

Economic Growth

7

Multiple Choice

- | | | | | | | | |
|---|---|----|---|----|---|----|---|
| 1 | A | 6 | D | 11 | A | 16 | B |
| 2 | A | 7 | C | 12 | C | 17 | B |
| 3 | D | 8 | B | 13 | A | 18 | B |
| 4 | B | 9 | D | 14 | D | 19 | D |
| 5 | B | 10 | C | 15 | A | 20 | C |

Short Answers

Question 1

- (a) Aggregate demand is the total demand for goods and services within an economy. Aggregate demand is equal to the sum of consumption, investment, government spending and net exports. Aggregate supply on the other hand is the total productive capacity of an economy.
- (b) Economic growth leads to higher living standards, meaning that individuals are able to enjoy greater material well-being through increases in their disposable income. Economic growth also creates jobs in an economy and lowers cyclical unemployment. Higher demand for goods and services leads firms to increase their demand for labour as an input into production. Economic growth can also lead to higher levels of investment in an economy as business expectations improve. Increased investment generates additional economic growth, as well as expanding an economy's long run productive capacity. However, unsustainable levels of economic growth may also have negative consequences if demand outstrips supply, such as increased levels of inflation and faster growth in imports than exports, thus worsening the current account balance. Increased economic growth can also lead to a faster depletion of non-renewable resources and environmental harm, thus reducing the living standards of future generations.
- (c) As shown in the diagram, Australia's economic growth fell during 2008-09. This was a result of the slowdown in the global economy due to the global financial crisis and global recession. A sharp decrease in global demand reduced both the prices of Australia's commodity exports and export volumes. The collapse in business confidence around the world also resulted in reduced investment and greater difficulties in accessing loans for business investment. Australia's economic growth recovered after 2009. This can be explained in part by the recovery in Australia's exports, as well as by the government's large fiscal stimulus package, which boosted aggregate demand in the Australian economy. In addition, expansionary monetary policy supported higher consumption and investment, boosting the economic recovery.

Question 2

- (a) $k = 1/(1-MPC) = 1/(1-0.7) = 3.3$
- (b) The marginal propensity to consume is the proportion of each extra dollar of earned income that is spent on consumption. This is in contrast to the average propensity to consume which is the proportion of total income that is spent on consumption.
- (c) The multiplier determines the size of the overall increase in national income resulting from an initial increase in aggregate demand. A decrease in the simple multiplier will mean that a change in the level of aggregate demand will now have a smaller effect on the level of national income. If aggregate demand increases, for example through an increase in investment, the level of national income will increase by a smaller amount. If aggregate demand decreases, the level of national income will decrease by a smaller amount. This means that the economy is now less susceptible to external shocks like changes in net exports, however national income is now also less responsive to government fiscal policy.
- (d) In the long run, an economy's level of economic growth is determined by the interaction between aggregate demand and aggregate supply, with most economists believing that expanding aggregate supply is the key to sustained long-term growth. The level of economic growth increases/decreases when there is an increase/decrease in the quantity or improvement/decline in the quality of the factors of production. One factor that can influence the level of growth is therefore the discovery of new resources such as mineral deposits that can be extracted from the ground and sold overseas for use in manufacturing. This can increase our level of exports and hence GDP (until those resources are depleted). The changing quality and quantity of our labour force also affects aggregate supply. If the health of workers improves, or they acquire new skills through greater educational attainment, then the productivity of workers will increase, increasing the amount of goods and services produced in the economy. Increased levels of workforce participation will also expand an economy's productive capacity as a larger number of people are able to work and therefore a higher amount of goods and services can be produced. Long-term increases in aggregate demand – such as developing new export markets, increased consumer spending or higher levels of investment will also contribute to higher long-term growth.

Question 3

- (a)
$$\begin{aligned} \text{Real GDP}_2 &= \text{Nominal GDP}_2 / \text{CPI}_2 \times 100 \\ &= 560 / 1.05 \times 100 \\ &= 533 \end{aligned}$$

$$\begin{aligned} \text{Economic growth} &= (\text{Real GDP}_2 - \text{Real GDP}_1) / \text{Real GDP}_1 \times 100 \\ &= (533 - 500) / 500 \times 100 \\ &= 6.6 \text{ per cent} \end{aligned}$$
- (b) A decrease in consumer confidence, for example due to an expectation that economic growth will slow in the near future, will decrease the average propensity to consume and therefore decrease the total level of consumption. An increase in interest rates would also lead to a decrease in consumption. Higher interest rates discourage consumers from borrowing (for consumer spending, housing etc) and also make saving more attractive, thus reducing consumption.
- (c) Higher productivity of labour will on the one hand result in businesses choosing to use more labour intensive rather than capital intensive production methods as labour will be relatively cheaper. This will tend to result in lower levels of investment in the long run. However, higher productivity also encourages a higher rate of economic growth as businesses are able to produce more goods and services with the same amount of inputs. Higher economic growth in turn leads to increased levels of investment. Increased productivity of labour therefore has mixed effects on investment decisions, but in general economies with higher labour productivity can expect increased levels of business investment.

- (d) The government may use macroeconomic policy to raise the level of aggregate demand and increase economic growth in the short to medium term. The government can use expansionary fiscal policy, which raises the level of net government expenditure and increases aggregate demand. The multiplier effect states that this initial increase in government spending will increase disposable incomes, leading to higher consumption and a much larger overall expansion of aggregate demand. The government may also use monetary policy to lower interest rates and boost consumption and investment in the economy, increasing aggregate demand and economic growth. The government can also use microeconomic policy to improve productivity, efficiency and international competitiveness in the economy. This would increase the level of aggregate supply and increase economic growth in the long term. Examples of microeconomic policy include National Competition Policy, labour market reforms and deregulation of the financial sector.

Skills Revision

(going left to right)

Box 1

- $1 + G + X = S + T + M$
- $20 + G + 25 = 100 + 65 + 40$
- $G = 160$
- Government spending \$160 billion

Box 2

- $AD = C + I + G + (X - M)$
- $125 = 20 + 25 + 50 + (X - 40)$
- $165 = 95 + X$
- $X = 70$
- Exports \$70 billion

Box 3

- $I + G + X = S + T + M$
- $55 + 85 + X = 56 + 110 + 32$
- $140 + X = 198$
- $X = 58$
- Exports \$58 billion

Box 4

- $AS = AD = C + I + G + (X - M)$
- $95 = 15 + I + 10 + (35 - 25)$
- $95 = 35 + I$
- $I = 60$
- Investment \$60 billion

Box 5

- $I + G + X = S + T + M$
- $20 + 85 + 70 = 40 + T + 45$
- $175 = T + 85$
- $T = 90$
- Taxation \$90 billion

Box 6

- $AS = AD = C + I + G + (X - M)$
- $AS = 34 + 75 + 90 + (37 - 37)$
- $AS = 199$
- Aggregate supply \$199 billion

The Multiplier and Equilibrium**Table 2:**

- $MPC = 0.75$, $MPS = 0.25$
- $k = 4$
- Change in GDP = \$800m
- Equilibrium Income = \$2800

Table 3:

- $MPC = 0.6$, $MPS = 0.4$
- $k = 2.5$
- Change in GDP = -\$125m
- Equilibrium Income = \$6000

Table 4:

- $MPC = 0.9$, $MPS = 0.1$
- $k = 10$
- Change in GDP = \$1bn
- Equilibrium Income = \$1000

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