QCE Unit 3 Topic 1: International Trade

Unit 3: International Economics

Comprehensive Study Guide with 20 Multiple Choice Questions

SECTION 1: KEY CONCEPTS & TERMINOLOGY

1.1 Trade and Advantage

- Absolute advantage: When a country can produce a good using fewer resources (more output per unit of input) than another country.
- Comparative advantage: When a country can produce a good at a lower opportunity cost than another country. This — not absolute advantage — is the basis for mutually beneficial trade.
- Competitive advantage: A firm's or nation's ability to out-perform rivals through factors such as innovation, branding, quality and productivity (Michael Porter), rather than resource endowments alone.
- Factor endowment: The quantity and quality of land, labour, capital and enterprise a country possesses; shapes what it produces cheaply.

1.2 Trade Flows and Openness

- Free trade: International trade without government-imposed barriers such as tariffs or quotas.
- Trade liberalisation: The process of reducing trade barriers to move toward freer trade.
- Open economy: An economy that engages in trade and financial flows with the rest of the world (exports, imports, capital movements).
- Terms of trade (ToT): The ratio of export prices to import prices, expressed as an index. Rising ToT means a given volume of exports buys more imports.
- Balance of trade: The difference between the value of exports and imports of goods and services (a surplus when exports exceed imports).

1.3 Exchange Rates

- Exchange rate: The price of one currency in terms of another (e.g. AUD 1 = USD 0.66).
- Floating exchange rate: Determined by market demand and supply for the currency (Australia since December 1983).
- Fixed exchange rate: Pegged by the central bank to another currency or basket at a set value.
- Managed (dirty) float: Market-determined but with periodic central bank intervention.
- Appreciation: A rise in the value of a currency under a floating system.

- Depreciation: A fall in the value of a currency under a floating system.
- Devaluation / revaluation: A deliberate lowering / raising of a currency's value under a fixed or managed system.

1.4 The External Accounts

- Balance of payments (BoP): The record of all transactions between Australia and the rest of the world over a period.
- Current account: Records trade in goods and services, primary income and secondary income.
- Current account deficit (CAD): When current account outflows exceed inflows.
- Capital and financial account: Records flows of investment and borrowing/lending between Australia and the world.
- Foreign investment: Funds from overseas invested in Australia (direct or portfolio).
- Foreign debt: Money borrowed by Australian residents (public and private) from overseas that must be repaid with interest.

1.5 Objectives Affected by Trade

- Sustainable economic growth: Growth that can be maintained without excessive inflation or external imbalance.
- Internal stability: Low inflation and low unemployment domestically.
- External stability: A sustainable external position — a manageable CAD, net foreign liabilities and a stable exchange rate.
- Economic integration / economic union: Deepening links between economies; a union (e.g. the EU) adds common policies and institutions.

SECTION 2: THE OPEN ECONOMY & CIRCULAR FLOW

2.1 The Five-Sector Model

- The open-economy circular flow adds the overseas (external) sector to households, firms, the financial sector and government.
- Injections: Investment (I), Government spending (G) and Exports (X).
- Leakages: Savings (S), Taxation (T) and Imports (M).
- Equilibrium (a stable level of national income) occurs when total injections equal total leakages: S + T + M = I + G + X.
- Exports inject income earned from overseas buyers; imports leak income to overseas producers.

2.2 Why Openness Matters

- Trade links domestic income to global demand: strong world growth lifts Australian export income; a global downturn reduces it.
- A change in any injection or leakage sets off the multiplier, altering national income by more than the initial change.

- Brettonomics interactive: the Circular Flow of Income model lets students add and remove the overseas sector to see the effect of export and import flows.

SECTION 3: WHY COUNTRIES TRADE — TRADE THEORIES

3.1 Absolute Advantage (Adam Smith)

- Smith argued that countries should specialise in goods they can produce most efficiently (using the fewest resources) and trade for the rest.
- Specialisation raises total world output because resources are used where they are most productive.
- Limitation: Absolute advantage cannot explain trade when one country is more efficient at producing everything.

3.2 Comparative Advantage (David Ricardo)

- Ricardo showed that trade is still mutually beneficial if each country specialises where its opportunity cost is lowest — even if one country has an absolute advantage in both goods.
- Worked example — output per worker:
- Australia: 8 units of wheat OR 4 units of cloth
- Indonesia: 2 units of wheat OR 3 units of cloth
- Australia's opportunity cost of 1 wheat = 0.5 cloth; Indonesia's = 1.5 cloth → Australia specialises in wheat.
- Indonesia's opportunity cost of 1 cloth = 0.67 wheat; Australia's = 2 wheat → Indonesia specialises in cloth.
- Both gain if they trade at a rate between 0.5 and 1.5 cloth per wheat.

3.3 Competitive Advantage (Michael Porter)

- Porter argued that national prosperity is created, not inherited: it depends on the capacity of industry to innovate and upgrade.
- Porter's "diamond" — four determinants: factor conditions; demand conditions; related and supporting industries; firm strategy, structure and rivalry.
- Explains why advanced economies trade similar goods (intra-industry trade) and why some industries cluster in particular nations.

SECTION 4: ADVANTAGES & DISADVANTAGES OF TRADE

4.1 Advantages

- Higher living standards through access to cheaper and more varied goods.
- Economies of scale from producing for a larger (world) market.
- Efficiency gains as resources shift to areas of comparative advantage.

- Access to capital, technology and skills via foreign investment.
- Competition that encourages innovation and productivity.

4.2 Disadvantages and Risks

- Structural unemployment as import-competing industries contract.
- Greater exposure to external shocks (commodity price swings, global recessions).
- Risk of a widening CAD and rising foreign liabilities.
- Over-reliance on a narrow range of commodity exports.
- Impact on sustainable growth, internal stability (jobs, inflation) and external stability must be weighed together.

SECTION 5: AUSTRALIA'S TRADE PATTERNS

5.1 Composition of Trade

- Exports are weighted toward resources and rural commodities: iron ore, coal, natural gas (LNG), gold, beef and wheat, plus services such as education and tourism.
- Imports are weighted toward manufactured and capital goods: refined petroleum, cars, telecommunications equipment and machinery.
- This structure makes export income sensitive to world commodity prices.

5.2 Direction of Trade

- Australia's trade is concentrated in Asia. China is the largest two-way partner, followed by Japan, South Korea, the United States, India and the ASEAN economies.
- Students should identify the five largest export and import partners from current data and track how the pattern is shifting (e.g. the rising role of India and ASEAN).

5.3 Calculating Percentage Change

- Percentage change = ((new value − old value) ÷ old value) × 100.
- Example: if iron ore export earnings rise from $120bn to $138bn, the change is ((138 − 120) ÷ 120) × 100 = 15%.
- Brettonomics interactive: the Composition of Trade tool displays Australia's export and import mix and partner shares for analysis of patterns and trends.

SECTION 6: TERMS OF TRADE

6.1 Definition and Measurement

- Terms of trade index = (export price index ÷ import price index) × 100.
- A rise (improvement) means export prices have risen relative to import prices, so each unit of exports buys more imports.
- A fall (deterioration) means the opposite.

6.2 Effects on the Australian Economy

- A higher ToT (e.g. during the 2003–2011 and 2021–2022 commodity booms) raises national income, company profits, tax revenue and the exchange rate.
- A falling ToT reduces export income and can weaken the dollar and the budget.
- Because Australia is a commodity exporter, the ToT is volatile and a key driver of the business cycle and the external accounts.

SECTION 7: EXCHANGE RATES — THE FLOATING AUD

7.1 The Demand and Supply Model

- The exchange rate is the price of the AUD, set where demand for AUD equals supply of AUD in the foreign exchange market.
- Demand for AUD comes from: exports, foreign investment inflows, speculation that the AUD will rise, and relatively high Australian interest rates.
- Supply of AUD comes from: imports, Australian investment abroad, speculation that the AUD will fall, and relatively low Australian interest rates.

7.2 Causes of Appreciation and Depreciation

- Appreciation (AUD rises): higher commodity prices/ToT, higher Australian interest rates relative to overseas, stronger foreign investment inflow, or improved confidence.
- Depreciation (AUD falls): falling commodity prices, lower relative interest rates, capital outflow, or weaker confidence.
- Construct demand/supply diagrams to show how each factor shifts a curve and changes the equilibrium rate.

7.3 How a Floating Rate Insulates the Economy

- A floating exchange rate acts as an automatic shock absorber. If export prices collapse, the AUD depreciates, which cushions export incomes and supports trade-exposed industries.
- Conversely, a commodity boom appreciates the AUD, which moderates inflation by making imports cheaper.
- Fixed and managed regimes remove this automatic adjustment and require the central bank to hold reserves and intervene.
- Brettonomics interactive: the AUD Exchange Rate Explorer lets students shift demand and supply factors and watch the equilibrium rate adjust.

SECTION 8: GOVERNMENT POLICY RESPONSES

8.1 Responding to Exchange Rate and Trade Movements

- Although the AUD floats, policy still responds to trade and currency conditions through monetary policy, fiscal settings, industry assistance and trade policy.

- Decisions are evaluated against criteria such as: employment in trade-exposed industries; economic growth (national, state and regional); efficiency (allocative and dynamic costs); and the price and availability of imported goods and services.
- Example: a sustained high AUD squeezes manufacturing and tourism, prompting debate over industry support versus letting the market adjust.

SECTION 9: THE BALANCE OF PAYMENTS

9.1 Structure of the Accounts

- The current account records: the balance on goods and services (BOGS); net primary income (interest and dividends paid on foreign liabilities, and earned on foreign assets); and net secondary income (minor transfers).
- The capital and financial account records: investment flows, borrowing and lending between Australia and the world.
- Double-entry principle: the current account and the capital and financial account are mirror images — a current account deficit is financed by a net inflow on the financial account, so the two broadly sum to zero (apart from a net errors and omissions item).

9.2 Cyclical and Structural Influences

- Cyclical: commodity price swings and the global cycle move the trade balance and the ToT in the short run (e.g. strong commodity prices produced rare current account surpluses from 2019 to 2022).
- Structural: a persistent gap between national saving and investment underlies Australia's long-run tendency to run current account deficits financed by capital inflow.
- Net primary income is typically in deficit because Australia services a large stock of net foreign liabilities.
- Brettonomics interactive: the Balance of Payments structural tool maps the accounts and double-entry flows, while the accounts explorer tracks BOGS, net primary income and net investment income over time.

SECTION 10: FOREIGN INVESTMENT & FOREIGN DEBT

10.1 Foreign Investment

- Foreign direct investment (FDI): a lasting ownership stake (10% or more) giving influence over a business; brings capital, technology and management.
- Portfolio investment: shares and debt securities without controlling influence; more mobile and volatile.
- Foreign investment has historically financed Australian development — for example, funding the capital-intensive mining investment boom when domestic saving was insufficient.

10.2 Foreign Debt and Net Foreign Liabilities

- Net foreign liabilities = net foreign debt (borrowing) + net foreign equity.
- Foreign debt must be serviced with interest, which shows up as a primary income outflow.
- Whether debt is a concern depends on how it is used: borrowing that funds productive investment (building export capacity) is more sustainable than borrowing for consumption.
- Students should track Australia's foreign debt and investment positions over time to evaluate external stability.

MULTIPLE CHOICE QUESTIONS

20 Questions Covering Unit 3 Topic 1 Content

Question 1

A country has a comparative advantage in a good when it can produce that good:

- A. Using fewer resources than any other country
- B. At a lower opportunity cost than another country
- C. With the most advanced technology available
- D. Only after imposing a tariff on competing imports

Question 2

Australia can produce 8 wheat or 4 cloth per worker; Indonesia can produce 2 wheat or 3 cloth per worker. Which statement is correct?

- A. Australia should specialise in cloth and Indonesia in wheat
- B. Australia should specialise in wheat and Indonesia in cloth
- C. No mutually beneficial trade is possible
- D. Indonesia has an absolute advantage in wheat

Question 3

In the five-sector circular flow, which of the following are all injections?

- A. Savings, taxation and imports
- B. Investment, government spending and exports
- C. Exports, savings and investment
- D. Imports, taxation and government spending

Question 4

The terms of trade index is calculated as:

- A. (Import price index ÷ export price index) × 100
- B. (Export price index ÷ import price index) × 100
- C. (Export volume ÷ import volume) × 100
- D. Exports minus imports

Question 5

Australia's terms of trade improve. The most likely immediate effect is:

- A. A fall in national income and a weaker dollar
- B. A rise in export income and upward pressure on the AUD
- C. An automatic current account deficit

- D. A fall in commodity prices

Question 6

Which factor would increase the demand for Australian dollars on the foreign exchange market?

- A. A rise in Australian imports
- B. Australian investors buying foreign assets
- C. A rise in Australian commodity export prices
- D. A fall in Australian interest rates relative to overseas

Question 7

A floating exchange rate helps insulate the economy from external shocks because:

- A. The central bank fixes the rate during a downturn
- B. A fall in export prices causes the AUD to depreciate, cushioning export incomes
- C. It prevents the terms of trade from ever changing
- D. It eliminates the need for a current account

Question 8

Iron ore export earnings rise from $120 billion to $138 billion. The percentage change is:

- A. 12%
- B. 15%
- C. 18%
- D. 1.15%

Question 9

The current account of the balance of payments records all of the following EXCEPT:

- A. The balance on goods and services
- B. Net primary income
- C. Net foreign direct investment inflows
- D. Net secondary income

Question 10

Australia typically records a deficit on net primary income mainly because:

- A. It imports more goods than it exports
- B. It must service a large stock of net foreign liabilities
- C. The AUD is overvalued
- D. Secondary income is always in surplus

Question 11

Under the double-entry principle of the balance of payments, a current account deficit is:

- A. Always a sign of economic weakness
- B. Financed by a net inflow on the capital and financial account
- C. Offset by an equal rise in the terms of trade
- D. Impossible under a floating exchange rate

Question 12

Which is the best example of foreign direct investment (FDI)?

- A. An overseas fund buying $2m of Australian government bonds
- B. A foreign company acquiring a 60% stake in an Australian mine
- C. An Australian tourist spending money in Japan
- D. The RBA purchasing foreign currency reserves

Question 13

Competitive advantage, as described by Michael Porter, is primarily based on:

- A. A country's natural resource endowment alone
- B. The capacity of industry to innovate and upgrade
- C. The size of a country's population
- D. Having the lowest wages in the world

Question 14

The main reason comparative advantage, rather than absolute advantage, is the basis for trade is that:

- A. Absolute advantage ignores opportunity cost and cannot explain trade when one country is more efficient at everything
- B. Comparative advantage requires a fixed exchange rate
- C. Absolute advantage only applies to services
- D. Comparative advantage guarantees a trade surplus

Question 15

A sustained appreciation of the AUD would most likely:

- A. Make Australian exports more competitive
- B. Reduce the price of imported goods and squeeze trade-exposed industries
- C. Increase the terms of trade automatically
- D. Raise the foreign debt servicing cost

Question 16

Which of the following is a structural (rather than cyclical) cause of Australia's current account position?

- A. A short-term spike in iron ore prices
- B. A persistent gap between national saving and investment
- C. A temporary global recession
- D. A one-off drought affecting wheat exports

Question 17

Australia's export base is dominated by resources and rural commodities. A key risk of this structure is:

- A. Export income is highly exposed to world commodity price swings
- B. Australia can never run a trade surplus
- C. The terms of trade can never change
- D. Imports become impossible to finance

Question 18

A country moves from a managed exchange rate to a floating rate. One consequence is that:

- A. The central bank must hold larger foreign currency reserves
- B. The exchange rate now adjusts automatically to market demand and supply
- C. Appreciation and depreciation can no longer occur
- D. The terms of trade become fixed

Question 19

Foreign borrowing used to fund productive, export-generating investment is generally considered more sustainable than borrowing for consumption because:

- A. It never has to be repaid
- B. It builds the capacity to earn the income needed to service the debt
- C. It reduces the exchange rate permanently
- D. It is recorded in the current account

Question 20

The equilibrium condition for national income in the open-economy circular flow is:

- A. $S + T + M = I + G + X$
- B. $S + I = T + G$
- C. $X = M$

- D. C + I + G = Y

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Answer Key & Explanations

Q1: B | Q2: B | Q3: B | Q4: B | Q5: B | Q6: C | Q7: B | Q8: B | Q9: C | Q10: B

Q11: B | Q12: B | Q13: B | Q14: A | Q15: B | Q16: B | Q17: A | Q18: B | Q19: B | Q20: A

Detailed Explanations

Q1 (B): Comparative advantage is defined by lower opportunity cost, not fewer resources (that is absolute advantage).

Q2 (B): Australia's opportunity cost of wheat (0.5 cloth) is lower than Indonesia's (1.5 cloth), so Australia specialises in wheat and Indonesia in cloth.

Q3 (B): Injections are investment, government spending and exports; leakages are savings, taxation and imports.

Q4 (B): ToT = (export price index ÷ import price index) × 100.

Q5 (B): Improving terms of trade raise export income and put upward pressure on the dollar.

Q6 (C): Higher commodity export prices raise demand for AUD; the other options raise supply or reduce demand.

Q7 (B): A floating rate absorbs shocks — falling export prices depreciate the AUD, cushioning exporters.

Q8 (B): ((138 − 120) ÷ 120) × 100 = 15%.

Q9 (C): Investment flows are recorded in the capital and financial account, not the current account.

Q10 (B): Servicing large net foreign liabilities creates a net primary income outflow.

Q11 (B): A CAD is financed by a net inflow on the capital and financial account (double-entry).

Q12 (B): FDI is a lasting ownership stake (10%+); a 60% acquisition qualifies.

Q13 (B): Porter stresses the capacity to innovate and upgrade, not endowments alone.

Q14 (A): Absolute advantage ignores opportunity cost and fails when one country is more efficient at everything.

Q15 (B): Appreciation lowers import prices and squeezes trade-exposed industries such as manufacturing and tourism.

Q16 (B): A persistent saving–investment gap is structural; the other options are cyclical or one-off.

Q17 (A): A commodity-heavy export base exposes income to world price swings.

Q18 (B): Floating means the rate adjusts automatically to market demand and supply.

Q19 (B): Productive borrowing builds the capacity to service the debt, making it more sustainable.

Q20 (A): Equilibrium occurs where leakages equal injections: S + T + M = I + G + X.