Examination feedback – June 2006

Q	A	Comment
1	B	Current data has inflation at 3%, Growth just under 3%, and unemployment just over 5%
2	C	They are relaxed about the current account deficit, let alone the trade balance.
3	C	A shift in the Phillips Curve suggests a structural or supply side change – higher natural rate of unemployment
4	D	Investment is an injection – a decrease in the budget surplus is a net injection too
5	C	Total leakages must equal total injections. If T > G (budget surplus) and M > X then S must be < I
6	A	Strong growth leads to inflation risks and a rise in import purchases
7	C	C is the best answer. B is wrong because there is just one autonomous spending change that sets the multiplier off.
8	D	Final change is spending change x multiplier coefficient (which is 1/1-mpc). Change for D only 30 x 2 = 60, change for C is 62.5, change for B is 66.7 and change for A is 75.
9	A	Add up the injections (G = 40, I – 80), add up the leakages (T = 40, S = 100). More leakages than injections so the level of economic activity falls. Consumption (c) is not a leakage nor an injection.
10	C	When income rises by 75, consumption rises by 50. MPC = 50/75 = 0.67, so MPS = 0.33. Multiplier is 1/mps = 3
11	B	Downturns or slumps happen quicker than recoveries.
12	B	Consumption is a function of income and wealth.
13	B	Calculate inflation (5%, 3%, 1% and 3% respectively – change in index divided by starting value). For real rates subtract inflation from nominal rate. Real rate stays at 2% each year.
14	C	Capacity constraints (labour shortages, infrastructure bottlenecks) make the AS curve close to vertical. Any change in demand is reflected in higher prices.
15	D	More debt increases the impact (bigger loss of cash flow, more likely to respond to change in climate)
16	A	Cash rates fall and that triggers the transmission mechanism
17	A	AD falls, so there will be more unemployment but less inflation
18	C	A is wrong (household production is not included), per capita measures do take into account population, real does adjust for inflation so correct answer must be C
19	A	Long term growth requires an increase in the capacity or ability of the economy to supply more products
20	C	C is part of their MTFS. They wanted to keep taxes at their 1996 level, not interest rates – so D is wrong
21	B	The emphasis was on increased emphasis and promoting savings – good for economic efficiency. Tax cuts went mainly to the higher income groups
22	B	The surplus got bigger in 2004-05. This is a net leakage from the flow compared to the previous year
23	C	Higher rates reduces consumption (more is saved, less cash flow, lower wealth, change to climate)
24	D	The policies work in opposite directions and will, therefore, tend to cancel each other out
25	B	More borrowing increases demand for loanable funds and increases interest rates. This is known as financial crowding out.

Question 26
(a) (i) About 2% - look at GDP line on graph; (ii) Negative net exports, a balance of trade deficit (see graph)

(b) Identify Consumption (C); Investment (I); Government Spending (G) and net Exports (X-M).
Describe each in turn.

(c) Rebalanced growth = more business investment and better export performance, 'softer' household consumption, housing investment and government spending. (The text by the graph says this).
This is better because investment raises aggregate supply (as well as aggregate demand), and a trade deficit acts as a drag on GDP growth. The government will not have to do worry about doing anything else to improve the external trade position.

Question 27
(a) (i) 3% - it says so in the text; (ii) 151.9 (Add 0.9% onto 150.57).

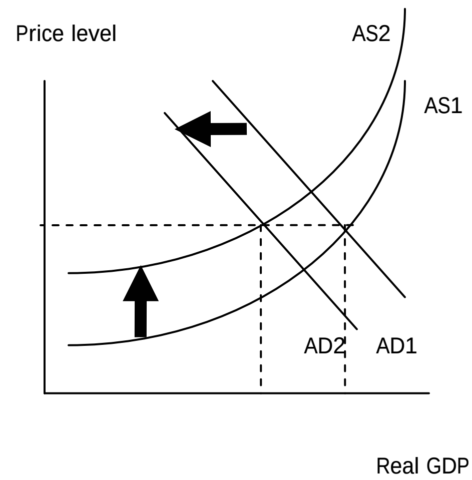
(b) Cheap imported manufactured products from China have helped reduce clothing and footwear and household contents and services. The extra competition from overseas will keep Australian prices low as they try to compete with the cheap imports. The rise in commodity prices has pushed up Australia's exchange rate which has reduced the price of imports. Demand for energy has pushed up the price of oil (but this is not on the chart).

(c) The target = 2% to 3% rise in CPI or 'core inflation' averaged over the economic cycle.
Why is inflation bad for the economy?

- Inflation leads to more inflation (expectations, wage price spirals)
- Inflation leads to unemployment (lowers consumer and business confidence which lowers aggregate demand, hits exports, makes imports more competitive)
- Inflation slows growth (loss of confidence by households and business, worse net exports as we become uncompetitive, interest rates rise in money terms)
- Inflation worsens balance of trade (harder to export, more attractive to import)
- Inflation leads to an arbitrary redistribution of income (list some winners and some losers)

Question 28
(a) (i) $250b (difference between equilibrium GDP and full capacity); (ii) 2, rise in GDP was $100b following an autonomous injection of $50b.

(b) Aggregate demand slopes down to the right because:
- o there is a wealth effect (higher prices reduce the real value of peoples' wealth so they spend less)
- o money interest rates rise as prices rise (so people may save more and invest less)
- o the economy becomes less competitive as prices rise (harder to export, more attractive to import)



(c) A rise in the price of oil shifts the AS curve upwards (more expensive to make plastics, fertilisers, more expensive to transport products). AD curve may shift to the left (loss of confidence by households and businesses, more expensive imports). Net result is fall in real GDP (economic activity) and some inflationary pressure (but not that much).

Other things are not equal, however. Oil prices have risen because of strong global demand (which helps keep the AD curve to the right), some of the oil prices are being absorbed by producers and supply-side reforms are keeping the AS curve down.

Question 29
(a) Explain the economic meaning of the term 'injection'. What kinds of injections are there in the Australian economy? (6 marks)

Define 'an injection' – spending that is not financed out of current income or income received by households or firms within the circular flow that was not induced by spending within the flow.

Injections come in three forms:
(1) Investment – purchase of capital or producer goods e.g. spending by business on buildings, machinery and equipment, spending by households on new homes
(2) Government spending –e.g. infrastructure spending, welfare spending
(3) Exports – e.g. mineral and energy exports.

Of these investment tends to be the most unstable, followed by exports and then government spending.
Drawing a circular flow diagram is acceptable.

(b) Explain why such an injection may lead to a more than proportionate increase in the level of real output. (9 marks)

Give an example of an injection happening (eg Commonwealth Games, City to Mandurah rail project). Then describe the multiplier process. The process is based on one person's spending is another person's income, and the receipt of income leads to further spending. The size of the process depends on what is passed on in the flow each time (stress importance of marginal propensity to consume).

Give an example. Assuming mpc = 0.75, autonomous injection of $64b leads to $64b extra income which leads to $48b extra spending. This in turn creates $48b extra income and this induces $36b extra spending and so on. The final change in income will be x4 the autonomous injection in this case, rising by $256b.
You were not asked for a Keynesian Y=Ex graph but you could have drawn one.

Question 30
(a) Describe the relationship between growth and unemployment. (7 marks)

Define growth and unemployment.
Growth will affect different types of unemployment in different ways.
- o Demand deficiency (general, cyclical) unemployment falls with growth.
- o Structural unemployment may rise (in short run) as a result of growth (technology, change in pattern of demand)
- o Classical unemployment may rise if growth is not accompanied by extra supply of skilled labour (wages rise).
- o Residual (hardcore) unemployment may fall (fewer people 'discouraged')
- o Frictional unemployment may rise (more people more confidence about trying to change jobs)

So growth can be 'jobless' growth if productivity rises and there is extra structural unemployment. The unemployment rate may not fall if there is a rise in the labour force (rise in participation rate with fewer discouraged workers, more migrants).

Summed up in Okun's Law. The rate of unemployment will not fall even if there is 4% growth if there is a 2% rise in productivity and a 2% rise in the labour force.

(b) To what extent may the pursuit of lower unemployment conflict with other economic objectives? (8 marks)

Topical reference – 30-year low level about 5% (at or below NAIRU level)

This level could cause some inflation wage-push inflation (labour shortages, especially in skilled areas eg, mining).
Workers may feel they have extra monopoly power in their labour market. Draw a Phillips Curve.
Inflation in turn is bad for growth and trade balance objectives.
Does not conflict with welfare objectives and is good for income distribution.
Encourages people to enter the labour force – increases participation rate.

Question 31

(a) Describe the Australian Government's medium term budgetary (fiscal policy) strategy and the reasons for adopting this strategy. (7 marks)

Define fiscal (budgetary policy) – use of taxation, government spending (and borrowing) to manage economic outcomes.

MTFS linked to the Charter for Budget Honesty introduced by Liberal-National coalition in 1996.

Overall aim is for 'structural neutrality' over the economic cycle – raise enough taxation to pay for the structural spending of the government (for income redistribution, direct provision of products, regulatory activities).

At present the government interprets or amplifies this aim by stressing:

(1) running surpluses while the economy is growing well (15 years of growth, big shift in terms of trade, boost to company profits)

(2) keeping taxation levels at or below 1996 levels (now around 23% of GDP)

(3) increasing the government's net worth (public debt now eliminated – building up future fund)

This is seen to be important because:

- Longer term planning provides some stability and takes it (to a degree) out of the political domain
- Small government seems to be the preference of the majority of Australians (although a vocal minority push for more services and higher taxes)
- Surpluses eliminate the debt (and save the $8b a year interest) and provide for a future fund
- Surpluses help keep interest rates relatively low (no financial crowding out)
- Surpluses boost national savings (and reduce the need for foreign capital inflows)

(b) Analyse the extent to which changes in the May 2006 budget conform to the principles of taxation. (8 marks)

State the principles of taxation

- Efficiency (do not have a negative impact on the performance of the economy)
- Horizontal equity (taxpayer in the same circumstances should pay the same level of tax)
- Vertical equity (taxpayers with a higher ability to pay should pay proportionately more in tax)
- Simplicity (leads to economy in collection, certainty in tax liability)

Tax changes in the budget included:

- Changes to income tax (marginal tax rate reductions, bracket thresholds increased)
- Changes to exit taxation of superannuation
- Changes to company tax (accelerated depreciation to encourage investment)

Analysis

- High incomes households gained the most in dollar terms for income tax cuts – suggests this does not conform to vertical equity principle
- Reducing tax rates to bring them into line with OECD and regional economies is efficient – stops a 'brain drain'
- Lower tax rates might reduce some tax avoidance and evasion – increases horizontal equity
- Encouragement for savings within superannuation is efficient and makes thing s more simple.

Question 32

(a) Describe the impact on the Australian economy of a rise in Australian cash rates. (7 marks)

Explain 'cash rates'

Impact on the economy involves the transmission mechanism.

Once cash rate changes have been reflected in changes in other interest rates there are five channels through which transmission mechanism operates:

(1) Savings and Investment decisions may be changed (S)

(2) Exchange rates may change (other things like commodity price fluctuations being equal) (Ex)

(3) Cash flow of households (and businesses) with outstanding flexible interest loans will change (C)

(4) Asset values will change (share, housing and bond prices all have an inverse relationship with interest rates) (A)

(5) Monetary climate will change (the media transmit gloomy or encouraging messages about economic performance) (M)

These changes will impact on the various components of aggregate demand (C + I + G + X – M). Changes in aggregate demand impact on the macroeconomic objectives (growth, unemployment, inflation, external balance and the distribution of income).

The strength of the separate transmission mechanism channels seems to vary from time to time but overall the relationship between interest rates and components of aggregate demand seems predictable. At present the cash flow changes seem important because of high levels of household debt, asset price changes are important (note reaction of house prices and share prices recently) and the general economic climate is subject to increasing influence by expanded media coverage.

(b) Describe why the Reserve Bank raised cash rates in May 2006 and the likelihood of the Reserve Bank Board increasing interest rates again in the next few months. (8 marks)

Set scene: Cash rates raised by 0.25% in May 2006, previous rise had been in March 2005.

RBA has an inflation target – keep CPI increases (or core inflation) between 2% and 3% over the life of the economic cycle. They aim to anticipate economic problems and make small pre-emptive strikes to avoid the need for bigger rate changes in the future. They were worried about inflation risks (wages rising a bit faster with skill shortages and a low unemployment rate, oil prices feeding into the distribution chain, falls in the exchange rate, strong global demand, strong consumer confidence and business investment, exports picking up).

Will there be another rise?

Yes if budget is seen as over-expansionary, yes if cost-push inflation rises, yes if the stock market and commodity price correction is mild.

No if budget is seen to be OK and people save their tax cuts, no if capacity constraints ease, no if the economic climate changes for the worse as a result of a big stock market correction and significantly weaker commodity prices (e.g. cheaper oil, cheaper copper).

In general:

Define all economic terms in questions, and terms you introduce.

Write SEE paragraphs: STATE the point, EXPLAIN the point, give an EXAMPLE.

Write with a clear logical structure:

- There are three reasons why…
- The first reason is…
- The second reason is…
- The final reason is…

Show knowledge and awareness of contemporary economic and political developments

Draw, a clearly label, diagrams whenever possible (and relevant)

If the question is asked in two (or more) parts keep your answers in the same parts