Economics for the Real World

Units 3 & 4

Douglas Cave
Tony De Luca
Ron Hanmer

4th Edition

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Douglas Cave
Tony De Luca
Ron Hanmer
Ian Searle
Lyle Kirkwood
Tom Cronk
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This syllabus forms part of a new senior assessment and tertiary entrance system in Queensland. Along with other senior syllabuses, it is still being refined in preparation for implementation in schools from 2019. For the most current syllabus versions and curriculum information please refer to the QCAA website www.qcaa.qld.edu.au.

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Contents

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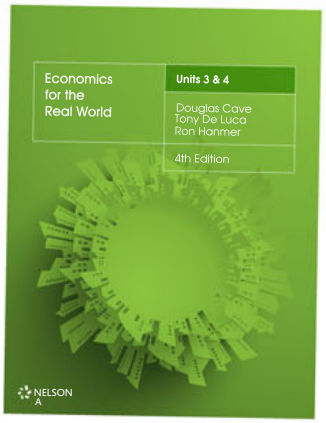
About this series

This new edition of *Economics for the Real World* has been fully updated for the QCAA Economics General Senior Syllabus implemented at Units 1 & 2 in 2019 and Units 3 & 4 in 2020. It comprehensively covers the syllabus and unit objectives using the inquiry approach valued in the syllabus, with integration of the underpinning factors throughout.

Student book



- The content reflects changing Australian and global economies, with current data, statistics and real-world applications.
- Updated 'Economics in action' sections provide realistic economics scenarios and allow students to learn through inquiry.
- Clear definitions of key concepts are provided throughout each chapter and included in a complete glossary.
- Updated reviews at the end of each chapter and a wealth of questions throughout ensure a steady development of knowledge and understanding.
- Questions and activities support the new assessment model and provide plenty of opportunity for revision and practice.
- Refreshed full-colour design allows for easy navigation through the topics.
- Numerous illustrative examples and diagrams assist learning.

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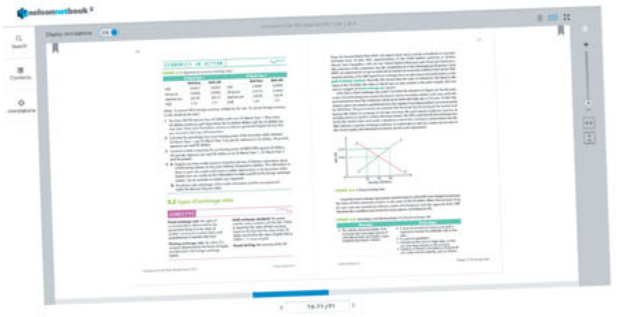

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Introduction

Assessment in Units 3 & 4

Assessment in Units 3 and 4 will be similar to the types of assessment conducted in Units 1 and 2. During the course of the year, you will have to complete four different assessment tasks, each of which is worth 25 per cent towards your overall result for Year 12. Three of the assessment instruments (1, 2 and 3) will be set and marked by your teachers in your school. The fourth will be an external examination that will be the same for all students in Economics across the state.

The tasks and requirements are stated in the Economics 2019 General Senior Syllabus developed by the Queensland Curriculum and Assessment Authority (QCAA), which can be located on the QCAA website.

QCAA Economics syllabus

All assessment instruments will be used to assess at least three of the five objectives stated in the syllabus.

The five objectives of the syllabus are:

1 comprehension of economic concepts, principle and models
2 selection of data and economic information from sources
3 analysis of economic issues
4 evaluation of economic outcomes
5 creation of responses that communicate economic meaning.

For a more in-depth explanation of what is required for each objective to be attained, refer to pages 4 and 5 of the Economics Syllabus.

Each assessment task is linked to a topic of study, one for each of the four topics as shown in Figure 1.

FIGURE 1 Summative assessment for Units 3 & 4

Topic	Assessment type	Conditions	Weighting
1: The global economy (Unit 3)	Examination – Combination response	• 2 hours plus 15 minutes planning time	25%
2: International economic issues (Unit 3)	Investigation – Research report	• 4 weeks, including 10 hours of class time • Length: 1500–2000 words	25%
1: Macroeconomic objectives and theory (Unit 4)	Examination – Extended response to stimulus	• 2 hours plus 15 minutes planning time • Length: 800–1000 words	25%
2: Economic management (Unit 4)	External assessment: Examination – Combination response	• 2 hours plus 15 minutes planning time	25%

Instrument-specific marking guides

Each of the assessment tasks will be accompanied by an **instrument-specific marking guide (ISMG)**. The marking guide will indicate the standards a student's work must demonstrate

to gain the marks. The highest marks a student can achieve is 25 per cent for each assessment instrument. Marks will be spread across the objectives of the syllabus that the summative assessment is measuring.

As an example, the first assessment instrument in Figure 1 will be based on the following break-up of tasks.

FIGURE 2 Summary of the ISMG

Criterion	Objectives	Marks
Part A – Comprehending	1	10
Part B – Analysing	3	8
Part C – Evaluating	4	7
Total		**25**

For each of the marks to be awarded for each criterion, there will then be a defined set of standards stated on the assessment instruments that shows what you need to achieve to be allocated the relevant mark. The following example shows this for the criterion 'Comprehending' in the first assessment instrument.

Assessment objective 1: Comprehend economic concepts, principles and models of exchange rates, international trade patterns and trade theories

FIGURE 3 Example of an instrument-specific marking guide

The student work has the following characteristics:	Marks
• *accurate and detailed identification* of the essential features of exchange rates, international trade patterns and trade theories • *perceptive application* of economic concepts, principles and models to exchange rates, international trade patterns and trade theories • *precise* use of economic terminology.	9–10
• *effective identification* of the essential features of exchange rates, international trade patterns and trade theories • *effective application* of economic concepts, principles and models to exchange rates, trade patterns and trade theories • *effective* use of economic terminology.	7–8
• *adequate identification* of the features of exchange rates, international trade patterns and trade theories • *adequate application* of economic concepts, principles and models to exchange rates, international trade patterns and trade theories • *adequate* use of economic terminology.	5–6
• *partial identification* of the features of exchange rates, international trade patterns and international trade theories • *partial application* of economic concepts, principles and/or models to exchange rates, international trade patterns and trade theories • *narrow* use of economic terminology.	3–4
• *identification* of aspects of exchange rates, international trade patterns and/or trade theories • *identification* of aspects of economic concepts, principles or models • *inconsistent* or unclear use of economic terminology.	1–2
• does not satisfy any of the descriptors above.	0

Similar tables will be used for every objective in all assessment instruments for your summative assessment results. You may consult the QCAA Economics 2019 Syllabus for these.

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Assessment instruments

We will now have a brief look at each of the assessment instruments that you will be required to complete in Year 12.

Examination – Combination response

The Examination – Combination response will be 2 hours in time plus 15 minutes planning time.

In this assessment instrument for 'Unit 3, Topic 1: The global economy', you will find a mixture of five multiple-choice questions, and between five to eight short response items that assess your ability to comprehend (Objective one).

The short response questions may include questions that ask you to explain, measure, calculate, label and name diagrams and graphs. Sentences, paragraphs, diagrams and graphs may be required in response to such questions. You may encounter some stimulus material, but these are not essential. These will be between 50 and 100 words in length.

You will also be required to analyse (Objective 3) and evaluate (Objective 4). There will be one extended response to unseen stimulus of between 400 and 500 words. You will be presented with a minimum of four different stimulus materials, none of which should exceed 100 words.

Investigation – Research report

The research report will be based on 'Unit 3, Topic 2: International economic issues'. In this task, all five objectives will be assessed – comprehension (Objective 1), selecting information (Objective 2), analysis (Objective 3), evaluation (Objective 4) and creating a response (Objective 5). You will be given four weeks to complete this task, including some class time, and your report will need to be between 1500 and 2000 words in length.

For the issue you are required to research, you should use a variety of primary and secondary sources such as government and other economics-related websites, media opinions, and commentaries from experts in the fields of economics and other related disciplines.

Examination – Extended response to stimulus

This examination relates to 'Unit 4, Topic 1: Macroeconomic objectives and theory'. All five objectives will be assessed in this two hour examination (plus 15 minutes planning time), which requires a response of between 800 and 1000 words.

You will be presented with primary and secondary sources, four to six of which you may have seen prior to the assessment and two to three of which are unseen. Your teacher will be looking for you to show your ability to demonstrate your skills of analysis and evaluation in constructing an analytical essay in response to the given task.

Examination – Combination response

This is the common external exam that all Economics students will be required to sit and is set by the QCAA. It will be on 'Unit 4 Topic 2: Economic management' and will be two hours in length, plus 15 minutes planning time.

Like the previous Examination – Combination response, it will contain multiple-choice questions, short response items and an extended response item. The examination will assess Objectives 1, 3 and 4 only.

UNIT 3

International economics

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1 International trade

This chapter examines trade and the circular flow of income, patterns and direction of Australia's trade and trade theories.

Focus questions and inquiries

- How does trade occur in an open economy?
- Why do nations trade, and how do they benefit from trade?
- How important is trade to Australia's economy?
- Does trade impact on Australia's economic policy?
- Are trade theories still relevant in today's globalised economy?

To provide a basis for answering such questions and carrying out such inquiries, this chapter will examine the following:

- imports, exports and the external sector in the circular flow of income model
- advantages and disadvantages of international trade
- trade and its impact on economic policy
- composition and direction of Australia's trade
- trade theories and their relevance in today's economies
- trends in trade.

Imagine for a moment a world in which each country operates as a closed economy; that is, each country relies totally on its own resources to satisfy the wants of its citizens. There is no problem in such a world if every country has an equal allocation of resources and an equal number of citizens.

But what happens when we introduce the element of inequality into our imaginary world? Assume that some countries have fewer people and more resources, and that other countries have vast supplies of some resources and no supply of others. It should be evident that, under these circumstances, if each nation continued to operate as a closed economy, living standards would differ greatly from nation to nation and opportunities for economic development would be severely curtailed.

How does the real world compare with this imaginary world? We do not have to look very far to notice that we live in a world of appreciable differences. When early humans ventured beyond their immediate environment, they discovered new resources and, as civilisation spread across the Earth's surface, humans recognised the need for trade. People saw that trade provided the means by which a greater number of wants could be satisfied. We are all familiar with the practice of swapping recipes, digital files and other items among friends. This is a version of the primitive barter system, the simplest form of trade, which even today still accounts for a substantial volume of internal trade in less-developed regions of the world.

KEY IDEA

Changes in the prosperity of a country's external sector can have significant effects on its domestic economy.

In today's global economy, international trade is a far more complex process, but the basic reason for its existence is the same. No country is so well endowed with resources that it does not have to rely on other countries for the supply of some commodities. For instance, Australia has ample supplies of coal and iron ore, while Japan does not. As a result, Japan trades with Australia to obtain these minerals for its productive processes. Australia, on the other hand, does not produce rubber, cocoa or computer chips and must rely on other nations to provide these commodities. Interdependence of this kind is a characteristic of all nations in the world today. Therefore, we can say that all contemporary nations operate as open economies.

1.1 The open economy and the external sector

CONCEPTS

Circular flow of income model: a model of the economy, based on income flows from one sector of the economy to another in a circular motion, which explains levels of national income and output, and how changes in these occur

Exchange rate: the value of the currency of a nation expressed in terms of the currency of another nation

External (foreign) sector: that sector of the circular flow of income model that identifies economic influences external to the domestic economy

Internal balance: a state of the economy in which there is full employment and acceptable levels of inflation

Open economy: any nation that trades with other nations

One way of illustrating how our domestic economy is linked to the rest of the world is through a **circular flow of income model** (or 'circular flow model') incorporating the **external (foreign) sector**.

A circular flow of income model for an **open economy** incorporates income flows generated by the external sector. These include leakages from the economy due to expenditure on imported commodities by residents, domestic businesses and governments. Injections into the circular flow are due to income received by residents for commodities exported to other nations.

Figure 1.1 shows how the external sector fits into a typical circular flow of income model. You will recall that, if we let *M* stand for expenditure by residents on imports and *X* stand for income received by residents from exports, then the equation for total income in the economy becomes:

$$Y = C + S + T + M$$

or

$$O = C + I + G + X$$

where:

Y = total income
C = consumption expenditure
S = savings
T = taxation
M = expenditure on imports
O = the value of the total output of production
I = investment expenditure
G = government expenditure
X = expenditure on exports.

Equilibrium is said to be achieved in the economy when:

$$Ip + G + X = Sp + T + M$$

where:

Ip = planned investment
Sp = planned saving.

From the above equation, it can be seen that it is possible to have inequality between *Ip* and *Sp*, between *G* and *T* and also between *X* and *M*, and still have overall equilibrium in the economy as long as the various inequalities compensate for one another to give overall equality. If the level of imports is greater than exports ($M > X$), then the level of economic activity (*O* and *Y*) will contract. In Australia, there has been an increasing gap between *X* and *M*, which has contributed to an increased external debt – investments, largely from overseas, are being used more than national savings. To narrow the difference between *X* and *M*, the circular flow of income model demonstrates that *I* should decrease or *S* increase or *T* increase or G decrease. In 2017 and 2018, the Australian Government delivered budget deficits (*G* increased more than *T*) and there has been a sustained campaign to encourage an increase in national savings.

International economics is an important area of economics. In studying this field we get a chance to integrate macro- and microeconomic concepts and models to create a framework within which we can apply theory to very real-world situations. Concerns such as increasing external debt, foreign ownership and international competition in industry are affected by pressures such as volatile **exchange rates**, decreasing commodity prices and tariffs. Economists have to make some difficult decisions to achieve their objective of external viability while maintaining **internal balance**, such as low levels of inflation and unemployment.

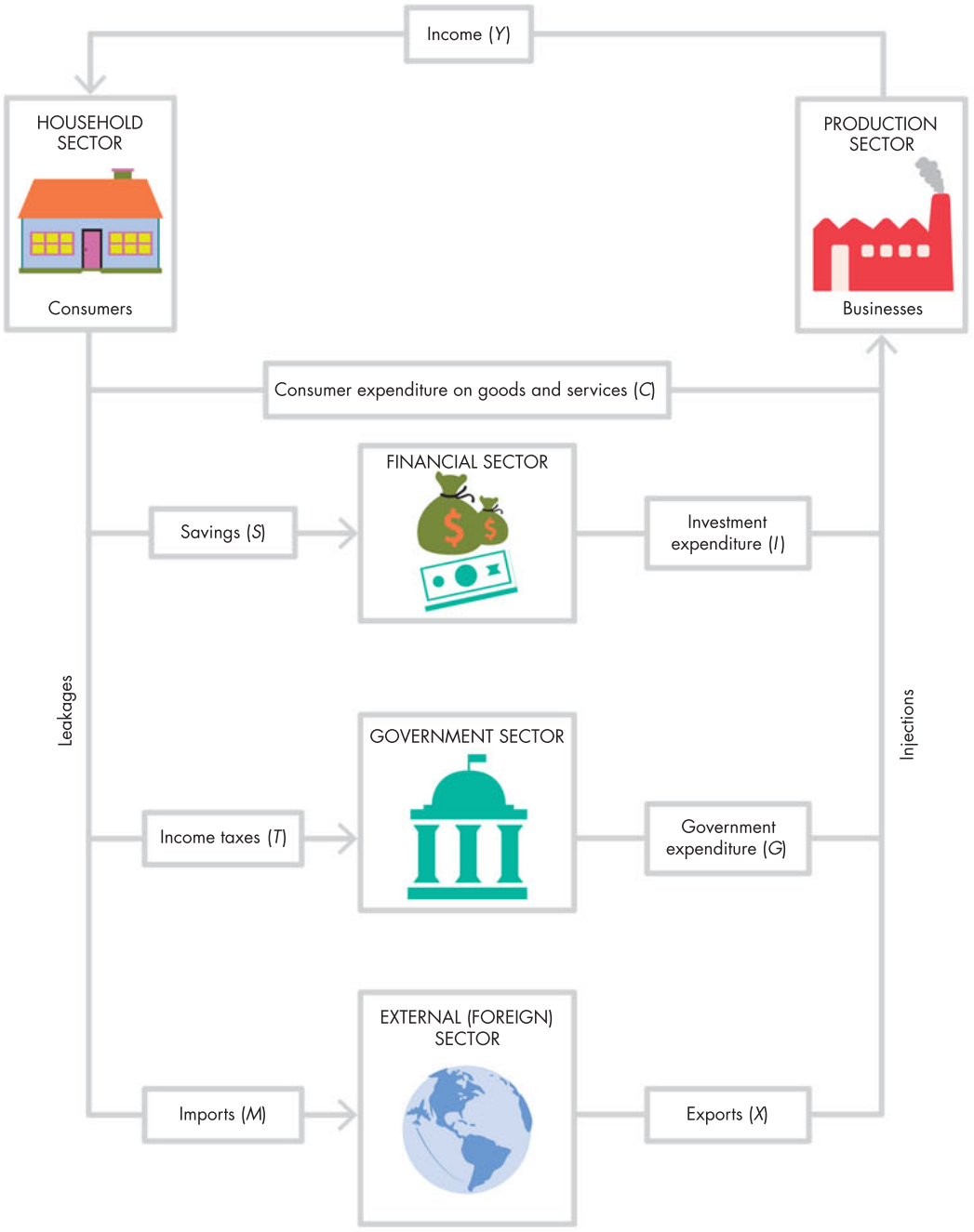

FIGURE 1.1 The circular flow of income model

QUESTIONS

1. Why are import payments a leakage from the circular flow-of-information model and export income an injection into it?
2. Why is Australia described as a small, open economy?
3. How does trade assist economic growth?

ECONOMICS DATA

Use the Internet to find the current rates of growth of Australia's imports and exports.

1 In the past five years, has there been a consistent trend in the growth of exports and imports, or are there fluctuations?

2 Suggest reasons why the growth rates are changing.

1.2 The international economic problem

CONCEPTS

Capital: the factor of production comprising the stock of human-made resources used to create further goods and services

Economic problem: the problem of deciding or choosing how to satisfy unlimited wants with limited resources

Factor endowment: the supply of the factors of production (land, labour, capital and enterprise) that exists in a country

Gross domestic product (GDP): the total value of final goods and services produced within an economy in a specified period of time

Human capital: the knowledge, experience and skills of individuals, in which nations must invest if they are to advance

Profit motive: the seeking of profit, the basic stimulus for economic activity in a free-enterprise economy

Relative scarcity: limited supply of a resource

Standard of living: a measure of lifestyle standards based on material and quantitative indicators, such as possessions, income, education and health standards, and housing standards

Widening gap: increasing economic difference between poor nations and economically advanced nations

It should now be evident that there is a similarity between the **economic problem** confronting an individual and the problem that faces all nations. **Relative scarcity** is the common element at both levels. Individuals allocate their limited income to maximise the satisfaction of unlimited wants. In the same way, nations distribute their scarce resources according to national objectives. Each nation seeks to supplement its own resources through international trade to compensate for the significant differences in **factor endowment** among nations of the world.

1.2.1 Unequal distribution of natural resources

Nations are not endowed with the same quantity and quality of natural resources. Geographical features such as climate and topography largely determine a nation's agricultural and pastoral capabilities. For example, a country with high temperatures, low rainfall and a denuded landscape is extremely limited in its capacity to produce agricultural products and it is unlikely that such a country could support a thriving pastoral industry. Australia is fortunate in that, even though only a very small proportion of our continent is considered arable, it has been sufficient to meet most of the needs of our population.

The unequal distribution of mineral resources throughout the world gives rise to a vast volume of trade. Modern production processes consume enormous quantities of energy, leading to a continuous demand for minerals such as coal and oil. The oil crises in the early 1970s and in 2003–04 highlighted the extent of international economic dependence upon oil-producing nations. In one respect, these crises were a welcome development because they brought with them the realisation that oil supply is limited and that nations need to closely examine their energy requirements. In recent years, we have seen the controversial development of uranium as an alternative energy source to replace the rapidly diminishing supplies of conventional fuels. Again, the known supply of this mineral is limited to a few countries of the world.

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FIGURE 1.2 A modern mine

It is important to remember that a nation's supply of natural resources can change with technological development. Scientific advancement in the twentieth century has led to the inclusion of minerals such as uranium and bauxite in our endowment of natural resources. It is not unreasonable to suggest that, in years to come, much of Australia's arid land surface may become arable through the application of improved technology.

1.2.2 Unequal distribution of capital and technology

The implementation of capital-intensive techniques in all types of production resulted in remarkable growth rates in productivity last century, and this growth rate is likely to continue. This, in turn, has led to greatly improved living standards in those countries where such innovation has been possible. However, the inability of many countries to accumulate capital means that these countries have been unable to develop capital-intensive forms of production. Many of the less-developed countries of the world fall into this category.

Less-developed economies typically produce primary products and rely upon trade with more advanced economies to meet their needs for manufactured goods. In a sense, the capital accumulation process is self-perpetuating. Advanced economies, with established capital infrastructures, have been able both to maintain high rates of economic growth and to achieve external viability. However, the less-developed economies are continually confronted with trade deficits and have been unable to accumulate sufficient capital to establish an efficient infrastructure upon which economic growth can be based. This has led to what is often referred to as the **widening gap** between the **gross domestic product (GDP)** of advanced economies and less-developed economies of the world.

1.2.3 Unequal distribution of human skills

In recent decades, some economists have focused on the concept of **human capital** as an essential component of economic development. The term merely highlights the fact that a nation's expenditure on education and health facilities can be interpreted as investment in human capital. Generally speaking, we can say that advanced economies have populations in which the proportion of skilled labour is higher than that found in less-developed economies. Consequently, this has enabled advanced economies to diversify production and to initiate and absorb technological change. The result has been that many nations of the world rely on others for the provision of the goods and services that they do not have the skills and expertise to produce themselves.

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FIGURE 1.3 Advanced economies have populations with a high proportion of skilled labour, enabling them to diversify production and to initiate and absorb technological change.

1.2.4 Desire for an improved standard of living

As mentioned earlier, if the Australian economy chose to operate as a closed economy, our **standard of living** would be severely reduced. Because endowment of natural resources, **capital**, technology and human skills differ from country to country, nations seek to trade with others in order to maximise their standard of living. International trade allows for a sharing of the world's resources, and enables nations to enjoy goods and services otherwise unavailable to them.

1.2.5 Profit motive

In the case of free-enterprise economies, the basic stimulus for economic activity is the **profit motive**. In Australia, for instance, even though we frequently speak collectively of our trade with other nations, we must remember that this trade is actually undertaken by individuals and firms, or by organisations acting on behalf of individuals and firms. We have entrepreneurs who are exporters and others who are importers. All seek to maximise their profits. Although the government intervenes in the national interest, free enterprise prevails. This partly explains why we import some commodities that are already produced within our domestic economy. If entrepreneurs think that they can successfully market imported products against locally produced commodities, then they are generally free to do so.

QUESTIONS

1. Explain the similarities between the economic problem of a household and the international economic problem.
2. Identify the main motivation for international trade.
3. Explain why you think some countries are more dependent on trade than others.
4. Construct a table to show the major differences between domestic and international trade.

ECONOMICS AND ICT

Create an economic profile for Australia and one other country.

1. Collect statistics to describe the distribution of natural resources, human skills, standard of living, and capital and technology.
2. Collate the data into tables and graphs.
3. Present this information as an infographic to your class. At the conclusion to your presentation, make a judgement as to which country has the best factor endowment, and justify this referring to the evaluative criteria used.

1.2.6 The complexity of international trade

CONCEPTS

Capital-intensive methods of production: a production process that predominantly uses capital rather than labour

Currency: the basic monetary unit of a country

Economies of scale: cost efficiencies that are derived by producing a large volume of standardised products

Intra-company trade: trade between affiliates of the one organisation; for example, between a home-based subsidiary and a foreign-based subsidiary of the same company

Labour-intensive production: a production process that predominantly uses labour rather than capital

Multinational corporation (MNC): an enterprise operating in several countries but managed from one (home) country; generally, any company or group that derives a quarter of its revenue from operations outside of its home country is considered a multinational corporation

Productivity: output per unit of input per unit of time

Although it is possible to identify similarities between interregional and international trade, there are numerous factors that make the process of international trade much more complex. When Queensland producers wish to sell goods in New South Wales or Western Australia, they encounter fewer difficulties than if they wish to market the same goods in Japan or India. Some obvious difficulties arise because of the many differences that exist between nations.

When products are traded between regions in the same country, they move within the same social and institutional system. On the other hand, when products are traded between nations, they must pass from one system into another. Nations differ in a number of ways.

Different currencies

A **currency** is the basic monetary unit that is used within a country. In most countries, only the national currency is considered to be legal tender. When a Queensland manufacturer sells goods to a New South Wales retailer, there is no issue because both parties deal in the basic Australian unit of currency: the dollar. On the other hand, when the Queensland manufacturer sells to a Japanese retailer, there are two currencies involved: Australian dollars and Japanese yen. The Japanese retailer pays for imported goods in yen and the Australian producer receives payment in dollars. For this to happen, it is necessary for the transaction to pass through the international banking system that converts the payment from one currency into another. The process is further complicated because one Australian dollar has a different purchasing power from one Japanese yen. It is, therefore, necessary to maintain rates of exchange that express the value of one currency in terms of other currencies. In recent years, the procedure for determining appropriate rates of exchange has come under a great deal of pressure because of differing inflation rates in countries around the world. Inflation results in the decline of the purchasing power of a unit of currency.

Different cost structures

Methods of production tend to differ greatly around the world. The labour–capital mix that producers choose to use depends very much upon the availability and relative costs of these resources within a country. In Australia, over recent decades we have witnessed a shift from **labour-intensive methods of production** to **capital-intensive methods of production**. This shift has come partly from the greater availability of capital and partly from the fact that the cost of employing labour has steadily increased. Currently, the shortage of skilled labour and the ageing of the population are other issues for Australia and its government to consider.

Generally speaking, the introduction of capital-intensive methods of production increases **productivity** and, therefore, reduces the unit cost of goods. In countries where labour is abundant and capital is relatively scarce, production tends to be labour-intensive. Because labour productivity is low in such countries, wages are also low by our standards. It is this imbalance in wages that often leads to conflict in international trade. For instance, Australian clothing manufacturers that use labour-intensive methods of production must compete with Asian manufacturers that use similar methods, but have access to cheaper labour. This often

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FIGURE 1.4 Labour-intensive methods of production require a pool of cheap labour, as in this clothing factory.

results in Australian companies moving their production offshore, as in the case of Bonds Clothing and Billabong. Banks, communication companies and some other businesses have moved their telephone call centres offshore for the same reason.

A further factor that contributes to differing cost structures is the size of the domestic market. Domestic markets in Australia are relatively small and local producers are often unable to attain the **economies of scale** that are available to their foreign competitors.

The disadvantage faced by our local producers is obvious. A prime example of an industry that suffered this market disadvantage is the Australian motor vehicle manufacturing industry. This industry was often criticised for the inefficiency resulting from its fragmentation. Our vehicle assembly plants were tiny compared with those that existed in Japan, the USA and countries such as South Africa and South Korea, and it was argued that there were too many producers for the size of the domestic market. The result was that Australian consumers had to pay a relatively high price for all motor vehicles, whether they were imported or locally produced. The main reasons for this were the inability of domestic firms to benefit from economies of scale, and the high level of tariffs on imported vehicles. In 2017, the last of the manufacturing plants in Australia was closed and Australia now has no motor vehicle manufacturing at all.

Transport cost is another factor that leads to differing cost structures between nations. It arises from – and varies according to – the distances over which goods must be carried, either to be processed or marketed. Australia suffers in this regard because of its vast land mass and relative isolation from major world markets. Australia's productive activities are scattered over an area that is approximately 25 times the size of Great Britain and almost as large as the USA, excluding Alaska. The distance to major Asian seaports and to the US west coast is about 12 000 kilometres, and the major European markets lie more than 17 000 kilometres from Australia. The result is clear: Australian exports and imports incur higher costs than they would if foreign markets were closer.

Social differences

International trade frequently encounters barriers such as different languages, customs, habits and tastes, which create difficulties that are not normally encountered within a nation.

Religion has often been cited by economists as a social factor that can have significant repercussions in terms of the economic development of some countries. For instance, the prevalence of Hinduism as a religion in India and parts of South-east Asia has a widespread effect upon the customs and habits of its followers. It denies Australia what might otherwise be a substantial market for beef. The Hindu faith promotes vegetarianism and 'ahimsa' – respect for life. The cow is venerated and protected by devotees of Hinduism.

Technical differences

A constant source of frustration for exporters has been the variety of technical specifications that exists from country to country. Typical examples are the different voltage systems for electrical appliances, and the left-hand- and right-hand-drive specifications for motor vehicles. A producer wishing to penetrate a foreign market may have to alter production processes if the requirements of the potential market differ from those in the established domestic market. Such alterations usually lead to higher production costs.

If there are higher risks associated with the potential market, foreign producers may decide that penetration is uneconomical. Such markets are, therefore, often left to domestic producers.

Different national policies

KEY IDEA

Decisions made by governments as well as by individual enterprises have a major influence on the pattern of world trade.

Even though international trade theory (see Section 1.6) clearly demonstrates the many advantages to be gained from free trade between nations, the real world is far removed from the theoretical world described in economists' models. International cooperation may be desirable, but the prime function of democratic governments is to put the welfare of their own citizens first.

In a sense, all governments are profit-maximisers in a competitive market place, attempting to secure an advantage over their competitors. For this reason, governments continually interfere with the process of international trade, altering their policies to accommodate changing conditions in their domestic economies. For instance, Australia in recent years has been actively pursuing free trade arrangements with various nations, while Japan and the European Union are still in favour of protecting their domestic industries, particularly agriculture, from international competition.

The problems of impoverished countries are often accentuated by social structures that lead to an inequitable distribution of national income. It is not uncommon to find in these countries that a significant proportion of national income accrues to a minority ruling class that determines national policies. Consequently, household disposable incomes are often far lower than is suggested by per capita figures. This means that, even though there are many countries with populations exceeding Australia's, their consumer markets may be smaller than ours.

Multinational corporations

It is estimated that **multinational corporations** now produce more than 25 per cent of the world's GDP. The ten largest multinationals each have an annual output that exceeds the individual GDP of 120 nations in the world. These kinds of figures indicate the enormous influence that multinationals have on international trade. Indeed, if one considers the multinational companies as separate economies, the top 100 economies in the world contain 69 multinational corporations and 31 countries.

Intra-company trade is a common feature of multinationals. Subsidiary companies of one corporation scattered throughout the world will often trade with each other, shutting out competitors and distorting the market. Transfer pricing is the practice of setting artificially high prices when one subsidiary company buys from another subsidiary company, thereby reducing apparent profits and avoiding taxation – shifting profits from high-taxing countries such as Australia and paying taxes in the lowest-taxing jurisdictions.

Multinational corporations tend to be highly mobile and show no hesitation in shifting their productive activities from nation to nation. A phenomenon of recent years has been the movement of multinationals into China as the Chinese Government has sought to attract foreign capital, technology and expertise. In some cases, corporations have moved their operations from Taiwan to China to take advantage of cheaper labour costs. Consider the implications for the economy that suddenly loses the production previously generated by a multinational corporation.

QUESTIONS

1. Identify conditions in Australia that may create difficulties for overseas trading firms.
2. Identify at least five multinational companies that operate in Australia. List some of their products.
3. How might an Australian multinational company operating in China be of benefit to China?

ECONOMICS AND ICT

You are a junior trade official and have been given the task of investigating and reporting on the ease with which Australian companies might be able to enter trading agreements with countries in the African or Latin American regions.

1. Choose one country in one of the above regions.
2. Investigate conditions that Australian firms may experience when trading in the chosen country. Follow the link to Austrade and use the information available on this website as the basis for your inquiry.
3. Design a web page that could be used by firms interested in seeking trade opportunities in your chosen country.
4. Include a list of other websites that could be used for further information.

Austrade

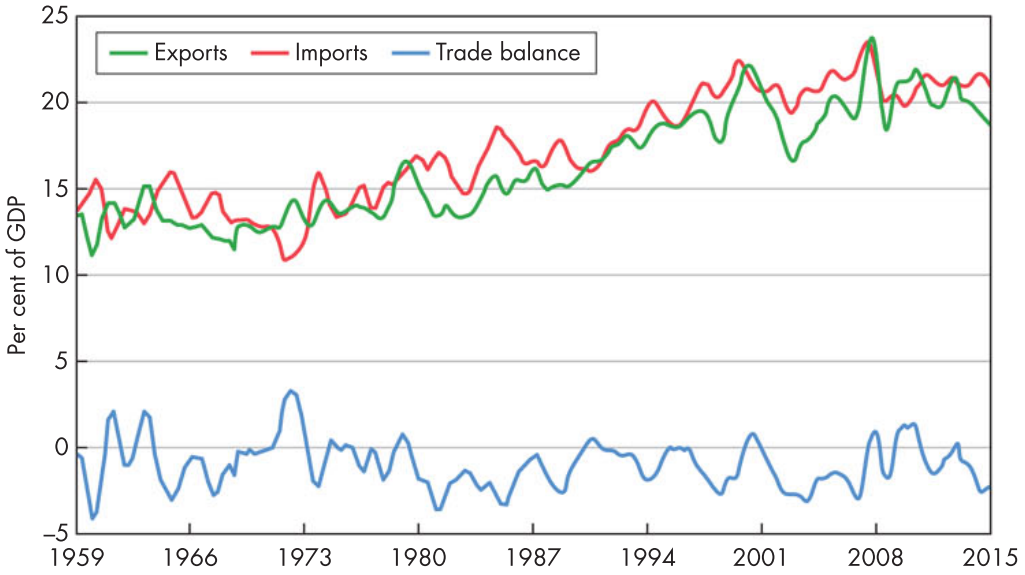
1.3 Advantages and disadvantages of international trade

Many people suspect that international trade operates as a zero-sum game; that is, they think of it like a game of football – a competition with rules that has one winner and one loser. Specifically, people sometimes believe that if our trading partners are gaining as a result of international trade, Australia must be losing. In this view, exported goods represent a gain for the economy and imported goods represent a loss for the economy.

This idea is nothing new; it dominated economic and political thought from the sixteenth to the eighteenth centuries. Known then as 'mercantilism', it led to government policies that encouraged exports and discouraged imports. Adam Smith's writing in *The Wealth of Nations* (1776) showed that the zero-sum game myth was not valid.

1.3.1 The costs and benefits of trade

In spite of people's apprehensions about trade, both imports and exports are at an all-time high in Australia (see Figure 1.5). For trade to occur it must make both nations better off. This is a positive-sum game, not a zero-sum game, because both sides gain.



Source: Australian Bureau of Statistics (ABS), Australian national accounts, cat. no. 5206.0, ABS, Canberra, March 2016. (CC BY 2.5 AU) (https://creativecommons.org/licenses/by/2.5/au/)

FIGURE 1.5 Australian exports, imports and trade balance as a proportion of GDP

ECONOMICS IN ACTION

1 Using the Internet, locate the most recent graph or statistics showing Australian exports, imports and trade balance. Use these figures to analyse the most recent trends for the Australian economy.

2 Use the statistics you have located to explain the following statement from Adam Smith in *The Wealth of Nations*: 'If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it off them with some part of the produce of our own industry.'

The winners

With international trade, the winners include consumers (buyers) and domestic companies that export goods (sellers). First, let's consider the benefits to buyers. Consumers see the benefits of trade in terms of variety and price. International trade results in consumers having access to a wider variety of goods and services. Think about some of the imported goods and brands that you buy on a regular basis. If imports were not available, you would have a more limited range of goods and services to purchase. Sometimes, the price of the imported good is less than that of the Australian-produced good, thus saving consumers money. This occurs because producers in foreign companies can produce goods – including motor vehicles, textiles and clothing – at a lower cost than Australian producers. These lower costs often result in lower prices, which benefit consumers by increasing their purchasing power. The competition provided by imported goods and services provides incentives for Australian producers to improve the quality of their goods and the efficiency of their production methods while keeping prices low.

Domestic sellers also benefit from trade. Domestic companies that export have a market that is far larger than the domestic market, and producing for a larger market allows them

the opportunity to grow and produce on a larger scale. These economies of scale permit such companies to benefit from efficiencies and produce goods at a lower average cost. The lower production costs help the companies be more competitive, and can result in lower prices for consumers.

Benefits of trade extend beyond the immediate buyers and sellers. International trade can result in economic growth and an improved standard of living. Trade gives countries access to physical capital (technology, tools and equipment) that is not produced domestically. This physical capital often results in increased productivity, which drives economic growth and an improved standard of living. Access to global markets increases export opportunities for developing nations. Examples include China, which has become a manufacturing powerhouse, and India, which is a leader in exporting services. Both countries have experienced development and growth that would not have happened without access to global markets. Many economists believe that countries can escape poverty through increased trade. Recent research suggests the income gap between rich and poor countries could be reduced by 50 per cent if trade barriers were removed.

The losers

Some third parties are worse off because of international trade. The most obvious third-party losers are companies selling products that cannot compete in a global market. An example is the Australian motor vehicle manufacturing industry, which was forced to shut down because imported motor vehicles were more competitive. When businesses shut down, workers lose their jobs. This is painful for workers, who must then be retrained and learn new job skills to find new employment.

Net benefits of trade

Economists argue that international trade has net benefits for a nation; in other words, the benefits outweigh the costs. This does not always seem obvious to many people because the costs are often more visible than the benefits; for example, it is relatively easy to identify businesses or industries that have shut down because of trade. Similarly, it is not difficult to identify people who have lost jobs in affected industries. It is more difficult, however, for consumers to identify how much cheaper their food, clothing, electrical goods and cars are because of international trade. The lower prices paid by consumers and businesses mean they have more money to spend on other items. As a result, there are businesses that have experienced more growth as a result of that spending, and this would not have happened without international trade.

QUESTIONS

1. Explain the objectives of trade under mercantilism.
2. Define what is meant by a 'zero-sum game'.
3. Explain who gains from international trade and give an additional example of each 'winner'.
4. Identify the 'losers' from international trade and give an example of each.
5. Explain why many economists consider that international trade is of net benefit to a nation.

1.4 Why international trade is important to Australia

CONCEPTS

External stability: the situation in which there are no unwanted movements of foreign reserves in the balance of payments

KEY IDEA

International trade is important to Australia for many reasons. Without international trade, Australia's economic growth would be much slower, and hence our living standards would be much lower.

Trade fluctuations can cause instability in the Australian economy. Fluctuations in demand for Australia's primary exports – such as beef, wool, coal, iron ore and other minerals – have repercussions within our economy. Producers need to expand or decrease production to match world demand for their product, and while coal and other minerals can be stockpiled, it is difficult to stockpile many agricultural products. Without the demand for our primary products internationally, domestic production would fall, and living standards would decline. The fluctuations in price for these goods can also have an impact on the Australian economy and affect the demand for products. Australian governments earn royalties from the sale of our minerals. An increase in world prices and demand for such a product increases the amount of money governments (both state and federal) receive, while a decline in price or demand results in a decline in revenue for governments.

As the value of exports as a percentage of GDP is high for Australia by world standards, any change in world demand and prices will affect the domestic economy. In addition, Australia's level of imports is high by world standards, also affecting the domestic economy and government economic policy.

International trade has been the catalyst for the high level of foreign investment in Australian enterprises. While the merit of such investment can be debated, foreign investment in Australian enterprises has meant a higher economic growth rate than would otherwise have been the case.

The increasing interdependence of the world's economies means trade is very important to individual countries. International tourism, the increasing numbers of overseas students studying in Australia, the growing importance of multinational corporations, economic integration, world conflicts, and world economic conditions (such as the Global Financial Crisis in 2008) all mean that Australia is more susceptible than ever to the impact of changes to world trade and world economic events.

Australia is particularly interested in a stable world monetary system, because if liquidity does not expand as trade expands, then the industrialised countries will curtail demand for industrialised goods and this means curtailing imports of raw materials.

There are many other reasons why trade is vital to Australia. For example, employment is generated by increased trade. Further, as Australia is not self-sufficient, it is necessary to rely on other countries for imports to provide goods that we are not able to produce domestically. Our standard of living is affected by world trade.

Australia's **external stability** is vital to our continued wealth. External stability is the situation in which there are no unwanted movements of foreign reserves. This is indicated by the balance of payments (see Chapter 4), which summarises a nation's dealings with the rest of the world over a period of time, usually a year. It records all the payments made to other nations, as well as all the payments received from other nations over the year. Major payments and receipts recorded in the current account include exports and imports of merchandise, services and income from foreign investments. If Australia is paying out more foreign currency for these current account items than it receives from other nations, the balance on current account is in deficit. If receipts exceed payments, the current account is in surplus.

The inflows and outflows of foreign currency that represent foreign investment, foreign loans and adjustments of reserve currency holdings are major items of the capital financial account.

1.5 Australia's trade

CONCEPTS

Exports: goods that Australia sells to foreign nations

Imports: goods that enter Australia from overseas

This section is concerned with the composition and direction of Australia's **imports** and **exports**. Imports are goods that enter Australia from overseas, while exports are goods that Australia sells to foreign nations.

1.5.1 Commodities traded

Imports

Australia's imports reflect the structural composition of the Australian economy, and are shown in Figure 1.6.

FIGURE 1.6 Major Australian merchandise imports, 2016 (A$m)

Passenger motor vehicles	21 403
Refined petroleum	14 289
Telecommunications equipment and parts	11 970
Crude petroleum	7 953
Medicaments	7 617

Source: DFAT 2017

Australia is reliant on overseas sources for many of the manufactured items that we use in our day-to-day living, as shown in Figure 1.7; consumption goods and services and intermediate goods make up the bulk of Australia's imports. Intermediate goods – also known as producer goods or semi-finished products – are goods (such as partly finished goods) used as inputs in the production of other goods.

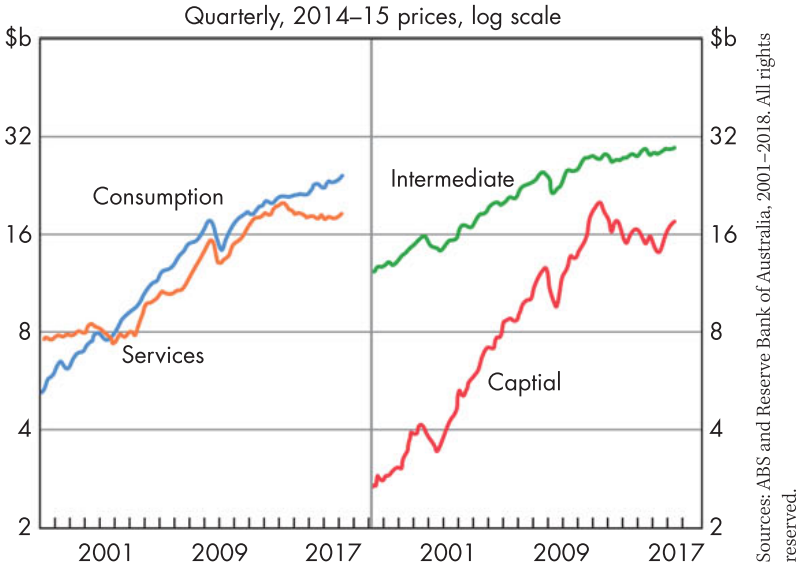


FIGURE 1.7 Australia's import volumes

Exports

Australia has 'ridden on the sheep's back' for much of its history since European settlement. This phrase was commonly used to describe Australia's reliance on wool, which was for so long our major export. As Figure 1.8 shows, this is no longer the case.

FIGURE 1.8 Major Australian merchandise exports, 2016 (A$m)

Iron ore and concentrates	53 703
Coal	42 326
Gold	18 857
Natural gas	17 911
Beef	7 401

Source: DFAT 2017

Figure 1.8 shows that Australia's main exports come from the resources sector, which outstrips the rural, services and manufacturing sectors combined, as shown in Figure 1.9.

In 2016, exports totalled A$259 065 million while imports totalled A$266 905 million, resulting in a merchandise trade deficit of A$7840 million.

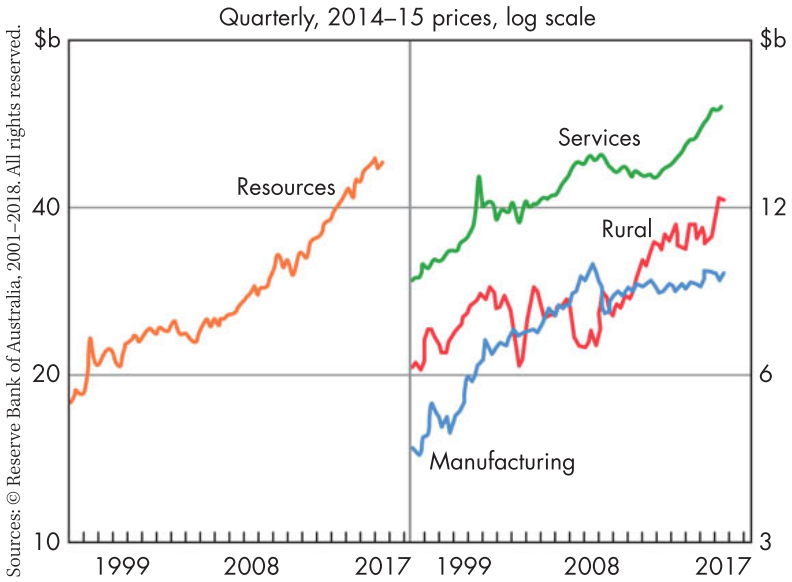


FIGURE 1.9 Australia's export volumes

ECONOMICS DATA

Use Internet sources to find the most recent statistics showing the value of imports, exports and trade deficit for Australia. The Department of Foreign Affairs and Trade, the Australian Bureau of Statistics, and the Reserve Bank of Australia Chart Pack would be suitable sites for finding this information.

Department of Foreign Affairs and Trade

Australian Bureau of Statistics

Reserve Bank of Australia

1.5.2 Direction of Australia's trade

For much of Australia's history, its main trading partner was Great Britain. In more recent times, however, Australia's trade has had an increasingly Asian focus, starting with Japan, and more recently with China, India and other Asian nations.

Imports

Three Asian nations were in the top five of Australia's import sources in 2016. These were China, Japan and Thailand, which together accounted for 35.2 per cent of our imports. The USA and Germany rounded out the top five. This reflects the growing importance of our trade with Asia, and Australia's greater participation in the Asian economy and regional trading blocs such as Asia-Pacific Economic Cooperation (APEC) and the Association of Southeast Asian Nations (ASEAN).

FIGURE 1.10 Australia's main merchandise import sources, 2016

China	22.3%
USA	11.2%
Japan	7.4%
Thailand	5.9%
Germany	5.1%

Source: DFAT

Exports

Given that our exports are primarily from the resources sector, it would come as no surprise that Australia exports primarily to nations that manufacture elaborately transformed manufactured goods. Four Asian nations are among the top five, these being China, Japan, Republic of Korea (South Korea) and India, with the USA being the other top five destination for our exports. This is shown in Figure 1.11.

FIGURE 1.11 Australia's main merchandise export destinations, 2016

China	31.6%
Japan	14.0%
Republic of Korea	7.0%
USA	4.8%
India	4.3%

Source: DFAT

ECONOMICS IN ACTION

Use the Internet to find the two most recent years for trade statistics.

1 Analyse these statistics and the changes from one year to the next, and show these changes as percentages.

2 Show these changes for type of exports and imports, and also for import and export destinations.

1.5.3 Implications of changes in trade

The trend to see Asia as our most important market for exports and source of imports has several implications for Australia:

1 Australia must continue to pursue membership of ASEAN, and maintain membership of APEC and the Trans-Pacific Partnership trade agreement. In addition, we need to make and continue free trade agreements with individual countries in Asia, as we have already done with China, Japan, Thailand, Singapore and many other countries.

2 The improvement in living standards in Asian nations gives Australia the opportunity to broaden its export base to include areas such as tourism and education. For example, there are increasing numbers of people from China visiting Australia as a result of the rise in income of the Chinese people. In addition, there are many Chinese students (in both secondary schools and universities) enrolling in Australian educational institutions.

3 Increasing our markets for exports, and increasing the competition from imports for domestic producers, mean that Australia is increasingly subject to fluctuations in world economic conditions.

4 Australia has an opportunity to increase export markets and thus economic growth, and domestic consumers are given better opportunities to buy goods on the Australian market. It is in Australia's interests to prioritise improving relationships with its Asian neighbours, with a focus on expanding access to their markets.

5 Australia's industry is under greater pressure to maintain and improve efficiency to increase market share. Therefore, increasing productivity in Australian industries is a major objective of current economic policy.