



## VCE ECONOMICS 3/4

### CPAP Practice examination No 1 2021

# SUGGESTED RESPONSES, MARKING SCHEME AND ADVICE

#### Answers to MC questions

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

## SECTION A

## Question 1

Table 1: Key forecasts for major economic statistics from Budget papers

	Outcomes	Forecasts				
	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Real GDP	-0.2	1 1/4	4 1/4	2 1/2	2 1/4	2 1/2
Employment	-4.2	6 1/2	1	1	1 1/4	1 1/4
Unemployment rate	6.9	5 1/2	5	4 3/4	4 1/2	4 1/2
Consumer price index	-0.3	3 1/2	1 3/4	2 1/4	2 1/2	2 1/2
Wage price index	1.8	1 1/4	1 1/2	2 1/4	2 1/2	2 3/4
Nominal GDP	1.7	3 3/4	3 1/2	2	4 3/4	5

The actual budget deficit for 2021-22 is likely to be higher than the estimated budget deficit of \$106.6 billion if the actual economic statistics for 2021-22 were as follows:

- A. The unemployment rate is 5.2% and nominal GDP growth is 4.5%
- B. The growth in consumer prices is 2% and real GDP is 4.5%
- C. Employment growth is 1.5% and nominal GDP is 4%
- D. *The unemployment rate is 5.3% and the wage price index 1.0%*

**Option D is the best response** the unemployment rate is higher than forecast and the wage price index is lower than forecast. Together, this indicates that economic activity is slower than expected, causing automatic stabilisers to reduce government revenue (e.g. via lower tax receipts) and increase government expenditure (e.g. via higher income support payments). Option A is incorrect because the statistics provide a conflicting message. The higher than expected unemployment rate suggests the deficit will be larger, however the significantly stronger growth in nominal GDP suggests that the actual deficit will be lower. Options B and C are both incorrect because all of the relevant statistics move in a way that indicates economic activity will be stronger, which causes the actual deficit to fall below the estimated deficit.

## Question 2

Consider the following hypothetical budget figures

Item	Amount (\$b)
Total receipts	400
Total expenditure	350
Net cash inflow from investment in financial assets for policy purposes	30

Which statement below is accurate?

- A. *The headline balance is a \$50b surplus and the underlying balance is a \$20b surplus*
- B. The headline balance is a \$50b deficit and the underlying balance is a \$20b surplus
- C. The headline balance is a \$50b surplus and the underlying balance is an \$80b surplus
- D. The headline balance is a \$50b surplus and the underlying balance is a \$30b deficit

**Option A is the best response** because the headline balance is \$50b (\$400b - \$350b). In addition, the net cash inflow from investment in financial assets for policy purposes (which are effectively asset sales) needs to be taken away from total receipts to arrive at the underlying balance of \$20b (i.e. \$400b - \$30b - \$350b = \$20b surplus). A similar question was asked in the 2020 exam and it was the most poorly handled question on the paper with only 14% of students choosing the correct response. It required students to calculate the underlying cash surplus from the following hypothetical figures: total receipts \$200B; total outlays \$175B; net cash flows from investments in financial assets \$10B; and Future Fund earnings \$5B. Students needed to recognise that the headline outcome was \$200B - \$175B = \$25B surplus and that \$15B of the total \$200B of receipts needed to be excluded from the headline balance to arrive at an underlying figure. That is, \$25B surplus less \$15B (IFAPP and FFE) = \$10B underlying surplus. Many students (39%) selected option B (\$25B) which is simply the headline surplus and some (13%) chose D (\$40B), making the mistake of adding \$15B to the headline surplus rather than subtracting. **Students should note** that the method of calculating the

underlying cash balance has now changed. From 2020-21 Future Fund earnings are no longer taken away from the headline cash balance to arrive at the underlying cash balance (as in previous years). It will therefore be simpler for students to determine the underlying outcome in the event that a question surfaces on the exam. However, given the change to the method of calculation, it is highly unlikely that a similar question will surface on the 2021 exam.

### Question 3

Consider the following statistics for a hypothetical economy over the year 2021-22

Trade Weighted Index	90
Consumer Price Index	135
Terms of Trade Index	105
Net exports of goods	\$120m
Net Services	\$80m
Net Primary and Secondary Incomes	-\$160m
Net Foreign Equity	-\$100m
Net Foreign Debt	\$950m

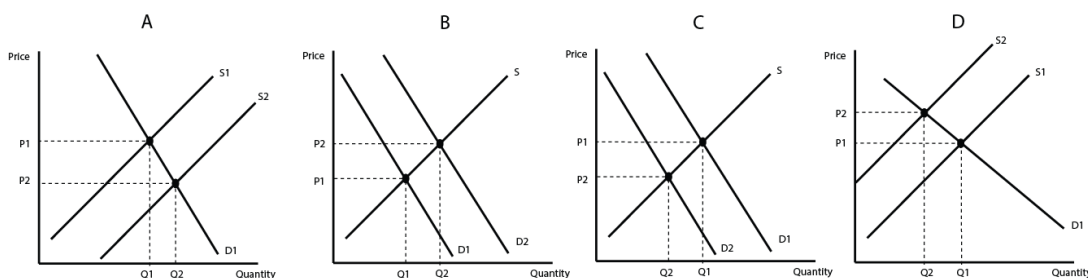
For 2021-22, which of the following statements is correct?

- A. There is a current account deficit of \$40m and net foreign liabilities are \$850m
- B. There is a current account surplus of \$40m and net foreign liabilities are \$1,050m
- C. *The Capital and Financial Account will be a deficit of \$40m and the Balance on Goods and Services will be a surplus of \$200m*
- D. The Balance on Merchandise Trade will be a balance of \$105m and net foreign debt is \$850m

A key skill in the Study Design is the requirement for students to 'calculate relevant economic indicators using real or hypothetical data' and this skill has been tested regularly within Part A of the examination over the life of the current Study Design. In the 2017 exam, students were required to calculate the rate of inflation from hypothetical (simplified) CPI numbers; terms of trade from hypothetical (simplified) export and import price indexes; and the current account from hypothetical (simplified) balance of payments data. In the 2018 exam, students were once again required to calculate inflation and the terms of trade from similar sets of data. In 2019, students were required to calculate the unemployment rate from hypothetical (simplified) labour force statistics. Students often struggle selecting the right response when calculating hypothetical statistics, so it is reasonable to expect at least one question to appear in Part A of the examination. For the current question, students should recognise that the actual CAFA balance is not contained in the table, but it can be deduced from the current account balance (given that the balance of payments must equal zero). Next, students should recognise that the statistics for the TWI, TOT and CPI are irrelevant. **Option C is the best response** because CAFA balance must be a \$40m deficit given that the current account is a surplus of \$40m ( $120+80-160$ ) and the BOGS is the combination of net exports of goods (BOMT) and Net Services. Option A is incorrect because there is no CAD. Option B is incorrect because NFLs are \$850m ( $\$950m - \$100m$ ). Option D is incorrect because the BOMT is net exports of goods plus net services ( $120 + 80 = 200$ ) and NFD is \$950m

### Question 4

Which of the following diagrams best illustrate the law of demand?



- A. *Diagrams A and D*
- B. Diagram B and C
- C. Diagram A and B
- D. Diagram C and D

The Study Design requires students to demonstrate an understanding of the law of demand and the demand curve including movements along, and shifts of, the demand curve. Students often confuse shifts of curves with movements along curves and it is useful to remember that it is the law of demand that is the driving force behind any movement along the demand curve. **Option A is the best response** because both diagrams A and D highlight a shift of supply which induces an expansion along the demand curve (Diagram A) and a contraction along the demand curve (Diagram D). In both cases, the decision by consumers to demand more or less is driven by the change in price. In market A, the shift to the right of supply causes a lower price which expands demand (in line with the law of demand) while in market B, the shift to the left of supply causes a higher price which contracts demand (in line with the law of demand).

### Question 5

Which of the following statements is most accurate in relation to the performance of the Australian economy over 2020-21?

- A. **The current account was in surplus, underlying inflation was below 3% and Net Foreign Debt was close to \$1 trillion**
- B. The unemployment rate fell below 6%, the cash rate fell to 1.0%, and the government delivered a budget deficit
- C. Real wages grew by 4%, the terms of trade had increased and real GDP growth was negative
- D. The underemployment rate was more than 15%, government debt was higher than one year earlier and the trade weighted index was lower than in 2019-20

Occasionally, VCE exams will include questions such as these in the multiple choice section that rely on students having a general (but not a precise) knowledge of contemporary economic statistics. There will usually be at least one statistic within each option that is clearly wrong. **Option A is the best response** because all three statistics are accurate. The incorrect statistics contained in the other options are underlined.

### Question 6

Disguised unemployment is best defined as:

- A. Those people who have stopped actively looking for work because they have become discouraged
- B. **Those people who are classified as employed but who are wanting to work more hours**
- C. Those people who have been unemployed for more than a year
- D. Those people who have stopped looking for work despite being willing to take a job if one was offered

The Study Design (U3, AOS 2) requires students to demonstrate an understanding of the different classifications within the labour force, including those classified as employed, unemployed, hidden unemployed and disguised unemployed (which is also referred to as underemployed). **Option B is the best response** because it is an accurate definition of disguised unemployment (or underemployment). Options A and D are incorrect because they both refer to hidden unemployment. Option C is incorrect because this refers to long term unemployment.

### Question 7

Cost inflation is most likely to be a consequence of which of the following events?

- A. **An increase in the compulsory superannuation guarantee levy from 9.5% to 12% over time**
- B. The government reducing company tax rates for small corporations to 25%
- C. There is a strong growth in the demand for Australian exports of consumer goods
- D. Interest rates fall to the lowest on record

A similar question was asked on the 2020 exam and it was the second most poorly handled question on the exam, with only 47% of students selecting the correct response. In that question, most students did not recognise that an increase in superannuation payments effectively add to the costs of production and ultimately increase cost inflationary pressures. For the current question, **option A is the best response** because the increase in the compulsory superannuation guarantee forces employers to pay more into the superannuation accounts of employees, which adds to total labour costs and contributes to an increase in cost inflation (or cost inflationary pressures). All other options will contribute to an increase in demand inflationary pressures.

**Question 8**

With respect to the terms production and productivity, which of the statements below is accurate?

- A. Production can be defined as outputs over inputs, while productivity represents the real value of goods and services produced over a given time period
- B. Production relates to how efficiently goods and services are made while productivity relates to the process of making goods and services
- C. *Production is the total volume of goods and services produced while productivity is the total volume of goods and services produced in relation to the inputs and/or resources used to produce those goods and services*
- D. Production only occurs in the household sector while productivity only occurs in the business sector

*In responses in VCE Economics exams, students continue to confuse production and productivity, often using the terms interchangeably and/or using the terms out of context. This point was highlighted in recent Examination Reports, where students were advised to improve 'by being able to clearly distinguish the differences between production, productivity and productive capacity'. In the 2020 Report, the Chief Assessor once again highlighted the confusion that was evident from student responses when noting the difference between production and productivity. For the current question, students need to appreciate that production can refer to the total output of an economy, the total volume or real value of production, or even the process of making goods and services. In contrast, productivity measures the efficiency of the resources/inputs (such as labour and capital) that are used to produce total output. Accordingly, **option C is the best response** because it refers to the volume of goods and services produced relative to the inputs used in that production. All other options contain inaccurate statements.*

**Question 9**

Which of the following is most likely to increase the price elasticity of supply for new motor vehicles?

- A. There is a reduction in productive capacity following a shortage of important computer chips used in their production
- B. There is a decrease in the availability of substitutes such as motor cycles and public transport
- C. There is an increase in industrial disputes which is impacting on the ability to meet vehicle production quotas
- D. *The robotics used manufacturing plants has been upgraded, which has raised productivity and technical efficiency*

*Past exams reveal that some students confuse the factors affecting the price elasticity of supply with factors affecting price elasticity of demand. The Study Design requires students to have a knowledge of the following factors affecting the PES: spare capacity, production period and durability of goods. For the current question, **option D is the best response** because the new robotics will enable to productive capacity of MV manufacturing plants to increase productive capacity, resulting in larger volumes of production that can stored to meet supply when the market requires. Options A and C are incorrect because they will both cause the PES to fall. Option B is incorrect because this relates to the price elasticity of demand (i.e. it will reduce the PED).*

**Question 10**

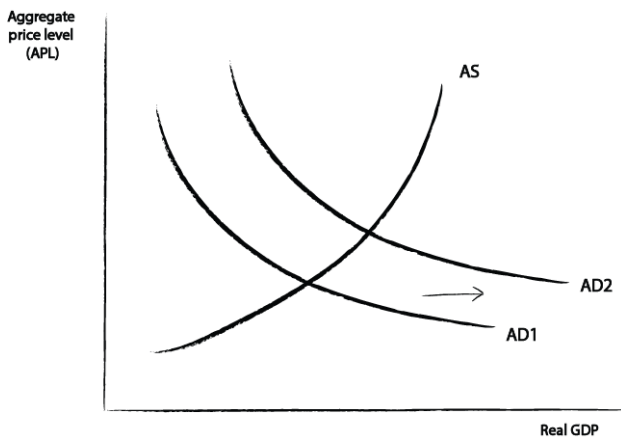
Relatively scarcity is a problem for all nations and occurs because

- A. Choices are relatively limited
- B. Opportunity costs relatively limited
- C. Needs and wants are relatively limited
- D. *Resources are relatively limited*

*The Study Design requires students to demonstrate an understanding of relative scarcity: needs, wants, resources and opportunity cost. **Option D is the best response** because resource is are relatively limited (compared to the demands placed on those resources by the wants and needs of a nation). Option A is incorrect because choices are relatively unlimited. Option B is incorrect because opportunity costs exist due to the problem of relative scarcity (not the other way around). Option C is incorrect because needs and wants are unlimited (not limited).*

### Question 11

In relation to the diagram below, which of the following statements is not a valid explanation for what may have occurred in the economy?



- A. There has been an increase in disposable incomes which has increased Consumption demand, stimulated economic growth, lifted the rate of inflation and reduced unemployment
- B. There has been an increase in the exchange rate which has increased net export demand, stimulated economic growth, lifted the rate of inflation and reduced unemployment**
- C. There has been a decrease in interest rates which has increased Investment demand, stimulated economic growth, lifted the rate of inflation and boosted employment
- D. There has been an increase in the rate of overseas economic growth which has increased net exports, stimulated economic growth, lifted the rate of inflation and boosted employment

The Study Design requires students to demonstrate an understanding of what is meant by the aggregate demand curve and the aggregate supply curve as well as an understanding of the effects of changes in aggregate demand and aggregate supply on the level of economic growth, employment and price levels. **Option B is the best response** because an increase in the exchange rate (i.e. an exchange rate appreciation) reduces international competitiveness and causes a decrease in net export demand, which reduces economic growth and inflation intends to increase the rate of unemployment. All other options relating to the impact of other aggregate demand side factors are accurate representations of what the diagram suggests is happening to the economy.

### Question 12

The headline rate of inflation for the year to end December 2020 was 0.9% while the underlying rate of inflation for the same period was 1.2%. This is best explained by:

- A. A 9.3% increase in the price of tobacco following the further increase in tobacco excise
- B. A fall in the price of non-volatile goods and services
- C. A 7.5% fall in the price of electricity**
- D. A 2.1% increase in the price of education

A key knowledge point in the Study Design requires students to understand the difference between the headline and underlying rates of inflation. Students should recognise that if the headline rate of inflation is below the underlying rate it suggests that there have been volatile or one-off price falls that are included in the measurement of headline inflation but excluded from the measurement of underlying inflation. This means that **Option C is the best response** because a 7.5% fall in electricity prices is a relatively large outlier that reduces the headline rate but is excluded from the underlying (trimmed mean) rate of inflation. Option A is incorrect because this increases pressures on the headline rate relative to the underlying rate. Option B is incorrect because a fall in the price of non-volatile goods and services will typically have the same impact on both the headline and the underlying rates. Option D is incorrect because the rising price of education is not significant enough to be excluded from the underlying calculation (i.e. it will increase both the headline and underlying rates by the same margin).

### Question 13

Which of the following statements is correct in relation to the effect that lower immigration levels is having on the labour market and aggregate supply?

- A. Lower rates of immigration is causing labour market tightness, downward pressure on wages and a decrease in aggregate supply
- B. Lower rates of immigration is causing labour market tightness, upward pressure on wages and a decrease in aggregate supply**
- C. Lower rates of immigration is causing labour market weakness, upward pressure on wages and a decrease in aggregate supply
- D. Lower rates of immigration is causing labour market tightness, upward pressure on wages and an increase in aggregate supply

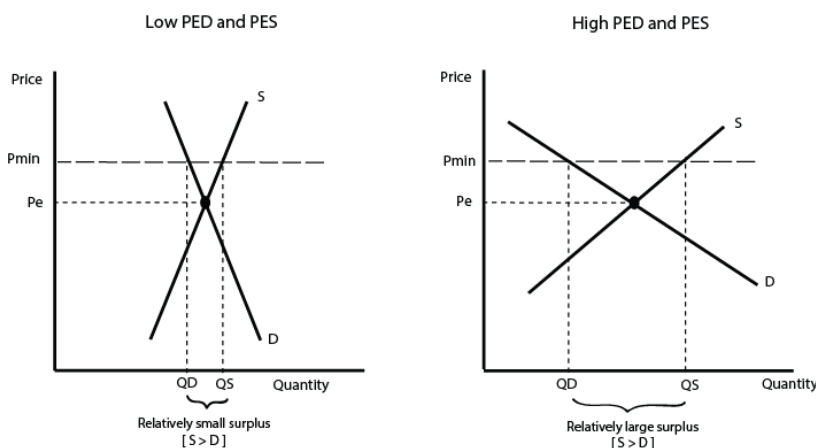
The Study Design requires students to demonstrate an understanding of the effects of immigration policies on the labour market and aggregate supply (and the way in which this influences the achievement of domestic macroeconomic goals). **Option B is the best response** because the COVID-19 related closure of international borders and the reduction in immigration has reduced the supply of labour to Australian labour markets, causing labour market tightness in many markets (e.g. shortages of workers exist in those labour markets that ordinarily rely on immigrant labour). These shortages are exerting upward pressure on the price of labour (i.e. wages) which raises the costs of production and therefore decreases aggregate supply. All other options have at least one of the key variables moving in the wrong direction.

### Question 14

A minimum price set above the equilibrium price will cause

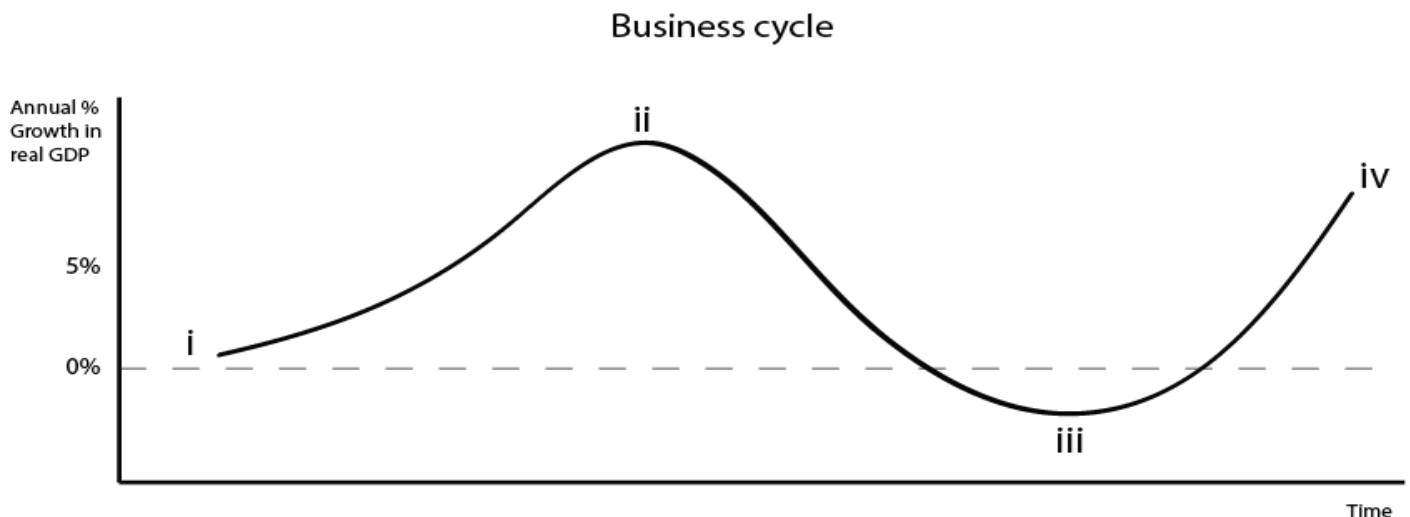
- A. a greater shortage if the demand and supply curves are both price inelastic
- B. a greater shortage if the demand and supply curves are both price elastic
- C. a greater surplus if the demand and supply curves are both price inelastic
- D. a greater surplus if the demand and supply curves are both price elastic**

In the 2019 exam, multiple choice question number 6 was the most poorly handled. Students were provided with a hypothetical scenario where a maximum price is set below the equilibrium price. Students were then effectively required to determine how the price elasticity of demand and supply influenced the size of the market shortage that would develop. Only 29% of students were able to correctly identify option B, which accurately referred to the shortage being greater in the presence of price elastic demand and supply [curves]. For many questions requiring students to mentally manipulate demand and supply diagrams, it is best practice to draw the diagrams somewhere in the margin of the exam. For the current question, the scenario has changed from the setting of a maximum price (below equilibrium) to the setting of a minimum price (above equilibrium). A quick drawing of a diagram, such as the one below (note there is no need to label curves or axes), should reveal that option D is the only viable response. This is because a minimum price above the equilibrium necessarily creates a surplus in the market, and the actual size of the surplus will depend on price elasticities of demand and supply – the greater is the PES and PED, the larger the surplus must be. Options A and B are incorrect because they refer to a shortage when a surplus will occur. Option C is incorrect because it refers to both curves being price inelastic.



## Question 15

In relation to the diagram below, which statement is most accurate in relation to Australia over 2020?



- A. The Australian economy was operating at point i where the rate of economic growth decreased, inflation was low (or negative) and unemployment was relatively high
- B. The Australian economy was operating at point iii where the rate of economic growth was negative, inflation was low (or negative) and unemployment was relatively high**
- C. The Australian economy was operating at point ii where the rate of economic growth increased, inflation was high and unemployment was relatively low
- D. The Australian economy was operating at point iii where the rate of economic growth decreased, inflation was low (or negative) and unemployment was relatively high

The Study Design requires students to be aware of both the nature and the causes of the business cycle. Accordingly, students should be prepared to answer questions that test their understanding of what might cause the economy to enter the boom phase of the cycle (e.g. excessive business and consumer confidence) or the downturn phase of the cycle (e.g. overinflated prices of various assets). In the 2020 exam, Q2b (5 marks) students were required to explain the role of automatic stabilisers in influencing aggregate demand and stabilising the business cycle in 2020 and in the 2019 exam, questions 2a, 2b and 2c required students to demonstrate an understanding of the meaning of 'business cycle', as well as the causes and effects. Common mistakes included; confusing the business cycle with a 'product life-cycle'; adopting too much of a micro focus (e.g. focusing on the drop in production for a particular product when attempting to describe the business cycle contraction) when a macro focus was required; and generally not being able to identify a factor contributing to a business cycle contraction. The current question focuses on the nature of the business cycle (e.g. what is likely to be happening to macroeconomic variables such as economic growth, inflation and (un)employment) during the recent downturn (trough) in the cycle. **Option B is the best response** because during 2020 Australia was in a trough (in fact a recession was recorded), where the rate of economic growth was negative, inflation was low (and even negative for a period) and unemployment was relatively high. Option B is incorrect because point i on the diagram does not show Australia experiencing a decrease in real GDP (i.e. negative economic growth). Option C is incorrect because Australia was not in the boom phase of the cycle. Option D appears correct, but it is inferior to option B because the rate of economic growth did more than decrease – it actually was negative as depicted on the business cycle diagram.



## SECTION B

## Question 1 (14 marks)

Perfectly competitive markets are assumed to exist because of conditions such as product homogeneity, perfect information, many buyers/sellers as well as freedom of entry into and out of the market.

a. Describe the nature of a perfectly competitive market.

2 marks

- 1 mark for a superficial description of the nature of a perfectly competitive market (e.g. simply listing one or two characteristics) or
- 2 marks for a more comprehensive description that includes at least two separate characteristics/features.

**Advice:** The Study Design requires students to possess an understanding of both the nature of, and conditions for, a perfectly competitive market. Question 4a of the 2020 exam specifically asked students to explain the nature of, and conditions for, a perfectly competitive market. Many students were able to identify and explain some of the key conditions required for the existence of a perfectly competitive market (e.g. those listed in the preamble to the question above) but experienced some difficulty making a connection to the nature of the market. Students should be prepared to draw a distinction between those factors that define the existence of a perfectly competitive market (i.e. the conditions or assumptions) and those characteristics that highlight what the market will look like (i.e. its nature).

**Sample answer:** *The nature of a perfectly competitive market will be such that prices of goods and services will be relatively low and there is an absence of market power, with businesses making only normal profits [i.e. super-normal or above normal profits are not made]. In addition, productive efficiency will typically be high, and consumer wants and needs are more likely to be satisfied compared to a less competitive market.*

b. Outline why product homogeneity helps to ensure that a market is more competitive.

2 marks

- 1 mark for demonstrating an understanding of product homogeneity
- 1 mark for linking product homogeneity to a more competitive market

**Advice:** As discussed in the advice for 1a, students struggled distinguishing the nature of, and conditions for, a perfectly competitive market in the 2020 exam. Importantly, students should be in a position to explain/outline/describe why or how each of the conditions/assumptions underpinning a perfectly competitive market actually make the market more competitive.

**Sample answer:** *Product homogeneity means that the products in a particular market are identical [i.e. there is no product differentiation]. This ensures that competition for buyers cannot be based on non-price characteristics of the product, such as quality [as the products are assumed to be identical]. This forces producers to compete more aggressively on price, and helps to ensure that prices will be at the lowest possible level [i.e. above normal profits are not made].*

c. Describe how a change in relative prices can cause a re-allocation of resources. In your answer, refer to price signals.

4 marks

- 1 mark for demonstrating an understanding of relative prices
- 1 mark for referring to the importance of price signals
- 2 marks for an accurate description of how resources move from one activity to another following a change in relative prices

**Advice:** The role of relative prices in allocating resources, and/or an understanding of the price mechanism more generally, is an area of VCE Economics that consistently troubles students. Past examination performances reveal that students fail to demonstrate an adequate understanding of this part of the course, with average results regularly falling below 50%. An understanding of relative prices and the price mechanism is a fundamental building block for understanding the nature of economics in a market system. Up until the 2020 exam, an exam question testing this part of the course had not been asked on Section B of the exam during the life of the current Study Design (i.e. since 2017). The 2020 exam question required students to ‘explain how an increase in demand for a product might result in a change in relative prices, and explain how this would influence resource allocation and living standards’. As noted in the Chief Assessor’s Report, ‘high-quality responses also included relevant examples, such as the increased demand and relative price of hand sanitisers and/or face masks during the Covid-19 pandemic’. This is valuable advice in the context of a question that is theoretical as it helps to bring the response to life and adds value in the event that the theoretical response is deficient in some respect.

**Note 1:** Students should be aware that the question is not requiring any description of how a change in relative prices impacts on ‘efficiency in the allocation of resources’ or living standards. The focus is purely on how resources move from one activity to another in response to a change in relative prices.

**Sample answer:** *Changes in relative prices largely determine how resources (such as labour and capital) will be allocated across industries and markets. It is the change in the prices of various goods and services, when compared to one another (i.e. relative to one another) that sends important signals to consumers and producers about which goods and services should be demanded and produced. For example, if the demand for a good increases, it creates shortages in the market for that good and causes the price to rise relative to other goods. It is this price signal that incentivises producers to allocate more resources to the production of that good as there is the expectation that profits from producing that good will be higher. Resources will therefore move from the production of other goods [or from sitting idle such as being unemployed or underemployed] to the production of the good enjoying a higher relative price. [For example, during the current coronavirus, the demand for hand sanitiser increased, which created shortages in the initial stages of the pandemic and resulted in a higher price of hand sanitiser relative to other goods (such as alcohol). Some alcohol producers were motivated by the higher relative price (and profit) and therefore shifted some of their resource is from the production of alcohol to the production of hand sanitiser.]*

**Note 2:** Square bracketed section is not required for full marks.

**d. Markets that are left unregulated by governments will achieve the most efficient allocation of resources for a nation like Australia. Evaluate.** **6 marks**

- 1 mark for demonstrating an understanding of an efficient allocation of resources
- 2 marks for discussing how markets can achieve an efficient allocation of resources (i.e. strengths of markets)
- 2 marks for discussing how markets fail to achieve the efficient allocation of resources, making accurate reference to market failure (i.e. weaknesses of markets)
- 1 mark for a reasoned conclusion that makes it clear that unregulated markets will not achieve the most efficient allocation of resources

**Advice 1:** The Study Design (U3 AOS 1) requires students to demonstrate the key skill ‘to evaluate the role of the market in allocating resources’. The task word in the question - ‘evaluate’ - will typically require students to at least examine the pros and cons, or costs and benefits (and typically arrive at a conclusion or overall judgement). Exams over the life of the current Study Design have not specifically required students to ‘evaluate the role of markets’. However, students have been required to discuss ‘market failures’, in both the 2017 exam (distinguishing public goods from common access resources) and the 2018 exam (students were required to explain how either externalities or asymmetric information results in a market failure). The 2020 exam included a 4 mark question that asked students to ‘describe one strength and one weakness associated with the use of the market to allocate resources’. While the average score of 2.4/4 (60%) was reasonable, only 32% of students achieved full marks. A common problem when describing a strength was that students simply described how markets work to allocate resources. In relation to weaknesses, the best students were able to make a direct link to market failures.

**Advice 2:** Students should recognise that (competitive) markets can be efficient in many respects, such as the ability for competition to drive prices to very low levels, maximising technical efficiency and increasing consumer satisfaction. However, markets are imperfect in the sense that, left unregulated, they will lead to an inefficient allocation of resources - hence market failures prevail. Past examinations reveal that students find asymmetric information the most difficult example of market failure to explain. So if choice is provided in the examination, such as this question, it is recommended that only high performing students choose to examine asymmetric information as their example for why or how unregulated markets do not achieve the most efficient allocation of resources.

**Sample answer:** *Markets left unregulated by governments will not result in the most efficient allocation of resources in Australia.*

*Markets will generally do a good job of allocating resources towards the production of goods and services that are needed and/or wanted by consumers (or society). This is particularly the case when markets are highly competitive, where producers will seek to supply goods and services to consumers at the lowest possible prices, which results in the production of goods and services at the lowest possible costs, maximising technical efficiency and resulting in the lowest prices, which in turn maximises consumer satisfaction. In a narrow sense, this helps to achieve allocative efficiency because the nation’s resources are more likely to be used in those combinations that yield the maximum net benefits or satisfaction for consumers. In other words, unregulated markets generally do a wonderful job at allocating resources to produce goods and services that ‘consumers want’.*

*However, without government regulation, markets result in undesirable outcomes for society, which are commonly referred to as market failures. In other words, markets will result in an allocation of resources that is sub-optimal, leading to an inability to achieve the most efficient allocation of resources (i.e. allocative inefficiency) which is defined as one where the living standards/welfare of Australians is not maximised. Ultimately, the efficiency with which markets allocate resources to the production of goods and services that consumers want, is what weakens the ability of markets to best serve the community as a whole. Unregulated markets will tend to over allocate resources to the production of some goods and services that are not in society’s best interests [e.g. demerit goods such as illicit drugs or goods with negative externalities] and under allocate resources to the production of those goods and services that are in society’s best interests [e.g. public goods or goods with positive externalities].*

*On balance, markets are very effective at allocating resources to the production of goods and services that people want, but they require government regulation to address the various market failures that ultimately prevent free markets from achieving allocative efficiency. However, as a means of allocating resources within nations, markets do a superior job compared to the alternatives (e.g. government/central planning).*

**Question 2 (16 marks)**

[Lower interest rates have] contributed to a lower exchange rate than otherwise, freed up cash flows for households and businesses, and strengthened balance sheets by supporting asset values. ...The Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. For this to occur, wages growth will have to be materially higher than it is currently. This will require significant gains in employment and a return to a tight labour market. The Board does not expect these conditions to be met until 2024 at the earliest. ...

*Source: Comments by the RBA Governor during 2021*

a. Explain how a more expansionary monetary policy stance can result in a lower exchange rate and assist with the achievement of full employment. 4 marks

- 0.5 marks for demonstrating an understanding of expansionary monetary policy stance
- 0.5 marks for demonstrating an understanding of full employment
- 1.5 marks for linking lower interest rates to a lower exchange rate
- 1.5 marks for linking lower interest rates/exchange rate to the achievement of full employment

**Advice 1:** While this question relates to the exchange rate transmission channel, it necessarily requires students to understand how a change in interest rates influences the exchange rate. A similar question was handled poorly in the 2020 examination (Q1a), with many students being unable to unpack the relationship between a lower cash rate and the exchange rate. As highlighted in the Chief Assessor's Report, the best responses made meaningful reference to important terms/concepts such as interest rate differentials, capital inflow/capital outflow and the demand/supply of the Australian dollar on foreign currency markets.

**Advice 2:** Students should be aware that there is no need to explore how the RBA achieves a more expansionary monetary policy stance. It is sufficient to identify that it involves a reduction in the target cash rate, or even interest rates, and then explore the effects from that point.

**Sample answer:** *A more expansionary monetary policy involves a reduction in the target cash rate, or interest rates more generally, and should both reduce the exchange rate and assist with the achievement of full employment. As Australian interest rates fall, it results in capital outflow as Australian investors (lenders) will be attracted to the relatively higher rates on offer overseas. This leads to an increased supply of Australian dollars on foreign currency markets, which in turn exerts downward pressure on the price of the AUD in foreign currency markets and an exchange rate depreciation. This in turn should stimulate net exports and aggregate demand (AD) as the international competitiveness of Australia's tradables sector improves. For example, Australian export prices will be relatively cheaper for foreigners, which stimulates export demand [and import prices will be relatively higher which stimulates the demand for domestically produced import competing products]. The resulting increase in AD and real GDP will lead to an increase in the demand for resources, including labour, boosting employment and helping to reduce the rate of unemployment towards the full employment level. This is currently about 4.5%, which is considered the lowest possible level of unemployment before unacceptable inflationary pressures take hold in the economy [or where cyclical unemployment is zero and the rate of unemployment that exists is consistent with a strong and sustainable rate of economic growth].*

**Note 1:** Square bracketed section is not required for full marks.

**Note 2:** Students who do not explore the exchange rate channel when explaining the impact on full employment can still receive full marks. It is anticipated that some students will explain one of the other four transmission channels when linking the expansionary monetary policy to the impact on full employment.

**b. With the exception of a change in interest rates, describe one other factor that might be responsible for an exchange rate depreciation.**

**2 marks**

- 1<sup>st</sup> mark for identifying a relevant factor
- 2<sup>nd</sup> mark for elaborating and explaining how the factor contributes to an exchange rate depreciation

**Advice 1:** Questions relating to causes and/or effects of changes in the exchange rate appear regularly on exams given that changes in the exchange rate are topical and feature heavily in the press every year. For example, in the 2020 exam, the first three questions (1a-1c), worth a total of 16 marks, related to either the cause (1a and 1b) or effects (1c) of a changing the exchange rate. Importantly, when responding to exchange rate questions, students should be careful not to confuse cause and effect – which is relatively common. On occasions, assessors will read responses that are brilliant in terms of the ability of the student to connect key economic variables but are awarded zero marks because the student confused cause and effect.

**Advice 2:** The Study Design lists a number of factors that can affect the exchange rate, including relative interest rates, demand for exports and imports, capital flows, the terms of trade and relative rates of inflation. In the 2020 exam, Q1b required students to explain how a more favourable terms of trade and a slowdown in global economic growth would influence the exchange rate. As noted in the Chief Assessor’s Report, the second part was handled better than the first, with many students being unable to understand the role of the terms of trade in the context of the question. ‘Students need to remember that growth in the TOT means that the prices received for exports are increasing relative to the prices paid for imports and it does not refer to exports over imports; or the value of exports over the value of imports; or worse the price of imports over the price of exports’. Also see Advice related to the Terms of Trade that is provided in Question 3d later in this paper.

**Advice 3:** It is worth remembering that the major drivers of a change in the exchange rate are changes in the interest rate differential and changes in the terms of trade. It is likely that students will be required to demonstrate an understanding of one or both in the examination.

**Sample answer:** *A decrease in the terms of trade (prices received for exports relative to the prices paid for imports) is likely to contribute to an exchange rate depreciation. This is because lower prices received for exports results in lower export income, which means that fewer Australian dollars will be demanded in foreign currency markets as exporters (or foreign buyers) convert less foreign currency into Australian dollars when purchasing any given volume of exports.*

**c. Describe one factor that has limited the effectiveness of monetary policy at achieving stronger growth in aggregate demand (AD) since 2020.**

**3 marks**

- 1 mark for identifying a relevant factor
- 2 marks for elaborating and explaining how the factor has limited the effectiveness of monetary policy at achieving stronger growth in AD since 2020

**Advice 1:** In the 2020 exam, the most poorly handled question (Q2d) required students to evaluate the effectiveness of monetary policy in achieving the goal of full employment. The average score was 2.5/6 and only 7% of students were able to achieve the full 6 marks, with 35% of students achieving either 0 or 1. The major mistake made by students was the inability to recognise that an evaluation of the effectiveness of policy required a discussion of the relative strengths and weaknesses. Instead, many students simply described how monetary policy was used throughout 2020. As noted in the 2020 Chief Assessor’s Report, the best performing students were able to prioritise their arguments (strengths/weaknesses) to arrive at a reasoned conclusion as to the overall effectiveness of monetary policy during 2020. With respect to the current question, students should recognise that the focus is on a weakness or constraint of monetary policy – what has made it relatively less potent in achieving growth in aggregate demand since 2020.

**Sample answer:** *The relatively high household debt levels in Australia has reduced the effectiveness of monetary policy. This is because recent attempts by the RBA to stimulate the economy via lower interest rates have not been able to ignite the same degree of household demand that it could in the past. This is because highly indebted households are reluctant to commit to further debt when they are already highly leveraged [which weakens the cost of credit channel] and the increased willingness of households to repay existing loans more quickly [which weakened the cash flow*

channel]. This means that the more expansionary monetary policy measures that had been introduced over 2020-21 have been less effective at achieving stronger growth in AD than would have been the case in the past.

**d. Distinguish the cash flow channel from the cost of credit channel (also known as the savings and investment channel) as part of the transmission mechanism of monetary policy.**

**3 marks**

- 1 mark for demonstrating an understanding of the cash flow channel
- 1 mark for demonstrating an understanding of the cost of credit channel
- 1 mark for clarifying a key point of difference between the two channels

**Advice 1:** The Study Design requires students to demonstrate an understanding of the five key transmission mechanisms/channels (savings and investment, cash flow, availability of credit, exchange rate movements and asset prices) and questions related to the transmission mechanisms have featured regularly in recent exams. This includes the 2019 and 2018 examinations, with relatively low average scores of 55 and 56%, as well as the 2020 exam (where the exchange rate channel was poorly handled – see Advice 1 from Question 2a above). A common point of confusion is the difference between the cash flow channel and the cost of credit/savings and investment channel, with many students naming the channels incorrectly (e.g. naming/identifying the cash flow channel and describing the cost of credit channel or naming/identifying the cost of credit channel and explaining the cash flow channel). Students need to remember that lower interest rates positively impact on spending by making it easier to repay existing loans, which improves discretionary income [the RBA refers to this as disposable income] and therefore improves cash flows (i.e. the cash flow channel). This is distinct from the ability of lower interest rates to encourage more households/businesses to take on more credit (e.g. increase the use of a credit card or even take out more loans), which of course is the cost of credit/savings and investment channel.

**Advice 2:** For the current question, students do not necessarily need to explain in full both transmission channels, although this approach is viable. More importantly, students need to show an understanding of each before clearly describing/explaining a key point of difference between the two channels.

**Sample answer:** *Following a change in monetary policy and a movement in interest rates, the cash flow channel involves households and businesses experiencing a change in 'discretionary income' because more/less of any given level of household/business income will be needed to service existing debt. In contrast, the cost of credit channel works by changing the incentive of households and businesses to take on more/less debt. For example, if interest rates are reduced, then both channels will typically trigger an increase in Consumption and Investment, with the cash flow channel working via a boost in cash (flow) available to be spent, and the cost of credit channel working to increase borrowing and spending. A major difference between the two is that the cash flow channel involves an increase in spending that is not fueled by growth in debt (or credit/borrowing), whereas the cost of credit channel necessarily involves an increase in the provision of credit and higher debt levels.*

e. Explain how the RBA changed monetary policy settings in late 2020. Make reference to the role of open market operations.

4 marks

- 0.5 marks for making a reference to a monetary policy loosening/easing (or even quantitative easing) and/or the adoption of a more expansionary stance
- 0.5 marks for reference to a reduction in the target cash rate (e.g. to 0.1% in November)
- 1 mark for a link between the target cash rate and the actual cash rate
- 1 mark for a superficial reference to OMOs
- 1 mark for additional detail in relation to how OMOs are used in the context of the question or accurate reference to non-conventional monetary policy measures employed at the time

**Note 1:** Reference to quantitative easing or nonconventional monetary policy measures is not required for full marks given that there is no reference to these measures in the Study Design.

**Advice 1:** There is no change in the way that the RBA manipulates the cash market via open market operations. For example, the RBA can reduce the cash rate by purchasing government securities/repos, which increases supply/liquidity and therefore reduces the price of cash – the cash rate. However, the RBA does NOT need to manipulate the cash market by buying or selling CGS or repos when it decides to change monetary policy settings. The RBA simply needs to alter the ‘policy interest rate corridor’ and the market will automatically adjust to the new rate. The RBA only uses OMOs to ensure that every day thereafter, the actual cash rate remains as close to the target as possible.

**Advice 2:** Students often struggle when interpreting questions related to monetary policy and sometimes include content or information that is not relevant to the question. For example, in the context of the current question, it is not necessary to describe why the RBA implemented a more expansionary monetary policy stance, nor how the more expansionary monetary policy stance will impact on the macroeconomy (i.e. there is no need to refer to transmission channels) or the achievement of government goals. Inclusion of this irrelevant information will waste valuable time and do little to enhance the quality of student responses.

**Sample answer:** *The RBA implemented a more expansionary monetary policy stance by further loosening of monetary policy in November 2020 and reducing the target cash rate (TCR) from an already expansionary level of 0.25% to a new historically low level of 0.1%. [This was accompanied by other expansionary measures which have generally been referred to as quantitative easing and the further injection of liquidity into the financial system.] This involved reducing the interest rate corridor [i.e. the range within which the cash rate will operate, which is currently 25 basis points above the TCR and 10 basis points below the TCR]. The cash market automatically adjusted, with the cash rate gravitating to its new target of 0.1% without the need for open market operations (OMOs). Every day thereafter, the RBA would have manipulated the cash market to ensure that the actual cash rate (ACR) was as close as possible to the TCR. For example, if liquidity in the market increased, and the ACR started to fall below 0.1%, then the RBA would immediately intervene by selling government securities/repos to cash market participants, to reduce the supply of cash in the market and force the ACR back towards the TCR. [The RBA would do the reverse if the ACR increased above 0.1%.]*

**The following is an alternative response that is also deserving of full marks even though it references the ‘dated way’ of explaining how monetary policy is altered:**

**Sample answer:** *The RBA implemented a more expansionary monetary policy stance by further loosening of monetary policy in November 2020 and reducing the target cash rate (TCR) from an already expansionary level of 0.25% to a new historically low level of 0.1%. [This was accompanied by other expansionary measures which have generally been referred to as quantitative easing and the further injection of the liquidity into the financial system.] This involved the RBA announcing a lower target cash rate in early November by 15 basis points, and then manipulating the cash market by purchasing government securities/repos from cash market participants, which works to increase the supply of cash in the market and drive the actual cash rate (ACR) down towards the new lower TCR. Every day thereafter, the RBA manipulated the cash market to ensure that the actual cash rate (ACR) was as close as possible to the TCR, purchasing securities if the ACR increased above the TCR or selling securities if the ACR fell below the TCR.*

**Note 2:** Square bracketed section is not required for full marks.

**Note 3:** Reference to the actual cash rate levels (e.g. the TCR falling from 0.25% to 0.1%) is desirable but not necessary for full marks.

**Question 3 (16 marks)**

**Budget aggregates and major economic parameters<sup>(a)</sup>**

	Actual	Estimates					Total <sup>(b)</sup>
	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	
<b>Underlying cash balance (\$b)<sup>(c)</sup></b>	<b>-85.3</b>	<b>-161.0</b>	<b>-106.6</b>	<b>-99.3</b>	<b>-79.5</b>	<b>-57.0</b>	<b>-342.4</b>
Per cent of GDP	-4.3	-7.8	-5.0	-4.6	-3.5	-2.4	
<b>Gross debt<sup>(d)</sup></b>	<b>684.3</b>	<b>829.0</b>	<b>963.0</b>	<b>1,058.0</b>	<b>1,134.0</b>	<b>1,199.0</b>	
Per cent of GDP	34.5	40.2	45.1	48.6	49.7	50.0	
<b>Net debt</b>	<b>491.2</b>	<b>617.5</b>	<b>729.0</b>	<b>835.0</b>	<b>920.4</b>	<b>980.6</b>	
Per cent of GDP	24.7	30.0	34.2	38.4	40.4	40.9	

Source: [www.budget.gov.au/overview](http://www.budget.gov.au/overview)

**a. Describe the movement in the estimated budget outcome between 2020-21 and 2021-22.**

**2 marks**

- 1 mark for identifying that the budget outcome has improved (or that the deficit is expected to fall)
- 1 mark for accurate use of the figures contained in the table

**Advice:** Students should always be prepared to use the figures/information contained charts or tables when asked to describe the movement/trend in certain economic variables.

**Sample answer:** *The budget outcome is estimated to improve with the underlying cash deficit falling from \$161 billion in 2020-21 to \$106.6 billion in 2021-22.*

**b. Describe how one initiative from the 2021-22 Budget influenced the estimated budget outcome and explain how this initiative can boost aggregate demand and economic growth.**

**4 marks**

- 1 mark for identifying a relevant budgetary policy initiative
- 1 mark for accurately describing the impact on the budget outcome
- 1 mark for linking the initiative to aggregate demand (i.e. demonstrating an understanding of aggregate demand)
- 1 mark for linking the initiative to economic growth (i.e. demonstrating an understanding of economic growth)

**Advice 1:** Examinations often test student understanding of discretionary stabilisers in terms of the impact on the budget outcome and/or the impact on the economy. Students generally handle these questions well, but on occasions students confuse the structural component of the budget (i.e. the operation of discretionary stabilisers) with the cyclical component of the budget (i.e. the operation of automatic stabilisers).

**Advice 2:** It is a common mistake for students to spend an excessive amount of time describing the nature of the budgetary policy initiative in question. For example, in relation to the income tax cuts delivered in the 2021-22 Budget, there is no need to go into excessive detail about the value of the income tax cuts (e.g. \$7.8 billion) or how the low and middle income tax offsets actually work to deliver a lower income tax liability for low/middle income earners. While some detail about the nature of the initiative is valuable, the focus should be on how the operation of the initiative influences the budget outcome and affects AD and economic growth.

**Sample answer:** *The government delivered further personal income tax cuts via the extension of the low and middle income tax offsets. This reduces the expected tax revenue for the federal government and therefore increases pressure on the size of the estimated budget deficit [i.e. causing the estimated deficit to be \$106.6 billion when it would have been somewhat lower.]. This initiative reduces the income tax liabilities for low/middle income earners, boosting disposable incomes and stimulating an increase in consumption demand as individuals will be more inclined to spend the windfall gains on goods and services. The growth in consumption demand [approximately 60% of aggregate demand] will lead to an increase in aggregate demand, which in turn results in growth in the production of goods and*



services to meet this demand. As production grows over time, it will be reflected by an increase in real GDP (the measure of production) and economic growth necessarily increases [as real GDP increases].

**Note:** Square bracketed section is not required for full marks.

**c. Describe how a cyclical component of the budget helped to support the household and business sectors of the economy over 2020-21.**

**4 marks**

- 1 mark for identifying a cyclical component of the budget (e.g. expenditure on unemployment benefits/income support or income tax receipts)
- 1 mark for a description of how the chosen cyclical component increased the budget deficit or supported AD
- 1 mark for a description of how the chosen cyclical component helped to support the household sector
- 1 mark for a description of how the chosen cyclical component helped to support the business sector

**Advice 1:** The Study Design (U4 AOS 1) requires students to demonstrate an understanding of the effects of automatic and discretionary changes in the budget on the budget outcome (as well as the effect of automatic and discretionary changes in influencing aggregate demand and stabilising the business cycle). It is quite common for students to lose valuable marks in the examination by misinterpreting questions that relate to the cyclical (and structural) components of the budget. First, students should be aware that the cyclical components of the budget refer to automatic stabilisers and the structural components of the budget refer to discretionary stabilisers. Importantly, students need to remember that automatic/discretionary stabilisers can be examined from two angles. First, the impact that they can have on the budget outcome and second, the impact that they can have on the economy (e.g. the impact on aggregate demand and the business cycle). It is not uncommon for students to write a brilliant response, demonstrating a clear understanding of how automatic/discretionary stabilisers impact on the budget outcome, when the question actually asked students to explain how these stabilisers impact on the economy (e.g. AD and economic growth).

**Advice 2:** The most recent two examinations (2020 and 2019) tested student understanding of the role of automatic stabilisers. On both occasions, students performed relatively poorly. Question 2b of the 2020 exam required students to explain the role of automatic stabilisers in influencing aggregate demand and stabilising the business cycle in 2020, which was very similar to Question 3b of the 2019 exam which required students to describe how a budgetary policy automatic stabiliser operates to influence aggregate demand and economic growth. The average scores achieved were very low (52% in 2020 and 45% in 2019). In both exams, students inappropriately examined the impact that automatic stabilisers have on the budget outcome and therefore erred by making no reference to how the automatic stabilisers help to influence AD and the rate of economic growth. In addition, while a number of students could appropriately select an example of an automatic stabiliser (e.g. the progressive tax system or unemployment benefits) they could not adequately describe how it influences AD and the rate of economic growth. Given the difficulty that students experienced in the 2019 and 2020 exams, it is not unreasonable to expect another question on automatic versus discretionary stabilisers on the 2021 exam.

**Advice 3:** As note in the 2020 Chief Assessor's Report, for a question focusing on current economic events, 'students should avoid explaining the role of automatic stabilisers in a theoretical context, including the way that the stabilisers work during the boom or peak phase of the economic cycle'.

**Sample answer:** *During 2020 in particular, economic growth was negative [Australia recorded its first recession since 1991-92] which resulted in a relatively large increase in both unemployment and underemployment. This caused large numbers of Australians to become eligible to receive income support in the form of Jobseeker allowance [i.e. unemployment benefits] which automatically inflated government expenditure [via transfer payments], resulting in a larger budget deficit which helped to prevent aggregate demand and economic growth from falling as much as otherwise. The additional transfer income received by the unemployed/underemployed was (partly) spent on goods and services [e.g. Consumption] which supported the household sector as they had continuing access to goods and services. This growth in Consumption contributed to a stronger than otherwise level of AD and production, thereby supporting the businesses in the economy as sales/profit levels were prevented from falling too far.*

**d. Explain how continuing growth in Australia's terms of trade might influence the setting of aggregate demand policies. 6 marks**

- 0.5 mark for demonstrating an understanding of the terms of trade
- 0.5 mark for demonstrating an understanding of aggregate demand policies
- 0.5 mark for recognising that a higher terms of trade is likely to result in higher government revenue and a lower budget deficit
- 0.5 mark for recognising that a higher terms of trade is likely to result in monetary policy becoming less expansionary than otherwise
- 2 marks for a valid explanation of *how* the high terms of trade might influence the budget outcome and/or the stance of policy
- 2 marks for a valid explanation of *how* the high terms of trade might cause monetary policy to become less expansionary than otherwise

**Advice 1:** A key skill in the Study Design is the requirement for students to analyse the effects of contemporary factors on the setting of aggregate demand policies. Students should therefore be aware of the various factors that may have contributed to the delivery of more expansionary monetary (and budgetary) policies over the past couple of years. While the 2020 exam contained no question testing this key skill, the 2019 and 2018 contained examples that were not well answered by students. With respect to the 2019 question, it was the most poorly handled question on the paper, with an average score of 38% (2.3/6). Students were asked to explain how a fall in the rate of unemployment and weaker than expected growth in wages would influence the setting of aggregate demand policies. Many students did not appreciate that the question was about the influence on the 'setting of AD policies' (e.g. how and why the scenario might encourage both monetary and budgetary policy to become more expansionary) and instead focused solely on how expansionary (AD) policies would encourage an increase in economic growth, growth in wages and a further reduction in the rate of unemployment towards the new lower NAIRU. In other words, insufficient time was spent on explaining/analysing how the combination of a lower rate of unemployment and weaker than expected wages growth can imply that AD is insufficient and that expansionary AD policies may have been an appropriate response. Many students were unable to reconcile the combination of lower unemployment rates and slow wages growth, therefore not recognising the relevance of underemployment/casualisation of the labour force and the existence of spare capacity in labour markets despite lower unemployment rates.

**Advice 2:** Questions related to the terms of trade, either in terms of a definition, or the causes/effects, regularly cause students problems in examinations. Students will typically confuse the terms of trade with the trade weighted index (TWI); the terms of trade with the balance of trade (or BOMT) and/or inappropriately define the terms of trade as the value of exports over the value of imports (or even 'exports over imports'). This was again illustrated by student responses to questions in the past two exams. In Question 4c on the 2019 exam, students found it difficult to explain how an unfavourable movement in the terms of trade affected the goal of strong and sustainable economic growth and living standards. In Question 1b of the 2020 exam, many students were unable to understand the role of the terms of trade in influencing the exchange rate. Further, a number of students erred by arguing that a favourable movement in the terms of trade means that the terms of trade index increases above 100. Students should recognise that a favourable movement does not require the index to be above 100.

**Advice 3:** A key knowledge point in Unit 3 AOS 3 of the Study Design require students to understand the effects of movements in the terms of trade on the current account balance, *domestic macroeconomic goals* and living standards. While a key skill in Unit 4 AOS 1 is to discuss and analyse the effect of contemporary factors on the setting of aggregate demand policies. The growth in the terms of trade over 2020-21 is indeed a contemporary factor that has influenced the setting of both monetary and budgetary policies given that the stronger terms of trade has stimulated economic growth and national income, boosting government revenue and exerting upward pressure on employment growth and prices.

**Sample answer:** *Growth in the terms of trade over 2020-21 means that the prices received for exports have increased relative to the prices paid for imports. [The major contributing factor behind the improvement has been the growth in the prices received for iron ore exports.] This has contributed to growth in the export income/profits received by commodity exporters [e.g. mining companies] which has boosted government revenue and reduced pressure on the size of the budget deficit. With relatively higher government revenue than originally anticipated, the size of the budget*

*deficit would have fallen significantly. However, the government decided to spend much of the windfall on additional programs, such as additional spending on health and infrastructure, which resulted in the estimated budget deficit not falling as much as otherwise, which meant that the budget became more expansionary in response to the stronger terms of trade [which means that the structural budget deficit increased].*

*With respect to monetary policy, the more favourable terms of trade was a major contributing factor behind the stronger than expected economic growth over 2021. This helped to increase employment, reducing the unemployment/underemployment rates, and contributing (albeit marginally) to an increase in wages and inflationary pressure. Under these conditions, the RBA became somewhat less concerned about unemployment and very low inflation rates compared to the recent past. While the RBA acknowledges that there is some way to go before the goals of price stability and full employment are achieved, the growth in the terms of trade has meant that a tightening of monetary policy (and the adoption of a less expansionary monetary policy stance) is likely to come earlier than expected. [The small tapering off of the RBA's bond purchases in the middle of 2021 provides evidence that the stance of monetary policy is becoming slightly less expansionary.]*

**Note 1:** Square bracketed sections are not required for full marks.

**Note 2:** The sample answer refers to the relationships in a contemporary setting. This approach is not required for full marks, which means that students are free to adopt a theoretical approach to answering the question.

#### **Question 4 (7 marks)**

**The Australian Government utilises aggregate supply policies to manage the Australian economy. If the productive capacity of the economy is expanding, growth in aggregate demand can be met and economic growth can be maintained both now and into the future.**

**a. Describe how a recent training and education spending initiative announced or implemented by the government can boost productive capacity and assist with the achievement of price stability.**

**4 marks**

- 1 mark for a description of the relevant initiative
- 0.5 mark for demonstrating an understanding of price stability
- 0.5 mark for demonstrating an understanding of productive capacity
- 1 mark for describing how spending on the initiative can boost productive capacity
- 1 mark for describing how the initiative reduces the rate of inflation (and therefore makes it more difficult to achieve price stability in the current context)

**Advice 1:** Often in examinations, students will spend an excessive amount of time describing the relevant initiative and insufficient time on an explanation/description of how the initiative actually influences the target variables in the question (e.g. productive capacity, inflation and price stability). Remember that, for a question such as this, the best responses will be those that provide a comprehensive description of how the initiative actually helps to increase productive capacity and reduce inflation.

**Sample answer:** *The government's extension of the Job Trainer program in the recent Budget will help to ensure that more younger Australians will have access to free or low fee courses across a range of industries/occupations. This should help to improve the quality of human capital, as younger Australians will ultimately exit these courses/programs with enhanced workplace skills, which improves productivity of labour, and reduces the effective costs of production for Australia's business sector. This, in turn, increases the willingness and/or ability of businesses to supply goods and services to the market, boosting aggregate supply and the capacity of the economy to produce goods and services (i.e. productive capacity). The higher productivity (and greater aggregate supply) exerts downward pressure on the rate of inflation because the lower average costs of production (and/or abundance of goods and services) encourages businesses to reduce prices in order to generate more sales, without eating into profit margins. Under normal circumstances, this should help to achieve the goal of price stability (to achieve 2-3% growth in the CPI on average over time), but given that the government is currently keen for inflation to climb up into the target range, this initiative is not helping to achieve price stability.*

**b. Distinguish market-based from interventionist approaches to managing the supply side of the economy.**

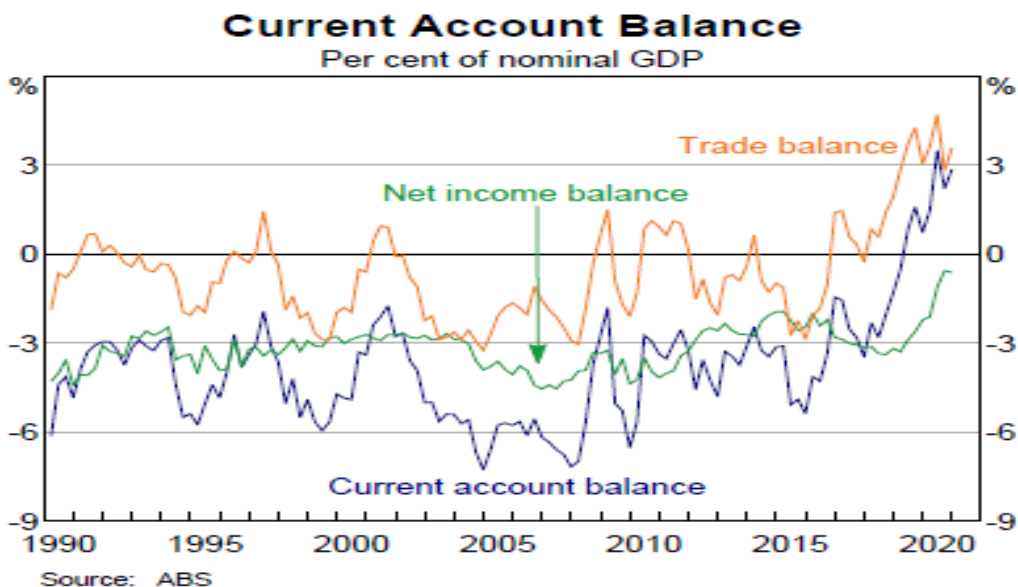
**3 marks**

- 1 mark for demonstrating an understanding of the interventionist approach
- 1 mark for demonstrating an understanding of the market-based approach
- 1 mark for establishing a clear point of difference between the two approaches

**Advice:** This question is very unlikely to appear on the examination because the difference between interventionist and market-based approaches is not specifically listed as one of the *key knowledge points* in Unit 4 of the Study Design. However, technically the exam setting panel could legitimately include a question testing this area of Economics because reference to the two approaches appears in the ‘preamble’ or ‘blurb’ to the Unit 4 section of the Study Design. Specifically, it notes that ‘*students investigate the role of both market-based and interventionist approaches to managing the supply side of the economy. They evaluate these policy responses in terms of their effect on incentives and consider how they increase competition and efficiency in the economy.*’

**Sample answer:** All aggregate supply policies are typically designed to boost productive capacity/aggregate supply and they can be classified as either ‘interventionist’ or ‘market-based’. Interventionist policies are those initiatives that are unlikely to occur without some form of government intervention, such as research and development incentives that are needed in order to rectify the market failure in the form of positive externalities in production. Market-based approaches on the other hand rely on the virtue or ability of ‘markets’ to boost aggregate supply and involve a withdrawal of government intervention that exposes businesses/markets to more competitive pressure, which creates incentives to boost efficiency. For example, deregulation of markets, including labour markets, can help to increase efficiency and boost productive capacity. The key difference between the two is that one involves a withdrawal of government (market-based) and the other involves the active intervention of government.

**Question 5 (12 marks)**



**a. Describe the trend movement in the current account balance since 2018.**

**2 marks**

- 1 mark for an accurate description of the trend
- 1 mark for accurate reference to the statistics contained in the chart

**Advice:** Questions requiring students to demonstrate an understanding of the current account (e.g. movements and causes) regularly feature in the examination. This includes every one of the past four exams since the inception of the new Study Design. Students should expect to either describe the trend and/or explain a factor that has contributed to the movement in the current account balance.

**Sample answer:** The current account balance has trended upwards from a current account deficit of approximately 3% of GDP in 2018 to a current account surplus of approximately 3% of GDP in early 2021.

**b. Explain how each of the following is likely to influence the current account balance over 2021-22**

- i. A higher trade weighted index (TWI)
- ii. A rise in labour productivity

**6 marks**

- 0.5 mark for demonstrating an understanding of a higher trade weighted index
- 0.5 mark for demonstrating an understanding of rise in labour productivity
- 0.5 mark for identifying that a higher TWI is likely to reduce the current account surplus (or decrease the current account balance)
- 0.5 mark for identifying that a rise in productivity is likely to increase the current account surplus (or increase the current account balance)
- 2 marks for accurately linking a higher TWI to a lower current account surplus
- 2 marks for accurately linking higher productivity to a higher current account surplus

**Advice 1:** As mentioned above, students should expect to either describe the trend and/or explain a factor that has contributed to the movement in the current account balance over time as these types of questions continue to surface on the exam. For example, Question 1c on the 2020 exam required students to explain how an exchange rate depreciation influenced the current account balance (3 marks). The best performing students were able to make logical links to the Trade balance ( $X - M$ ), making valuable reference to credits vs debits. It is advisable for students not to attempt to explain the link between the exchange rate and the current account balance via the Net Primary Income section. This is less important in the current context given that the vast majority of Australia's foreign liabilities (NFL) are denominated in Australian dollars - which means that an exchange rate depreciation has a minimal impact on debits through the Net Primary Income section of the current account compared to the past when the bulk of Australia's NFL were denominated in foreign currencies.

**Advice 2:** As noted in the Chief Assessor's Report (2020), there continue to be misconceptions about the nature of the current account, with some students confusing the CAD with net foreign debt (NFD) and inappropriately responding to the question by saying that a lower exchange rate will make it more difficult to pay off NFD. Students should always remember that the current account balance represents a flow of money over time (i.e. it is a flow variable) which should not be confused with NFD, which represents a value measured at a point in time (i.e. it is a stock variable).

**Sample answer:** *A higher TWI effectively means that we are experiencing an appreciation of Australia's exchange rate. This is likely to reduce the current account surplus (CAS) because it reduces the international competitiveness of Australia's tradables sector (i.e. exporting and import competing businesses) given that the price of exports in foreign currency terms increases and the price of imports decreases. Export sales are likely to fall and import sales are likely to increase, which reduces both net export values and the Trade Balance (or Balance on Goods and Services or BOGS) and necessarily decreases the size of the CAS given that the BOGS is a significant component of the current account.*

*Labour productivity is defined as the total output that is produced per unit of labour input and is commonly measured by real GDP per hour worked. As labour productivity rises, it means that workers are creating more value at workplaces, producing more goods and services for any given hour worked. This decreases the real costs of employing labour (e.g. real unit labour costs will fall), reducing the costs of production and allowing businesses to reduce prices to attract sales without reducing profit margins. This will tend to reduce inflation and increase Australia's international competitiveness as prices of both exports and import competing goods and services fall. The demand for exports is therefore likely to rise and the demand for imports is likely to fall, resulting in net export growth, a rise in the Trade Balance (or BOGS) and an increase in the current account surplus.*

c. Explain how a retreat from trade liberalisation might influence Australia's current account balance and living standards.

4 marks

- 0.5 mark for demonstrating an understanding of (a retreat from) trade liberalisation
- 0.5 mark for demonstrating an understanding of living standards
- 1.5 marks for explaining how the current account balance might be affected
- 1.5 marks for explaining how Australian living standards might be affected

**Advice:** The Study Design require students to demonstrate an understanding of trade liberalisation in terms of its impacts on international competitiveness, Australia's macroeconomic goals and living standards. Over recent years we have seen the proliferation of protectionist measures by various countries, most notably the 'trade war' between China and the USA, as well as the increase in protectionist measures imposed on Australia by China (for political reasons). In this context, it is not unreasonable for the exam setting panel to ask a question related to a slow down or retreat from trade liberalisation.

**Sample answer:** Trade liberalisation involves the freeing up of global trade via the removal of protectionist measures [such as tariffs and quotas] that have traditionally inhibited free trade between countries. The apparent retreat from trade liberalisation which is manifested in trade wars and a greater incidence of protectionist measures can be costly for Australia, particularly given that it damages Australia's relationship with a major trading partner, China. The imposition of protectionist measures on Australia's exports, such as the bans/tariffs imposed on Australian goods, such as lobsters and wine, and the active discouraging of Chinese consumers from spending money on Australian tourism/education, effectively reduces the [net] demand for Australian exports, decreasing [net] export values, reducing the Balance on Goods and Services and reducing the size of the current account surplus. The reduction net exports ultimately reduces aggregate demand and real GDP over time, which negatively incomes on average incomes (i.e. reducing national income/GDP per capita) and therefore reduces the capacity of households (on average) to access goods and services. This will reflect a decrease in the material living standards of Australian households on average.