Centre for International Economics estimated that a global reduction in tariffs that reduces import prices by 10 per cent would increase Australia's real GDP by 0.6 per cent a year.

As a small economy with a high level of agricultural trade, Australia suffers particular disadvantages as a result of the protectionist policies of other nations and trading blocs. The EU has, for several decades, heavily subsidised agricultural production through the Common Agricultural Policy, which absorbs over one-third of the European Union's budget, and supplies around 15 per cent of European farmers' incomes. Farmers also receive significant subsidies in Japan, South Korea and Switzerland. Australian farmers are therefore competing in global markets at a significant disadvantage to their counterparts in the rest of the industrialised world. Figure 6.6 shows that agricultural protection makes a significant (although declining) contribution to farm income in the countries of the OECD.

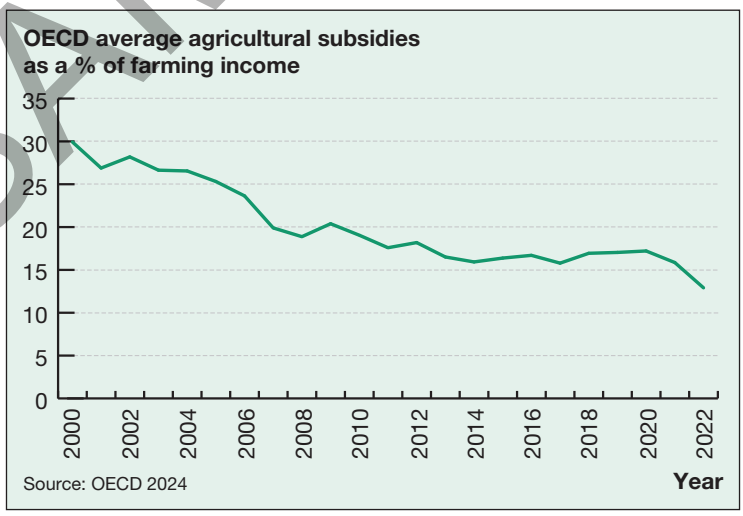


Figure 6.6 – Subsidies as a percentage of farm incomes for OECD countries

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AGRICULTURAL PROTECTION AND CARBON EMISSIONS

As governments step up their efforts to reduce carbon emissions, a key challenge is to prevent "carbon leakage", where domestic producers who are paying higher costs to reduce emissions are undercut by overseas producers who are not taking action. The European Union (EU) from 2026 is introducing an import tax on emission-intensive goods that come to the EU from countries that do not adequately charge their producers for carbon emissions (via a domestic carbon tax or emissions trading scheme, for instance). These taxes are called carbon border adjustments (CBAs, sometimes also called carbon border taxes) and they work in a similar way to regular tariffs. Because the EU imposes a carbon price on domestic production, its businesses may be at a competitive disadvantage compared with firms in other countries that do not have to pay as much for their emissions. CBAs can help create incentives for firms in countries without carbon prices (such as Australia) to reduce their emissions. In contrast, the Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) has highlighted the importance of global agricultural support reform in reducing emissions. In 2023, ABARES said that removing global agricultural subsidies would reduce distortions, resulting in a fall in inefficient production, improved productivity, and reduced waste and emissions, while maintaining global food security.

THE AUSTRALIAN DOMESTIC GAS SECURITY MECHANISM

Most trade restrictions are imposed on imports, but sometimes governments impose restrictions on exports when they conclude that markets are not operating in the national interest. Natural gas is one such market. Most gas exporting countries apply some form of gas reservation policy, or other policy mechanism, to protect their national interest in supplying their domestic energy market. Although Australia is the world's third-largest supplier of liquefied natural gas (LNG), until recently it had no national policy to guarantee its own domestic supplies – there was only a state-based law in Western Australia requiring that 15 per cent of the state's natural gas production be made available for domestic use.

Energy retailers and manufacturers have for many years criticised the gas industry for making long-term sales contracts with overseas buyers, and in the process shutting out their smaller domestic customers or selling at unfairly inflated prices. The Australian Government responded to these concerns in 2015 by establishing the Australian Domestic Gas Security Mechanism (ADGSM) to restrict exports of LNG in situations of gas supply shortages on the east coast of Australia. Further reforms were introduced in 2023 to increase flexibility in responding to domestic gas supply shortfalls. These reforms included the ability to activate the AGDSM quarterly, ahead of peak seasonal demand, the introduction of new protections for long-term gas contracts, and shared responsibility for LNG exporters in preventing shortfalls. The ADGSM was also extended to 2030.

While Australia's agricultural sector is mostly affected by protection levels in developed countries, the policies of other major export markets such as China also have a significant domestic impact in Australia. For example, tariffs imposed by China in 2020 resulted in Australian wine exports to China falling from $1.3 billion prior to the COVID-19 pandemic to less than $1 million in 2023 (recovering to a projected $1 billion in 2025).

Global progress towards reducing **agricultural protection** has been slow in recent years. In addition to recent tariff increases, agricultural trade has remained more protected than other industries throughout several decades of trade liberalisation. Many of the most protectionist agricultural trading nations have taken advantage of complex loopholes in the WTO regulations to avoid genuinely freeing up agricultural trade. According to the Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) in 2020, global agricultural subsidies and trade barriers are currently reducing Australian agricultural exports by between $8 billion and $10 billion per year.

Australian firms exporting **non-agricultural goods** generally face fewer barriers to trade compared with the agricultural sector. The **mining and resources sector**, whose exports contribute the largest share of Australia's exports, faces very few barriers to trade. The products from this sector, such as coal, natural gas, oil and iron ore, are in high demand worldwide. As a result, mining companies and gas producers may be more likely to face export restrictions from an Australian Government trying to secure energy supplies for the domestic economy than from a foreign government trying to protect its minerals and resources industries. In many instances, overseas buyers of Australian energy and mineral resources do not have domestic substitutes for the commodity goods that Australia exports. If a foreign government was to impose tariffs on Australian resource exports, it would simply raise costs for its own consumers and businesses.

Likewise, Australia's **manufacturing industries** generally face few barriers to trade because of the substantial reduction in industrial tariffs in recent decades that have been negotiated through multilateral and bilateral trade agreements. Like Australia, most industrialised economies in the world have low manufacturing tariffs. Within the Asia-Pacific region, which includes many industrialising and developing countries, average manufacturing tariffs are also low, although there are exceptions, such as for motor vehicles, which incur tariffs of around 15 per cent in

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China. Additionally, some Australian exporters argue that **non-tariff barriers** to trade, such as technical restrictions and licensing rules, play a greater role in modern protectionism. For example, inconsistent or varying health regulations for processed food products in different areas of a country can make it difficult for Australian exporters to penetrate foreign markets (at times, other countries have made the same claims about Australia's strict quarantine rules). For this reason, technical barriers to trade are now formally part of trade negotiations at the WTO and in bilateral trade agreements.

Australia's **service industries**, which account for around 70 per cent of the Australian economy but less than one-fifth of our exports, often face the most prohibitive barriers to international trade. In many situations, trade in services is simply not feasible. This is because of **natural barriers** caused by geography and transport costs, language and cultural differences, and local tastes and preferences, rather than the result of protectionist trade policies in other countries. For example, the market for tourism exports is limited to the number of tourists who physically visit Australia.

However, protectionism also plays a role in reducing services trade in the global economy. Unlike goods, the main barriers to services trade are not tariffs, but a range of government regulations and practices that have the effect of restricting services trade. Many countries' banking sectors are protected from foreign competition by restrictions on granting licences for overseas-owned banks. This restricts the growth of Australia's financial services industry in overseas markets. Similarly, competitive Australian firms in the electricity, recycling and communications industries face many overseas markets that are dominated by monopoly government providers or procurement arrangements that favour local providers. Figure 6.7 lists some common barriers that Australian service businesses face in overseas markets. Restrictions on trade in services have a significant impact on service-based economies like Australia. For example, the Asia Society think tank published an article in 2024 highlighting how Australia's world leading talent in financial services has only a small presence in nearby Asian markets because of regulatory barriers that are costly and hard to navigate.

While trade agreements with countries like Japan and South Korea aim to reduce these barriers, Australia also protects some of its services sectors. In 2022–23, the Productivity Commission estimated Australia provided $7 billion in services protection.

Service industry	Potential trade barriers
Financial services	Restrictions on foreign ownership of banks and other financial institutions
Transport services	Restrictions on the number of flight routes in another country
Professional services	Licensing laws that only recognise own country's educational qualifications
Construction services	Government procurement rules that mandate use of local suppliers
Utility services	Government monopoly provision of electricity, gas and water
Environmental services	Government preferences for local suppliers of waste or recycling services
Media and entertainment	Minimum local content requirements to preserve country's culture

Figure 6.7 – Trade barriers that often affect Australian services exporters

Government procurement refers to the policies and procedures for purchasing goods and services for the use of the government and public trading enterprises.

reviewquestions

1. Discuss the impact of subsidies in overseas economies on Australia's trade performance.
2. Compare and contrast recent trends in global protection levels across different industries in the global economy.

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6.6 The future of Australian industry in the global economy

The outlook for the global trading environment in the late 2020s is more uncertain than it has been for several decades. Increasing tensions between the United States and China over trade have destabilised the global trading system, with knock-on effects for small, open economies like Australia. The WTO's role in the global trading system has been weakened. The COVID-19 pandemic and the war in Ukraine strengthened protectionist sentiments around the world. Accelerating progress on the "net zero" transformation of economies is a growing priority for economies across the world, and likely to see fossil fuel energy markets decline in the years ahead. All of these factors are likely to significantly affect Australia's trade patterns in the coming years.

Predicting future trade patterns is always difficult. In the 2010s and early 2020s, many expected Australia's mining boom would come an to end as global demand eased and commodity prices fell. Instead, strong demand, particularly from China and Japan, kept commodity prices high, and export revenue from mining continued to grow. Even the COVID-19 border restrictions in 2020 had a smaller-than-expected impact on exports like mining and agriculture, despite some processing delays.

Mining will likely remain Australia's most important export industry for the foreseeable future. The share of Australia's total export revenue earned by minerals and metals industries has almost doubled in the past three decades. The average value of resources exports each year in the 2020s has been roughly $400 billion. Nevertheless, elevated trade tensions with China pose some risk to mining exports, although China has a limited number of alternative reliable sources elsewhere in the world. The global shift away from coal is also likely to reduce Australia's coal exports in the coming years. But other commodities, such as iron ore, will remain important and the value of critical minerals like lithium and cobalt (which Australia has large deposits of) will grow, as they are important components in batteries for everything from mobile phones to electric vehicles. Global demand should continue growing because there are no substitute products available. In addition, natural gas is playing a role as a "transition" source of energy that countries can use to gradually reduce emissions (since gas has fewer emissions than coal). This should support the demand for Australian LNG exports over the short-to-medium term. Overall, the composition of Australia's mining exports may change in coming years but they will remain a key component of Australia's economy.

Trends affecting the Australian economy



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Australian **agricultural industries** face a more mixed outlook. Global food prices have increased significantly in recent years. This has lifted farm incomes. The return of the Australian dollar closer to historic averages has also made farming exports more competitive. However, Australian agriculture faces major long-term challenges: more extreme weather patterns resulting from climate change, including increased drought, bushfires, floods and threats to livestock. Access to overseas markets may also be affected by trade barriers and increasing levels of agricultural efficiency among competitors. Processed food industries that add value to traditional agriculture (such as wine and dairy industries) are playing a larger role in exports, particularly as they have been afforded greater market access under Australia's more recent trade agreements than traditional areas of agriculture. The global market for high-quality processed foods is expected to continue growing strongly in coming years, fuelled by the growth of the middle class in China and India, and Australia's high-quality food industries are well positioned for export growth.

Although Australia has seen a gradual reduction in its older, import-competing **manufacturing sector**, at the same time, smaller, export-oriented manufacturing has continued to grow. Overall, manufactured exports grew from less than $10 billion to around $40 billion in the three decades to 2024. This growth is expected to continue at a slower pace, as specialised manufacturers expand their markets by producing high-quality goods aimed at specific market niches. For example, an Australian lithium-ion battery manufacturing industry is developing (in addition to lithium mining) to meet global demand which is expected to grow forty-fold by 2050. A new "gigafactory" opened in the Hunter Valley in 2023, and work is underway on another gigafactory in Geelong. Further, manufacturing will grow in Australia if the government's industrial policies targeting critical sectors, like Future Made in Australia, are successful.

Services exports are likely to continue growing. These fell sharply during the COVID-19 pandemic, but by 2023 (other than for travel) had recovered to pre-pandemic levels. The recovery in international tourism has been held back by limited capacity on overseas plane routes and ongoing high costs for airfares and accommodation. Australia's other major services export is international education, worth $51 billion in 2024, up from $40 billion prior to the pandemic, though facing restrictions on its growth (see text box on the following page).

Other key areas of services exports include:

- **Digital services**: information and communications technology (or digital goods and services) have become Australia's fourth-largest export, expected to be worth $19 billion by 2030, according to a report by the Export Council of Australia.
- **Environmental services**: these have longer-term growth potential, such as in the renewable energy sector, where historically Australia has been an innovator. According to research by the Superpower Institute, a green energy organisation founded by economists Ross Garnaut and Rod Sims, Australia could earn $1 trillion a year from exports of low-emission products by 2060.

Other services sector exports for Australia that may grow in the future include professional services, financial services and services related to infrastructure.

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INTERNATIONAL STUDENT CAPS: AUSTRALIA MOVES TO LIMIT A MAJOR EXPORT INDUSTRY

Governments usually try to restrict imports, rather than exports, so it was a surprise in 2024 to see Australia – along with the US, UK and Canada – beginning to cap international student enrolments because of concerns that housing shortages were being made worse by a surge in overseas students.

International education is an export, in the sense that Australia earns income from overseas customers that appears as a credit on the balance of goods and services. But like tourism, not only is the service delivered in Australia, but students also come to Australia to receive the service. Mostly, students come for courses from Australia's top-ranking universities.

Education was Australia's fourth-largest export in 2024, earning $51 billion in revenue, behind three commodity exports (iron ore, coal and natural gas) but ahead of tourism. It is even more important for New South Wales, where education is second only to coal as the state's largest export. The top five source countries for international students in Australia were China (23 per cent), India (17 per cent), Nepal (8 per cent), Vietnam (5 per cent) and Philippines (4 per cent). International student numbers have grown by an average of around 5 per cent per year since 2005 and by mid-2025 the overall number of international students in Australia had surged to a record level of 794,000.

Australia's education sector has made large investments to build overseas markets in the past two decades, but its rapid expansion has also brought concerns about the quality and sustainability of courses, exploitation of foreign students, and more recently, its effect on housing shortages. Enrolment numbers surged after the COVID-19 pandemic, at the same time as house prices were rising and rents increasing sharply in major cities.

In response to these concerns, the Albanese Government took the unusual step of announcing a restriction on the number of international students allowed into Australia from 2025. In effect, this represents an **export quota**. The Government's plan involved restricting the number of new international enrolments at Australia's tertiary institutions to 270,000 in 2025 (which is 7000 less than the number of students pre-pandemic and 53,000 less than in 2023). Under the plan, education providers are each allocated a limit, which they can only exceed if they build new accommodation for domestic and international students. Similar measures were also announced in Canada and the UK, which are also experiencing housing shortages.

There was significant criticism of the plan to limit student numbers. University heads argued that it will damage international perceptions of Australia's higher education system, as well as limiting universities' ability to fund facilities and research, and potentially raising fees for domestic students. Economists also questioned whether there is any direct link between international students and the housing crisis, given that they account for only 4 per cent of Australia's rental market.

reviewquestions

1. List THREE industries that you think will play a greater role in Australia's export mix in the future. Justify your answer.
2. Outline the likely future trends in the direction of Australia's exports.

SAMPLE PAGES

A FUTURE MADE IN AUSTRALIA: PROMOTING STRUCTURAL CHANGE IN THE 2020S

In 2024, the Albanese Government introduced a major new policy focused on developing the industries needed for the transition to a "Net Zero" economy and that strengthen supply chains at a time of greater geopolitical uncertainty. The Future Made in Australia (FMIA) policy reflects a global trend towards more interventionist industry policies in recent years, with similar initiatives implemented in the US, UK, Canada, France and India.

The 2024–25 Budget included funding of **$22.7 billion over 10 years** for FMIA, with five focus industries: renewable hydrogen, critical minerals, green metals, low carbon liquid fuels and clean energy manufacturing. Some targeted initiatives include:

- **The Hydrogen Headstart program**: $2 billion for major projects producing hydrogen.
- **The Solar Sunshot program**: $1 billion to fund solar photovoltaic panel manufacturing.
- **Quantum computing**: $470 million for PsiQuantum to build a commercially useful quantum computer.

The largest funding component of FMIA is a tax incentive for production in Australia of renewable hydrogen or critical minerals such as copper, lithium, nickel and cobalt, which are increasingly in demand as components of clean energy technologies such as wind turbines and electric vehicles. Projects led by small and medium enterprises (SMEs) that involve innovation and commercialisation activities will be supported through a $1.7 billion FMIA Innovation Fund. In 2025, $750 million of this funding was allocated to green metal projects.

FMIA is more ambitious than any industry policy of recent decades because it seeks not only to lift innovation and efficiency in general, but structurally shift the economy towards becoming a "renewable energy superpower". Further, it aims to influence how Australia interacts with the global economy, not relying purely on private sector decisions about what is commercially profitable, but instead taking into account geopolitical trends, and deliberately building resilience against the risk of being exposed to fragile global supply chains.

FMIA is governed by a **National Interest Framework**, overseen by the Commonwealth Treasury, to ensure industries only qualify for support under certain conditions:

- For the **Net Zero Transformation Stream**, industries must be expected to have a "sustained comparative advantage in a net zero global economy" and reduce emissions at an efficient cost.
- For the **Economic Resilience & Security Stream**, there must be a need to have the production capability in Australia, and it must be shown that "the private sector will not deliver the necessary investment in the absence of government support".

A supporting paper published by the Commonwealth Treasury makes the economic case for FMIA. Government intervention is necessary because of two key market failures: first, economic production processes result in carbon emissions that create negative externalities, and second, being an "early mover" in certain industries can create positive externalities. Key economic opportunities in Australia, Treasury says, face a range of financial and non-financial barriers, which mean that private sector activities alone may not see Australia shift fast enough to being a clean and resilient economy of the future.

The Treasury cites evidence that Australia has the potential to develop key industries that will help the transition to a net zero economy:

- By 2050, the CSIRO projects Australia will produce renewable energy more cost-effectively than any economy other than China and India.
- Australia could export liquid hydrogen to Japan at around 80 cents a kilogram, less than other producers such as Saudi Arabia, Chile, the US, and Algeria.

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- Australia's world ranking for critical minerals deposits is among the top five countries for nickel, vanadium, lithium, cobalt and manganese.
- Global production of both solar PV cells and batteries is highly concentrated, with China alone controlling around three-quarters of supply, according to the International Energy Agency.

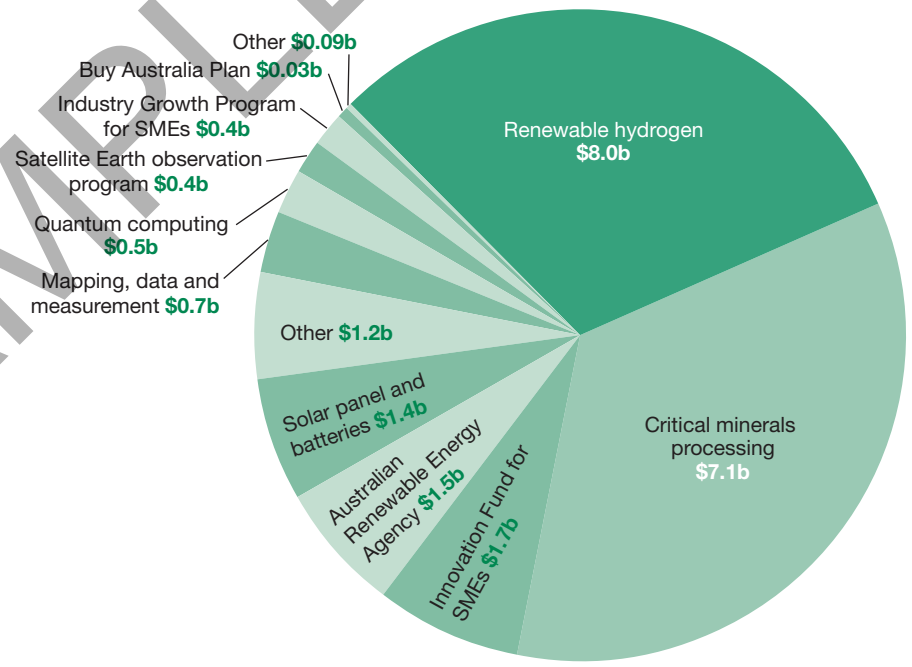
Initial reactions to the FMIA policy were mixed. The business community was broadly supportive of the policy direction, with the Business Council of Australia pointing to the potential of FMIA to "drive investment, increase productivity and improve living standards for all Australians".

The Productivity Commission expressed concerns about expanding industry policy, arguing FMIA could waste public money and create industries reliant on public subsidies. Productivity Commissioner Danielle Wood said, "One view of the world is that when others subsidise their production, we say thank you very much … That means lower prices for Australian consumers … [We will] need some kind of process for independent assessment otherwise we risk sort of a giant pork-barrelling scheme or lobbying dictating where these big pots of government money are going to go".

However, the government argued FMIA was not old-fashioned industry policy subsidising loss-making business, but instead an economic policy focused on long-term geopolitical and environmental realities that is also directly targeted at market failures and barriers to structural change.

As a ten-year plan, the effectiveness of FMIA will take time to evaluate. Early signs indicate many industries have benefited from Government support during a period of high interest rates and weakness in the global economy. However, there has been criticism of delays in providing grants, and setbacks in the global hydrogen industry (which have seen many projects initially marked for funding fall through).

Future Made in Australia components
($Billion)



Source: 2024–25 Budget Paper 2, pp.65–71
Note: Figures do not equal $22.7 billion because some funding components are reported over 11 years rather than 10

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chapter summary

1 The aim of **reductions in protection** over recent decades has been to make Australian industry more internationally competitive and to reallocate resources to the most efficient sectors of the economy.

2 For most of the twentieth century, the Australian economy had relatively high levels of protection. However, tariff reductions began in 1973, and during the 1990s and 2000s Australia phased out most of its tariffs barriers. **Tariff levels** in Australia are low with an average tariff rate of 0.5 per cent. Almost 90 per cent of imported goods and services are tariff free, and the general tariff rate is 5 per cent or less. Non-tariff barriers in Australia are low compared with other industrialised countries.

3 Australia's free trade agreements include **bilateral agreements** with Chile, China, India, Japan, Malaysia, New Zealand, Singapore, Indonesia, Peru, South Korea, Thailand, the United Kingdom and the United States; and **multilateral agreements** with ASEAN and New Zealand, the Asia-Pacific Economic Cooperation forum, Pacific nations and the CP–TPP.

4 The effects of reducing protection levels on **firms** vary across different industries, with traditional import-competing manufacturers losing out due to cheaper imports, while export-oriented industries benefit from lower input costs.

5 The impact of lower protection levels on **individuals** varies. Most individuals benefit as consumers from goods and services becoming cheaper, and from a wider product choice and a higher quality of service. However, with the decline of older import-competing industries, employees with less flexible skills may experience long-term unemployment.

6 While lower levels of protection may benefit the economy generally, in the short to medium term, **governments** may lose out from reduced revenue, increased expenditure (such as for higher unemployment benefits and structural adjustment packages) and a loss of public support. The economy may also experience a higher current account deficit in the short to medium term.

7 The use of **protectionist policies in other countries** has resulted in significant economic costs, in particular the loss of potential export revenue as a result of lower export prices and reduced access to overseas markets.

8 Risks to Australia's trade outlook include trade tensions with China, rising trade barriers, and the impacts of climate change on exports, both through extreme weather events and potential carbon border taxes.

9 Australia's approach of phasing out protection is likely to lead to an economy that is **more integrated with the global economy**, with a higher proportion of production and consumption going to exports and imports.

10 The resources boom of the 2000s resulted in a large expansion in Australia's mining and energy exports, underpinned also by higher commodity prices. Although resources are expected to remain Australia's largest source of exports, future export growth is also expected to come from services and a more diversified export base.

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chapterreview

1 Describe the factors that have influenced government policies to reduce protection in Australia during recent decades.

2 Explain how the short-term problems associated with a reduction in protection might be outweighed by the long-term benefits.

3 Discuss recent changes in Australia's protection levels and the outlook for protection levels in the future.

4 Describe the main features of TWO of Australia's bilateral and TWO of Australia's multilateral free trade agreements.

5 Assess the potential impacts of the government's Future Made in Australia industry policy.

6 Examine how changes to protection levels in Australia have impacted Australia's trade performance and economic growth.

7 Discuss the impact of reduced protection levels on individuals.

8 Outline the impacts of lower tariffs on the Australian Government.

9 Discuss the impacts of increased global protectionist policies on the Australian economy.

10 Outline possible future changes in the structure of industry within Australia as a result of current trends in the global economy.

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