Economic Fundamentals in Australia Salla, MacGregor and Grinham (6th edition)
Sample responses to questions contained in
Activity Centre: Unit 3 Outcome 3

Question 1

a) Tariffs and quotas are both examples of means by which countries seek to protect local producers from imported competition. A tariff seeks to restrict imports via the imposition of a tax on imports. Accordingly, it uses 'price mechanism' or 'prices' to restrict demand for and quantities of imports. Quotas, on the other hand, directly restrict the legally permitted quantity of certain imports. Both tariffs and quotas ultimately result in higher import prices and lower import quantities. However, tariffs directly target the former and quotas directly target the latter

b) Free trade implies that there is an absence of trade barriers. It can boost living standards (or prosperity of Australians) by:

- forcing local businesses to increase efficiency in order to remain competitive against relatively cheaper imports. As import prices fall following the move to free trade (or the removal of protection), local import competing businesses find ways to improve productivity and reduce costs. As prices fall, consumers of the product (both local and imported versions) will be able to purchase greater quantities or have more money to spend on other goods and services. Accordingly, material living standards increase because consumers have access to more goods and services. (Students may also refer to the lower import prices and greater efficiency resulting in lower costs across the economy, facilitating an increase in international competitiveness, greater AD, real GDP, incomes and employment, thus boosting material living standards – this could also be considered as a 'separate point.')

- providing Australian consumers and businesses with a wider range of goods and services from which to select. Businesses may be able to purchase equipment or inputs that were previously restricted via quotas and/or consumers will be able to select goods that were previously priced out of reach (via tariffs) or difficult to obtain (due to quotas). For businesses, efficiency and costs can improve and for consumers, satisfaction can increase. Both working to improve material living standards of Australians as consumers will ultimately have access to more goods and services and at relatively lower prices.

c) The BOMT is likely to move towards a deficit (or reduced surplus) in the shorter term because Australian dairy exports will be adversely affected. USA subsidies will lower the prices of dairy products for US consumers resulting in less demand for US dairy imports from Australia (because Australian dairy exports are less price competitive). This reduces X in the BOMT, reducing the surplus or increasing the deficit on merchandise trade.

d) Lower tariffs on MV directly reduced the price of imported motor vehicles. To the extent that the cost of MVs to consumers forms part of the CPI, we can expect the reported inflation rate to fall (ceteris paribus). In addition, the lower cost of MVs resulted in lower production costs for businesses purchasing imported MVs, which then filtered through to reduce price (inflationary) pressure. Further, lower tariffs forced local MV manufacturers to become more efficient over time, with greater efficiency (or productivity) causing lower production costs and prices.

e) **i**. A higher TOT typically results in Australian exporters receiving higher prices for their exports. Accordingly, X incomes increase which results in higher national income (or Gross Domestic Income) and higher demand for goods and services (i.e. AD). This exerts additional demand inflationary pressure on the economy, adding to capacity constraints and contributing to a higher inflation rate. [Students who argue that a higher TOT can actually result in lower inflation (e.g. if the price of M fall without a change in X prices) should receive zero marks, regardless of the quality of their response. This is because they are specifically asked to examine the positive relationship between the TOT and inflation.]

ii. A higher TOT typically results in Australian exporters receiving higher prices for X, which increases Australia's national income, boosts the Balance on Goods and Services (BOGS) and reduces the CAD. The higher income (and lower CAD) means that Australia requires less foreign funds (capital inflow) to finance the smaller CAD. In other words, the smaller gap between national spending and income (the primary reason for Australia's CAD) means that less debt is required to 'fill the gap.' Accordingly, the level of NFD should fall.

iii. A higher TOT typically results in higher export incomes, which then filters through the economy to boost national income, AD, real GDP and employment. With greater employment (and lower unemployment) and higher incomes, the purchasing power of Australians will increase as reflected by an increase in real net national disposable income per capita (or simply income per capita), allowing Australians (on average) to purchase more goods and services, boosting their material standards of living

iv. An increase in the terms of trade (price of exports over the price of imports) is likely to contribute to stronger rates of economic growth. This is because the higher terms of trade boosts national income via the direct impact on mining company profits/income and the indirect effects on the income received by labour in mining and related industries as well as the return of profits to Australian shareholders. Accordingly, the higher prices received for mining output helps to increase AD via increased consumption and (mining) investment, boosting real GDP and economic growth.

Question 2

a. The fall in the exchange rate is likely to have created downward pressure on the CAD. This is because the lower AUD helps to increase the international competitiveness of Australia's tradables sector (exporters and import competing businesses). With relatively cheaper exports and more expensive imports, the overall demand for net exports (X – M) should rise, which boosts the Balance on Goods and Services (BOGS). Given that the BOGS is a component of the current account, a higher BOGS surplus (or lower deficit) should help to reduce the size of Australia's CAD.

   The fall in the exchange rate should positively impact on material living standards. This is because the growth in net exports (which results from the improvement in international competitiveness) will stimulate AD and growth in real GDP. This in turn should help to increase real GDP per capita (or Gross National Income per capita) which means that households, on average, will have more money to purchase goods and services. With greater access to goods and services, material living standards will necessarily be higher.

b. Lower oil prices are likely to have helped to improve the BOMT because Australia is currently a net importer of oil. Therefore the total cost or value of oil imports will have fallen (for any given volume of oil imports) by more than the total cost or value of oil exports. With a fall in the total value of net oil imports (i.e. M – X), the debits within the BOMT will be decreasing by more than credits, leading to a fall in any BOMT deficit (or rise in the BOMT surplus).

c. Slower global growth makes it more difficult to meet our international financial obligations because slower growth overseas results in a reduced demand for Australian exports, such as minerals and other commodities that fuel overseas growth. This impacts negatively on net export demand (X-M), reducing our trade balance and increasing pressure on the CAD, as the BOGS is a component of the current account. [The reduced income from abroad raises the gap between national spending and income and increases pressure on foreign debt to finance the shortfall. A growing CAD and NFD therefore reduces Australia's ability to meet its international financial obligations.]

d. Net Foreign Debt (NFD) is defined as the total stock of debt owed by Australians to the rest of the world, less the amount the rest of the world owes to Australians.

e. The higher NFD level in Australia has contributed to the continuing CAD. This is because the interest debits required to service gross debt to overseas investors must continue to exceed the interest credits received by Australian lenders. This results in the Net Primary Income section of the current account balance to be negative. This large negative contribution to the current account balance is the biggest contributor to the CAD.

f. The lower terms of trade (TOT) is likely to have increased pressure on the CAD. This is because the lower prices received for Australian (commodity) exports [which was the primary reason for the lower TOT] resulted in lower export values [since value is price multiplied by quantity] and necessarily had a negative impact on the Balance on Merchandise Trade (BOMT) as the **value** of commodity exports will have fallen – ceteris paribus - relative to imports. Lower Net Exports will therefore have had a negative impact on the current account balance.

   The lower value of the Australian dollar is likely to have decreased pressure on the CAD. This is because the lower exchange rate helped to increase the competiveness of Australia's tradables sector. Exporters of goods and services will find that their sales will increase as their products are relatively cheaper for foreigners. Similarly, Australian import-competing businesses experience higher sales as the price of their competitors' products (i.e. imports) necessarily rise with the depreciating AUD. The combined effect is to increase Net Export values, improving the BOMT and/or Balance on Goods and Services (BOGS) and reducing pressure on the CAD.

Question 3

[Note that the question in the text should have read: Explain how lower company tax rates might impact on external stability (3 marks)]

a. Lower company tax rates might help to achieve external stability, which is to ensure that Australia is able to meet its international financial obligations that result from trade with the rest of the world (evidenced by a relatively low and sustainable CAD and/or NFD). This is because the lower tax rates help to reduce costs of production either directly, or via the possible improvement in productivity and/or productive capacity that results from greater investment in capital. This reduces pressure on prices, helps to contain or reduce rates of inflation and improves Australia's international competitiveness as our exports become relatively cheaper and imports relatively more expensive compared to domestic alternatives. Net export demand should therefore increase, which improves the balance on merchandise trade (BOMT), reduces pressure on the CAD and NFD, and makes it less likely that Australia will be unable to meet its international financial obligations

b. The stronger value of the Australian dollar over the course of 2016 [rising from below 0.70 USD to more than 0.75 USD] contributed to the extremely low annual inflation rate [of 1% for the year ended June 2016]. This is because a higher dollar reduces demand inflationary pressures because of Australia's international competitiveness falls causing a lower net export demand and reduced growth in AD. In addition, cost inflationary pressures fall as the price of consumer and business imports decline, which not only directly reduces the CPI but also helps to reduce costs of production (e.g. the cost of capital imports) and therefore final prices.

c. The fall in the TOT that has occurred since 2011 has negatively impacted upon AD because mining companies in particular have been receiving lower prices, and therefore less income, for any given volume of iron ore taken from the ground. This reduces the rate of growth in AD because mining companies decided to undertake lower levels of Investment (a key component of AD) as lower prices impact negatively upon (future) profitability. In addition, the lower levels of income received by stakeholders in the mining industry (e.g. workers and shareholders) will further contribute to lower levels of AD as Consumption demand [the largest component of AD] falls. The lower TOT also negatively effects the net export component of AD, as the lower prices received for exports results in lower export values. Given that net export receipts (or values) are also a component of the current account, the lower prices received for mining exports negatively impacts on the balance on merchandise trade (BOMT), as export credits will be lower than otherwise, which should cause the current account to move further into deficit [i.e. the CAD gets bigger.]

d. Subsidy support for exporters will involve the government providing funds (or some other non-financial support) to help small businesses to access export markets. The subsidy works to reduce the effective costs of production for export businesses, enabling them to reduce prices and increase their international competitiveness. This helps to increase export demand and the value of net exports should rise, which reflects an increased share of world income earned by Australian businesses. This improves the Balance on Goods and Services, reduces the Current Account Deficit (CAD) and leads to a lower Capital and Financial Account (CAFA) surplus as the smaller gap between national income and spending reduces the inflow (credits) of foreign liabilities to fund the shortfall. This is likely to be reflected in a smaller inflow of foreign debt, which reduces the growth in Net Foreign Debt. [However, in the LR the subsidy can worsen Australia's international competitiveness and therefore have the reverse effects]

Question 4

a. A depreciation of the exchange rate occurs when the value of a country's currency on the foreign exchange market falls. This means that in Australia's case, a falling exchange rate results in one Australian dollar being able to purchase less foreign currency. For example, when the Australian dollar fell from USD1.00 to USD.90 it represented a fall in the exchange rate and meant that 1AUD could only purchase 90 US cents when it could previously purchase 100 US cents.

b. When the Australian dollar depreciates, it results in higher prices and inflation on the demand side because it reduces the international price of Australian exports and increases the Australian price of imports. This leads to a reduction in net export demand as more exports are demanded and fewer imports are purchased. The combined effect is to raise AD via stronger X growth and a reduction in M which are partly replaced with stronger demand for goods and services produced by import competing businesses. The increase in AD therefore leads to demand inflationary pressures in the economy.On the supply side, the lower dollar also tends to raise the costs of production for those firms relying on intermediate or capital imports. This is because these imports tend to have a relatively low price elasticity of demand, with fewer domestic alternatives. Accordingly, when the prices rise because of a lower AUD, it raised production costs which are then (partly or fully) passed on to consumers in the form of higher prices – contributing to inflation.

c. A lower value for the AUD is likely to increase the international competitiveness of Australia's traded goods sector (exporters and import competing businesses) because export prices on foreign markets decrease and import prices increase. This leads to an increase in net exports, thereby increasing credits relative to debits in the Balance on Merchandise Trade (BOMT) and Net Services (NS) accounts, which helps to reduce the CAD. Slower growth in labour costs means that there is less pressure on the costs of production for Australian businesses. This enables businesses to maintain downward pressure on prices (or increase profit margins which can then be re-invested for future growth) and improve the competitiveness of their goods and services on international markets. This leads to an increase in net exports, once more increasing credits relative to debits in the Balance on Merchandise Trade (BOMT) and Net Services (NS) accounts and helping to reduce the CAD.

d. A low CAD will mean that the national Savings/Investment imbalance is smaller and/or the gap between spending and income is narrowing. This means that growth in net foreign debt is likely to fall and the country is likely to be in a better position to meet its international financial obligations. Accordingly, the country's credit rating should fall, as will the cost of debt, exerting downward pressure on domestic interest rates which fuels consumption, Investment, AD and real GDP. This boosts material living standards as measured by growth in real GDP per capita.

Question 5

a. The TOT is an index of export prices relative to an index of import prices. It provides an indication of the volume of imports that could be purchased with a given volume of exports. In contrast, the TWI is an index comprising the value of Australia's exchange rate relative to the (weighted) exchange rates of Australia's trading partners. The TOT relates to price of goods and services that are traded whereas the TWI relates to price of currencies.

b. The higher TOT is likely to increase net exports because commodity exporters (such as miners) will be receiving higher prices for any given volume of exports, which tends to increase export values. To the extent that the TOT has also been caused by lower import prices (e.g. cheaper goods from China), it means that any given volume of imports will be cheaper to purchase, therefore reducing import values. The combined effect is to increase export values and reduce import values (particularly in the short term), therefore boosting net exports (X-M).

c. The higher exchange rate will tend to reduce the domestic price of imports, helping to reduce the CPI directly (e.g. consumer imports) and reduce CPI over time as the fall in the cost of capital or intermediate imports works to reduce the costs of production and contain price (inflationary) pressure. In addition, the higher exchange rate tends to reduce net export demand (because local products are relatively less price competitive), thereby reducing AD and helping to contain demand inflationary pressure.Given that the higher exchange rate makes imports relatively more price competitive and exports less price competitive, it means that Australia's tradables sector becomes less internationally competitive. Accordingly, the demand for X should fall and the demand for M should rise, helping to increase the value of M relative to X, worsening net exports and causing the BOMT (X-M of goods) surplus to fall or deficit to increase.

d. The floods make it more difficult to achieve external stability because many Australian exporters in the mining and agriculture sectors will be facing supply shortages which directly reduce exportable volumes. In addition, the higher prices for local goods and services will decrease the international competitiveness of Australia's tradables sector, which reduces the demand for net exports. As a consequence, net export values fall, which causes a reduction in any Balance on Goods and Services surplus, and increases the CAD.

e. The lower value of the AUD has increased the international competitiveness of local tourism operators competing against imported substitutes, such as tourist destinations abroad. This is because the lower AUD raises the Australian dollar price of imports (e.g. it is more expensive to purchase a foreign holiday or travel overseas), which in turn makes the domestic substitutes relatively more price competitive. This raises the demand for local tourism services, benefitting local operators as they will be able to sell their services at a higher price.

Question 6

a. The terms of trade is defined as a ratio of average prices received for Australia's exports to the average prices paid for Australia's imports. It effectively represents the volume of imports that can be purchased with a given volume of exports. In contrast, the current account (CA) balance refers to the balance (deficit or surplus) that exists in one of the two major accounts within Australia's balance of payments. The TOT is simply a ratio of 'prices' and does not reflect values of exports or imports, whilst the CA balance is what 'value' remains after deducting all current outflows (debits) for items such as imports, from all current inflows (credits) for items such as exports.

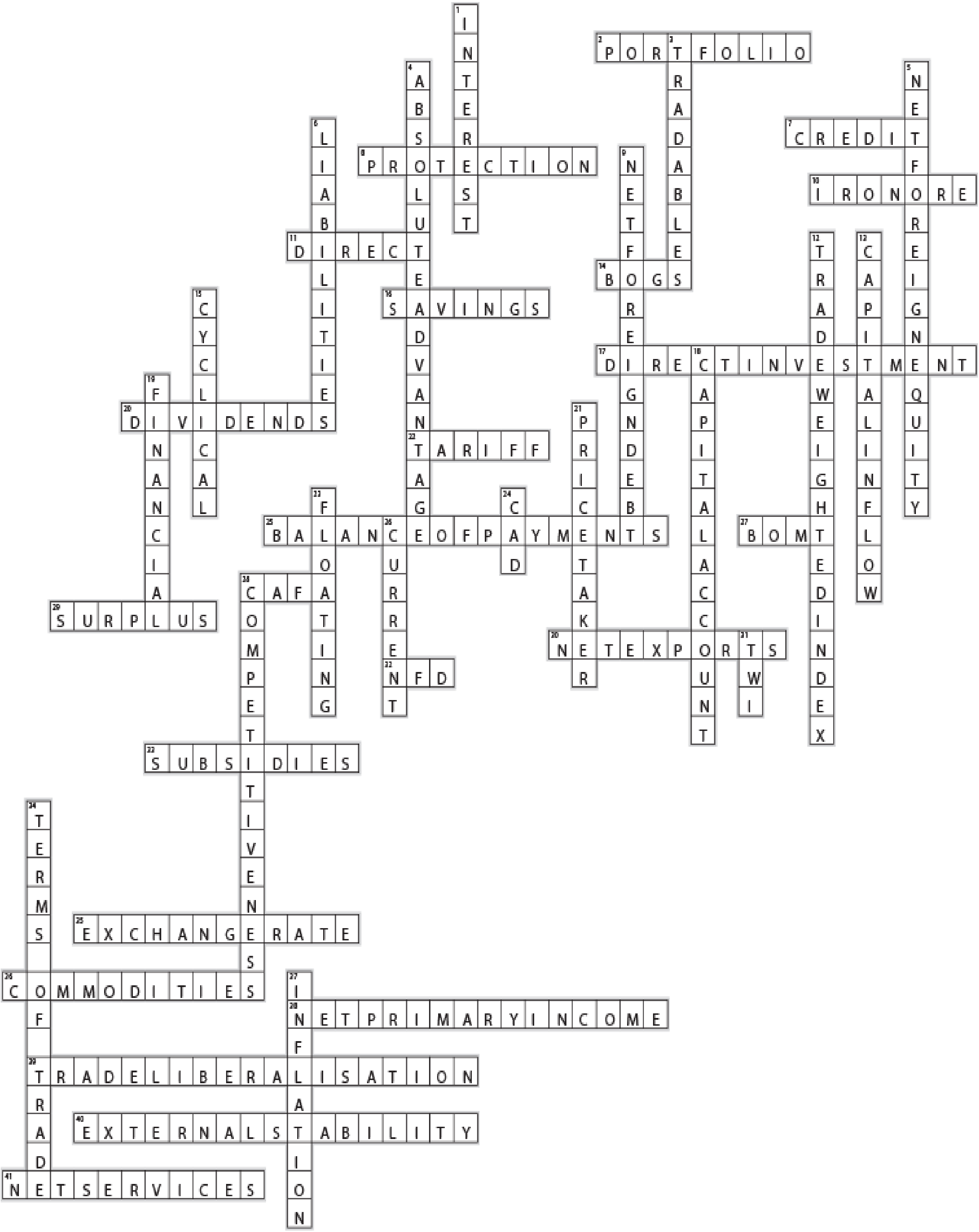
b. [The fall in the terms of trade over recent years has been a major factor explaining the lower Australian exchange rate as measured by the TWI (and the AUD/USD exchange rate)]. This is because Australian exporters, particularly commodity producers who have experienced much lower prices for their exported commodities, have received less value for any given quantity of exports sold on global markets. This has therefore reduced the demand for and value of the AUD in foreign exchange markets as foreign buyers require fewer AUD to purchase any given quantity of exports.

c. The volume of exports has increased over the past year because of the increased mining capacity that has followed the investment phase of the mining boom. As such, Australian miners are currently in the production phase of the mining boom, able to extract significantly more ore from the ground following periods of heavy investment in new mines and/or expanded capacity. These larger volumes are then shipped to export markets despite the fact that miners are receiving significantly less for each ton of exported ore.

d. The fall in the value of the AUD has helped to boost the international competitiveness of Australia's tradables sector (exporters and import-competing businesses) over the past year. Exporters have been able to more easily penetrate export markets as the prices of their exports are lower when purchased with foreign currency. Similarly, import-competing businesses have been able to regain some market share as imports become more expensive and Australians substitute into the relatively cheaper domestic alternatives/substitutes. With an increase in net exports, this boosts AD and economic growth and helps to maintain employment growth as the derived demand for labour by trade-exposed industries increases. This should place downward pressure on the unemployment rate towards the full employment or NAIRU (non-accelerating inflation rate of unemployment) level of approximately 5%.

e. To the extent that the lower AUD helps to increase net export demand and economic growth, it also helps to lift real GDP per capita, which is a measure of material living standards of Australians. This means that, on average, Australians will have a higher level of income, which increases their access to goods and services and boosts their material prosperity and living standards. To the extent that the higher level of real GDP contributes to a larger derived demand for labour and lower unemployment, the non-material benefits provided by employment (such as self-esteem and a sense of purpose) will also increase, providing a further boost to living standards.

Answers to crossword



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