

Answers to the TEE Economics 2006

At the time of preparation the Examiners' Report for the 2006 TEE Economics Paper was not available on the Curriculum Council Website. The answers here are grouped by question topic.

Chapter 1 (Intro to Macro)

Chapter 2 (AD/AS)

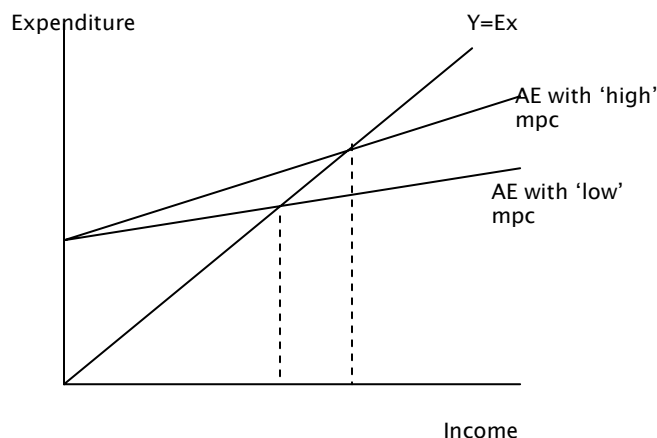
Qu	Ans	Explanation
1	B	Net exports (exports minus imports) is only about -3% of GDP
2	D	A rise in savings reduces equilibrium real GDP or income. People are forced to save less as their income drops.
17	D	A rise in tax represents a leakage. AD will fall.
22	D	Rising costs shift the AS upwards and to the left. AD may shift as well, if there is a loss of consumer and business confidence – it is a question of what comes first.

Chapter 3 (Multiplier)

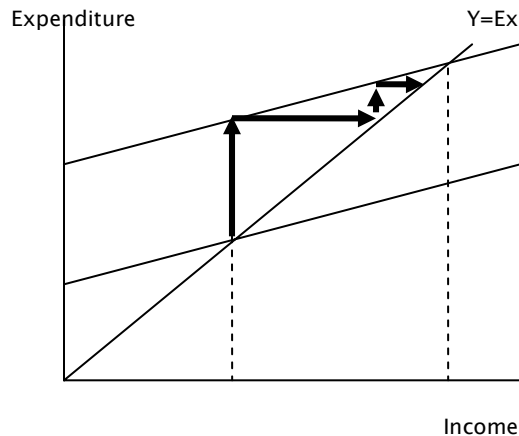
Qu	Ans	Explanation
3	B	The multiplier is $(1/1 - mpc)$. The change in real GDP is the injection multiplied by the multiplier. $\$30b \times 3.33 = \text{almost } \$100b$

Question 32

(a) A rise in the marginal propensity to consume (mpc) implies a fall in the marginal propensity to save and vice versa. An increase in the mpc increases the gradient of the Aggregate Expenditure line and assuming no change in autonomous consumption increases equilibrium income.



(b) Investment is the purchase of capital goods. An increase in investment is an injection into the circular flow which triggers a multiplier process. The process is based on the relationships between income and spending. One person's spending is another person's income. More income leads to more spending. The size depends of the process depends on the marginal propensity to consume – the proportion of extra income is spent within the domestic economy.



Chapter 4 (Cycles)

Chapter 5 (Market failure and objectives)

Chapter 6 (Unemployment)

Qu	Ans	Explanation
4	D	The worker who leaves their job has to stay active in the labour force to be counted as unemployed.
15	B	Cost-push inflation shifts the AS curve upwards. The new equilibrium for the economy is at a lower level of real GDP. Cyclical unemployment will rise as a result.

Question 28

(a) (i) $U \text{ rate} = \frac{\text{unemployed persons}}{\text{labour force}} = 4.88\%$

(ii) $\text{Participation rate} = \frac{\text{labour force}}{\text{civilian population}} = 63.46\%$

(b) There was a recession in 1900/91. Since then cyclical unemployment has fallen due to steady and sustained growth, which in turn is the result of a smart combination of a monetary policy led demand management and microeconomic reform led supply-side policy mix.

Classical unemployment has fallen because of closer links between pay and productivity (as a result of labour market reform).

Hardcore or residual unemployment has fallen as the government pushes the concept of mutual obligation (e.g. work for the dole) and makes it harder for people to 'cruise' (e.g. by having tighter qualifications for welfare payments).

Note that these have more than offset possible rises in structural unemployment (trade liberalisation, new technology, restructuring early pains of microeconomic reform measures) and frictional unemployment.

(c) It is unlikely to go down much further. The overall rate of unemployment is just under 5%, at a level believed to be below the current level of the natural or non-accelerating inflation rate of unemployment (NAIRU). If demand continues to rise (without a supply side

change) then wage inflation will rise, the economy will slow and unemployment will rise again.

Unemployment can go lower if supply-side reforms are continued. WorkChoices was designed to provide a close link to pay and productivity (to increase the 'world-of-truth' into the labour market). Further labour market reform may depend on the High Court and result of the next election. Extra migration of skill workers might increase the labour force, and government measures such as the superannuation changes may increase the participation rate. If the Australian and world economies were to slow then the unemployment rate would not fall.

Chapter 7 (Inflation)

Qu	Ans	Explanation
7	D	A fall in the value of the \$A increases import prices.
19	B	Borrowers gain assuming the nominal interest rate does not fully reflect the rise in prices.

Question 29

(a) There are four main causes of inflation. Inflationary pressure was being applied by three of these. First demand-pull inflation results from a narrowing of the GDP or output gap. The gap was being reduced by sustained (15 years) growth (linked to strong world growth, the resources boom and high levels of consumer confidence) but at the same time capacity constraints were holding back an expansion of aggregate supply.

As a result of the reduced GDP or output gap unemployment fell to 30-year low levels, arguably below the non-accelerating inflation rate. This created tight labour market conditions.

Second, there is cost-push inflation. Oil prices were rising and influencing costs in the distribution chain. Food prices were being affected by shortages due to drought and the impact of cyclones.

Credit was expanding with the interest rates being set at a mildly expansionary level. The Reserve Bank was, however, making it clear it was determined to keep to its 2 to 3% inflation target thus reducing inflationary expectations.

(b) Inflation has a detrimental impact on competitiveness, confidence and income distribution.

First, if our inflation rises above that of other trading nations our goods become price uncompetitive and net exports fall.

Second, consumers and business lose confidence and as a result cut back on consumption and investment. The resultant fall in aggregate demand reduces growth and increases unemployment.

Third, as some groups anticipate the inflation and some don't, and as some groups can make changes to their prices or incomes, inflation creates winners and losers. For example, unanticipated inflation benefits borrowers and hits creditors. People on fixed incomes (such as self-funded retirees) may lose out while workers in key industries may win compensating pay rises.

Also inflation triggers more inflation by setting off wage-price spirals.

So above target level inflation harms all of the macroeconomic objectives, worsening the external balance, increasing unemployment, slowing growth, arbitrarily redistributing incomes and ultimately fuelling more inflation.

Chapter 8 (Growth)

Qu	Ans	Explanation
5	A	Long term sustained growth is a supply-side process. Getting more out of your workers is a way to increase aggregate supply
6	A	GDP accounts make no allowance for the mix of goods produced.

Chapter 9 (Fiscal Policy)

Qu	Ans	Explanation
18	C	Monetary Policy may not work if the economy is in a recession. Fiscal Policy can give the economy a short-run boost.
21	A	It represents a government spending increase.
23	D	As economic activity rises and falls tax and government spending changes without any change in rates or policy.
24	D	The deficit may cause financial crowding out.

Question 26

(a) (i) An excess of taxation and other revenue receipts over government spending. ($T > G$)
(ii) The government has paid back (Labor's) debt and now established the Future Fund to cover their liability for public servants' pensions. The examiners allowed people to talk about infrastructure spending and tax cuts (but this would erode the surplus).

(b) Budget surpluses are part of the medium term fiscal strategy (pay off debt, keep taxes down to 1996 levels, keep share of government spending as component of GDP steady).

Therefore, the surplus is a matter of policy.

Secondly, strong economic growth has contributed to the surplus through automatic stabilisation (for example more income tax collected and less spending on welfare as employment rises).

Thirdly, tax collections have risen due to bracket creep. Without a change in tax rates people pay more tax as their money incomes rise.

Fourth, the government has undertaken asset sales (e.g. Telstra)

Finally steps have been taken to reduce tax evasion (e.g. tax file numbers, PAYG etc).

(c) Mr Costello is guarding the budget surplus. There are a number of reasons he would want to do this. First, to avoid financial crowding out, a situation where government borrowing adds to pressure on interest rates. Second, this is consistent with the medium term fiscal strategy to reduce government debt (and to avoid the interest bill on that debt). Third, the surplus allows the creation of the Future Fund to help meet the future government liabilities linked to public servant pensions and an ageing population. Fourth, a budget surplus may be seen as a sign of good fiscal management by overseas investors, which leads to a stronger exchange rate and foreign investment inflows. Finally, the surplus may reflect strong economic growth – the Treasurer would not want to shift to an expansionary fiscal policy in such circumstances. He is keen to rebalance the economy, so that investment and exports rather than consumption drives economic growth.

Chapter 10 (Monetary Policy)

Qu	Ans	Explanation
20	D	Both lower interest rates and increased government spending raise the level of AD and hence real GDP

Chapter 11 (MER)

Qu	Ans	Explanation
16	B	Trade liberalisation is one feature of microeconomic reform.
25	A	B, C and D all lead to improved efficiency. Answer 'A' leads to a rise in production.

Question 30

The macro-managers will want to increase growth and reduce unemployment.

There are three main policy weapons available, monetary, fiscal and microeconomic reform policies. The mix of policy measures is important but the Reserve Bank, the Fair Pay Commission and the world trade organisations (such as WTO and APEC) are independent of government and the policy mix may not be coordinated well.

Growth can be achieved by corresponding increases in aggregate demand and aggregate supply.

Expansionary monetary policy involving reduced cash rates will lead to an expansion in aggregated demand through the transmission process, albeit after an effect time lag. An expansionary fiscal policy in the form a decreased budget surplus could be used to support this rise in aggregate demand.

Sustained growth requires a rise in aggregate supply. Microeconomic reform is the key policy here. Microeconomic Reform has a wide scope covering areas such as reform in financial markets (e.g. greater competition), reform in product markets (e.g. privatisation), infrastructure development (e.g. extending facilities at Dalrymple Bay), labour market reform (such as weakening trade unions and changing the way pay is fixed), international trade reforms (such as tariff cuts) and taxation reform (such as increased tax thresholds and reduced tax rates). The emphasis is on increased efficiency and productivity.

Increasingly fiscal policy is being used to support microeconomic reform (e.g. to fund infrastructure and education initiatives) rather than as a demand-side policy tool. This new emphasis reflects the problems of running budget deficits (with their potential impact of interest rates and the confidence of overseas investors).

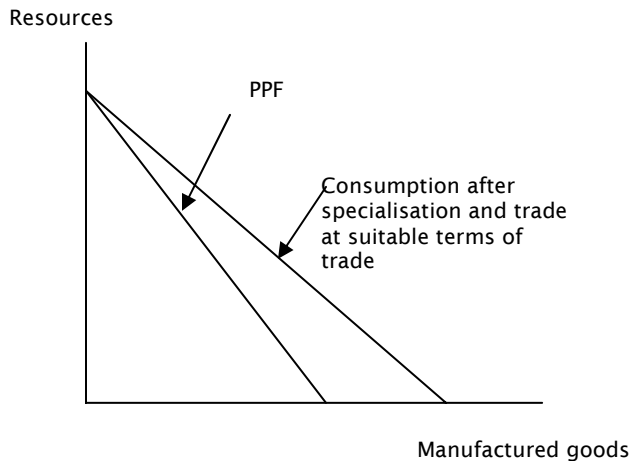
Growth in demand will not reduce all types of unemployment. Changes in the operation of the labour market (such as introduction of workplace agreements and a new fair pay commission) aim to reduce classical unemployment while changes to welfare arrangements (such as tougher job-search requirements and work for the dole schemes) reduce the level of residual unemployment. Other initiatives such as better job information, mobility grants and new home owner grants may reduce frictional unemployment.

Chapter 12 (Trade liberalisation)

Qu	Ans	Explanation
8	B	Any regulation or control on free market economies reduces efficiency and therefore reduces living standards.
10	C	China is only 50% as efficient at producing food compared to Australia, but is 83% as efficient in producing clothing.
13	A	Countries specialise in areas of production in which they are efficient. Specialisation allows reductions in unit costs as a result of a larger scale of production.

Question 33

International trade is beneficial because it allows Australia to live outside its production possibility frontier. By specialising in the production of goods and services in which we are relatively efficient (where opportunity cost is relatively low) the allocation of resources is improved.



It is also possible to show the gains from trade using a table of production possibilities or by drawing the tariff diagram and showing the gain to net welfare.

There are dynamic gains from trade as well. Trade increases competition and forces domestic to be more efficient if it is to stay competitive. Prices are held down and consumer choice is increased.

There are some downsides to trade to consider. Freer trade may lead to structural unemployment or impact on strategic or sensitive industries. Trade may allow goods to be 'dumped' leading to the collapse of an otherwise viable industry. The increased material standard of living resulting from free trade may be achieved at the expense of other factors (e.g. the exploitation of workers in other countries, supporting countries with poor human rights records).

Chapter 13 (Balance of Payments)

Qu	Ans	Explanation
9	C	The fundamentals of the Australian economy have improved, and our products have become relatively more competitive.
11	B	By definition
12	D	The trade balance reflects the imbalance between savings and investment.

Chapter 14 (Foreign Investment and Debt)

Question 27

(a) (i) About 48% of the total, therefore close to \$384b

(ii) Public debt is the lowest line on the graph. The public debt percentage of the total debt was about 30 to 35%.

(b) Costs of foreign debt include (i) interest payments (which are recorded in the net incomes deficit on the current account of the balance of payments, (ii) it adds to potential instability because they can be withdrawn if overseas investors become worried about the future value of their investment, (iii) if borrowed by the government may represent a burden to future generations. The benefits include (i) it helps finance the current account deficit and therefore protects the value of the \$A, (ii) it helps finance expansion in productive capacity with in turn may help improve the economy's external balance, (iii) it may help introduce new technologies (embodied technological progress).

(c) Total debt levels have been rising as a percentage of GDP, but the growth is mainly private sector debt. This is recorded as a credit on the financial account of the balance of payments. There has to be a corresponding deficit on the current account (given a floating exchange rate). The debt creates an outflow of interest recorded in the net incomes section of the current account. The use of overseas' savings may help boost production and in turn boost exports of goods and services (or provide substitutes for imported goods and services). If however the debt finances unproductive investments (e.g. in existing houses) it may cause asset price inflation.

Question 31

(a) Define foreign investment (changes in the stock of assets in Australia owned by non-residents). Foreign investment can be (i) portfolio (less than 10% ownership) or (ii) direct (more than 10% ownership). There are other flows involving financial derivatives (e.g. hedging arrangements and junk bonds) and movements of reserve assets. Investment can be in the form of debt (borrowing) or equity (shares). Investment flows can be public (official or government) or in the private sector.

(b) These flows boost Australia's savings. We are capital starved (because of a relatively low savings ratio and small population) but resource rich. The impact on growth depends largely on the uses to which the imported savings are put. Investment in productive industry (such as mines in West Australia) helps boost exports and investment in infrastructure helps reduce capacity constraints and allows the exports to get to overseas markets. The investment is a direct injection into the circular flow (as well as the cause of indirect injections such as infrastructure spending and higher exports) will lead to multiplier and super-multiplier effects which increase growth.

Direct flows allow firms to introduce new management practices and build technological developments into their production processes.

However, there are outflows of interest, dividends and profits which increase the current account deficit and cause money to leak from the circular flow. The foreign investment inflows raise the value of the \$A and make exporting harder. Investment flows attracted to specific industries (e.g. resources) may push to \$A too high for other sectors of the economy (e.g. clothing) causing these industries to suffer from the so-called Dutch Disease.

Also the foreign investment might be channelled into property which does not raise the capacity of the economy and leads to house price inflation.

Chapter 15 (Terms of Trade)

Chapter 16 (Exchange Rates)

Qu	Ans	Explanation
14	A	As the currency falls import prices rise. If elasticity is low we go on buying the more expensive imports. The extra export sales from lower foreign currency prices do not compensate for the higher import bill.
