ECONOMICS

Analyse the impact of changes in the global economy on Australia's economic growth and external stability.

The process of globalisation has had profound changes on Australia as our economy becomes more closely integrated with rest of the world, through trade, investment and financial flows, facilitated by an improvement in technology. These changes have resulted in both positive and negative impacts on Australia's economic growth and external stability. An increase in the volume of trade and investment due to the removal of protection and restriction on capital flows has provided many opportunity for economic growth but the increased integration has also strengthened the international business cycle, making Australia more susceptible to global economic downturns. The increase in financial flows, including direct and portfolio investment and most importantly currency speculation due to global financial deregulation, has resulted in a higher CAD and higher levels of foreign liabilities, as well as greater volatility in the value of the AUD.

Globalisation has had significant impacts on Australia's trade flows, with Australia experiencing higher levels of exports and imports and the direction and composition of trade being revolutionised. Globalisation strengthened Australia's ties with the rest of the world, allowing Australia to take advantage of trade opportunities with emerging economies like China and India. China is now Australia's largest trading partner, with China's share of Australia's imports growing five folds over the last twenty five years. China's demand for Australia's export, especially minerals, has also grown rapidly as a result of globalisation. The increase in demands for minerals has resulted in a commodity boom, allowing Australia to enjoy the longest sustained period of economic growth, with an average of 3.5% per annum, the second highest economic growth amongst the OECD countries prior to 2008. The increase in the level of investment was another major impact resulted from globalisation. Increased integration in international capital markets made it easier for foreign investors to invest their money in Australia, either in the form of direct and portfolio investment, especially in the mining sector, with most of the mining industry now owned by foreign investors. An increased level of investment results in higher aggregate demand, further adding to Australia's economic growth. This is evident in Australia's unemployment approached its NAIRU at 4% during early 2008.

However, the increase in trade and investment has also resulted in the strengthening of the international business cycle, where changes in one economy impacts on the economic growth of other economies due to increased cross border integration. This is evident in the late 2000s Global Financial Crisis (GFC), where a collapse in the USA subprime housing market has resulted in worldwide recession. Australia was also affected from the GFC with the level of economic growth slowed markedly to as low as -0.7% due to Australia's trade and investment links with the USA. USA also has close trade and investment ties with China, resulting in a fall in economic growth in China and hence a decline in China's demand for Australia's exports, creating a contagion effect. Despite the slight fall in the general level of trade, the demand for Australia's commodity exports still remained high and assisted by successful use of macroeconomic policies, Australia was one of the few developed economies that were able to avoid a technical recession. Unlike many advanced countries who suffered from extended periods of negative economic growth and high levels of unemployment, for example, Greece's unemployment reached 25%, Australia's unemployment only rose to 5.8% and economic growth was able to be quickly returned back to trend.

Another major change brought about by globalisation is the increase level of financial flows. The increase flow of capital and levels of foreign transaction has heavily impacted on Australia's external stability. The deregulation of Australia's financial market saw a rapid increase in the level of foreign debt and equity. Prior to the financial deregulation, most financial flows that came into Australia was in the form of direct investment, which include any foreign transaction to establish a new business or purchase more than 10% share in an existing business. After the deregulation, both direct and portfolio investment has increase rapidly, but portfolio investment, which include transaction to buy land, obtain loan and purchase other securities and smaller shares, has grown significantly faster as Australia began to see the importance of injecting flows of finance into the economy. This saw Australia's current account deficit (CAD) rising from -$5.1bn in early 1980s to -$74bn in 2007-08 with much of the increase contributed by a rapid growth in net primary income deficit due to the need to service our foreign liabilities. Growth in trade has also impacted on the CAD but being the cyclical component of the current account, net goods and services fluctuates greatly from year to year as the business and international business cycle varies. Generally, a high level CAD and foreign liability does not pose problems because it boosts economic growth through investments. However, there are some risks. For example, foreign investors may withdraw their investment or demand higher risk premium if CAD level becomes unsustainable. This could result in a collapse of the economy and a recession, such as the sovereign debt crisis experienced by the some of the European economies.

In 1873, Australia switched from a managed flexible peg system to a floating exchange rate system, where the price of Australia's currency is determined by forces of demand and supply in the foreign exchange (FOREX) markets. The floating of the AUD and the increase in financial flows between countries due to increase in trade, investment and foreign aid has resulted in greater volatility of the dollar. A major factor that has contributed to the volatility of the dollar is the increase dominance of currency speculation, accounting for about 95% of transactions in the FOREX markets. Currency speculation occurs when investors buy and sell currencies to make short term gains on movements in the exchange rate. This makes the Australian economy more prone to a destabilisation of financial markets if international investors lose confidence on the economy and sell AUD in exchange for foreign currencies. For example, the 1997 Asian Financial Crisis started as a result of the collapse of the Thai baht. Changes in the value of the AUD can affect the international competitiveness in Australia's export and import-competing firms, which have significant implications to the size of Australia's current account and the level of foreign debt. For example, an appreciation of the AUD will raise the prices of exports which reduces Aust's international competitiveness, and reduces the prices of imports which encourages import spending, worsening Aust's trade balance and CAD. The value of Australia's foreign debt borrowed in foreign currency will increase while Aust's servicing costs will be reduced.

As a result, globalisation and increased integration of trade, investment and financial flows has had significant impacts on Australia's economic growth and external stability. An increase in trade and investment provide opportunities for economic growth however the strengthening of the international business cycle may cause Australia to become more affected during a global economic downturn. The size of the current account deficit and level of foreign debt has risen notably as a result of the increase in financial flows. The exchange has also become more volatile as currency speculation plays a more dominant role in the FOREX markets.