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1 The Australian economy

1.1 Overview

1.1.1 Our needs and wants

What is economics?

The **economy** is often spoken about as if it were something separate with a life of its own, when in fact the economy comprises all of us. The Australian economy can be defined as the total of all activities undertaken for the purpose of producing, distributing and consuming the goods and services we require to satisfy our needs and wants. Because we all participate in one or more of these activities, we are all part of Australia's **economic system**.

Let us look at this definition in more detail. As human beings we all have needs and wants. Needs can be described as those things that are essential for survival. They include food, clothing and shelter. Wants include those things we desire but which are not necessary for survival or to meet the basic standard of living in a community. They can include everything from TV sets, to motor vehicles, to mobile phones.

Figure 1 Consumers have to make choices in order to satisfy their needs and wants.

We satisfy our needs and wants by acquiring goods and services. Goods are physical, tangible items that can be seen and touched. They include all those products we buy from shops. Services are the actions which are done for us by others, and are designed to satisfy needs and wants. They include the services provided by doctors, dentists, banks, telephone companies, entertainers, mechanics and teachers. Whenever we make use of goods and services we are said to consume those goods and services, and so are regarded as **consumers**. As we all consume goods and services, we are all participants in the Australian economy.

Goods and services have to be provided by someone, and we usually expect businesses or other organisations to do this. All individuals, organisations and businesses that provide goods and services are known as **producers**. This term does not just refer to the manufacture of goods in a factory but extends to all those who provide goods and services. To the economist, a producer can be a dentist filling teeth, a band performing at a venue, a supermarket selling groceries or a teacher in a classroom.

As individuals and as a society, our needs and wants will always be greater than our means of satisfying all those needs and wants. This is the fundamental problem facing any economy, no matter how wealthy it is. Economists refer to this as the problem of **relative scarcity**. The main aim of an economic system is to satisfy as many needs and wants as possible within the constraints imposed by relative scarcity. Inevitably, choices have to be made by both consumers and producers. We cannot have everything and so must choose what is most important to us.

The economic problem of relative scarcity

You are hungry and thirsty on your way home from school, and have only $6 to spend. A burger is going to cost $4, a drink $3 and a small serving of fries $3. If you buy the burger, you will have $2 change but won't be able to afford a drink. You could afford a drink if you buy the fries, but the fries won't satisfy your hunger as much as a burger would. You are facing the fundamental economic problem of relative scarcity, and you have to make a choice.

Consumers and producers have to make choices all the time. It is through the totality of these choices that the economic system attempts to satisfy as many needs and wants as possible.

1.2 Participants in the Australian economy

1.2.1 Who and what is part of our economy?

We know that the Australian economy is the total of all activities undertaken for the purpose of the production, distribution and consumption of goods and services in our country. This leads us to two questions:

1. *Who or what carries out all these activities to achieve this purpose?* We need to examine exactly who participates in the economy to achieve the production, distribution and consumption of goods and services. The major participants in the Australian economy include the household sector, the business sector, the financial sector and the government sector.
2. *What activities are undertaken in achieving this purpose?* We need to examine what each of those participants does to achieve this purpose, or what roles each of them performs in our economic system.

We will now examine each participant and the roles they play in the economy.

1.2.2 Household sector

The household sector is a term used by economists to refer to the total of all consumers in the economy. Of course, every person in the economy is a consumer — we all acquire goods and services to satisfy our needs and wants. As well as acquiring goods and services, the household sector provides the **labour** required by the business sector to produce those goods and services. Whether we consider ourselves part of the household sector or part of the business sector depends on the economic role we are performing at the time. When buying goods and services, we are part of the household sector. When at work, we are part of the business sector.

Members of the household sector make decisions about the particular goods and services they desire to satisfy their needs and wants. The amount of goods or services that consumers are willing and able to purchase at a particular point in time is known as consumer or household *demand*. If businesses wish to be successful, they need to respond to this demand. A business producing goods or services that do not meet consumer demand is likely to fail. While we can all identify food, clothing and shelter as basic needs that households demand, it is not always so easy to identify the *types* of food, clothing and shelter that will most successfully satisfy those needs.

Figure 1 Members of the household sector receive wages for their labour, and use the money they receive to buy goods and services to satisfy their needs and wants.

1.2.3 Business sector

The business sector is made up of a large number of producers, all seeking to provide goods and services to satisfy the needs and wants of households. In order to do so, businesses make use of **resources**. Economists classify resources into four categories:

- land
- labour
- capital
- enterprise.

These are sometimes also called *factors of production*.

Land

'Land' is the word used by economists to refer to all the raw materials and other natural resources that go into the production of goods and services. It is a broad concept that includes minerals dug up from the earth, food crops ready for processing, timber harvested from forests, and raw fibres such as wool or cotton that are available for processing into clothing. Australia's diverse and abundant **resource base** has been an important source of export earnings for the Australian economy. Some of the most important export commodities for Australia include: iron ore, coal, natural gas, gold, beef and wheat.

Figure 2 In economics, 'land' refers to all the raw materials and other natural resources that go into the production process, including minerals that have been dug up from the earth.

Labour

Labour, as we have seen, is the human skills and effort required in the production process. It includes the physical effort contributed by a builder or process worker in a factory, and the intellectual skills applied by a computer programmer. Businesses usually rely on the household sector to provide them with labour. In return, businesses pay wages which are used by consumers to purchase goods and services from the business sector.

Capital

Capital is defined as all the equipment (machinery, buildings, tools) used by human labour in the process of production. For example, an accountant uses a computer, a bricklayer uses a trowel and a farmer uses a plough. In a supermarket, capital includes the actual building; shelving for storing goods for sale; refrigerators and freezers; trolleys and baskets for collecting goods; and the cash registers, scales, barcode readers and EFTPOS facilities used at the checkouts.

Figure 3 In economics, 'capital' refers to all equipment used in a production process.

Enterprise

Enterprise is the ability to recognise the demand for new goods or services, and to start up a new business or expand an existing business to attempt to satisfy that demand. It also includes the ability to organise the resources necessary to produce the goods and services required, and a willingness to take the risks that can accompany these decisions. A person who demonstrates these abilities is sometimes known as an entrepreneur. People such as Google founder Larry Page and Facebook founder Mark Zuckerberg are regarded as entrepreneurs.

1.2.4 The relationship between households and business

As we have seen, the household sector and business sector depend heavily on each other. The household sector depends on the business sector to provide employment and wages, as well as the goods and services needed to satisfy demand. The business sector depends on the household sector to provide it with labour, as well as the consumers to purchase the goods and services produced. We can examine the relationship between the business sector and the household sector by looking at the model shown in the following interactivity. It demonstrates how labour is exchanged for money, and how that money is used to purchase goods and services.

The interrelationship between consumers and business

Interactivity: The interrelationship between consumers and business

We can simplify this model by removing the flow of goods and services, and simply showing the flow of money between households and businesses (see figure 5). This focuses on the financial relationship between consumers and producers in our economic system. Economists sometimes refer to this as a circular flow diagram because it illustrates how money circulates in the economy.

Figure 5 The circular flow of money between households and businesses in the Australian economy

1.2.5 The financial sector

Both the household and business sectors rely on a functioning financial sector. As the name suggests, the financial sector is concerned with money. In order to understand the role of the financial sector, we first need to examine the functions of money in our economy.

Money performs the following four very important functions in our economic system:

1. *Medium of exchange* — money allows us to pay for goods and services because it is accepted by everyone in our economy in exchange for goods and services. Hence employees exchange their labour for money, and businesses accept money in exchange for the goods and services they supply.
2. *Measure of value* — money allows us to put a price on the goods and services we exchange. The price is a measure of what we believe the goods or services to be worth when compared to other goods and services.
3. *Store of value* — money allows us to save our income or wealth for spending at a later date because it holds its value.
4. *Standard of deferred payment* — money allows us to purchase goods and services on credit, with both buyer and seller knowing exactly how much has to be paid at a later date.

Figure 6 Money performs four important economic functions.

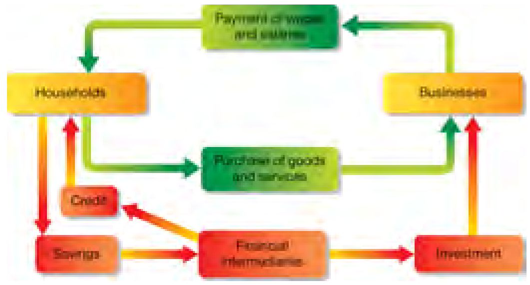
The financial sector is made up of a number of **financial intermediaries**. These include banks and other similar organisations, such as **superannuation funds**. Financial intermediaries receive deposits and then use this money to lend out to others who need to borrow money. Most businesses will borrow money, particularly when they need to expand the business. This may involve buying new equipment or moving to larger premises. Money spent in this way is known as **investment**. This is how financial intermediaries enable accumulated savings, collected from thousands of depositors, to be directed towards business growth. As businesses grow they can employ more people, and the people they employ in turn have more money to spend on goods and services.

Figure 7 Financial intermediaries can direct savings into investment, which funds the growth of businesses.

In addition to providing the business sector with funds for investing in business growth, banks and other financial intermediaries provide credit to households. When consumers make a large purchase such as a house or car, it is usually easier to borrow the money to buy the item immediately (known as buying on credit) than to save up for years to pay cash for it. When purchasing a house or land, most people take out a **mortgage loan**. This enables the house purchaser to borrow to pay for the property now, and pay back the loan in instalments over a relatively long period of time (often 25 years). The size of the housing market depends on the amount of money available for mortgage loans. If more people can buy houses, more new houses can be built and therefore more jobs created in the construction industry.

By adding financial intermediaries to the circular flow diagram, we can see how the financial sector participates in the economy. As shown in figure 8, banks and other financial intermediaries receive savings from households. They use this money to lend to businesses for investment, and also lend the money back to households in the form of credit.

Figure 8 The circular flow of money between households, businesses and financial intermediaries in the Australian economy



1.2.6 The government sector

Another significant participant in our economic system is government. In Australia that refers to the federal government based in Canberra, the state and territory governments based in capital cities, and local councils across the country. In addition to using money to spend on consumption or accumulate in savings, households and businesses pay money to government in the form of taxes and receive certain goods and services from the government. The government plays an important role in the economy for a number of reasons:

1. The amount of money taken by the government in taxes can affect the amount of money consumers have available to spend on goods and services. High levels of taxation can leave consumers with less to spend, and businesses cannot grow as quickly and therefore employ as many people as they might if taxation was lower.
2. Money collected in taxes can be used to provide welfare payments in the form of pensions and unemployment benefits. Such payments allow many people to purchase more goods and services as consumers, thereby providing more income to businesses and creating more jobs as businesses grow.
3. Money collected in taxes from households and businesses can be used to provide essential services. By spending money on building roads, schools and hospitals, the government is providing money for the businesses that do the actual building and thereby helping those businesses to grow and employ more people.

A high level of taxation gives the government more money to provide welfare payments and essential services - such as schools, hospitals and roads - whereas a low level of taxation gives individuals more money to spend as they would like. Do you think the current balance we have is right? **[Personal and social capability]**

Figure 9 When a government pays businesses to build facilities such as hospitals, it helps those businesses to grow and employ more people.

By adding government to the circular flow diagram, we can see how the government sector participates in the economy. As shown in figure 10, households and businesses pay taxes to the government. Some of this money comes back to households in the form of welfare payments such as pensions, or as services such as education and healthcare. Some of it comes back to businesses when the government buys goods and services from them, or pays them to build roads, schools and hospitals.

Figure 10 The circular flow of money between households, businesses, financial intermediaries and government in the Australian economy

1.3 Objectives of the Australian economy

1.3.1 Satisfying needs and wants efficiently

The major issue facing any economy is the problem of relative scarcity. This problem cannot be completely solved or eliminated, but its impact can be minimised by ensuring the most efficient use of resources. The objectives of the Australian economy are to satisfy the greatest range of needs and wants by efficiently producing as many goods and services as possible. This is accomplished by addressing three key economic questions.

1.3.2 Key economic questions

All the participants in the Australian economy — consumers, producers, financial intermediaries and government — make choices to minimise the impact of the relative scarcity of resources and to maximise the range of needs and wants that can be satisfied. When put together, these choices provide answers to the following questions:

- *What to produce?* What goods and services should be produced, and in what quantities?
- *How to produce?* What methods should be used to produce those goods and services?
- *For whom to produce?* To whom should those goods and services be distributed?

What to produce?

How does our economic system help producers decide what goods and services to supply, and in what quantities to supply them? This is determined largely by trial and error. A producer may make certain goods or services available to consumers in the expectation that these will satisfy the needs and wants of those consumers. If the goods or services fail to sell, the producer will probably go out of business. When a business is successful in selling goods or services to consumers, other businesses will attempt to enter the same **market** and start making or selling those goods or services that consumers have shown they wish to buy.

Figure 1 Changes in the market for cars will see the closure of the three remaining car manufacturers in Australia by 2017.

In our economy, markets largely determine which businesses are likely to be successful. Factors that can influence markets include:

- *Established habits and experience*. Producers know from people's existing behaviour that there will always be a demand for certain types of goods or services. Families need to buy food on a regular basis, so a supermarket in a new suburb may well be successful. Most communities will need services such as medical and dental surgeries, schools, hairdressers and trades such as plumbers and electricians.
- *Changing tastes and preferences*. Changing consumer tastes and preferences influence what is produced, and in what quantities. An example of this is the market for Australian-made cars. For many years, family sedans and wagons such as the Holden and Falcon were Australia's best selling cars. Car manufacturing was so successful that Toyota and other car manufacturers also set up factories in Australia. Over time, consumers' preferences changed and smaller imported cars became more popular. As a result, car manufacturing in Australia has declined and will cease altogether by 2017.

- *Marketing and advertising*. Any business introducing a new product or service into the market needs to ensure that consumers are aware of its availability. Advertising is designed to inform consumers of new products and to convince them to buy a particular product instead of an alternative. Online advertising through search engines such as Google has increased dramatically, and an online presence is essential for most businesses these days.
- *Technological change*. As a society, we have become very enthusiastic about new technology over the last 20 years. Whenever a new model iPhone is released into the marketplace, consumers queue outside their nearest Apple store to be the first to buy it. Consumers monitor new developments in technology, and many will quickly replace outdated products with newer models. Producers can be quite confident that improvements in technology will quickly attract buyers to new goods and services.

Figure 2 Improvements in technology often persuade consumers to update their existing gadgets.

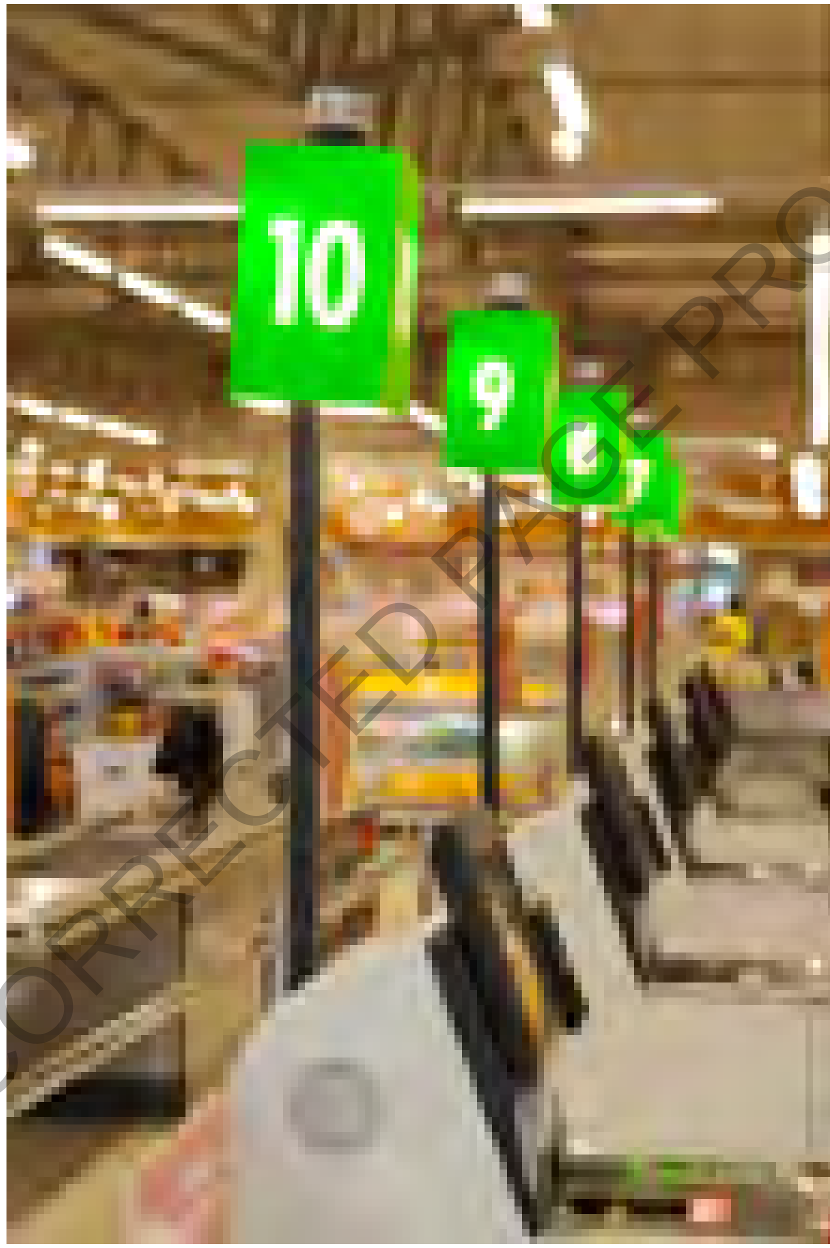
Technology companies, such as Apple and Samsung, encourage users to buy the latest models of their products every year, even if the improvements over last year's model are small. This can have a negative effect on the environment, as thousands of unwanted or broken products end up going to waste. Should consumers or technology companies look to change their behaviour? **[Creative and critical thinking]**

How to produce?

The production of goods and services involves a combination of resources — land (raw materials), labour and capital (equipment). A factory producing frozen vegetables will be set up with different types of capital equipment. These include machines that cook the vegetables, and others that pack and seal them in plastic packaging before freezing them. The same factory will employ workers to control those machines and perhaps carry out other tasks such as managing the process. The raw materials are the vegetables that are processed during production, as well as the materials used in packaging.

Competition from rival producers encourages businesses to keep their costs as low as possible. If new equipment becomes available that works more efficiently, it may be worthwhile for a business to change its methods of production to take advantage of the new equipment. Over the last 50 years or so, the use of robotics-based equipment has increased dramatically in factory production. In most cases it enables the factory to employ fewer workers, reducing wage costs and allowing the prices of products to be kept at a level where they can compete in the marketplace. The use of self-service checkouts in supermarkets is designed to have a similar effect.

Figure 3 The use of self-service checkouts is aimed at keeping costs down.



For whom to produce?

Our economic system has to determine how to distribute goods and services to consumers. It makes use of markets and prices as a means of doing this. As we have seen, the basic model of the circular flow of income involves the household sector exchanging labour with the business sector for money in the form of wages. Those wages are then used to purchase goods and services from the business sector. So goods and services are distributed to those who are willing and able to pay the prices asked for them, although governments can intervene in these markets to ensure that the most disadvantaged in our society are able to have some of their needs and wants satisfied.

The quantities of goods and services that can be purchased by any household will depend on the levels of wages received. If wages across the economy are relatively low compared to prices, relatively large numbers of people may be living in poverty because they cannot afford to buy necessities. If prices are relatively low compared to wages, households will be able to buy more goods and services and fewer people may be living in poverty. The choices and decisions made by businesses about the wages they pay and the prices they charge affect the whole economy and determine to whom goods are distributed.

Figure 4 Prices can have a strong influence on which goods and services consumers will be able to buy.

Opportunity cost

Whenever we make a choice between two or more alternatives, we may gain the benefits of the alternative we choose but we lose any benefits that may have come from choosing differently. Think back to the example of relative scarcity discussed in section 1.1.1: with only $6 in your pocket, you have to choose between a burger for $4 or a drink and fries for $3 each. If you choose the burger, you will have to give up the fries and drink. If you choose the fries and drink, you miss out on the burger. To an economist, the real cost of choosing the burger is not the $4 you spend, but missing out on the opportunity of enjoying the fries and drink. In the same way, the real cost of choosing the drink and fries is the opportunity to enjoy the burger. This is known as **opportunity cost**. When choices are made in the economy — regardless of whether they relate to what goods and services to produce, how to produce them, or to whom to distribute these goods and services — it is important to weigh up the opportunities that are lost before making a final choice.

Figure 5 There is an opportunity cost associated with all economic choices.

1.4 Indicators of economic performance

1.4.1 Indicators of economic performance

Have you ever tried to measure your own performance at school? If so, what indicators did you use? Perhaps you considered some of the following: your attendance rate, your homework completion rate, the marks you received for tests and assignments, comments on your report, and any awards you may have received. Each of these indicators provide an insight into how well you are performing at school. You may have performed very well in regards to some of the indicators and not so well for others.

Similarly, if you play a sport, you could measure the performance of your team. What kinds of indicators would give you information about how well your team is performing?

The performance of Australia's economy can also be measured by considering a range of economic indicators. Each indicator provides a snapshot of the economy at a particular point in time and helps identify strengths and weaknesses within it. Figure 1 below provides a snapshot of the Australian economy at one point in time (6th April, 2016).

Figure 1 A range of indicators can provide information about the performance of the economy.

Source: Reserve Bank of Australia

While there are numerous indicators of economic performance, some of the key indicators that will be examined below include:

- economic growth
- unemployment
- inflation
- alternative indicators (e.g. sustainability, development, happiness)

1.4.2 Economic growth

Each day we consume a range of goods and services. This consumption ranges from the food we eat, to the transport we use to get to school, to the electricity required to charge our devices. Businesses within the

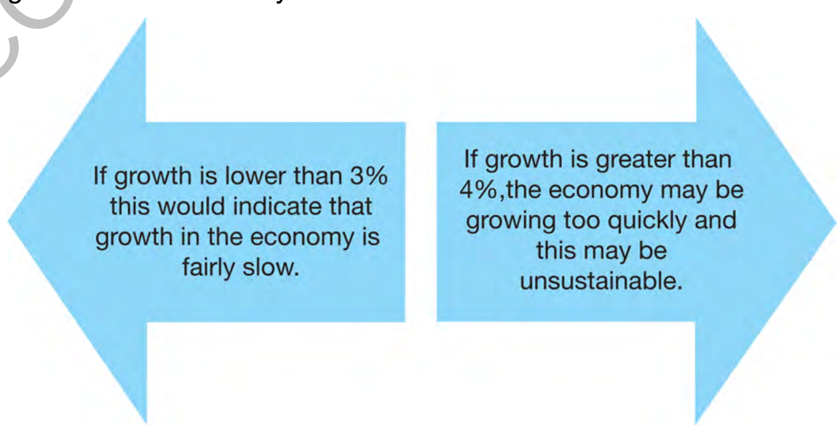
Australian economy attempt to meet the demands of consumers. As the demands of customers change, businesses must offer new or modified products and services to ensure that they continue to meet the needs of customers. In addition, population increases mean that production levels must increase to satisfy demand.

Economic growth is defined as the real growth in the volume (value) of goods and services produced by an economy over a period of time.

Figure 2 Economic growth occurs when an economy increases the volume of goods and services produced.

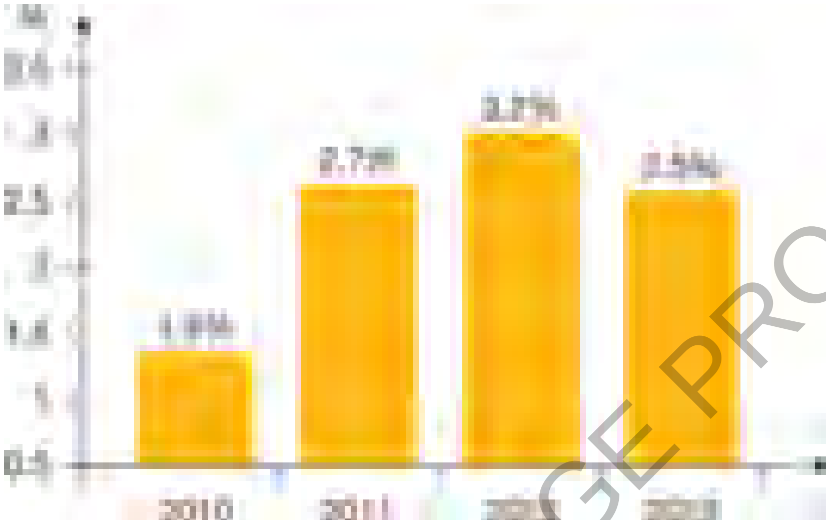
The most common method used to measure economic growth is by calculating the rate of growth of gross domestic product (GDP). GDP is the total value of goods and services produced in an economy over a certain period of time – for example a quarter or a year. This figure can be determined by comparing the GDP of one year with that of the previous year. The change in GDP from year to year is expressed as a percentage.

Figure 3 The change in GDP per year indicates the level of growth in the economy.



Generally, an acceptable rate of increase in GDP is 3–4% per year. If the level of growth is less than 3% this indicates slow growth. If the level of growth is higher than 4% it may mean that the economy is growing too quickly and the growth may not be sustainable. Figure 4 shows Australia's annual GDP growth rate from 2010–2013.

Figure 4 Australia's annual GDP growth rate, 2010–2013



1.4.3 Unemployment

As a student you may have already thought about the type of job you would like to have as an adult. You may even have a part-time job now. Employment is important because it allows us to earn an income so that we can buy goods and services to improve our quality of life. Most people are able to secure employment. However, for a variety of reasons, others may not. Those people who are not employed but are actively looking for work are called 'unemployed'.

Figure 5 Unemployed people are those who don't have a job but are actively looking for work.

The unemployment rate is an important indicator that provides an insight into the performance of the Australian economy. It tells us what percentage of the total labour force is without a job but actively looking for work. Before trying to calculate the unemployment rate, it is important to understand the following key terms:

- Employed people – any person who works more than one hour per week
- Unemployed people – a person without a job who is actively looking for work
- Total labour force – the total of all employed people plus all unemployed people.

The unemployment rate is calculated using the formula below:

$$\text{Unemployment rate (\%)} = \frac{\text{Number of unemployed}}{\text{Total labour force}} \times \frac{100}{1}$$

Consider the following ABS employment data for March 2016:

Number of people employed	Number of people unemployed	Total labour force (employed + unemployed)
11 910 000	729 600	12 639 600

Using the above information, we can calculate the unemployment rate. Once calculated, the unemployment rate is expressed as a percentage:

$$\text{Unemployment rate (\%)} = \frac{\text{Number of unemployed}}{\text{Total labour force}} \times \frac{100}{1}$$

$$= \frac{729\,600}{12\,639\,600} \times \frac{100}{1}$$

$$= 5.8\%$$

As you can see from the example above, the unemployment rate is 5.8%. This is slightly higher than the 5% target that the Australian government sets for the unemployment rate. While the government recognises that there will always be some level of unemployment, it implements a range of policies and programs in an attempt to reduce the unemployment rate.

Figure 6 The government implements a range of programs to help people find jobs.

1.4.4 Inflation

The price of products and services is one of the most important considerations for us as consumers. All consumers wish to purchase good quality products for a reasonable price. When the price of a product rises, we may ask questions such as: why has the price increased? Should I still buy this product? Are there alternative products that I could purchase? Increases in the prices of goods and services mean we are not able to buy as much with our money. This may impact on our quality of life.

Figure 7 Price rises lead consumers to question whether or not they really need a product or service.

When there is a general increase in prices across the economy, this is known as **inflation**. Of course, inflation is considered a negative thing for both the government and for consumers, as it results in consumers being able to purchase less with their money.

To measure inflation, the Australian Bureau of Statistics (ABS) calculates the Consumer Price Index (CPI). This is done by gathering data on the prices of goods and services in the economy. The CPI measures the average change in retail price of a 'basket of goods and services' over a certain period of time.

The 'basket of goods and services' contains over 80 000 items. All of the items fit into one of the following categories:

- food and non-alcoholic drinks
- alcohol and tobacco
- clothing and footwear
- housing
- furnishings, household equipment and services
- health
- transport
- communication
- recreation and culture
- education
- insurance and financial services

The inflation rate tells us about the change in the price of goods and services in the economy. For example, the inflation rate for the period from the December Quarter 2014 to the December Quarter 2015 was 1.7%. This means that over that time period, the average prices of goods and services increased by 1.7%. The government tries to manage inflation carefully and sets a target of between 2–3% for the inflation rate. Figure 8 provides information about Australia's inflation performance between 1995 and 2015.

Figure 8 Australia's inflation performance (yearly and quarterly) between 1995 and 2015.

Content to come

Source – Reserve Bank of Australia website

1.4.5 Alternative indicators (e.g. development, liveability and happiness)

So far, we have considered a number of quantitative indicators which tell us about the performance of the Australian economy. These include economic growth, unemployment and inflation. As well as these indicators, there are a range of alternative indicators that attempt to provide a more complete picture of the performance of the economy. They measure a variety of things such as: the level of wellbeing of people in a country, how liveable a particular city or country is, and the level of happiness of people in different countries throughout the world.

Table 1 identifies three of these alternative indicators and provides a brief overview of each of them.

Table 1 Alternative indicators which attempt to provide a more complete picture of the performance of the Australian economy.

Alternative indicator	Overview
Human Development Index (HDI)	The United Nations Human Development Index (HDI) is a global indicator that compares the wellbeing of people in different countries. It considers positive and negative things about each country and generates a statistical index number. When a country's index number rises, it means there has been an improvement in the living standards of the country.
Global Liveability Ranking	This indicator attempts to rank cities throughout the world in terms of their 'liveability'. In order to rank the cities, a number of factors are considered, such as: safety, healthcare, population density, infrastructure and the state of the environment. Australian cities such as Melbourne, Adelaide and Sydney have consistently been ranked in the Top 10 most liveable cities.
The World Happiness Report	The World Happiness Report was first published in 2012 and ranks 156 countries by their happiness level. It considers a range of factors such as Gross Domestic Product (GDP), people's freedom to make decisions about their own lives, the level of social support, and life expectancy. Figure 9 shows the countries that were ranked in the Top 10 by the World Happiness Report 2015.

Figure 9 The world's 10 happiest countries according the World Happiness Report, 2015.

Rank	Country
1	Switzerland
2	Iceland
3	Denmark
4	Norway
5	Canada
6	Finland
7	Netherlands
8	Sweden
9	New Zealand
10	Australia

Source: World Happiness Report, 2015

1.5 Trade with other economies

1.5.1 Changing trading partners

Australia has been involved in trade since European settlement. During the nineteenth century, the Australian colonies were a major source of agricultural products such as wool, and minerals such as gold, for Britain and its empire. In recent years Australia has developed strong trading links with our Asian neighbours: four of our five most important trading partners are now in Asia.

1.5.2 Trade and the Australian economy

Australia is an open economy, meaning that we trade in goods and services with other countries. Australian businesses sell **exports** to both consumers and producers in other countries. Australian consumers buy **imports** that have been manufactured in other parts of the world and brought into this country.

Figure 1 Australia imports many goods from overseas and exports to many other countries.

International trade can affect our economic system in a number of ways:

- Australia has a relatively small population, so if overseas consumers are willing to buy the goods and services we produce, this can help our local businesses to grow and employ more people. Today over 1.7 million jobs in Australia are directly or indirectly connected with the production of exports.
- Some products cannot be made here as efficiently as in other countries. A lot of the highly sophisticated machinery used in factories here is imported. However, such machinery can help local factories remain competitive by producing goods more cheaply.
- Imported goods are sometimes cheaper than locally produced goods, so local producers can find it difficult to compete with imported products. Some local producers may even be forced to close down. Australian clothing and footwear manufacturing has declined over the last 30 years as cheaper imports from Asian countries have increased dramatically. While this may not be good for those Australian manufacturers, it is a positive trend for consumers because they have access to cheaper clothing.

By adding overseas trade to the circular flow diagram, we can see how overseas consumers and producers participate in the Australian economy. As shown in figure 2, we can see that households spend money buying imports from overseas businesses, while businesses can earn money from exporting goods and services to overseas consumers. Exports are good for the Australian economy because they bring money into our market system, while imports take money out of the country and pay it to overseas businesses.

If we consistently spend more on imports than we earn from exports, money will continue to flow out of the country. Ultimately this will leave us poorer as a nation. Ideally we want to sell enough exports to provide us with the extra money needed to pay for the goods and services we need to import. If we have more money flowing into Australia from exports than we have flowing out to pay for imports, this additional money can add to our wealth as a nation.

Figure 2 The circular flow of money between households, businesses, financial intermediaries, government, and overseas consumers and businesses in the Australian economy

1.5.3 Trade with the Asia region

As a relatively wealthy and advanced economy, Australia is an important trading nation for countries in the Asia region. As illustrated in figure 3, in 2013 over 73 per cent of Australia's trade with our top ten trading partners was with Asian countries. Six of our top ten trading partners were Asian countries, including four of the top five.

Figure 3 Australia's trade with our top 10 trading partners in 2013

Trade with Asia

Position	Country	Exports A$ million	%	Imports A$ million	%	Total trade A$ million	%
1	China	101 590	52.3	49 329	39.8	150 919	47.4
2	Japan	49 532	25.5	21 221	17.1	70 753	22.2
4	South Korea	21 274	11.0	10 813	8.7	32 087	10.1
5	Singapore	9 209	4.7	17 878	14.4	27 087	8.5
8	Thailand	5 714	2.9	13 832	11.2	19 546	6.1
9	Malaysia	6 945	3.6	10 944	8.8	17 889	5.6
	Total	194 264	100.0	124 017	100.0	318 281	100.0

Non-Asian trade

Position	Country	Exports A$ million	%	Imports A$ million	%	Total trade A$ million	%
3	United States	15 533	41.5	39 181	52.3	54 714	48.7
6	New Zealand	11 022	29.5	10 532	14.1	21 554	19.2
7	United Kingdom	7 841	21.0	12 044	16.1	19 885	17.7
10	Germany	3 023	8.1	13 099	17.5	16 122	14.4
	Total	37 419	100.0	74 856	100.0	112 275	100.0

Asian and non-Asian trade

	Exports A$ million	%	Imports A$ million	%	Total trade A$ million	%
Trade with Asia	194 264	83.8	124 017	62.4	318 281	73.9
Non-Asian trade	37 419	16.2	74 856	37.6	112 275	26.1
Total	231 683	100.0	198 873	100.0	430 556	100.0

Source: Data derived from *Australia's trade at a glance*, Department of Foreign Affairs and Trade.

Let us examine the importance of China as our largest trading partner. As you can see from figure 3, the value of our exports to China is A$101 590 million. This represents just over 52 per cent of our exports to Asia, and is more than double the value of imports from that country. The largest proportion of our exports to China is made up of iron ore and coal, which China buys to fuel its industrial growth. Japan and South Korea are also large buyers of Australian mineral resources. The value of our exports to each of these countries is also much greater than the value of goods and services we import from them. This adds to Australia's wealth, allowing us to use the money we earn from selling our exports to pay for the goods and services we import from other countries.

More than 83 per cent of the value of our exports in 2013 was earned from selling to Asian countries. This money was particularly important because most of our non-Asian trade involved much higher levels of imports than exports. When we compare the value of exports with the value of imports, we can calculate Australia's **balance of trade**. If the value of exports is greater than the value of imports in a particular period of time, we are said to have a *trade surplus* for that period. If the value of imports is greater than the value of exports, we are said to have a *trade deficit*. We can see from figure 3 that in 2013 Australia had an overall trade surplus with our ten largest trading partners. When we look at trade with individual countries, we see that we had a trade surplus with some of them and a trade deficit with others.

1 The Australian economy

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1.6 Global events and the Australian economy

1.6.1 Positive and negative effects

Today all countries are connected to a greater extent than ever before in human history. International trade has contributed to economic growth and the generation of wealth in all nations that engage in the import and export of goods and services. Developments in travel and communications have made trade easier and broken down many traditional barriers between countries. While we have benefited in many ways from these connections with other countries, there have also been some detrimental effects. The ease of travel between countries has seen the rapid international spread of infectious diseases, while the widespread use of electronic communication has made internet fraud and identity theft much easier for criminal groups.

Figure 1 International flights have made travel between countries both quick and easy, but they come with risks such as the possibility of spreading contagious diseases across the globe.

1.6.2 Our interconnected world

The growth of trade between almost all countries has created greater economic interdependence between those countries. As a result of this interconnectedness, both positive and negative economic events can spread quickly between trading partners. The rapid economic growth of China over the last 30 years has had a beneficial effect on the many other countries that trade with it. On the other hand, problems with housing loans that began in the United States in 2006 eventually spread to many other countries, creating a global financial crisis.

The growth of the Chinese economy

Since the early 1980s, the Chinese government has pursued a number of policies designed to bring about rapid economic growth. Economic growth is measured by increases in a country's **gross domestic product (GDP)**. As GDP is the total value of all goods and services produced in a country in any given year, the rate by which GDP increases each year is effectively the rate of economic growth of that country. China has averaged increases in GDP of more than 10 per cent a year for most of the last 30 years. One way in which the Chinese have been able to achieve this level of growth is through a rapid expansion in trade with other countries. As a result of this policy China has become the world's largest trading nation, with a total trade value of US$3.87 trillion in 2012.

China has set out to increase its manufacturing capacity in order to provide all the goods and services required by its own huge population and also to export to other countries. It has had to import large quantities of raw materials from other countries, including the materials to build hundreds of new factories and the fuel to power them. Countries such as Australia have benefited enormously from this growth in the Chinese economy. As we have seen, China is Australia's largest export customer, buying large quantities of Australian iron ore and coal. This has generated a mining boom in Australia that has contributed significantly to our growth in GDP. Australia also imports large quantities of consumer goods from China, particularly clothing and other textiles products, as well as increasing quantities of electronic goods and other home appliances. Most of these are produced more cheaply than we can produce them ourselves, so Australian consumers benefit from paying lower prices for a wide variety of goods imported from China.

Figure 2 China produces high-quality electronic products more cheaply than we can in Australia.

Global financial crisis (GFC)

During the early years of this century, many American banks lent money in mortgage loans to people who were ultimately unable to repay the amount they had borrowed. In 2006 and 2007 a fall in US house prices left many of these people with houses that were valued less than the money owing on their mortgage loans. When large numbers of them defaulted on their loans and had to abandon their houses, many of the banks and other financial intermediaries lost a lot of money, severely damaging the reputation of the American financial system. This led to a tightening of credit, with banks lending less money and a slowing in growth of the United States economy. In 2008 the American economy went into **recession**. Around 9 million people lost their jobs in the following two years.

Figure 3 Many US home owners had to abandon their mortgaged homes when house prices fell dramatically during 2006 and 2007.

In response to the problems in the American banking system, other banking systems throughout the world placed restrictions on lending. This led to a recession throughout much of the rest of the world. In many European countries GDP declined by as much as 10 per cent, with some countries experiencing even greater decreases in economic growth and high levels of unemployment. Recession was largely avoided in Australia because the government rapidly increased spending, injecting more money into the circular flow and stimulating economic growth.

The global financial crisis (GFC) of 2008 and 2009 occurred because of the close connections between the economic and financial systems of most of the world's countries. International trade and the flow of money between nations means that events that occur in one country can have an influence on the economic conditions in other countries — for better or worse.

1.6.3 Natural disasters

A natural disaster can have a serious economic impact on a country. When houses and businesses are destroyed, money and resources are needed to repair and replace them. These resources cannot therefore be used for other purposes. In February 2009 the Black Saturday bushfires in Victoria caused damage to the Victorian economy valued at more than $5 billion. In January 2011 the Queensland floods that damaged many homes and businesses also devastated a great deal of valuable farming land. The resulting shortages forced up food prices all over Australia. Rail lines and coal mines were also damaged. Natural disasters in other countries can also affect the Australian economy, particularly if they occur in the Asia region to which we are so closely tied.

Figure 4 The Queensland floods affected food prices all over Australia, as well as some of our export industries.

The 2011 Japanese earthquake and tsunami

In March 2011 the largest earthquake ever to hit Japan occurred under the ocean to the country's east, causing a 40-metre tsunami. As many as 18 000 people are believed to have died. Tens of thousands of buildings were destroyed, and a meltdown at the Fukushima nuclear power station led to serious radioactive pollution. There was an immediate slowdown in the growth of the Japanese economy, but the international economy was also seriously affected. Japan is a major trading nation and the world's third largest economy.

Japanese cars, computers and electronics products are assembled in many factories around the world, and they rely on parts imported from Japan. The slowdown in the Japanese economy had an impact on many Japanese-owned businesses globally.

Japan is Australia's second largest trading partner, so an event as dramatic as the 2011 tsunami had an impact on Australia's economy although the effects were largely short term. These effects were positive as well as negative:

- The slowdown in the Japanese economy resulted in a reduction in demand for Australian exports such as coal, iron ore and beef. However, the reconstruction effort in Japan eventually led to a rise in demand for steel, so many of these exports subsequently increased.
- Pollution from the Fukushima nuclear power station raised concerns about the safety of the food supply in that area. This led to a rise in imports of food into Japan. As a significant supplier of food to Japan, Australia exported more food to that country in the period after the tsunami.
- The nuclear meltdown also caused Japan to reassess its reliance on nuclear power. As a result, it has been making greater use of coal- and gas-fired power stations. This is likely to result in a higher demand for coal and liquefied natural gas (LNG) from Australia. The 13 million tonnes of LNG exported from Australia to Japan in 2010 is expected to rise to 30 million tonnes by 2016.

Figure 5 The destruction caused by the 2011 tsunami had an impact on Japan's trading partners as well as on its own economy.

1.7 SkillBuilder: Questioning and research

1.7.1 Tell me

When carrying out your own research, the steps in figure 1 can provide a useful guide.

Figure 1 How to carry out your own research

1.7.2 Show me

Imagine you have been asked to investigate Australia's trade with China. You need to find out details of the major imports and exports between the two countries and any recent changes that have occurred in the trade relationship.

Your first step is to clearly identify the essential key task. This could be expressed as: 'Prepare a report on Australia's trade with China. Include the major exports and imports, recent trends in our trade relationship with that country, and the value of that trade to the Australian economy.'

Now break this down into a series of more specific questions. These could include:

1. What are Australia's major exports to China?
2. What are the values and/or percentages of these exports?
3. What are our major imports from China?
4. How are these imports broken down, from most important to least important?
5. Which areas of trade have been growing most rapidly over the last few years, and which have been in decline?
6. How does trade with China affect the Australian economy? What are the benefits, and what are the disadvantages?

The next step is to locate appropriate sources. By entering the search term 'Australian trade with China' in your favourite search engine, you will be presented with a number of sources. A Wikipedia entry is often found at or near the top of the list of sources, and many students will be familiar with this resource. There is no problem with using Wikipedia as one of your sources — so long as you remember that it is not always reliable, and any information gathered from Wikipedia should always be checked against another source to make sure it is accurate. To help ensure that your information is correct, it is a good idea to use at least two sources to answer each question.

Keep your questions beside you as you read each source, and note the location of material that provides answers. You can select and print some text, and then highlight those sentences or paragraphs that provide answers to your questions. Sometimes a complete answer to a question may be found in several places in a piece of text. Be sure to highlight all relevant text, and indicate with a number which question the information answers.

When you are satisfied that you have found the answers to all the questions, you need to write the answers in order, making sure to use your own words as much as possible. You can then use the answers to present your information in the required form. This may be a report to the rest of the class, an essay to be marked by your teacher, a PowerPoint or Keynote presentation, or any other format that is appropriate.

1.7.3 Let me do it

Practise the skill

Using the above process as a model, your research task is to prepare a report on Australia's trade with one of these Asian countries: Japan, South Korea, Singapore, Thailand or Malaysia. Your report should include details of goods and services traded, recent trends or changes in that trade, and the importance of that trade to the Australian economy.

1.8 Review

1.8.1 Summary

The Australian economy is the total of all activities undertaken for the purpose of the production, distribution and consumption of goods and services in our country. Because Australia is a major trading nation, economic activities in this country can affect other countries, and activities in those countries can have an impact on our economy.

- The household sector makes decisions about which goods and services to purchase, as well as providing labour for businesses.
- The business sector is made up of a large number of producers, all seeking to provide goods and services to satisfy the needs and wants of households.
- Businesses make use of land, labour and capital to produce goods and services to sell to consumers.
- Financial intermediaries perform an important role because they enable accumulated savings to be directed towards business growth.
- Government plays an important role in the economy because households and businesses pay money to government in the form of taxes, and receive particular types of goods and services in return.
- The economic system aims to answer three key questions: what to produce, how to produce and for whom to produce.
- Indicators such as economic growth, unemployment and inflation provide us with information about the performance of the Australian economy.

- Whenever we make a choice between two or more alternatives, we may gain the benefits of the alternative we choose, but we lose any benefits that may have come from choosing the next best alternative. This is known as opportunity cost.
- Australia is a trading nation — it exports goods and services to other countries, and Australian businesses and consumers import goods and services from overseas.
- The circular flow diagram represents the flow of money between households, businesses, financial intermediaries, government, and overseas consumers and businesses.
- The balance of trade is the difference between the value of a country's exports and its imports over a specific period.
- Australia's largest trading partner is China, with other Asian countries making up four of our five top trading partners.
- Trade and other connections between countries mean that events in one part of the world can affect economies in other countries.

1.8.2 Your turn

Australia regularly suffers from drought. These events can sometimes last for years, having a serious impact on the production of food and other agricultural products.

1. What do you think the impact of drought would be on the price of fruit, vegetables and meat in Australia? Give reasons for your answer.
2. How do you think a drought might affect Australia's trade in food products with our Asian neighbours? Give reasons for your answer.
3. What impact would a drought have on the circular flow of money in the economy? Explain why.
4. Imagine you are a grazier who sells beef to local and overseas butchers. You have 100 specially bred animals that in good condition are worth $80 000 in total. The drought has left your pastures with nothing for the livestock to eat so, with no rain in sight, you believe your options are to:

   A. pay $8 per head per week to relocate them to a better farm for three months to reach peak quality for sale.

   B. sell some or all of the cattle now for an average of $500 per head, depending on their condition.

   C. buy fodder and hand feed at a cost of $20 per head per week for three months before selling them in prime condition.

   D. any combination of the above.

   After identifying the costs and benefits involved in each option, make a decision and justify your selected option.