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Economics Exam 2024

When: ***Tuesday 11th November 9.20am***

1. *Know the **Syllabus in Units 3 & 4*** – textbook theory and concepts account for around 80% of the paper
2. *Be aware of **current economic conditions & events –** around 20% of the paper*
3. *Use **models** to support your explanations (both Sections 2 & 3)*

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Unit 3 Australia & the Global Economy

1. ***Australia's international trade (s3)***
2. ***Free Trade & Protection (s3)***
3. ***Balance of payments (s3)***
4. ***Terms of trade (s2)***
5. ***Exchange rates (s3)***
6. ***Foreign investment***

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Unit 3

The KEY MODELS – use the demand/supply model to explain

1. ***The gains from trade – exports & imports***
2. ***The costs of protection – tariffs & subsidies***
3. ***The exchange rate – AUD***

The KEY ANSWERS I should know

1. ***China***
2. ***Commodity prices***
3. ***The S - I gap***

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Australia's Trade

- What are Australia's three main exports (2023)?
  1. _*Iron ore*___________
  2. _*Coal*______________
  3. _*Natural gas*________
- What are Australia's three main imports (2023)?
  1. _*Refined petroleum*___
  2. _*Personal travel*______
  3. _*Passenger motor vehicles*
- Who are Australia's three main trading partners (2023)?
  1. _*China*______________
  2. _*Japan*______________
  3. _*United States*_______
- Australia has _*18*_ FTAs, the most recent with _*United Kingdom*_

14 bilateral
4 regional

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Comparative Advantage

Good	Coal (tonnes)	Iron ore (tonnes)
Country A	50	100
Country B	80	320

Who has the comparative advantage in each good?

Use the 'criss-cross' method

Good	1 Scooter (No. of hours)	1 Bicycle (No. of hours)
Country A	18	6
Country B	24	30

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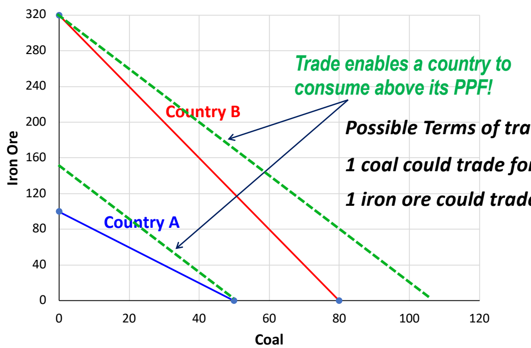
Comparative Advantage



Possible Terms of trade:

1 coal could trade for __3__ iron ore

1 iron ore could trade for _0.33_ coal

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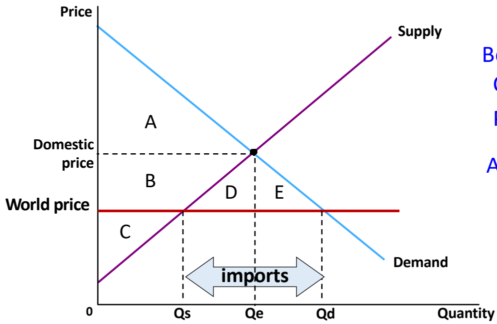
D/S Model – Gains From Imports



Before trade:
CS = _*A*________
PS = _*B + C*______

After imports:
CS = _*A + B + D + E*_
PS = _*C*_________
TS increases by _*D + E*_

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Protection – Tariffs

- *A tariff is a tax placed on imports – this raises the world price line causing*
  - imports to *decrease*
  - domestic production & employment to *increase*
  - producer surplus to *increase*
  - consumer surplus to *decrease*
  - total surplus to *decrease* (**deadweight loss**)
  - tariffs increase costs to other industries, including export sector, reducing production & *employment*

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Protection – Subsidies

- *A subsidy is a payment (grant) to domestic industries to reduce costs – this shifts the S curve to the right causing*
  - no change to the world price line
  - imports to decrease
  - domestic production & employment to *increase*
  - producer surplus to *increase*
  - *No change* to consumer surplus
  - total surplus to *decrease* Why?
  - cost of subsidy is *greater* than increase in producer surplus

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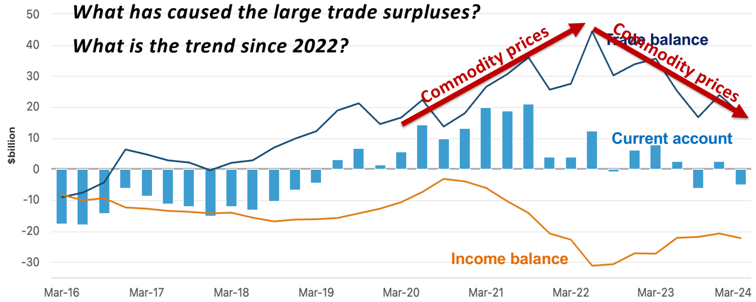
The Current Account

Can you label the curves?

What has caused the large trade surpluses?

What is the trend since 2022?



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The Current Account

- *Factors affecting the* ***trade balance***
  - *Commodity prices – if commodity prices increase, the CAB will* *increase* *Why?* **The value of exports increases**
  - *The business cycle of our trading partners – if China's economy grows faster, the trade balance will* *increase*
  - *Australia's business cycle – if our economy grows faster, the trade balance will* *decrease* *Why?* **Imports will increase**
  - *The value of the $AUD – if the AUD depreciates the trade balance will* *increase*

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The Current Account

- *Factors affecting the **income balance***
  - *Australia's large income deficit is related to our historical reliance on net capital inflow (_**Foreign investment**_)*
  - *An increase in capital inflow will _**increase**_ income payments and _**decrease**_ the CAB*
  - *An increase in capital outflow will _**increase**_ income receipts and _**increase**_ the CAB*
  - *An increase in Australia's growth rate will increase business profits which will _**increase**_ dividend payments and _**decrease**_ the CAB*

dividends
interest

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The Savings-Investment gap

- **The CAB = S – I**
- Australia's investment is normally greater than its savings: when I > S the current account will record a __***deficit***__
- But between 2019-23, S > I so the current account recorded a __***surplus***__
- In 2024 the current account is in __***deficit***__ which means that saving __**<**__ investment
- If I increases relative to S, the CAB will __***decrease***__ Why?
  - Because the increase in I will increase __***imports***__

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Terms of Trade

- Australia's terms of trade is calculated as the ratio of i es to its import prices.
- ToT = XPI/MPI x 100
- What's the most important category in the XPI? __***Commodities***__
- What's the most important category in the MPI? __***Manufactures***__

Iron ore
Coal
Natural gas
Rural

Period	Export price Index	Import Price Index	Terms of Trade
Mar 2022	103	102	**101**
Mar 2023	110	108	**102**
Mar 2024	101	107	**94**

Refined petroleum
Motor vehicles
Computers

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Terms of Trade

- Over the past year Aust's terms of trade have __***decreased***__
- Why? __***Fall in the XPI***______
- Is a decrease in the ToT positive or negative for the economy? __***Negative***____
- A fall in the terms of trade will
  - __***decrease***___ the trade balance
  - __***depreciate***__ the AUD
  - __***decrease***___ aggregate demand (AD)
  - __***decrease***___ real GDP/national income

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The Exchange Rate $A

- You need to know
  - What has happened to the $AUD/$USD & the TWI during 2023-24
  - Factors driving the $AUD
  - Effects of a depreciation/appreciation
- Use a ***model*** to show changes in the $AUD
- February 2023: **$US0.71**; **TWI 62**

  February 2024: **$US0.65**; **TWI 61**

Renminbi
Yen
Euro

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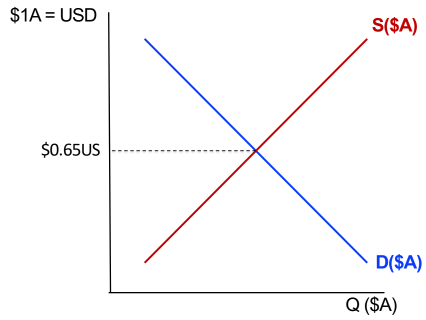
The Exchange Rate $AUD



- **How do I label the axes?**
- **What determines the D($A)?**

  1. Exports

  2. Foreign investment into Aust
- **What determines the S($A)**

  1. Imports

  2. Aust investment overseas

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Major Influences on the $A

- ***China***
  - If China's economic grows faster, the $AUD will ***appreciate***
  - Which curve will shift? ***D($A) shifts to the right***
- ***Commodity prices***
  - A decrease in commodity prices will ***depreciate*** $AUD
  - Which curve will shift? ***D($A) shifts to the left***
- ***Interest rate differential***
  - If Australia's i/rs fall relative to the US, the $A will ***depreciate***

    Why? ***Relative i/rs affect foreign investment flows***
  - Which curve will shift – D($A) or S(A)? ***Both***

    D($A) will decrease & S($A) will increase

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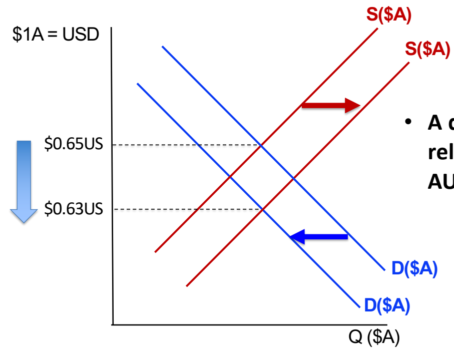
The Exchange Rate $AUD



- **A decrease in i/rs in Australia relative to the US will cause the AUD to depreciate**

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Foreign Investment

- Foreign investment & investment are ***different*** concepts
- Investment refers to ***capital investment*** – the purchase of __***physical***___ capital such as machinery, construction
  - an increase in interest rates ***decreases***_ capital investment Why?
- Foreign investment refers to ***financial investment*** – the buying & selling of financial _***assets***_____
  - shares, bonds, property
  - an increase in interest rates ***increases***_ foreign investment Why?

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The Flow of Foreign Investment

Key learning points

- Foreign investment is recorded in the _***Financial***__ account
- A financial account surplus = ***net capital inflow***
- A financial account deficit = _***net capital outflow***_
- Foreign ***direct:*** new business, joint ventures > 10% equity
- Foreign ***portfolio:*** purchase of shares, bonds < 10% equity
- Which is larger? _***Portfolio***__
- What are the income flows associated with foreign investment? 1) _***Dividends***__ 2) __***Interest***____
- Where are these income flows recorded? _***Current account***_

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The Stock of Foreign Investment

Key learning points

- The sum of all foreign investment in Australia is called our ***foreign*** _***liabilities***_
- The sum of all Australian investment in overseas countries is called our ***foreign*** _***assets***_
- Which is larger? __***liabilities***__
- The difference between foreign liabilities and foreign assets = ***International investment position***
- The main categories of foreign investment are
  1. borrowing/lending funds – foreign _***debt***__
  2. selling/buying assets – foreign _***equity***__

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International Investment Position

- During 2023, foreign investment in Australia (***foreign liabs***) rose \$63b to \$4,660bn
- During 2023, Australian investment abroad (***foreign assets***) rose \$170.3b to \$3,823bn
- This means that Australia's IIP was a _***Net liability***_ of \$837bn
- Most of the foreign investment into Australia is in the form of foreign __***debt (60%)***___
- Most of Australia's investment abroad is in the form of foreign __***equity (60%)***_
- Why does Australia have a net foreign liability (and a net foreign debt)? __***The I – S Gap***__

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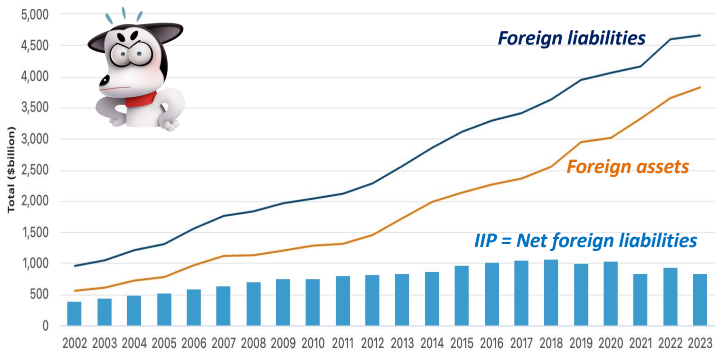
International Investment Position



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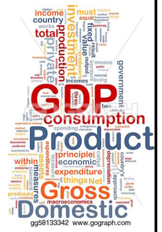
Unit 4: Macroeconomics



1. *Macro performance & the business cycle*
2. *The AE model & the multiplier (s2 & s3)*
3. *The AD/AS model (s2 & s3)*
4. *Fiscal policy (s2)*
5. *Monetary policy (s3)*
6. *Labour productivity (s2)*

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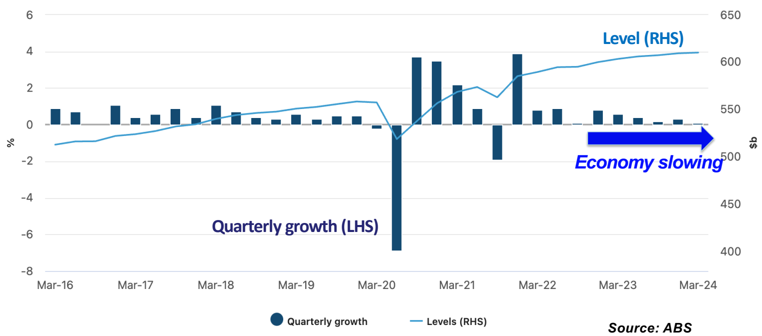
The Australian Economy – Real GDP



Source: ABS

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Macro Performance

- ***Real GDP growth rate*** **1.1% (Mar qrt)**
- ***Inflation rate*** **3.6% (Mar qrt)**
- ***Unemployment rate*** **4% (2024 average)**
- *What phase of the business cycle is the economy in?* ***Peak***
- *Evidence?* ***Unemployment = Un***
  High inflation rate
- ***Turning points** – what could cause the economy to go from a peak to a contraction?*
  Slowdown in China
  Fall in commodity prices
  Share market collapse

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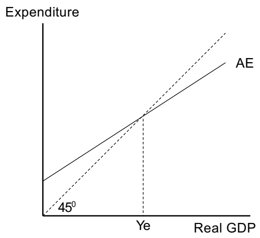
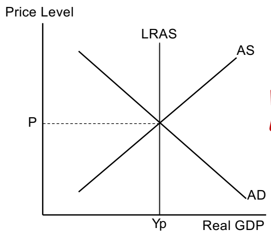
Unit 4 Models

There are now THREE models:

1. AE MODEL



2. AD/AS MODEL



When should I use the models?

Very important – label the axes correctly

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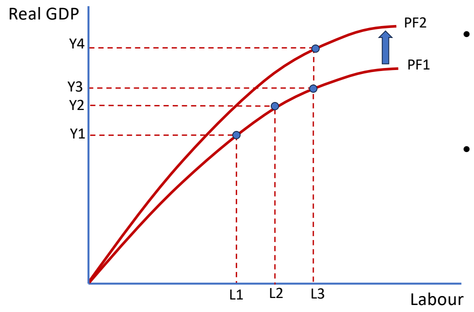
Unit 4 Models

3. APF MODEL



- Along PF1, as Labour increases, real GDP increases but at a ***decreasing rate***
  - ⇢ labour productivity ***falls***
- What can shift the APF upwards
  - ⇢ ***increase in capital***
  - ⇢ ***improvement in quality of labour***

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The AE Model

- The components of AE – C, I, G & NX
- The largest component is ___*Consumption*___
- The vertical axis: ___*Expenditure*___
- The horizontal axis: ___*Real GDP*___
- mpc = ___*ΔC/ΔY*___
- mpc + mps = ___*1*___
- Slope of the C & AE functions = ___*mpc*___
- Equilibrium occurs where ___*total spending*___ = total output
- If spending < output, inventories ___*increase*___

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The Multiplier

- If spending increases by $10bn and GDP rises by $25bn then the multiplier = ___**2.5**___
- The formula for the multiplier (k) is

k = 1/(1 – *mpc*) or ___***k = 1/mps***___

if the mpc = 0.5; mps = ___**0.5**___ *then k =* ___**2**___

if the mpc = 0.67; mps = ___**0.33**___ *then k =* ___**3**___

if the mpc = 0.8; mps = ___**0.2**___ *then k =* ___**5**___

if k = 4 then mpc = ___**0.75**___ mps = ___**0.25**___

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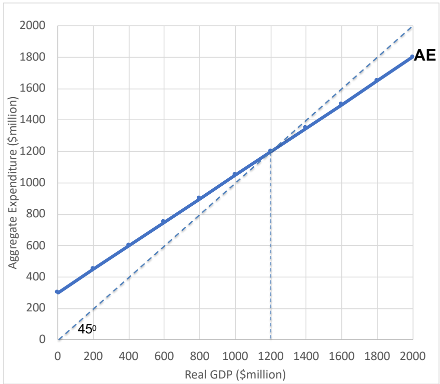
The AE Model



What is the equilibrium level of real GDP? _$1200m_

If GDP = $800m, inventories would __decrease__

What is the mpc? _0.75_

What is the multiplier? _4_

If Yp = $1600 million, then govt should increase G by _$100m_

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AE Model

How would each of the following affect the AE function?

	AE line	Why?
I. The Chinese economy expands	*Shifts up*	*NXs increase*
II. The RBA increases the cash rate	*Shifts down*	*C & I decrease*
III. House prices rise	*Shifts up*	*C increases*
IV. Iron ore prices fall	*Shifts down*	*NXs decrease*
V. The budget deficit increases	*Shifts up*	*G increases*

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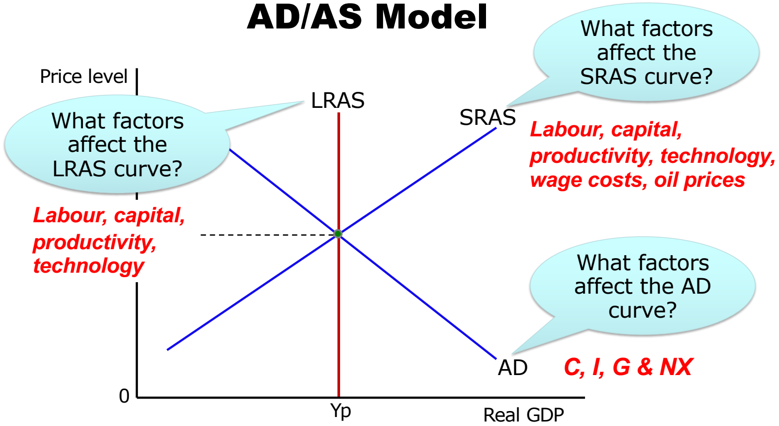
AD/AS Model



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AD/AS Model & the Business Cycle

What is the effect of a **negative AD shock**?

- *The AD curve shifts to the __left__*
- *Real GDP _decreases_, unemployment _increases_ and the price level _decreases_*
- *Fiscal/Monetary policy? _Expansionary_*

What is the effect of a **negative SRAS shock**?

- *The SRAS curve shifts to the __left__*
- *Real GDP _decreases_, unemployment _increases_ and the price level _increases_*
- *Fiscal/Monetary policy? __Neutral__*

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Review

How would each of the following affect the AD/AS model?

	AD/AS Model
I. Share prices fall	*AD decreases*
II. Oil prices increase	*SRAS decreases*
III. China's economy contracts	*AD decreases*
IV. Productivity increases	*LRAS & SRAS increases*
V. Govt spending on infrastructure increases	*AD increases / LRAS & SRAS increases*

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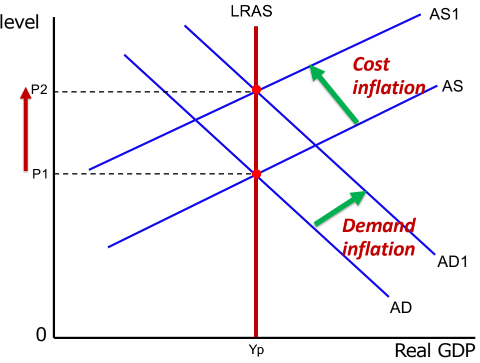
The Economy 2023-24

In 2023-24 the economy is on the LRAS curve at full employment
U rate = __4%__
Inflation remains high due to . . . .

Increased costs
Increased spending



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What is fiscal policy?

- **Fiscal Policy**: changes in government taxes (T) and spending (G) that are intended to achieve economic policy objectives:
  i. Full employment
  ii. Price stability
  iii. *Economic growth*_____
  iv. *Reduce income inequality*
- Fiscal policy is reflected in the government's budget
  - A budget deficit (G > T) will have __*an expansionary*__ effect
  - A budget surplus (T > G) will have _*a contractionary*__ effect
- Fiscal policy consists of
  1. *Discretionary policy – purposeful changes to G & T*
  2. *Automatic stabilisers – changes to G & T due to _the business cycle__*

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Automatic Stabilisers

- Automatic fiscal stabilisers have an important effect on the budget balance
- When the economy contracts the budget ... fall & automatically shift to a __*deficit*__
- Why? Because G will _↑__& T will __↓__
- When the economy expands, the budget balance will rise & automatically shift to a __*surplus*__
- Why? Because G will __↓__ & T will __↑__

Income tax
Unemployment benefits

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Fiscal Policy & the Multiplier

- What has a stronger multiplier effect – an equivalent change in G or T?
- If the mpc = 0.75, then k = __*4*__
  - An increase in G of $10bn will increase GDP by _*$40bn*__
  - A decrease in T of $10bn will increase C by _*$7.5bn*_ and then increase GDP by _*$30bn*_
- What would happen to GDP if the government increased G by $10bn & increased taxes by $10bn?

GDP would increase by $10bn

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Fiscal Policy

- A change in G and/or a change in T will shift the AD curve
- Can fiscal policy affect the AS curves? _*Yes*__
- An increase in government investment (infrastructure) will increase the _*capital stock*_ & shift the AS curves to the _*right*_
- How does the government finance a budget deficit?
- By _*borrowing*_
- How? _*By selling new govt bonds*_
- A budget deficit will _*increase*_ government debt which will result in higher interest payments
- Is this a problem? *Not if the borrowing is used for govt investment*

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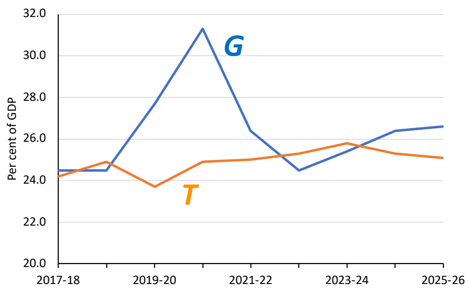
Current Fiscal Policy



On the graph, label G and T

In which year was the budget deficit highest? *2020-21*

Why did the budget return to surplus in 2022-23?

Automatic stabilisers

What is the stance of fiscal policy now? *Expansionary*

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What is monetary policy?

- The Reserve Bank Board sets the *cash rate* so as to achieve its economic objectives:
  1. *The stability of the currency of Australia*
     - *what does this mean? Price stability – inflation between 2-3%*
  2. *The maintenance of full employment in Australia*
     - *achieving an unemployment rate of around _4%_*
  3. *The economic prosperity and welfare of the people of Australia.*
- What is conventional monetary policy?

  Changing the cash rate to affect other i/rs

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Monetary Policy

The Reserve Bank will ***increase*** the cash rate. . .

- When the economy ***expands too quickly***
  - *Inflation* ***rises above 3%***
  - *Unemployment* ***decreases*** *to or below the natural rate*
  - ***Positive*** *shocks to AD*
- The current cash rate is ***4.35%***
- The current stance of monetary policy is ***contractionary***
- *Aim?* ***Decrease inflation***

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The Transmission Mechanism

How do interest rates affect the AD curve?

1. ***Saving & Investment –*** higher interest rates increase the ***cost of borrowing***, decreasing the incentive to ***borrow*** & increasing the incentive to ***save***
2. ***Cash flow –*** a rise in interest rates increases ***debt repayments*** which decreases the cash flow of households & firms & ***decreases*** ***C and I***
3. ***Asset prices –*** a rise in interest rates decreases the price of ***shares*** & ***property***, decreasing ***wealth & consumption***
4. ***Exchange rate –*** a rise in interest rates will ***appreciate*** the ***$AUD*** which will ***decrease*** net exports

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Unconventional Monetary Policy

- This involves the Reserve Bank using tools ***other*** than the cash rate to influence economic activity
- Why? The cash rate is close to ***zero*** and is no longer effective
- Main type - ***Quantitative easing***
  - the Reserve Bank purchases ***Govt bonds*** from the public to increase ***liquidity*** & decrease ***long term*** interest rates.

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Fiscal & Monetary Policy

- Which policy is best to use to stabilise the business cycle? ***Both***
- Which policy works best in a contraction? ***Fiscal***
- Which policy works best in a boom? ***Monetary***
- Which policy is the most direct? ***Fiscal***
- Which policy is the most flexible? ***Monetary***
- Which policy has the shortest effect lag? ***Fiscal***
- Which policy has the shortest decision lag? ***Monetary***
- Which policy suffers from political bias? ***Fiscal***

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