Practice HSC Economics Exam

Multiple Choice

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

Short Answers

Question 21

(a) In 2009-10 the BOGS = 253.8 – 258.4 = -$4.6bn (deficit)

In 2010-11 the BOGS = 297.5 – 276.5 = +$21bn (surplus)

Change in BOGS = +$21bn – (-$4.6bn) = $25.6bn. The BOGS has improved by $25.6bn.

(b) The improvement in the current account deficit (CAD) from -$56.0bn in 2009-10 to -$33.0bn in 2010-11 is mainly explained by the $25.6bn improvement in the BOGS. This $23bn reduction in the CAD was due to a large increase in export revenue, which reflected strong demand for Australia's mineral exports from Asia and the terms of trade reaching a record high. At the same time, import growth remained low, reflecting lower household consumption. At the same time there was only a small increase in the net primary income deficit, which rose by only $3.2bn between 2009-10 and 2010-11. This can be explained by the appreciation of the Australian dollar and low global interest rates, which decreased the interest repayments on Australia's foreign debt.

(c) A persistent CAD can lead to a reduction in Australia's economic growth rate (the 'balance of payments constraint'). A high CAD caused by a balance on goods and services deficit will subtract from aggregate demand as imports (a leakage) outstrip exports (an injection) in the economy. Also, a high CAD increases financial inflow, as high CADs must be matched by capital and financial account surpluses. This will increase foreign liabilities and future servicing costs. In extreme situations, this may lead to a 'debt trap' scenario where businesses must borrow from overseas just to repay existing debt. Finally, a high CAD may weaken international investor confidence in the Australian economy, leading to exchange rate volatility and capital flight. However, some economists argue that Australia's persistent CAD need not have any significant negative impacts, provided it reflects private sector decisions about savings and investment.

Question 22

(a) Developing economies tend to have low material living standards, low economic development, high levels of absolute poverty, and in some more extreme cases may rely on foreign aid and assistance.

(b) Economic growth – an increase in GDP – can lead to improvements in economic development – a broader quality of life measure. This is because rising incomes allow people to access improved health and educational opportunities, while also allowing the government (through higher taxation revenue) to provide these services. However, in some instances economic growth can worsen economic development if it contributes to environmental degradation or high levels of income inequality.

(c) A range of global and domestic factors contribute to income inequality between nations: (*Answers may include reference to any three of the following*)

- Agricultural protectionism makes it difficult for developing countries to sell their agricultural goods in many wealthy countries, and reduce the prices for some commodities on global markets.
- The high level of agricultural protection in advanced economies reduces the export opportunities for farmers in developing economies. For example, economies in Sub-Saharan Africa have limited access to export markets in advanced economies.
- Foreign direct investment inflows are concentrated in advanced economies, and a small number of emerging economies in East Asia – making it difficult for poorer countries to expand economic growth.
- International financial rules favour wealthier nations (in part because the large majority of voting shares in organisations such as the World Bank and International Monetary Fund) so that, for example multinational companies are able to use offshore tax havens to minimise paying tax in developing countries.
- Many countries have limited factors of production such as natural resources, capital or skilled labour, which allows an economy to generate income and economic growth.
- Some developing countries lack stable economic and political institutions (for example due to high levels of corruption), discouraging investors from taking risks in those countries.

Official statistics show a fall in absolute poverty from 43.1 per cent of the world's population to 22.4 per cent between 1990 and 2008, reflecting progress in economic growth and development. Much of this progress has been concentrated in Asia. Trade liberalisation through the World Trade Organisation (WTO) has provided developing economies with access to overseas export markets and increased incomes. Progress in liberalising manufacturing trade has driven rapid economic growth that has reduced absolute poverty in East Asia & Pacific, which has been reduced from 56 per cent to 14 per cent according to the data table. However, the slow progress in reducing agricultural protection through the WTO Doha Round partly explains why absolute poverty in Sub-Saharan Africa remains high. The World Bank also has a role in providing aid and debt-relief to developing economies through programs such as the Multilateral Debt Relief Initiative. This has assisted progress towards achieving the first Millennium Development Goal of halving absolute poverty by 2015.

Question 23

(a) An externality refers to an unintended cost or benefit of economic activity that is not reflected in the price mechanism. An example is carbon dioxide pollution arising from power generation.

(b) The quote highlights the short-term trade-off between economic growth and environmental sustainability. This is because pollution often arises as a negative externality of production. At the same time, growth can accelerate the depletion of renewable and non-renewable resources. This will reduce an economy's productive capacity by damaging what the Climate Institute report describes as its 'natural capital'. In particular, natural resources that are non-excludable are often overused due to the inability of the price mechanism to assign them a price, a problem known as the 'tragedy of the commons'.

(c) The government can impose regulations on certain economic activities in order to reduce pollution. For example, the government bans the use of leaded petrol. The government can also commit to environmental targets. The Renewable Energy Target aims to ensure that 20 per cent of Australia's electricity supply is generated by renewable energy by 2020. This target aims to encourage the development of the 'smarter, cleaner and healthier' technologies referred to in the quote. Market-based policies can also be used to internalise the externalities associated with production, such as pollution. For example, in response to climate change the government has implemented a tax on carbon dioxide, which will transition into an emissions trading scheme. At the international level, the government can also participate in global agreements such as the Kyoto Protocol and the Copenhagen Accord in order to address environmental issues such as climate change.

Question 24

(a) The transmission mechanism refers to the causal link between changes in the cash rate (and hence general interest rates in the economy) and changes in aggregate demand. In other words, it refers to the impact of interest rate changes on the level of economic activity.

(b) From 2010 monetary policy was progressively tightened following indications that the Australian economy had begun its economic recovery after the mild downturn experienced during the global financial crisis. As inflation began to pick up throughout 2010 the RBA responded by raising the cash rate in order to prevent an overheating of the economy. However, in 2011 the RBA stopped tightening monetary policy, and in 2012 the RBA began to cut the cash rate in response to global economic uncertainty.

(c) Monetary policy changes can have an indirect impact on imported inflation by affecting the exchange rate under a floating exchange rate system. For example, when the Reserve Bank raises interest rates to fight inflation, this will increase Australia's interest rate differential. In turn, higher domestic interest rates relative to overseas will attract greater foreign capital inflows, due to higher potential returns. This will increase the demand for Australian dollars on the foreign exchange market, in turn causing an appreciation of the Australian dollar. An appreciation reduces the cost of imports when expressed in Australian dollars, reducing the price of imported goods on the domestic market and thus lowering inflationary pressures.

(d) Through its domestic market operations undertaken with financial institutions in the overnight money market, the Reserve Bank will sell second hand Commonwealth Government Securities (or repurchase agreements) at a discount. Other participants in the overnight money market will draw down the funds in their exchange settlement accounts held with the Reserve Bank, in turn reducing the supply of short-term funds in the overnight money market. This will place upward pressure on the cash rate, causing general market interest rates to increase. Higher interest rates, through the transmission mechanism, will lead to a reduction in aggregate demand as domestic consumption and investment fall. This will lower demand pull inflation and inflationary expectations in the economy. Furthermore, higher interest rates will attract more foreign investment, causing an appreciation in the currency and making imports cheaper, thereby indirectly reducing imported inflation.