

Economic Growth

7

Multiple Choice Answers

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

Short Answer Questions

Question 1

- a) $MPC = 0.6$
- b) $k = \frac{1}{1 - MPC}$
 $= \frac{1}{1 - 0.6}$
 $= 2.5$
- c) $\text{Change in GDP} = k \times \Delta AD$
 $= 2.5 \times 40$
 $= \$100\text{bn increase}$
- d) Economic growth is measured in terms of real GDP to remove the effects of inflation. The change in nominal GDP reflects both an increase in production levels and prices. However, since economic growth involves only an increase in production levels, the effect of price increases must be removed. Real GDP reflects the change in nominal GDP adjusted to remove the effects of price increases.

- e) Economic growth leads to higher living standards. Economic growth means that disposable incomes throughout the economy are rising (since the value of the increase in production is equal to the value of the increase in income, *ceteris paribus*). This means that individuals are able to enjoy a greater material wellbeing. Economic growth also creates jobs in the economy and lowers unemployment. Economic growth means that there is higher demand for goods and services, leading firms to increase their demand for labour as an input into production. Economic growth can lead to higher levels of investment in the economy. Businesses plan their investment decisions based on whether the investment is likely to be profitable in the future. Businesses are more likely to invest during a period of economic growth as the firm is more likely to make a profit. Higher investment not only generates more economic growth, but it also expands productive capacity for the future, which ensures that economic growth can be sustained into the long term. Finally, economic growth provides more revenue to the government to spend on essential items of social infrastructure such as health, education and defence. This will in turn lead to higher levels of economic growth and development in the economy over time.

Question 2

a)
$$\text{Real GDP}_2 = \frac{\text{Nominal GDP}_2}{\text{CPI}_2} \times \text{CPI}_1$$

$$= \frac{540}{108} \times 100$$

$$= 500$$

$$\text{Economic growth} = \frac{500 - 480}{480}$$

$$= 4.2 \text{ per cent}$$

- b) A fall in the price Australia receives for its exports, as reflected in the terms of trade, would reduce export revenues and lower exports. Also, a downturn in the international business cycle would decrease demand for Australia's exports, lowering export volumes and decreasing exports.
- c) An improvement in productivity means that the economy is producing more output per unit of input. In other words, the economy is able to produce more output without altering its inputs. This would result in an increase in aggregate supply, increasing economic growth in the economy.
- d) The government may use macroeconomic policy to raise the level of aggregate demand and increase economic growth. The government may use expansionary fiscal policy, which raises the level of net government expenditure. This increases aggregate demand. Additionally, the initial increase in government spending would increase incomes, some of which would be spent on consumption in accordance with the marginal propensity to consume, leading to an increase in consumption as part of the multiplier process. Overall, economic growth would increase by more than the initial increase in government spending. The government may also use monetary policy to lower interest rates and boost consumption and investment in the economy, increasing aggregate demand and economic growth. The government can also use microeconomic policy to improve productivity, efficiency and international competitiveness in the economy. This would increase the level of aggregate supply and increase economic growth. The use of microeconomic policy provides for a higher sustainable rate of economic growth in the long term. Examples of microeconomic policy include national competition policy, labour market reforms and deregulation of the financial sector.

Question 3

- a) Gross domestic product is the total value of goods and services produced in an economy over time.
- b) Consumption is primarily affected by the level of income. As income rises, individuals tend to spend a proportion of it on consumption, given by the marginal propensity to consume. Individuals may also finance their consumption out of debt, and so the level of interest rates will affect consumption. The lower the interest rate, the more likely individuals will borrow in order to consume. Consumption is also affected by expectations about prices and economic conditions. If consumers expect prices to rise, they are more likely to increase consumption immediately, whereas if prices are expected to fall, consumers may postpone their consumption. Similarly, if consumers expect economic conditions to deteriorate, they may postpone consumption and increase savings. Investment, like consumption, is affected by the affordability of the investment itself. Firms tend to finance investment by borrowing and so the interest rate is an important factor affecting investment. The lower the interest rate, the more investment a firm is able to afford. Investment is also affected by the profitability of the investment. Firms will be more likely to invest if economic conditions are strong, since the investment is more likely to generate a profit. Business expectations will affect the decisions to invest, as firms must make a judgement as to future economic conditions and how they will affect the profitability of the investment.
- c) In 2000-01, Australia experienced a slowdown in economic growth due to deteriorating global economic conditions. Globally, there was a stock market crash in the US as the tech boom came to an end, and soon after the effects of September 11 lowered confidence in the global economy. In Australia, the deterioration of global economic conditions led to a decrease in investment and consumption levels due to lower business and consumer confidence. By the mid 2000s, however, the Australian economy was once again maintaining steady economic growth between 3 and 4 per cent due to a boom in global commodity prices. Over the 2000s, the emergence of China and India as major manufacturing economies increased demand for commodities worldwide. This drove up global commodity prices and pushed Australia's terms of trade to record highs. This increased export revenues and raised domestic incomes, boosting consumption. As a result, Australia was able to maintain a strong level of economic growth.

Skills Revision

- Government spending = 90
- Investment = 45
- Savings = 25
- Exports = 50
- Investment = 25
- Aggregate supply = 150

The multiplier and equilibrium:

Please note that there is an error in the example. Under the third step the change in GDP is \$500m

Table 1:

- $MPC = 0.75$, $MPS = 0.25$
- $k = 4$
- Change in GDP = \$800m
- Equilibrium Income = \$700

Table 2:

- $MPC = 0.6$, $MPS = 0.4$
- $k = 2.5$
- Change in GDP = -\$125m
- Equilibrium Income = \$8000

Table 3:

- $MPC = 0.9$, $MPS = 0.1$
- $k = 10$
- Change in GDP = \$1bn
- Equilibrium Income = \$2,000