Practice Economics Extension Exam

Multiple Choice

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

Short Answers

Question 21

(a) Unemployment refers to the situation where an individual is not currently working but is actively seeking work. The unemployment rate is calculated as the number of unemployed people as a percentage of the labour force. Unemployment rate = 1.5/(11+1.5) = 0.12 = 12 per cent.

(b) The non-accelerating inflation rate of unemployment (NAIRU) refers to the level of unemployment at which there is no cyclical unemployment. It is made up mostly of structural unemployment. It is the lowest level of unemployment that can be achieved before inflation increases.

(c) Labour market programs such as skills policies can reduce structural unemployment by re-skilling or up-skilling people who are structurally unemployed. For example, in the 2012-13 Federal Budget the Government announced $1.75 billion in funding for the vocational education and training system through the National Partnership Agreement on Skills Reform.

(d) A decentralised system of wage determination can promote productivity growth by linking wage rises to productivity improvements. This ensures that nominal wage growth does not force businesses to increase prices, since they receive greater output from higher labour productivity. This allows workers to enjoy moderate real wage growth but ensures that inflation remains at a stable level. A decentralised system also improves allocative efficiency by allowing more efficient and profitable firms to offer higher wages and attract higher skilled employees. Another advantage is that decentralisation creates greater wage flexibility that prevents a high growth in one sector of the economy (eg during the mining boom) spilling over into higher wages across the whole economy.

Question 22

(a) Free trade refers to the situation where there are no artificial barriers imposed by governments that restrict the free exchange of goods and services between countries.

(b) Trade flows strengthen the influence of regional business cycles by strengthening the transmission of regional growth between different countries in the same economic region, such as countries that are part of regionally integrated production chains. Stronger growth in one economy will lead to increased demand for exports from another economy, boosting growth in the second economy. Investment flows within regions also mean that stronger economic conditions in one economy make it more likely that businesses in that economy will invest in new operations elsewhere in that region, boosting growth in the neighbouring country.

(c) One role of the World Trade Organisation (WTO) is to promote global free trade by providing a forum for negotiating trade liberalisation between member economies. The second role of the WTO is to resolve trade disputes between member economies, such as allegations of subsidies to exporters in breach of WTO rules.

(d) China is an emerging economy that has experienced the benefits of globalisation by promoting trade liberalisation. Since the 1980s China has engaged in a trade liberalisation program that has seen reduced trade protection, particularly for manufactured goods. China has also participated in global trade agreements such as the World Trade Organisation and regional forums such as ASEAN Plus Three. The Chinese government has fostered the development of large-scale manufacturing through the creation of Special Economic Zones, which has supported export-led development and boosted trade growth. These policies have seen China sustain double-digit economic growth for most of the past quarter century. The industrialisation process, urbanisation and rising per capita incomes have also seen rising imports into China. China is also involved in cross-border regional production networks for many goods, as suggested by the stimulus, increasing China's regional integration. However, by becoming more reliant on foreign markets China is exposed to changes in the international business cycle that may create volatility in its export and growth performance.

Question 23

(a) As seen in the diagram, government net borrowing increased sharply after 2007-08 due to large budget deficits that followed the global financial crisis.

(b) Fiscal policy is limited by political constraints such as the role of the Senate. Many economic policies that are implemented through legislation face major amendments or compromises in order to pass the Senate. A second limitation on fiscal policy is that although it can influence the level of aggregate demand in the short term, its capacity to achieve structural change is limited for example, because many areas of government programs are delivered by state governments, and also because fiscal policy cannot directly change regulatory arrangements that have long term structural impacts.

(c) During an upturn, there are greater employment opportunities and incomes may be rising. Higher incomes move workers into higher income tax brackets, and many previously unemployed workers now pay tax. This leads to an increase in income taxation receipts. At the same time, stronger economic activity leads to lower unemployment and decreased welfare expenditure on unemployment benefits. The combined effect of the increase in income taxation and decrease in government expenditure is to improve the budget outcome and constrain the increase in economic activity, thereby playing a countercyclical role.

(d) The government can directly add to national savings by running a fiscal surplus. On the other hand, when the government budgets for a fiscal deficit, it must draw on the supply of national savings. The fiscal consolidation and return to surplus announced in the 2012-13 Budget aimed to increase public savings. Fiscal policy can also increase private savings, such as through the introduction of compulsory superannuation in the early 1990s. More recently, the Government's proposal to increase compulsory superannuation from 9 per cent to 12 per cent should also raise the level of national savings. The government can also increase national savings by improving incentives to save. For instance, the superannuation co-contribution scheme encourages individuals to make voluntary contributions to their superannuation savings.

Question 24

(a) The prices of base metals increased sharply in the mid 2000s, reflecting the global commodities boom. After peaking in 2007-2008 they fell sharply due to the downturn in the international business cycle caused by the global financial crisis.

(b) Higher commodity prices are likely to lead to higher export revenue for commodity exporters, particularly minerals and metals. This will improve Australia's balance on goods and services, as well as the current account. However, higher commodity prices may lead to an appreciation of the Australian dollar, which will reduce the export revenue earned by other sectors such as manufacturing. Higher commodity prices may also encourage greater foreign investment on the capital and financial account, as foreign mining companies seek to invest in Australian mining assets. This will worsen the net primary income account as dividends are returned on these investments.

(c) The government may use macroeconomic policies such as contractionary fiscal policy to cushion the impact of a commodities price boom. By increasing income taxes or decreasing expenditure the government can partly offset the expansionary impact of rising commodity prices. The government has recently used fiscal policy to spread the benefits of the commodities boom to other sectors, such as by increasing the tax paid by mining companies. The Reserve Bank of Australia (RBA) could also use tighter monetary policy to offset the boost to economic activity from higher commodity prices. However, contractionary monetary policy risks causing a downturn in other sectors of the economy. Since higher commodity prices may lead to an appreciation of the exchange rate, the RBA could also sell Australian dollars in the foreign exchange market in order to put downward pressure on the Australian dollar. Finally, the government can implement microeconomic reform policies that will ease capacity constraints on Australia's mining sector, such as through higher expenditure on infrastructure and on training to boost workforce skills.