



2021
ATAR STUDENT
REVISION SEMINAR

Presenter: Mr Steven Kemp

Venue courtesy of



Examiners Report

- The use of **economic models** (diagrams) is important – you must be able to use an appropriate model, fully labelled, and refer to it in your written responses.
- In Section Two, it is vital that you **refer to the data** provided in the question within your answer – e.g. the question will often state ‘with reference to the data/table/graph/article’.
- Graphs with 2 vertical axes - ensure you understand whether you must refer to the LHS axis or the RHS axis.

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Examiners Report

- Significant **economic events** – e.g. changes in the business cycle, the current account surplus, the terms of trade, the exchange rate, monetary & fiscal policy – are likely to be directly referenced in the examination.
- The most appropriate model to use to show the different phases of the **business cycle** is the one showing **both the LRAS and the SRAS curves**.

Q30 (a) Use the AD/AS model to demonstrate and explain the characteristics of the boom phase of the business cycle. (10 marks)

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Unit 3 Australia & the Global Economy



1. **Global interdependence (s2)**
 2. **Free Trade & Protection (s3)**
 3. **Pattern of trade**
 4. **Balance of payments (s3)**
 5. **Terms of trade**
 6. **Exchange rates (s2)**
 7. **Foreign investment/foreign liabilities**
- } Important links to unit 4

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Unit 3



The key models – use the **demand/supply model** to explain

1. The gains from trade/comparative advantage
2. The costs of protection – tariffs & subsidies
3. The exchange rate – AUD

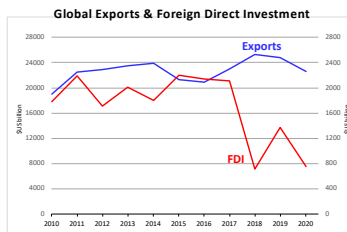
The key answers I should know

1. Current account surplus
2. Commodity prices (inside the ToT)
3. China
4. The S - I gap

4

Global Interdependence

- Globalisation has been **slowing** since the GFC.
- In 2020, the COVID-19 pandemic caused global trade to fall by **10%** and global FDI to fall by **35%**.
- The pandemic highlights both the negatives & positives of interdependence.



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International Competitiveness

- Linked to comparative advantage
- Why is competitiveness important?
- How would the following factors affect a country's competitiveness?
 - An increase in **productivity** _____
 - A rise in the **exchange rate** _____
 - An increase in **inflation** _____
 - A cut in **tariffs** _____
 - An increase in **subsidies** _____

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Comparative Advantage

	Output			Output	
	Beef			Corn	
Country A	5000	or	5000		
Country B	2000	or	4000		

Who has the comparative advantage in each good?

A possible terms of trade could be

- (a) 1 beef trades for 0.5 corn
- (b) 1 beef trades for 1.5 corn
- (c) 1 corn trades for 1.5 beef
- (d) 1 corn trades for 0.4 beef

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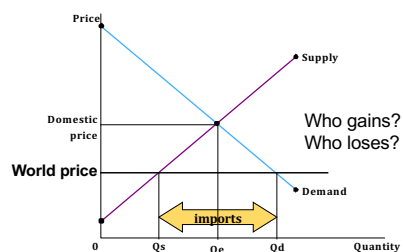
The Benefits of Free Trade

Comparative advantage & the gains from trade can be shown using the *Demand/Supply model*

- Compare world price with domestic price
 - if $P_w > P_d$, then the country has a **comparative advantage** – it **exports**
 - If $P_w < P_d$, then the country has a **comparative disadvantage** – it **imports**
- In each case you need to show clearly who gains & who loses using *consumer & producer surplus*

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Gains From Imports



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Protection

- **Tariffs & subsidies (2020)**

- use the D/S model
- Both tariffs & subsidies are inefficient because they create a deadweight loss

- Arguments for **protection/against trade liberalisation**

- **Infant industry**
- **Dumping**
- **Diversification**
- **Strategic industries (national defence)**

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WACE 2020 41%

Which of the following is **not** a possible argument for supporting the implementation of trade restrictions by a nation?

- (a) retaliation
- (b) specialisation
- (c) protection against cheaper foreign labour
- (d) promotion of economic diversification

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The Balance of Payments

The balance of payments is a record of a country's economic transactions with the rest of the world

It comprises 2 *interlinked* accounts

1. The **current account** – records transactions in *goods, services & income*
2. The **capital & financial account** – records transactions in **financial assets** (foreign investment)

The two accounts MUST sum to ZERO Why??

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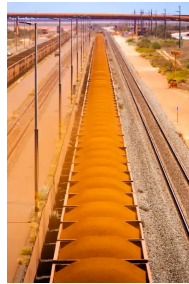
The Balance of Payments

- For each transaction there is a matching credit and debit entry – this means that the overall balance of payments must always **balance**.
 - If Australia imports \$1 million of cars, then it will be recorded as a **\$1m debit** in the current account & a _____ (export of currency) in the financial account

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Topical Stuff

- Australia has recorded **8** consecutive qrtly **current account surpluses!**
- Why?
- What has happened to the **trade balance?**
- What has happened to the **income balance?**



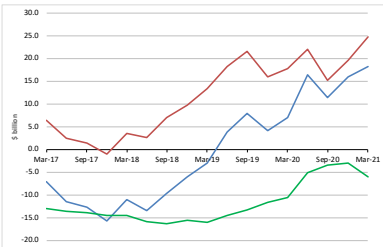
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Aust's Balance of Payments

	Dec 19	Dec 20
Current account	\$bn	\$bn
Exports	122	111
Imports	106	91
Trade balance	_____	_____
Net income	-12	-4
Current account	_____	_____
Capital/Financial	_____	_____

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The Current Account



Can you label the curves?
 Why is the current account in surplus?
 1. Trade balance
 2. Income balance
 3. $S > I$

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The Current Account Surplus

- **Cyclical factors affecting the trade balance**
 - China's demand for Aust's resources
 - Weak domestic demand in Australia
 - Commodity prices
- **Structural factors affecting the income balance**
 - Record low global interest rates
 - Decreased foreign investment (financial account deficit)

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The Savings-Investment gap

- **The CAB = $S - I$**
- Australia's investment is normally greater than its savings: ($I > S$) resulting in a current account deficit
- But over the past few years $S > I$ so the current account has recorded a _____
- If saving increases relative to investment, the CAB will _____
- If Aust's economic growth increases, the CAB will _____

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Terms of Trade

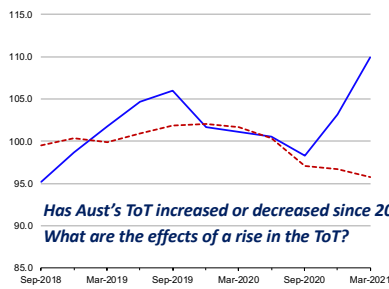
- Australia's terms of trade is calculated as the ratio of its export prices to its import prices.
- $ToT = XPI/MPI \times 100$
- What's the most important category in Aust's XPI?

- What are commodities? Examples
- What's the most important category in the Aust's MPI?

- Can the ToT increase if the export price index falls?

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Australia's Terms of Trade



Label the XPI & the MPI
Which is more volatile?

Has Aust's ToT increased or decreased since 2019?
What are the effects of a rise in the ToT?

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Terms of Trade

- If Australia's terms of trade increase, then
- The trade balance _____
 - Real GDP _____
 - The AD curve shifts to _____
 - National income/living stds will _____
 - The AUD will _____

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Review

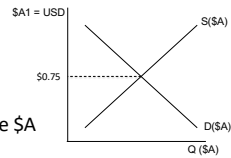
What would be the **most** likely effect on the Australian economy of an increase in iron ore prices (ceteris paribus)?

- (a) A rise in the terms of trade and a decrease in the trade balance
- (b) A rise in the terms of trade and an increase in the trade balance
- (c) A fall in the terms of trade and a decrease in the trade balance
- (d) A fall in the terms of trade and an increase in the trade balance

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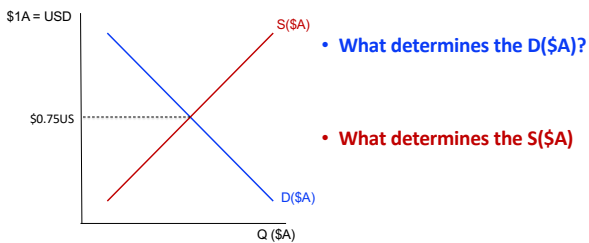
The Exchange Rate \$A

- Changes in the value of the \$A have important effects on the balance of payments and on economic activity
- You need to know
 - What has happened to the **TWI** & the **\$AUD** during 2020-21
 - Factors driving the \$A
 - Effects on the economy
- Use a model to show changes in the \$A



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The Exchange Rate \$A



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Major Influences on the \$A

- **Demand for Australian exports**
 - If China's economic growth slows, the \$AUD will _____
 - Which curve will shift – D(\$A) or S(A)?
- **Commodity prices**
 - An increase in commodity prices will _____ \$AUD
 - Which curve will shift – D(\$A) or S(A)?
- **Interest rates**
 - If Australia's i/r differential decreases, the \$A will _____
 - Why?
 - Which curve will shift – D(\$A) or S(A)?

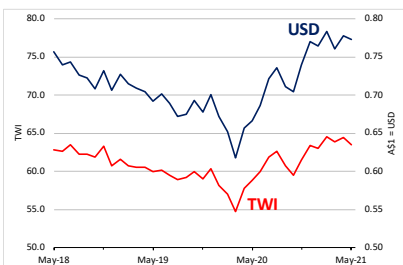
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Review

- Which of the following would occur if there was a decrease in US interest rates relative to Australia?
- (a) There would be decreased supply of \$AUD and the \$AUD would depreciate.
 - (b) There would be increased supply of \$AUD and the \$AUD would appreciate.
 - (c) There would be decreased demand for \$AUD and the \$AUD would depreciate.
 - (d) There would be increased demand for \$AUD and the \$AUD would appreciate.

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\$AUD exchange rate



What are the 3 most important currencies in the TWI?

Which is more volatile – USD or TWI?

What has happened to the AUD during 2020-21?

Why?

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Effects of an appreciation?

- An appreciation will reduce competitiveness because export prices _____ while import prices _____
- What effect will an appreciation have on *the trade balance*?
- What effect will an appreciation have on *the AD curve*?
- What effect will an appreciation have on *real GDP*?
- What effect will an appreciation have on *inflation*?

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The Flow of Foreign Investment

Key learning points

- Foreign investment & investment are *different* concepts
- A financial account surplus = *net capital inflow*
- A financial account deficit = *net capital outflow*
- Foreign *direct*: new business, joint venture, >10% equity
- Foreign *portfolio*: purchase of shares, property, < 10% equity
- What are the income flows associated with foreign investment? _____

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Portfolio/Direct

- Which is more stable?
- Which is more speculative?
- Which is more beneficial?
- What are the *benefits* of FDI?
 1. Helped to fill the _____
 2. Developed Aust's mining industry
 3. Boosts Aust's production & employment
 4. Brings new _____ increasing productivity
 5. Increases Australia's export income

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The Stock of Foreign Investment

Key learning points

- The stock (accumulation) of foreign investment in Australia is total **foreign liabilities (\$3,925 billion)**
- The stock (accumulation) of Australian investment overseas is total **foreign assets (\$3,050 billion)**
- **Net foreign liabilities (\$875 bn)**
 - = **Foreign liabilities** – **Foreign assets**
 - = **Net foreign debt** + **Net foreign equity**

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Australia's Net Foreign Liabilities

	Foreign Liabilities % GDP	Foreign Debt % GDP	Foreign Equity % GDP	Foreign Debt Private %	Foreign Debt Public %
Mar 2011	55	48	7	78	22
Mar 2021	44	58	-13	63	37

Key points:

- **Net foreign liabilities** have been _____
- **Foreign equity assets** have been _____
- **The gov't's share of foreign debt** has _____

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Unit 4: Macroeconomics

1. **The business cycle (s3)**
2. **The AE model & the multiplier**
3. **The AD & AS model**
4. **Economic policy objectives (s3)**
5. **Fiscal policy (s3)**
6. **Monetary policy (s3)**
7. **Structural change & productivity (s2)**



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The Covid Pandemic

- The COVID-19 pandemic triggered the largest **contraction** in the Australian economy since the Great Depression of the 1930s and required an unprecedented monetary and fiscal policy **stimulus**.

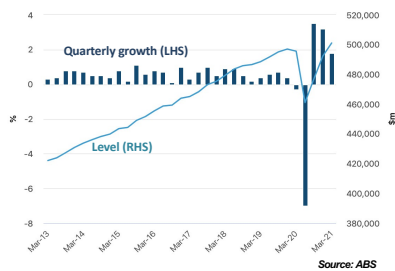
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The Australian Economy – Real GDP

Annual growth rate

- Dec 2020: -1%
- Mar 2021: +1%

What is the target rate of GDP growth?



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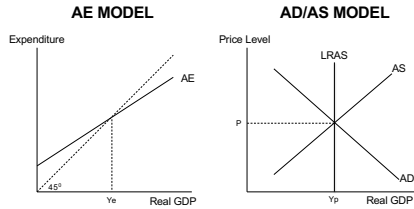
The Australian Economy - Unemployment



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Unit 4 Macro Models

There are two key models:



Very important – label the axes correctly

When should I use the models?

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The AE Model

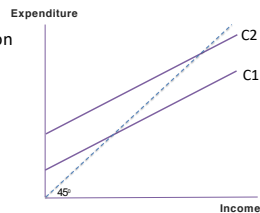
- Use this model for to explain **macro equilibrium** & the **multiplier**
- The **consumption function** is the building block of the AE model
- $C = f(Y)$ – a rise in Y causes an increase in C (movement up along the C line)
- The slope of the consumption function = _____
- The C function shifts when one of the other factors affecting consumption change e.g. wealth, consumer confidence, interest rates

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Consumption Function

A shift in the consumption function from $C1$ to $C2$ could be caused by

- _____ in wealth
- _____ in interest rates
- _____ in consumer confidence

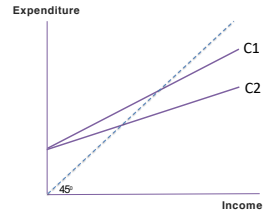


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Consumption Function

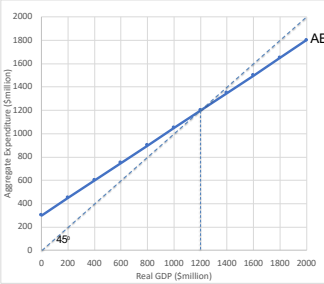
A decrease in the slope of the consumption function from C1 to C2 represents

- a decrease in the _____
- an increase in the _____
- a _____ in the size of the multiplier



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The AE Model



- What is autonomous expenditure? _____
- What is the equilibrium level of real GDP? _____
- If $Y = \$1000m$, what will happen to inventories? _____
- What will happen to production? _____
- What is the mpc? _____
- What is the multiplier? _____
- If $Y_p = \$2000$ million, then govt should increase G by _____

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WACE 23%

Which of the following statements about the consumption function is correct?

- As disposable income rises, the marginal propensity to consume falls.
- As disposable income rises, the marginal propensity to consume rises.
- As disposable income rises, the marginal propensity to consume does not change.
- As disposable income rises, the marginal propensity to save rises.

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Review

How would each of the following affect the level of AE in Australia?

- I. The covid pandemic _____
- II. The Chinese economy expands _____
- III. The government cuts income taxes _____
- IV. The RBA cuts the cash rate _____
- V. Housing prices rise _____
- VI. The AUD appreciates _____

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The Multiplier

- If spending increases by \$10bn and GDP rises by \$30bn then the multiplier = _____
- The multiplier depends on the marginal propensity to consume: $mpc = \frac{\Delta C}{\Delta Y}$
- The formula for the multiplier (k) is
 $k = \frac{1}{1 - mpc}$ or $k = \frac{1}{mps}$
e.g. if the $mpc = \frac{2}{3}$ (0.67)
Then $k = \frac{1}{(0.33)} = \underline{\hspace{2cm}}$

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WACE 2020

Using the data in the table, which of the following is correct? The mpc is

- (a) 0.75 and the multiplier is 4.
- (b) 0.5 and the multiplier is 2.
- (c) 0.75 and the multiplier is 1.33.
- (d) 0.4 and the multiplier is 2.5.

Income	Consumption
120	90
140	105
160	120

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WACE 2020

If the marginal propensity to consume is 0.8, an increase in investment of \$100bn would cause income to

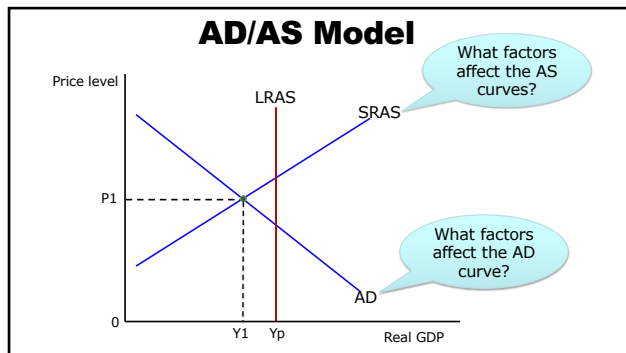
- (a) rise by \$100bn.
- (b) rise by \$500bn.
- (c) fall by \$80bn.
- (d) fall by \$20bn.

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The AD/AS Model

- Best used for explaining the *business cycle* – for showing the economy growing above or below potential GDP
- Best for showing the effect of *economic policy & changes in productivity*
- *What is the AD curve? What shifts the AD curve?*
- *What is the AS curve? What shifts the AS curve?*

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The AD/AS Model

How would the following affect the AD/AS curves?

- 1. An increase in the labour force _____
- 2. The terms of trade increase _____
- 3. Bushfires destroy property _____
- 4. AUD appreciates _____
- 5. An increase in house prices _____
- 6. A decrease in productivity _____
- 7. Govt cuts income taxes _____
- 8. Govt spending on infrastructure _____

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WACE

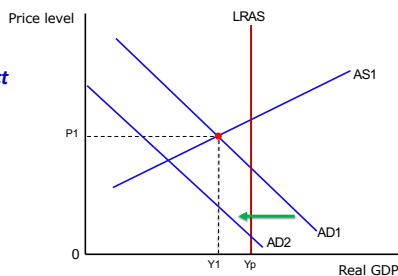
Which of the following will shift the aggregate supply (AS) curve to the left?

- (a) An increase in interest rates
- (b) An increase in imports
- (c) An increase in productivity
- (d) An increase in energy prices

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The Economy 2020

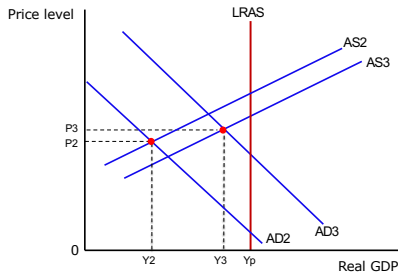
*What was the effect of the Covid crisis?
Which components of AD fell?*



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The Economy 2021

*The economy recovers
Why?*



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Economic Objectives

- What are the **five** economic objectives of the government?
- What are the **three** policy objectives of the RBA?
- Do I know the time lags of economic policy?
 - **Recognition** (data) lag
 - **Implementation** (decision) lag
 - **Effect** (impact) lag
- How are these lags different for fiscal/monetary policy?

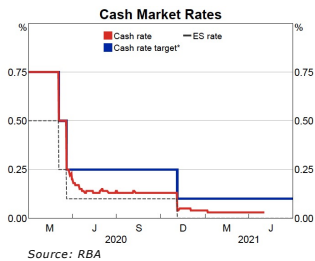
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Monetary Policy

- What is '**conventional**' monetary policy?
 - > Changing the **cash rate** rate to affect interest rates in order to affect private spending – consumption investment & net exports
 - > In 2020 the cash rate was reduced from 0.75% to _____
 - > The '**transmission mechanism**'
What are the four channels?

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Monetary Policy



Reducing the cash rate decreases interest rates which

1. encourages new *borrowing*
2. increases *cash flow* of existing borrowers
3. increases *asset prices*
4. lowers the *\$AUD*

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Monetary Policy

- What is '*unconventional*' monetary policy?
 1. *Forward guidance* – a commitment by the RBA to keep interest rates low for 'as long as it takes'
 2. *Quantitative easing* – the RBA purchases a large quantity of govt bonds from the private sector to increase liquidity & reduce longer term interest rates

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Monetary – Strengths/Weaknesses

- What are *THREE* strengths of monetary policy?
- In which part of the business cycle will monetary policy be powerful?
- Which policy lag is short for monetary policy?
- What are *THREE* weaknesses of monetary policy?
- In which part of the business cycle is monetary policy less effective?
- Which policy lag is long for fiscal policy?

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Fiscal Policy

- What are the tools of fiscal policy?
- Important to know the difference between . . .
 - planned & actual budget outcome
 - *discretionary policy & automatic stabilisers*
- What happened to fiscal policy in 2019-20?
 - Planned budget surplus turned into a large budget
- The budget deficits for 2020-21 & 2021-22 will be the largest on record. Why?

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Discretionary or Automatic

Are the following examples of discretionary or automatic fiscal policy?

- 1) *Announcement of 'jobkeeper' allowance*
- 2) *An increase in welfare spending because of higher unemployment*
- 3) *An increase in spending on infrastructure during a contraction*
- 4) *A decrease in personal income tax receipts during a contraction*

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Automatic Stabilisers

- Automatic fiscal stabilisers have an important effect on the budget balance
- When the economy contracts the budget balance will fall & automatically shift to a _____
- Why? Because G will ____ & T will ____
- When the economy expands, the budget balance will rise & automatically shift to a _____
- Why? Because G will ____ & T will ____

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Fiscal Policy

	Receipts \$b	Payments \$b	Underlying cash balance \$m	
2018-19	477.4	478.1	-0.7	Effect of Covid
2019-20	464.4	549.6	-85.2	
2020-21 (e)	499.8	660.8	-161.0	
2021-22 (e)	482.1	588.7	-106.6	
2022-23 (e)	494.0	593.3	-99.3	

- Why do the planned budget deficits get smaller after 2020-21?

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Fiscal Policy

- How does the government finance a budget deficit?
 - By _____
 - How? _____
 - Main methods:
 1. Borrow from the **RBA**
 2. Borrow from **domestic residents**
 3. Borrow from **overseas**
 4. Sell govt assets
- Which of these is most important?*

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Budget Deficits

- Budget deficits lead to increased **government** _____
- Is this a problem?
- The 'negatives'
 - **Opportunity cost** of interest payments
 - Possible **high inflation?**
- The 'positives'
 - **Saves the economy** from severe recession & high unemployment
 - Record **low interest rates**

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Fiscal – Strengths/Weaknesses

- What are **THREE** strengths of fiscal policy?
- In which part of the business cycle will fiscal policy be powerful?
- Which policy lag is short for fiscal policy?
- What are **THREE** weaknesses of fiscal policy?
- In which part of the business cycle is fiscal policy constrained?
- Which policy lag is long for fiscal policy?

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Productivity

- Productivity is NOT production – It is GDP per worker or GDP per hour worked (**labour productivity**)
- Why is productivity so important?
 - It is the most important determinant of economic growth and _____
- An increase in productivity shifts both the **AS curves** to the **right** increasing **real GDP** & reducing the **price level**

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Productivity

- **Labour productivity** consists of:
 - i) **capital deepening** – increasing the **K/L ratio**
 - ii) **multifactor productivity (mfp)** – the contribution of **technology**, advances in **knowledge**
- **Measures to improve productivity**
 - Increasing **physical capital**: _____
 - Investment in **human capital**: _____
 - Incentives for **innovation** & research & development

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Additional Notes