Practice questions

Question 1

Using the Keynesian income and expenditure model, analyze the effect of Global Financial Crisis on the Australian Economy.

The financial crisis caused a collapse in consumer and business confidence. Both consumption and investment expenditure fell. Also recession in the world economy means that the demand for exports goes down.

\[ AD = C + I + G + X - M \]

\[ E = AD = Cd + J \] (all imports are assumed to be bought for consumption and therefore the two AD equations are equivalent)

\[ GDP = Cd + W = Y \]

As both consumption and investment fell, AD shifted down because both \( Cd \) and \( J \) reduced. Equilibrium GDP fell from GDP1 to GDP2 and unemployment increased.
**Question 2**

Demonstrate the effects of price ceiling on the rental markets in Darwin. Does the policy of price ceiling provide a long-term solution to high housing prices in the Darwin region?

Price ceiling refers to a situation where price is not allowed to rise above a certain level and is only meaningful when it is below the equilibrium level. Price will be $P_1$ and quantity will be $Q_2$. Price set below the equilibrium will cause a shortage of $Q_2 - Q_1$.

Price ceiling leads to the following:

a) Black markets  
b) Allocation on first come first basis  
c) Preferential treatment.  
d) Reduced supply

The above are problematic from efficiency and welfare perspectives and therefore price ceiling fails to provide effective long term solutions.

**Question 3**

Explain and illustrate with diagrams the differences between diminishing marginal returns and decreasing economies of scale and cite causes and examples.

Economies of scale is concerned with long-run average cost, while diminishing returns is concerned with short-run marginal product and total output. Economies of scale (falling long-run average cost) cannot continue indefinitely. A time comes in the life of a firm or an industry when further expansion leads to diseconomies of scale.

Diseconomies of scale mean long-run average cost rises as output expands. One main reason for diseconomies of scale is managerial diseconomies of scale. Large companies

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**Diagram**

[Diagram showing price ceiling with price $P_1$ and quantity $Q_2$, explaining the shortage $Q_2 - Q_1$.]
need many layers of management, themselves needing to be managed. The company becomes bureaucratic, co-ordination problems arrive and average costs begin to rise.

As output increases, the shape of the average cost curve thus depends on two things: how long economies of scale persist, and how quickly the diseconomies of scale set in. The balance of these two forces varies from industry to industry, and firm to firm.

The law of diminishing returns states that, holding one or more input factors fixed, when more and more units of the variable factor are used a point is reached beyond which the marginal product, then the average and finally the total output will diminish.

If labour is the variable factor and capital the fixed factor, employing more and more labour to a given quantity of capital might initially lead to large increases in output but would soon encounter diminishing returns as the marginal product of labour decreases and hence marginal cost increases.

NB: to be explained with diagrams.
Question 4

Use the Keynesian income and expenditure model to analyse the effect of reduction of company tax rate on the Australian economy. Provide a detailed explanation and diagram.

\[ AD = C + I + G + X - M \]

\[ E = AD = C + J \] (all imports are assumed to be bought for consumption and therefore the two AD equations are equivalent)

\[ GDP = C + W \]

The reduction in company tax rate increases firm’s profitability inducing greater investment. Since Investment is part of injections, AD increases. This is represented on the following diagram:

AD shifts from AD1 to AD2. Equilibrium output increases from GDP1 to GDP2 and unemployment falls.

Question 5

Using demand and supply model, examine the effect of the following events on the price charged by Qantas airlines:

a) the global recession
   If there is a global recession then demand for travel reduces for both domestic and
international travel. Demand curve shifts to the left causing equilibrium price to fall

![Diagram showing supply and demand curves for international travel with an increase in price due to higher fuel costs.]

b) higher fuel costs

Since costs increase, the supply of available flights reduces. Supply curve shifts to the left causing an increase in price.

![Diagram showing supply and demand curves for international travel with a decrease in price due to the spread of Ebola virus.]

The spread of Ebola virus causes a global panic reducing the demand for international travel. Demand curve shifts to the left causing equilibrium price to fall. Diagram same as part b.

The answer must contain clear diagrams and explanations.