

2

How Economies Operate

Multiple Choice Answers

- | | | | | | |
|---|---|----|---|----|---|
| 1 | B | 6 | B | 11 | B |
| 2 | A | 7 | C | 12 | D |
| 3 | C | 8 | D | 13 | A |
| 4 | C | 9 | A | 14 | C |
| 5 | D | 10 | B | 15 | D |

Short Answer Questions

Question 1

- (a) Land (natural resources), labour, capital and enterprise.
- (b) Gross domestic product is the total output produced in an economy over a period of time (usually in one year)
- (c) Labour refers to human effort used in the production of goods and services, and receives wages as income. Enterprise involves the organisation of other factors of production, and receives profits. Although both require human effort, enterprise is involved in organising the production process, whereas labour is a part of the production process.
- (d) A decrease in wages will reduce the cost of labour in production. This will make labour more attractive than capital in production, and businesses are likely to switch (where possible) to labour-intensive production, reducing the use of capital.
- (e) The problem of scarcity is the fact that resources in the economy are limited (or scarce). Land is limited to the natural resources which can be accessed and used in production. Labour is limited by the size of the population, its willingness to work, and level of skills and experience. Capital is limited by the production of capital goods in the economy (the level of investment) as well as the level of savings to fund investment. Capital is also limited by the rate of technological progress. Enterprise is limited by the same factors as labour, as well as the willingness of individuals to take up the risk of running the production process.

Question 2

- (a) Recession
- (b) In a barter economy, individuals exchange one product directly for another. Exchange will only occur when individuals find someone else willing to make the same exchange. In a cash economy, individuals value all their products in terms of money, and will be willing to exchange with anyone who possesses money.
- (c) An economic boom, such as in point B in the stimulus, is associated with increasing production of goods and services in the economy. Firms will demand more labour for use in the production process, lowering the levels of unemployment. As more goods and services are produced, income levels and standards of living start to rise. Consumers will spend more on consumption of goods and services, and firms will increase investment in capital goods to be able to produce more goods and services in the future.
- (d) The government influences the business cycle through its use of taxation and government spending. If the government wanted to reduce economic activity, it would increase taxes and decrease government spending. As a result, leakages would be greater than injections resulting in a fall in production. If the government wanted to increase economic activity, it would decrease taxes and increase government spending, resulting in injections being higher than leakages, increasing production levels in the economy.

Question 3

- (a) Equilibrium is a state of economic activity where there is no tendency for change. Equilibrium in the circular flow of income occurs when the level of leakages is equal to the level of injections, which means that income levels will remain unchanged.
- (b) Year 3
- (c) In equilibrium: Leakages = Injections
- $$S + T + M = I + G + X$$
- $$20 + 40 + 15 = 15 + 65 + X$$
- $$X = -5$$
- (d) An improvement in the US business cycle would result in higher income levels in the US. US consumers may choose to purchase Australian exports (which is an import to America). This would raise Australian exports, increasing injections.
- (e) The government could increase economic activity by lowering the level of taxation. Since taxes are a leakage from the economy, by lowering taxes, leakages would fall relative to injections. Income levels would rise due to lower taxes, increasing economic activity. The government could also increase its level of government expenditure, increasing the level of injections. This would raise income levels and increase economic activity.

Economic Terms

The economic terms should appear in the following order:

- Recession
- Services
- Infrastructure
- Enterprise
- Gross domestic product
- Productivity
- Financial institutions
- Investment
- Labour
- Public sector