Outline in detail the features of the balance of payments and its relationship with the current account deficit.

The balance of payment (BOP) records the trade and money flows into and out of Australia and the rest of the world over a set amount of time. There are two main components in the Australia BOP and it includes the current account (CA) and the financial and capital account (KFA). The CA and KFA when added always equals zero, and any surplus in either account will become deficit on the other.

The current account covers all goods and services, income and current transfers and is separated into four different types including goods account, services account, incomes account and current transfers account.

The goods account and services account includes the export and import of goods and services, where exports are regarded as credit as Australia is receiving money returns. Conversely, the import of goods and services is considered a debit as Australia is using money to pay for it. The value of Australia's imports and exports rely heavily upon the economic growth rates of itself and its main trading partners' eg Japan and ASEAN. Strong economic growth at 3.5-4% in Australia in recent times (2000/01) have increased the CAD as a result of rising imports, particularly because most of Australia's imports are capital and intermediary goods. The strength of Australia's main trading partners also determine Australia's CAD as Australia's main exports are minerals and agricultural goods which are highly demanded during economic growth.

The incomes account calculates the payment for the use of factors of production and is the main contributor to Australia's large CAD. It is the main link between CA and KFA. An increase in any form of foreign capital and/or financial inflows would worsen the CAD as it must own some form of return and this return is recorded as a debit in the income account. Australia over the years has had a CAD fluctuating between 3 and 6% of GDP, the lowest being during periods of recession. The overall CAD in 2001/02 was $22 billion and the income account deficit alone was $20.2 billion. This large income account deficit was a consequence of Australia receiving more from foreign saving and investment than it has sent overseas.

The current transfer account covers non-commercial payments, which are not offset by trade and which have no returns. These include gifts, foreign aid and charity, and only play a small part in the CA.

The KFA includes assets and liabilities between Australia and the rest of the world. The capital account is non-commercial, involving capital transfers such as migrants bringing in or taking out savings from Australia, and debt forgiveness. Financial accounts, which deal with commercial payments, have four components: direct investment, portfolio investment, other investment and reserve assets.

Direct investment involves the buying and selling of assets or lending loans. It usually involves Australia Company taking control over foreign assets or vice versa so it involves the reinvestment of profits. In recent times direct invest from Australia boomed after the improvement of Asia economy. Direct investments to Aus have stayed large and constant over the years.

Portfolio investments involve buying and selling of shares, treasury bonds and debentures, which does not give provider control over assets. The recent trend for portfolio investment fluctuated greatly due to global financial market's speculation on Australian market eg increase of exchange rate and economic growth rate.

Other investment includes mainly short-term loans and speculative investments by banks buying and selling currencies in the hope of gaining a profit in currency changes.

Reserve assets include gold holdings by the RBA and deposits in foreign financial institutions. Australian reserve assets also fluctuate greatly such as during 2001/02 when the RBA bought Australian currencies to stabilise the Australian dollar. It created a $–9 billion deficit but it recovered in 2003 as the Australian dollar appreciated dramatically, and the RBA appears to be once again buying foreign currencies.

The main balancing mechanism for the BOP is the exchange rate. If export falls $A becomes cheaper and automatically increases the CAD, as debts are usually made in foreign currency, so a drop in $A buying power means a larger amount will be needed to pay off the same debt. It will nonetheless attract more foreign investment, increasing credits on the KFA, which is matched by the high CAD.

A high CAD is caused by factors including high economic growth that leads to high demand for imports, a low $A, low levels of consumer saving and an overall stable economy, which attracts foreign investors. Having a high CAD has a number of affects on the economy. First of all the government may feel the economy is growing too fast and there is a risk of turning Australia into a "banana republic," where rising CAD pushes inflation up, triggering a greater CAD as the level of income and jobs drop, and the cycle continues. To prevent this, the government must increase its budget surplus, by reducing public expenditure, sending the economy into recession. Large CADs can also cause foreigners to lose confidence and withdraw savings from Australian assets. In effect it will cause a collapse of the financial market followed by an economic crisis similar to the Asian crisis of 1997.

	Short run effects on CAD	Long run effects CAD
Money into Australia	• Increases capacity of production in Australia, which reduces CAD • Increasing import replacing industries reduces CAD • Increase import industries increases CAD	• Becomes a foreign liability as investment will eventually earn some form of return for its owner, which increases CAD
Money out of Australia	• Drains the saving pool in Australia, which forces other industries to borrow from over sea banks, which increases the CAD	• Earns interest, profit which reduces CAD