ECONOMICS

**ECO 3A & 3B**

**PRACTICE MOCK #2**

#### Time allowed for this paper

Reading time before commencing work: ten minutes

Working time for paper: three hours

**Marking Key**

**Section One: Multiple-choice 24% (24 Marks)**

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| --- | --- |
| **Question** | **Answer** |
| 1 | A |
| 2 | C |
| 3 | D |
| 4 | B |
| 5 | B |
| 6 | A |
| 7 | D |
| 8 | C |
| 9 | C |
| 10 | A |
| 11 | A |
| 12 | D |
| 13 | B |
| 14 | B |
| 15 | D |
| 16 | C |
| 17 | A |
| 18 | B |
| 19 | C |
| 20 | D |
| 21 | A |
| 22 | D |
| 23 | C |
| 24 | A |

**Section Two: Data interpretation/Short response 36% (36 Marks)**

**Question 25 (12 marks)**

(a) (i) Total imports is shown by Q1Q3. (1 mark)

(ii) When the price is Pw (world price) the consumer surplus is represented by the area R + S + U + V. (1 mark)

(iii) Explain what is meant by total surplus. (1 mark)

* Total surplus refers to the net benefits to society from the production and consumption of goods and services. It is consumer surplus + producer surplus. It therefore signifies the benefits to consumers and exporters the benefits of trade.

(b) Using a model of demand and supply, show how total surplus is affected by the imposition of a tariff. (3 marks)

* A tariff is a tax imposed on imported goods.
* A tariff increases the price of imported goods that therefore raises the price that domestic goods, which are unable to compete against the lower priced imports, can be sold for.
* A tariff will see the total surplus falling by areas I and K which indicates the deadweight loss.



(c) Explain how a country such as Australia can benefit from both importing and exporting goods and services. (6 marks)

* Australia produces goods that it has a comparative advantage in i.e. it can produce those more efficiently than can other countries.
* If it has a comparative advantage then it should export those goods.
* Other countries have a comparative advantage in some goods, therefore we should import those goods which are cheaper in price.
* When we have a comparative advantage the domestic price is below the world price.
* Exporting results in increased total surplus for Australia – consumer surplus falls but producer surplus rises by more, therefore total surplus increases.
* U + V is the increase in total surplus.



* When other countries have a comparative advantage the world price is below our domestic price.
* Importing results in total surplus increasing with consumer surplus rising by more than producer surplus falling, therefore total surplus increases.
* Area I is the increase in total surplus.



**Question 26 (12 marks)**

(a) (i) Identify two industries that have had the largest reduction in protection.

(1 mark)

* Wearing apparel and motor vehicles

(ii) Identify which sector in the Australian economy has had the most significant reduction in protection. (1 mark)

* Manufacturing

(b) Explain what is meant by ‘trade intensity’. (2 marks)

* A measure of the total value of exports and imports of goods and services as a percentage of GDP.
* Exports + Imports x 100 = Trade Intensity Ratio

GDP

(c) Explain how trade liberalisation has contributed to globalisation. (3 marks)

* trade liberalisation refers to the freeing up of world markets.
* it takes the form of international organisations such as GATT, WTO, IMF, World Bank encouraging trade, reduced protection.
* regional trading groups such as APEC, ASEAN, EU have been encouraged.
* agreements such as FTAs have also flourished.
* pressure on developed countries to reduce protection such as tariffs, quotas and subsidies has led to increased trade between countries

(d) Evaluate two arguments in favour of protection. (5 marks)

* protection is any govt action that gives domestic producers an artificial advantage over foreign producers.
* the main types of protection are tariff, subsidy, quota.
* infant industry argument

- firms in the early stages of their development.

- faced with initial high set up costs due to economies of scale.

- expectation is for these industries to develop and improve their efficiency over time – they may not have a comparative advantage yet but will in the future.

- Japanese motor industry is an example.

* diversification argument

- to avoid specialising in a few industries.

- avoids relying on a select few industries and therefore broadens the base.

- the aim is for industries to become more efficient but in the meantime there is revenue from a wider range of industries.

- Aust producing more than just minerals and wheat and sheep – as well manufacturing, services, etc.

* dumping argument

- occurs when overseas firms sell their goods at a below cost price in another country it does not normally trade with.

- may occur due to overproduction of a good.

- the dumping firm is engaging in unfair competition.

- destroys in the short term the domestic market.

* national defence/self-sufficiency argument

- especially after world war II.

- not be reliant on other countries who you may not be able to trade with if they have poor economic or seasonal conditions or if in conflict.

- Aust developed motor industry after WWII.

* increased employment argument

- buying imported goods is providing employment to overseas workers at the expense of local employment.

- domestic consumption is on cheap imported goods and not local produced goods.

**Question 27 (12 marks)**

(a) (i) The economic concept of the multiplier is being discussed in this article. (1 mark)

(ii) The injection into the economy from hosting the FIFA World Cup is anticipated to be $36 billion. (1 mark)

(b) Identify and outline which components of Aggregate Expenditure would be affected by hosting the FIFA World Cup. (4 marks)

* Investment – need for increased grounds, improved airports, roads and rail, improved telecommunications, hotels, etc
* consumption – incomes from increased employment would be higher and households would therefore spend more.
* export earnings - from inflow of 500,000 tourists who would be paying for air flights to and around the country, bus travel, taxi, train travel, hotels, meals, sight seeing sights, etc
* government expenditure – required to install some new infrastructure from the increased demand for services. Also govt would receive much more revenue due to increased income tax receipts, company tax receipts and GST receipts.

(c) Illustrate and explain why it could be said that the economic effects of such a stimulus generated by hosting the FIFA World Cup may depend on where the Australian economy is on the business cycle. (6 marks)

* increase in investment and exports will lead to increases in AD/AE.
* this will have a multiplier effect throughout the economy, leading to a larger increase in income than the initial increase in expenditure.



* trade cycle shows where the economy is at in regards levels of economic activity, indicating phases of booms, followed by downswings, troughs and then upswings.
* size of the multiplier is determined by the size of the mpc – multiplier = 1
* 1 – mpc
* at the trough the mpc is low due to low consumer confidence therefore there will be a small multiplier effect.
* if the economy is closer to the peak then the mpc is higher due to greater confidence therefore a larger multiplier effect.



**End of Section Two**

**Section Three: Extended response 40% (40 Marks)**

Question 28 (20 marks)

(a) Account for the increase in Australia’s terms of trade in recent years. (10 marks)

* ToT is a ratio of export prices relative to import prices.
* ToT refers to export prices relative to import prices.
* ToT can increase - if export prices increase relative to import prices, export prices stay same and import prices fall, etc.
* Major exports are fuels and minerals which are determined by world demand.
* World demand, especially China has been massive, leading to large demand (and therefore prices) of Australia’s exports.
* Price of imports have fallen as there has been rapid technological development and competition in manufacturing.
* China has grown in importance as a trading partner for Australia and had a major impact on value of our imports.
* During GFC of late 2007/2008 Australia’s ToT fell due to fall in demand from world including China.

As GFC faded ToT have increased again due to higher export prices.

(b) Explain why, despite Australia experiencing an improving terms of trade, its current account deficit has not shown the same improvement. (10 marks)

* Terms of trade is a ratio of export prices relative to import prices.
* ToT indicates how much imports can be purchased with a given amount of exports sold.
* Over the last 10 years (except during GFC) Australia has been experiencing rising ToT due to rising export prices and falling import prices.
* The price of exports determines value of exports and price of imports determines value of imports.
* If ToT increase then value of exports should increase relative to value of imports purchased.
* However value of exports and imports is only one factor that determines CAD.
* CAD is also made up of value of net services, value of net income and value of net current transfers.
* Net exports have generally been rising but so too has net imports due to rising demand for capital goods and consumer goods. This therefore negates increases in export earnings.
* Net income has been rising rapidly too due to large borrowings and foreign investment into Australia to pay for CAD and to fund mining boom.
* Large dividend repayments and interest payments have led to increases in net income deficits and CAD.
* Capacity constraints have also inhibited export sales with bottlenecks in transport of goods and issues such as long widespread drought. This has inhibited export output.

Question 29 (20 marks)

With the onset of the global financial crisis in mid-2007 the value of the Australian dollar has fluctuated widely.

(a) Illustrate and explain why this large fluctuation in the value of the Australian dollar would have occurred. (12 marks)

* Aust exchange rate flexible/free/floating type – determined by demand for $A and supply of $A.
* When GFC occurred, demand for $A fell, causing a depreciation of $A.

- confidence around the world fell therefore little FI,

- investment in Aust fell therefore less demand for FI,

- Profits fell in Aust therefore less return for FI,

- RBA reduced interest rates therefore less return therefore less FI,

- Aust’s CAD improved therefore less need for FI to finance it,

- US financial organisations recalled overseas funds therefore increased demand for $US

and less for other currencies.

* July 2007 $A1 = $US0.97, after depreciation, December 2007 $A1 = $US0.80
* On diagram below demand for $A fell fro D$A1 to D$A2 therefore depreciation.



* As GFC began to ease, demand for $A began to increase
* - Aust recovered quickly from GFC – improved consumption therefore prospect of better return improved,

- RBA has been increasing interest rates, increasing interest rate differential,

- CAD worsening again therefore need to finance from FI,

- investment picking up therefore greater need for FI,

- increased confidence of future therefore increased FI.

* August 2010 $A1 = $US0.91.
* From diagram below, increased demand for $A moves demand to D$A2 from D$A1, leading to appreciation to $A! = $US0.91.



(b) Outline the impact of an appreciation of the Australian dollar on the Australian economy. (8 marks)

* When appreciation of $A there are several effects:

- price of imports become cheaper – may increase the quantity which would worsen our CAD. This will reduce the inflationary pressures with lower prices for consumer goods and capital goods.

- should prevent the development of domestic firms that are now less competitive due to lower priced imports. This would decrease employment in those areas.

- price of exports increase to overseas therefore if price elastic we will sell less and earn decreased export earnings – this will worsen our CAD. This should decrease employment in these industries.

- Valuation effect – as large amounts of Aust debt is repaid in overseas currencies appreciation makes the payments less expensive as less $A are needed. Decreases our debt payments.

* There are sectors that gain and sectors that lose when the currency appreciates.

Question 30 (20 marks)

In announcing the pause in interest rate increases in August this year the Reserve Bank of Australia identified both positive and negative factors that could influence the Australian economy. These were:

1. Measures taken by the Chinese authorities to slow the growth of their economy might be too effective.

2. Mining companies might increase their investment more than anticipated, putting pressure on the economy’s productive capacity.

(a) With reference to both factors, explain how each would impact on the Australian economy, using the AD/AS or Keynesian model in your explanation. (10 marks)

* The RBA uses monetary policy to control the level of aggregate demand/expenditure in the economy. This involves controlling the level of interest rates in the economy through the cash rate.
* The first measure refers to the fact that Chinese authorities have been deliberately slowing the growth rate in China due to fears of increasing inflation through both cost push and demand pull factors. These efforts may have led to the slow down being larger than anticipated.
* Slowing the Chinese economy would result in less demand for imports – coal, iron, natural gas and other resources from Australia.
* Decreased demand for Australian imports will reduce the level of export earnings for Australia, lowering AD/AE therefore lower employment/higher unemployment, lower output/economic growth and increasing CAD.

 

* The second measure suggests that if mining companies expand their investment this would raise the level of AD/AE to a point that could lead to inflationary pressures in Australia due to capacity constraints.
* The AS is not able to, at least in the short run, increase sufficiently to keep pace with the level of AD. The AE would increase beyond full employment and move into an inflationary gap.

 

(b) Explain how the economy reaching its productive capacity could impact on the government’s economic objectives. (10 marks)

* There are a number of economic objectives the government aims to achieve

- sustainable economic growth - low inflation (price stability)

- low unemployment (full employment) - more equitable income distribution

* Governments aim to achieve all but their priority often changes depending upon the current economic circumstances.
* The Aust economy reaching its productive capacity would impact on each of the objectives.
* low unemployment would be easier to achieve as the economy is demanding as much labour as is available. Cyclical unemployment would disappear but frictional unemployment would rise.
* economic growth would have risen but upon reaching productive capacity there is no more capability of increasing output therefore economic growth will fall.
* inflationary pressures would rise as demand pull factors caused by increasing AD force up price levels.
* Cost push factors would also rise as demand for resources is high and causes their price to also rise.
* income distribution is likely to be improved with lower levels of unemployment, however inflationary pressures will lead to some groups (fixed income earners, pensioners, etc) becoming worse off due to falling real incomes and loss of value of money assets.
* Policies would need to be implemented in order to bring down the inflationary pressures

- monetary policy in short term to reduce AD.

- fiscal policy to reduce demand pressures and increase supply.

- MERs to improve efficiency of production and increase supply.

Question 31 (20 marks)

Fiscal policy has always been at the disposal of governments. What has returned in the past couple of years has been the use of active, discretionary fiscal policy as a stabilisation tool to influence the level of aggregate demand. Recently, this has diminished as monetary policy has once again become the main tool for economic management.

Account for the changing mix of fiscal and monetary policy over the period 2006-2010, making use of appropriate economic models.

* Fiscal policy is the use of a budget by a government to control the level of government expenditure and government revenue in a year. This has a role in the stabilisation of the economy.
* Monetary policy is the discretionary policy implemented by the Reserve bank of Australia to affect monetary and financial conditions within the economy through interest rates. This also has a role in the stabilisation of the economy.
* In 2006 and most of 2007 Australia was experiencing rising AD/AE which led to decreasing unemployment, rising economic growth and rising inflationary pressures.
* Fiscal policy saw the automatic stabilisers aspect of the budget adding to government revenue through increasing taxation receipts along with falling levels of government expenditure. These resulted in growing budget surpluses and little/no government debt.
* Discretionary fiscal policy actions were more about increasing AS in the medium to long term through budget initiatives such as increasing technical schools, taxation changes and infrastructure development. Little discretionary action was taken to modify the levels of demand, though several years had seen tax cuts by both governments.
* Monetary policy was seeing interest rates gradually rising from the lows of 2002, endeavouring to restrict inflationary pressures.
* MERs were also being implemented to increase AS growth.
* Generally there was a contractionary policy mix in place.

 

* Onset of the GFC in late 2007 saw AD/AE fall rapidly due to decreased confidence, decreased investment, decreased exports, decreased consumption, decreased credit availability, etc.
* Rapid fall in AD/AE saw the world economies moving into deep recessions.
* Multiplier effect saw the fall in income even greater than the fall in spending.
* RBA reacted by reducing interest rates to record low levels in an attempt to make the cost of borrowing cheaper.
* Government reacted by initiating several fiscal stimulus packages, late in 2007 and early in 2008. Massive increases in spending to households, firms, schools, local governments, infrastructure.
* The aim was to stimulate spending by government in absence of investment and exports and cause a positive multiplier impact on the economy.
* Resulted in elimination of budget surplus and moving into growing budget deficits.
* These deficits required borrowing and therefore increased government debt.
* This reaction was based on the Keynesian view to stimulate spending and confidence.
* First time in many years the budget was used in a discretionary manner to fulfil stabilisation function.

 

**End of Section Three**