



Practice Half Yearly Examination

Multiple Choice

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

Short Answers

Question 21

- (a)** A boom in global commodity prices, as seen between 2003 and 2009, would cause export prices to increase relative to import prices, leading to an improvement in Australia's terms of trade.
- (b)** In the 2000s, Australia's terms of trade significantly improved, primarily because of the sharp increase in the global prices of commodities such as coal, iron ore and nickel, which Australia exports. Over the same period, prices for manufacturing goods, which Australia tends to import, declined, also strengthening the terms of trade. As demand for commodities strengthens with the global economic recovery, Australia's terms of trade is likely to improve over 2010-11.
- (c)** Foreign investment inflows – such as the purchase of Australian land, shares or companies by foreign investors – are recorded initially as credits on the financial account of Australia's balance of payments. However, investment inflows require returns in the form of rent, dividends and profits to be repatriated to overseas investors. The payment of these returns are recorded as debits on the net primary income component of the current account, potentially contributing to high current account deficits over time.
- (d)** An improvement in Australia's terms of trade indicates that export prices are increasing relative to import prices. This means that if output is the same, exports will rise and imports will fall, causing an improvement in the balance on goods and services (BOGS). For the balance of payments overall, there will be a reduction in the current account deficit and reduced reliance on foreign financial inflows. However, an improvement in the terms of trade can also lead to a phenomenon known as 'Dutch Disease', where the rising terms of trade (driven by a boom in one industry, such as mining) causes an appreciation of the exchange rate. This appreciation reduces the international competitiveness of Australia's other sectors (such as agriculture or manufacturing), partially offsetting the benefits of an improved BOGS.

Question 22

- (a)** As FDI flows are strongly influenced by the level of economic activity, the global financial crisis in 2008-09 saw FDI flows fall significantly (from over \$US2 trillion), however they are now rising with the global economic recovery.
- (b)** Foreign direct investment creates employment opportunities for the local workforce in the recipient economy, leading to greater output and a higher level of economic growth. FDI flows also facilitate technology transfers between economies, increasing a nation's productive capacity and future standards of living.
- (c)** The removal of restrictions on foreign ownership has spurred the growth of cross-border FDI flows and transnational corporations (TNCs) in emerging economies. As a result, emerging economies are experiencing increased foreign investment flows, new technologies and job creation, all of which have contributed to the high rates of economic growth observed in emerging economies throughout the last decade.
- (d)** Foreign direct investment flows have, until recently, heavily favoured advanced economies, with around two thirds of total FDI in 2007 flowing to such economies. The benefit of such long term investment lies in its productive ability to create jobs and increase technology transfers between economies, and thus fuel economic growth. As economic growth increases in an economy, it also raises income levels, educational resources, health care funding and programs aimed at protecting the natural environment, all of which improve economic development. Developing economies – particularly those low-income economies in Sub-Saharan Africa – have typically been excluded from many of the benefits of global FDI flows, thus worsening global inequality. However in recent years, developing and emerging economies have attracted a greater share of FDI flows, equal to around half of the total in 2009. This has been concentrated across rapidly industrialising economies throughout South and East Asia, which have experienced fast growth over the past two decades. Greater FDI flows have seen steady improvements in income levels across emerging economies, which in turn has improved economic development. However, many developing economies still receive an insignificant fraction of global FDI flows.

Question 23

- (a)** A bilateral exchange rate is a measure of the value of one nation's currency expressed in terms of another. For example, the Australian dollar expressed in terms of the US dollar. The Trade Weighted Index (TWI) measures the value of the Australian dollar against a basket of foreign currencies of Australia's major trading partners, weighted according to their significance to Australia's trade flows.
- (b)** Since 2008-09, strong growth in emerging markets has seen an increase in global commodities prices. This has fuelled both demand from trade as well as speculative investment in the Australian dollar, causing the dollar to appreciate to above parity with the US dollar.
- (c)** One benefit of a floating exchange rate is that market forces of supply and demand freely determine the value of a nation's currency. As a result, the exchange rate is more likely to resemble the 'true' value of the individual currency. However, a floating exchange rate is also susceptible to large and sudden fluctuations in its value, due to speculation in foreign exchange markets. Such volatility creates uncertainty for investors, discouraging financial inflows.
- (d)** In the short term, a depreciation of the Australia dollar will lead to a deterioration of Australia's balance on goods and services (BOGS) as a result of fixed international contracts. Exporters receive lower revenue for a given quantity of exports and import spending rises for a given quantity of imports. However over time, a depreciation of the exchange rate makes Australian exports more competitive and discourages import spending. This will lead to a long term improvement in the trade balance, reducing the current account deficit. A depreciation also makes investing in Australia relatively less expensive for foreign investors, leading to greater financial inflows. However, a depreciation also increases the Australian dollar value of Australia's foreign debt and interest servicing costs (for that which is denominated in foreign currency). This increases income outflows on the net primary income component of the current account, worsening the current account deficit.

Question 24

- (a)** With the imposition of the tariff, domestic producers supply a greater quantity of the good. As a result, imports decrease from 8,000 units to 4,000 units, after the tariff is imposed.

$$\begin{aligned}\text{Producer revenue before tariff} &= 10,000 \times \$55 \\ &= \$550,000\end{aligned}$$

$$\begin{aligned}\text{Producer revenue after tariff} &= 12,000 \times \$60 \\ &= \$720,000\end{aligned}$$

$$\begin{aligned}\text{Change in producer revenue} &= \$720,000 - \$550,000 \\ &= \$170,000\end{aligned}$$

- (b)** Protection improves the competitiveness of domestic producers, increasing the demand for domestically produced goods, creating local jobs and shielding domestic employment. On the other hand, protection distorts the allocation of resources in an economy towards protected industries and away from those where resources are used most efficiently.
- (c)** An increase in global protection reduces Australia's access to overseas markets and leads to lower export earnings. As a result, Australian exporters are made less internationally competitive, reducing their income and Australia's total output. For example, the European Union Common Agricultural Policy provides European farmers with an artificial advantage over their Australian competitors.
- (d)** Regional trading blocs have reduced protectionist barriers between member countries and increased trade flows. However, regional trading blocs are closed or discriminatory, meaning that non-member countries still face barriers to market access. For example, the EU's Common External Tariff and the Common Agricultural Policy restrict non-member countries from accessing European markets. Some economists argue that regional trading blocs are an important 'stepping-stone' to global free trade, because they demonstrate the benefits of trade liberalisation for countries on a smaller scale. However, critics argue that regional trading blocs only divide the global economy into specific trading regions, hindering attempts at further economic integration.