



VCE ECONOMICS UNIT 3/4
CPAP Practice examination B 2023

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

Questions 1

Table 1: Australian Resident tax rates 2023–24	
Taxable income	Tax on this income
0 – \$18,200	Nil
\$18,201 – \$45,000	19c for each \$1 over \$18,200
\$45,001 – \$120,000	\$5,092 plus 32.5c for each \$1 over \$45,000
\$120,001 – \$180,000	\$29,467 plus 37c for each \$1 over \$120,000
\$180,001 and over	\$51,667 plus 45c for each \$1 over \$180,000

Source: www.ato.gov.au

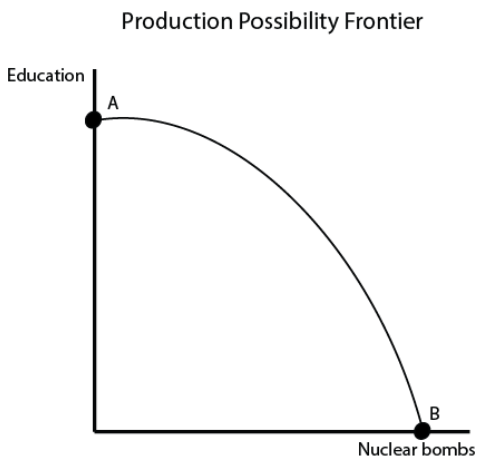
The table above highlights that personal income taxes in Australia are:

- A. Direct and regressive
- B. **Direct and progressive**
- C. Direct and proportional
- D. Indirect and progressive

The Study Design requires students to demonstrate an understanding of the sources of government revenue, including direct and indirect taxation; progressive, regressive and proportional taxes. **Option B best response** because the personal income tax system in Australia (as summarised in Table 1) is progressive because higher income earners are required to pay a higher proportion or percentage of their income in tax compared to lower income earners. Personal income taxes are also direct taxes because they are levied directly against a person's income, which contrasts with indirect taxes (such as excise duties or the GST) which are levied on the production or sale of goods and services and therefore paid for indirectly when people purchase goods and services. Option A is incorrect because personal income taxes are not regressive. Option C is incorrect because personal income taxes are not proportional. Option D is incorrect because personal income taxes are not indirect.

Question 2

Analyse the PPF model below which hypothetically shows the only production possibilities available to a government with \$500 million to spend on an investment project.



- A. Productive efficiency and allocative efficiency are likely to be achieved at points A and B
- B. Productive efficiency is likely to be achieved at points A and B, but allocative efficiency is only achieved at point B
- C. Allocative efficiency is likely to be achieved at points A and B, but productive efficiency is only achieved at point A
- D. Productive efficiency is likely to be achieved at points A and B, but allocative efficiency is only achieved at point A**

The Study Design continues to require students to understand the meaning and significance of economic efficiency, including allocative efficiency, productive efficiency, dynamic efficiency and intertemporal efficiency. However, new key knowledge has been added, requiring students to understand the relationship between the different types of efficiency and the PPF model. **Option D is the best response** because any production that occurs along the PPF, regardless of the goods in question, will be productively efficient. However, given that allocative efficiency hinges on the perceived 'value of the goods to society' in question, then option A is the only production point where allocative efficiency occurs if it is accepted that investment in education is a much better choice for society. Options A and B are incorrect because allocative efficiency only occurs at point A. Option C is incorrect because Productive efficiency also occurs at point B.

Question 3

Which of the factors below is least likely to be a necessary condition for the existence of a perfectly competitive market?

- A. An absence of government intervention**
- B. Lots of buyers and sellers
- C. Freedom of entry and exit into and out of the market
- D. perfect information

The new Study Design requires students to demonstrate an understanding of 'the conditions for a free and perfectly competitive market'. This represents a slight departure from the previous, where students were required to understand both 'the nature of' and conditions for a perfectly competitive market. Despite this change, students should still understand the relationship between a perfectly competitive market and nature of the market – such as what is likely to be happening to prices and efficiency compared to markets that are not perfectly competitive (such as oligopolies). In relation to the current question, at first glance it appears that all four options are necessary conditions for the existence of perfect competition. However, **option A is the best response** because governments are sometimes needed to create regulations that foster the emergence of a more perfectly competitive market (such as laws enforced by the Australian Competition and Consumer Commission (ACCC) that are designed to eliminate anti-competitive behaviour) and/or create the conditions for perfect competition (such as laws against the creation of artificial barriers to entry). Options B- D are all necessary conditions for the existence of a perfectly competitive market.

Question 4

The role of the RBA as outlined in its charter is to achieve all of the except:

- A. Price stability
- B. Low and stable exchange rate**
- C. Full employment
- D. Economic prosperity and welfare of Australians

The Study Design requires students understand 'the role of the RBA with respect to monetary policy as outlined in its charter'. While the charter makes reference to 'the stability of the currency of Australia', it is important that students do not interpret this to mean 'the stability of the exchange rate'. In the context of monetary policy and the RBA's charter, it is necessary to interpret 'currency' as 'prices' and not currency as in the Australian currency on foreign exchange markets. This means that **option B is the best response** because it refers to a low and stable exchange rate. All other options, A, C and D are all valid objectives as outlined in the RBA's charter.

Question 5

Which of the following is least likely to be an example of an aggregate supply policy initiative that will assist aggregate demand policies in promoting non-inflationary economic growth over time?

- A. An increase in research and development tax concessions
- B. Expenditure on training and education
- C. *Subsidies or grants to consumers to reduce cost of living pressures*
- D. Investment in port and rail infrastructure

The Study Design requires students to be aware of a host of aggregate supply policies that can be employed to complement aggregate demand policies in promoting non-inflationary economic growth over time. **Option C is the best response** because the provision of subsidies to consumers will tend to add to AD and prices, which works against the achievement of non-inflationary growth. All other options have the capacity to boost productive capacity/aggregate supply, which in turn contributes to the achievement of a stronger rate of economic growth alongside low(er) inflation (i.e. non-inflationary economic growth) in the long term.

Question 6

Which of the following is most likely to be a cause of a downturn in the business cycle?

- A. A low level of interest rates
- B. A low rate of growth in the Consumer Price Index
- C. A high rate of growth in business confidence
- D. *A high rate of growth in the exchange rate*

The Study Design requires students to be aware of the business cycle and its causes. 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 past exams, 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 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 not on the nature of the business cycle itself (e.g. what is likely to be happening to macroeconomic variables such as economic growth, inflation and (un)employment) during a downturn, but what causes economic growth to be low/negative for example. **Option D is the best response** because a high rate of growth in the exchange rate works to reduce growth in net exports and aggregate demand, which leads to a lower rate of economic growth that is consistent with a downturn in the business cycle. Option A is incorrect because a low level of interest rates is likely to exist when the economy is in a downturn but low interest rates will not cause a downturn (the opposite is true). Option B is incorrect because a low rate of growth in the CPI equates to a low rate of inflation which, like option A, is likely to exist when the economy is in a downturn but will not cause the downturn (again, the opposite is true). Option C is incorrect because strong growth in business confidence is more likely to contribute to an upturn or an economic recovery.

Question 7

Which of the following combination of factors are not examples of aggregate demand and/or aggregate supply factors that will contribute to a stronger rate of economic growth?

- A. A lower exchange rate and a stronger terms of trade
- B. The end of a global conflict and lower interest rates
- C. Stronger business confidence and higher disposable income
- D. *A higher trade weighted index and an increase in the number of government regulations*

The Study Design requires students to understand the factors that may affect the level of AD (e.g. disposable income, interest rates, consumer confidence, business confidence, the exchange rate and rates of economic growth overseas) and AS (e.g. including quantity and quality of the factors of production, costs of production, technological change, productivity growth, exchange rates and climatic conditions, and other events including government regulations and

disruptions to international supply chains). Question 1c of the 2022 exam required students to, 'explain how one AD factor and one AS factor have influenced the inflation rate over the past 12 months'. It demonstrates the importance of understanding the AD/AS factors and knowledge of contemporary macroeconomic factors. When responding to these types of questions, students should also avoid reference to microeconomic factors that influence the prices of specific goods, such as changes in the price of substitutes or complements, which was a problem for some students in the 2022 exam. **Option D is the best response** because a higher trade weighted index (i.e. a higher exchange rate) will reduce international competitiveness and lead to a reduction in both net exports ($X - M$), AD and economic growth. While an increase in government regulations will tend to impede business performance, potentially deter investment and reduce AD/economic growth.

Question 8

A key difference between cyclical and structural unemployment is that:

- A. Structural unemployment will be zero when full employment is achieved, unlike cyclical unemployment which will usually be above zero
- B. Structural unemployment will typically be reduced via the use of expansionary monetary policy, unlike cyclical unemployment which requires budgetary policy supply initiatives
- C. **Cyclical unemployment will be linked to the movement in economic growth whereas structural unemployment will be linked to changes in technology**
- D. Cyclical unemployment is made up of hidden and disguised unemployment while structural unemployment is made up of long-term unemployment and frictional unemployment

The study design requires students to demonstrate an understanding of the difference between cyclical and structural unemployment. In addition, students need to be aware of the different classifications within the labour force, including employed, unemployed, hidden unemployed, long-term unemployed, underemployed and frictional unemployment, as well as the appropriate policy options that can be used to reduce unemployment. **Option C is the best response** because it contains the only combination of factors that accurately describes the difference between the two types of unemployment. In particular, the movement in economic growth (or the business cycle) reflects changes in production volumes, demand for labour, employment and (cyclical) unemployment, while structural unemployment is indeed linked to changes in technology which can often lead to workers' skills becoming redundant, which increases structural unemployment. Options A and B are incorrect because the reverse is true. Option D is incorrect as cyclical unemployment is not made up of hidden + disguised unemployment, and frictional unemployment is not directly related to structural unemployment.

Question 9

If the rate of unemployment increases above 6%, as it did in 2020, then it is likely to result in:

- A. An increase in living standards
- B. **A reduction in the budget surplus**
- C. An increase in the rate of inflation
- D. A reduction in government expenditure

The Study Design requires students to demonstrate an understanding of 'the consequences of not achieving the goal of full employment and its effect on living standards, including the impact on GDP and tax revenue if unemployment is too high and the effects on inflation if unemployment is too low'. Students are also required to be aware of the impact of a change in the rate of unemployment on the budget outcome in the context of the cyclical component of the budget (or automatic stabilisers). **Option B is the best response** because an increase in the rate of unemployment will automatically reduce the (cyclical) budget surplus because government expenditure on income support will rise relative to income tax revenue. In addition, an unemployment rate above 6% would most likely cause the government to implement structural changes to the budget (i.e. discretionary stabilisers that increase expenditure relative to revenue) that will be designed to reduce the unemployment rate back towards the full employment level. All other options are incorrect because the reverse is true in each case.

Question 10

An increase in the number of skilled migrants entering Australia would be expected to:

- A. boost productivity and increase skills shortages
- B. reduce productivity and increase the unemployment rate
- C. boost productivity and shift the PPF to the right**
- D. reduce the quality of the labour force and reduce house prices

Option C is the best response because an increase in skilled immigration is likely to improve both the quantity (size of labour force) and quality (higher productivity) of Australia's factors of production, which increases the ability of the country to produce goods and services. This boosts productivity and productive capacity, which is represented by a shift of the PPF to the right. Option A is invalid because skills shortages restricts productive capacity and reflects that the nation cannot produce to its productive capacity. Option B is invalid because an increase in the unemployment rate also reflects an inability to produce to our potential. However, to the extent that a higher rate of unemployment contributes to a growth in productivity, then it is possible that the PPF could shift to the right. Despite this, option C is more convincing (less ambiguous) than option B. Finally, option D is invalid because the reverse is likely to be true.

Questions 11 and 12 relate to the increases in excise tax on alcohol (an indirect tax) during 2023.

Questions 11

An increase in excise tax on alcohol should result in:

- A. A higher budget surplus, a decrease in the relative price of soft drinks and lower beer consumption**
- B. A higher budget surplus, an increase in the relative price of beer and higher beer production
- C. A lower budget surplus, a decrease in the relative price of soft drinks and lower beer consumption
- D. A higher budget surplus, an increase in the relative price of beer and higher beer consumption

The study design requires students to demonstrate an understanding of non-price factors likely to affect supply and the position of the supply curve, including changes in the costs of production, which is the avenue by which indirect taxes influence prices.' In addition, students need to understand 'the effects of changes in supply and demand on equilibrium prices and quantity traded' as well as understand the meaning/significance of relative prices, and the role and effect of indirect taxation, including its effect on government revenue (and the budget outcome). Option A is the best response because an increase in an indirect tax on a product like alcohol (i.e. one with a low PED) will lead to an increase in government revenue and a corresponding rise in the budget surplus. The higher absolute price of alcohol will also mean that the 'relative price' of other products or substitutes (such as softdrinks) will fall. The combined effect will see the demand for, and consumption of, alcohol to fall (albeit by a relatively small amount).

Questions 12

Higher excise tax on alcohol will tend to have a significant (positive) impact on government revenue but a relatively insignificant (negative) impact on consumption if

- a) the price elasticity of supply for alcohol is low
- b) the price elasticity of supply for alcohol is high
- c) the price elasticity of demand for alcohol is low**
- d) the price elasticity of demand for alcohol is high

The study design requires students to demonstrate an understanding of the meaning and significance of price elasticity of demand (PED) and supply (PES), as well as the factors affecting the PED (degree of necessity, availability of substitutes, proportion of income and time) and PES (including spare capacity, production period and durability of goods). In examinations, it is common for students to confuse both the PED with the PES, and the factors affecting the PED with the factors affecting the PES. If in doubt, it can be useful for students to draw small demand and supply diagrams in the border of the examination to support your analysis of the effects referred to in the question. For the current question, drawing a relatively steep demand curve for alcohol and shifting the supply curve to the left (because of the higher excise) will reveal the relatively insignificant impact on consumption (i.e. Q does not decrease by much) compared to the relatively significant impact on price (and therefore government revenue). This means that **option C is the best response** because it is the only option referring to a low PED for alcohol. Options A and B are less valid

because the respective impacts on price (or government revenue) and quantity (or consumption) are primarily determined by the gradient or slope of the demand curve (i.e. PED). Option D is invalid because the reverse is true.

Questions 13

In relation to the concepts of relative scarcity and opportunity costs, identify the statement below that is inaccurate.

- A. *In Economics, money is an example of a scarce resource because it is limited*
- B. The problem of relative scarcity creates opportunity costs
- C. The production possibility frontier (PPF) model can be used to demonstrate the concept of relative scarcity and opportunity cost
- D. In Economics, the three basic economic questions are related to the concept of relative scarcity

The Study Design requires students to understand the 'concept of relative scarcity, including needs, wants, resources, opportunity cost and the production possibility frontier (PPF) model, and the three basic economic questions'. **Option A is the best response** because money in itself is not an example of a scarce resource given that economists have a specific definition for scarce resources (e.g. labour and capital). Instead, money is the method or means by which we value scarce resources. All other options are accurate statements.

Question 14

Which of the following is likely to cause a cyclical increase in the current account deficit?

- A. A higher unemployment rate and an increase in government expenditure on income support
- B. *An increase in the total demand for goods and services by Australians*
- C. An increase in national savings
- D. A rise in productivity and international competitiveness

The study design requires students to demonstrate an understanding of the cyclical and structural influences on Australia's current account balance. Student responses in past examinations reveals that this area of the course poses difficulties for many students. It is common for students to confuse cyclical and structural component influences on the current account balance with cyclical and structural influences on the budget balance. It is advisable that students review the relevant parts of the course (Unit 3 AOS 3 and Unit 4 AOS1) to ensure that these types of errors are not made in the examination. It is also common for students to demonstrate a shallow understanding of the difference between the structural and cyclical factors affecting the CA or CAD. This was evidenced by student responses to Q4d of the 2021 exam ('explain how a change in one structural factor might result in improvement in the CA balance'). This was the most poorly handled question on the examination, with an average score of 33% and only 19% of students achieving the full 3 marks. Students should remember that structural factors are those unrelated to the economic cycle, and instead relate to the underlying factors or forces driving any particular current account outcome (such as savings and investment imbalance, higher rates of productivity growth, shifts in technology uptake, international competitiveness, changes in resource endowments and shifts in comparative advantage). In relation to the current question, **option B is the best response** because an increase in the demand for goods and services (i.e. an increase in final demand or gross national expenditure) will typically lead to a cyclical rise in import spending which reduces the BOGS and increases the CAD (or alternatively, an increase in GNE inflates any difference between national spending and income, giving rise to a higher CAD). Option A is incorrect because an increase in the unemployment rate that causes government expenditure on income support to rise will cause an increase in the budget deficit rather than the current account deficit. Options C&D are both examples of structural factors that are likely to reduce (not increase) the current account deficit.

Question 15

Which of the following is an example of a change to the cyclical component of the budget that helped the Australian economy to emerge from the recent economic downturn?

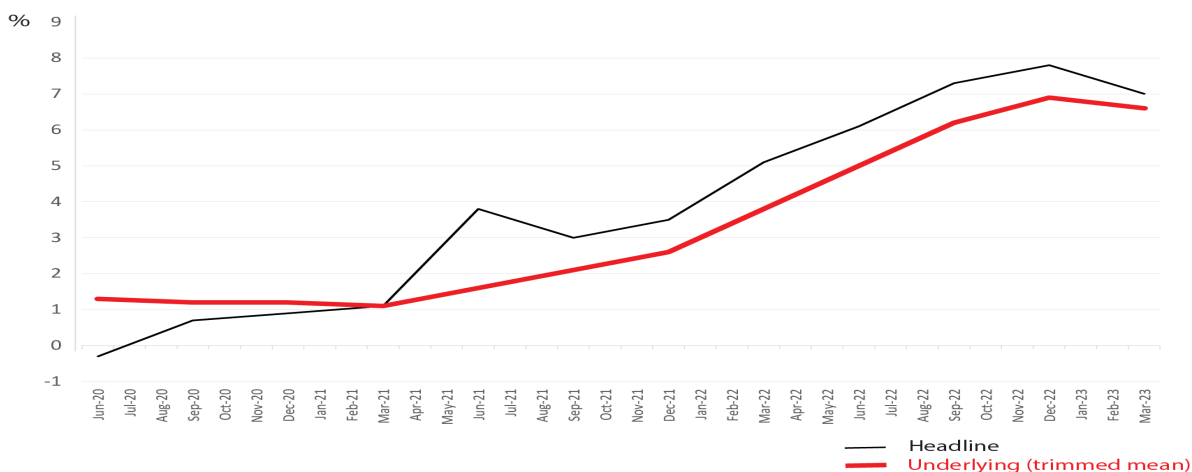
- A. The doubling of the unemployment benefit (JobSeeker) for a period of time
- B. The reduction in the company tax rate
- C. The \$250 cash bonuses to some welfare recipients
- D. *The reduction in average taxes paid by income earners*

*The Study Design requires students to demonstrate an understanding of the role of automatic stabilisers (cyclical component of the budget) in influencing aggregate demand and stabilising the business cycle. As noted in Exam A, and again in Question 4 (Part B) of this exam (which focuses on structural stabilisers) 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, which is the focus of this question. 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 is actually asking students to explain how these stabilisers impact on the economy (e.g. AD and economic growth). **Option D is the best response** because the downturn/recession resulted in average incomes falling as many people lost their jobs and many business owners experienced a drop in their income. This meant that people's incomes on average fell, which not only reduced income taxes payable at their pre-existing marginal rate, but also caused some income earners to fall into a lower tax bracket, which further reduced average tax paid (and the income tax burden). In fact, some income earners received (larger) tax returns at the end of the financial year, which all helped to support Consumption and AD, and helped the economy to emerge from the downturn. All other options are examples of changes to the structural (not cyclical) component of the budget that helped the economy to emerge from the downturn.*

SECTION B

Question 1 (17 marks)

Annual rate of inflation - Australia



a. Describe and account for the movement in the headline rate of inflation relative to the underlying rate of inflation since March 2021.

4 marks

- 1 mark for an accurate description of the trend in headline inflation relative to underlying inflation (e.g. headline inflation increased relative to underlying inflation since March 2021)
- 1 mark for accurate use of the data from the chart
- 2 marks for accurately accounting for the trend (i.e. explaining why headline rose relative to underlying inflation)

Note: in terms of a students' account for the movement', it is sufficient to focus on why the underlying rate is lower than the headline rate (e.g. referring to one off measures being removed or the top 15% of price rises being removed) without specifically referring to the causes of the one off/large price increases, such as the war in Ukraine. However, meaningful reference to the cause(s) can add value to a student response.

Advice 1: In relation to the description of the trend, these types of questions are often asked in the examination and relate to the key skill: 'explain and interpret trends and patterns in economic data and other information'. The marks allocated for these questions (or parts of questions) will usually be 2 marks, with 1 mark for an indication of the trend movement in the relevant variable (e.g. an increase in the headline rate of inflation since March 2021) and 1 mark for an accurate use of the data/information contained in the chart. It is common for students to err by referring to a period outside that referred to in the question; to spend too much time examining the rises and falls in the relevant variable over the given time period.

Advice 2: In relation to accounting for 'the movement in the headline rate of inflation relative to the underlying rate of inflation', students need to accept this terminology ('account for the movement') requires students to explain the reasons for the movement in the relevant variable(s). This terminology has been used in past exams and students have made the mistake of writing about the effects of the movement instead of the causes of the movement.

Sample answer: The headline rate of inflation has increased relative to the underlying rate of inflation since March 2021. The headline rate increased from 1% for the ending March 2021 to 7% for the ending March 2023, while the underlying rate rose from the same 1% but to approximately 6.6% over the same time period. [Over the entire two year period, the headline rate remained consistently above the underlying rate.] The relatively higher headline rate of inflation can be accounted for by the one-off increases in energy prices over the period, such as the rise in the price of gas, electricity and fuel [due to both the conflict in Ukraine and the lingering Covid-19 supply constraints impacting on shipping costs and the supply of key resources to global markets.]. This caused the headline rate to increase, but because large one off price increases such as these are removed from measures of underlying inflation [e.g. the trimmed mean measure removes the top 15% of price increases] it results in the underlying measures being lower than the headline measure.

b. Explain how a higher rate of inflation might increase the size of the government's budget surplus.

2 marks

- 1 mark for a superficial explanation or the identification of a relevant reason (e.g. because of the effects of bracket creep)
- 2 marks for additional information that explains why the budget surplus increases

Advice 1: The Study Design require students to demonstrate an understanding of the consequences of not achieving the goal of price stability. This is another way of saying that students need to understand how an excessive rate of inflation impacts on the economy. The key knowledge in Unit 3 AOS 2 specifically refers to the following types of consequences/effects: 'effect on living standards, including erosion of purchasing power, development of a wage-price spiral, distortion of spending and investment decisions, lower returns on investment, loss of international competitiveness if it is too high, and delayed consumption and unemployment if it is too low'. While the effects on the budget outcome are not specifically listed in this part of the Study Design, the key knowledge in Unit 4, AOS 1 requires a knowledge of the effect of automatic changes in the budget on the budget outcome. Inflation, and its effects on wages and tax revenue via bracket creep, is an example of an automatic change to the budget outcome, one that occurs independently to changes in the structural component of the budget (or discretionary stabilisers).

Advice 2: As noted in the advice provided in Exam A, questions related to automatic and discretionary stabilisers regularly feature on the examination and students will often demonstrate a poor understanding of this area of the course. They will often talk about the effect that automatic stabilisers might have on the economy when the question requires them to talk about the effects that automatic stabilisers will have on the budget outcome. Alternatively, they will do the reverse and talk about the effect that automatic stabilisers might have on the budget outcome when the question requires them to talk about the effects that automatic stabilisers will have on the economy.

Sample answer: *A higher rate of inflation can contribute to a rise in the [cyclical] budget surplus because of the effects of bracket creep (or fiscal drag). Inflation will tend to result in higher nominal wages [which is happening in Australia during 2023] as workers demand higher wages in order to prevent a reduction in their real wage. This causes income earners to move into higher tax brackets, which increases the average rate of tax they are required to pay to the government, and leads to an automatic increase in government tax revenue relative to expenditure, further increasing the size of the budget surplus [without a change to the structure of the budget].*

c. Define a wage price spiral and outline the relevance of NAIRU in the development of a wage-price spiral developing.

3 marks

- 1.5 marks for a comprehensive definition
- 1.5 marks for outlining the relevance of NAIRU

Note: Student marks should be rounded up in the event of half marks being awarded in total.

Advice: The new Study Design now requires students to demonstrate an understanding of how a wage-price spiral develops in the context of the goal of price stability and also an understanding of NAIRU in the context of full employment. While reference to the NAIRU is not necessarily required to explain how a wage price spiral develops (e.g. reference to a tight labour market or very low rates of unemployment would suffice), it is certainly a concept that is useful to keep in mind when seeking to unravel the relationship between wages and prices.

Sample answer: *The wage price spiral refers to a situation where wages increase over a given period of time which results in higher cost of production and leads to employers passing on these higher wage costs to consumers via higher prices. As prices increase, workers seek to protect their real wages and demand higher nominal wages from their employers. To the extent that employers agree to these wage claims, costs and prices rise once more and a spiral is entered into. The NAIRU [non-accelerating inflation rate of unemployment] is a relevant consideration or concept that helps to explain how a wage price spiral develops because once unemployment falls below the NAIRU, it highlights a tight labour market and the emergence of increasing claims for higher wages. This, by definition, leads to an acceleration of costs and inflation, and potentially develops into a wage price spiral.*

d. Outline how and why the Reserve Bank of Australia (RBA) responded to the movement in inflation over the past year

2 marks

- 1 mark for identifying how the RBA responded (e.g. increasing the TCR/tightening monetary policy)
- 1 mark for why the RBA responded in this way (e.g. to assist with the achievement of price stability)

Advice 1: A key skill in the Study Design requires students to analyse the effect of current factors on the setting of aggregate demand policies and living standards. Students should therefore be prepared to analyse the range of factors that can influence the rate of inflation (or the rate of unemployment), which in turn has implications for the setting monetary (and budgetary) policy. These factors can be the aggregate demand and supply factors that are listed in the study design (i.e. disposable income, interest rates, consumer confidence, business confidence, the exchange rate, rates of economic growth overseas, costs of production, technological change, productivity growth, exchange rates, climatic conditions, and other events including government regulations and disruptions to international supply chains) or indeed any other factor that the RBA Board would consider when deliberating on monetary policy (e.g. vacancy rates, capacity utilisation rates, unemployment, etc.). Importantly, students should not lose sight of the most important factor or variable influencing monetary policy decision making – i.e. the rate of inflation itself.

Advice 2: The marks allocated to this question (i.e. 2 marks) and the command term used (i.e. Outline) should provide students with an idea as to the depth required in their response. There is no need to include an excessive amount of detail, such as how the RBA increases the target cash rate or how the tightening of monetary policy has helped to reduce demand inflationary pressures in the economy. This is a common mistake made by students when responding to questions related to monetary policy.

Sample answer: *The RBA responded by tightening of monetary policy, increasing the target cash rate from a very low 0.1% during 2022 to a restrictive 4.1% by the middle of 2023. It did this to assist with the achievement of price stability as the (headline) rate inflation climbed well beyond the RBA's target range of 2-3% [on average over time].*

e. Describe whether the RBA response referred to in the previous question represents conventional or unconventional use of monetary policy.

2 marks

- 1 mark for identifying that the response represents conventional use of monetary policy
- 1 mark for justification (e.g. contrasting with non-conventional use)

Advice: The Study Design requires students to demonstrate an understanding of conventional monetary policy (cash rate target) and how it affects interest rates (in addition to one example of the operation of an unconventional monetary policy tool from the past two years). Students should avoid making reference to aspects of monetary policy that are unrelated to the question, such as the goals of the RBA or its charter, a discussion of open market operations, the transmission channels or the impact on other macroeconomic goals.

Sample answer: *The RBA response represents the use of conventional monetary policy given that it involves the traditional means of raising interest rates in the economy, which is via an increase in the target cash rate. This is in contrast to unconventional monetary policy that was implemented during 2020-2022 in order to reduce longer term interest rates in the economy (e.g. quantitative easing/purchases of three year government securities)*

f. Describe how the exchange rate influences the setting of monetary policy and is also a transmission channel of monetary policy.

4 marks

- 2 marks for an accurate and detailed description of the link between a change in the exchange rate and the setting of monetary policy
- 2 marks for an accurate and detailed description of the exchange rate transmission channel

Advice 1: As noted in the Advice in Part d above, a key skill in the Study Design requires students to analyse the effect of current factors on the setting of aggregate demand policies, which includes how changes in the exchange rate influence the RBA Board when deliberating on monetary policy settings. In addition, students are required to have an understanding of the transmission mechanism of monetary policy and its effect on the level of aggregate demand, which includes the role of the exchange rate as one of the four recognised transmission channels (the others being savings and investment, cash-flow, and asset prices and wealth). Students should be prepared for questions on the exam that either test their understanding of the role the exchange rate plays in influencing policy settings, or the role it plays in the operation/transmission of monetary policy, or both (which is the nature of the current question).

Advice 2: The mark allocation will provide students with a guide as to the length and depth of the response. Given that students should anticipate a mark allocation of 2 marks for each part of the question, there would be no need to explore the effects (of a depreciation for example) on both demand and cost inflation to achieve full marks. In relation to the exchange rate channel, there is no need to explore all of the avenues by which tighter monetary policy (for example) influences the exchange rate and AD. Use the sample answer as a guide.

Advice 3: Questions related to the channels of monetary policy transmission have featured on the past five exams. In the 2022 exam (Q1f) focused on the exchange rate mechanism and the achievement of one macroeconomic goal, and only 25% of students were able to achieve the full 4 marks. In the 2021 exam (Q1c), only 34% of students were able to achieve the full 5 marks and in the 2020 exam (Q1c) only 28% of students were able to achieve the full 6 marks. The 2019 and 2018 examinations saw relatively low average scores of 55% and 56% for questions related to the transmission channels. In these exams, students continued with the same types of mistakes. In relation to the exchange rate channel (e.g. Q1f of the 2022 exam), students spent insufficient time explaining how higher interest rates actually contribute to a higher exchange rate (e.g. referring to the role of interest rate relativities, capital inflow/outflow and the change in the demand/supply of the AUD on foreign exchange markets). In relation to mistakes more generally, 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 4: As noted in the advice provided in the previous question (i.e. part e), students should avoid making reference to aspects of monetary policy that are unrelated to the question, such as the goals of the RBA or its charter, a discussion of open market operations, other transmission channels, or the impact on other macroeconomic goals.

Sample answer: *A depreciation of the exchange rate [such as that which has occurred over 2023] adds to both demand [and cost] inflation in the economy as it stimulates aggregate demand (AD) via the boost to international competitiveness [and contributes to higher costs of production via the increase in the cost of imported capital and raw materials]. The increased inflationary pressure is one of many factors considered by the RBA Board when determining the appropriate monetary policy settings to implement. In the current context, with inflation already above the top end of the RBA's target range [2-3%], the inflationary impact of the depreciation makes it more likely that the RBA will further tighten monetary policy and adopt a more restrictive monetary policy stance.*

The exchange rate is also one of the transmission channels of monetary policy because any change in the target cash rate is designed to influence AD and inflation via the exchange rate channel [as well as other channels]. For example, the tightening of monetary policy during 2023 [with the cash rate rising to 4.1%] is designed to appreciate the AUD via capital inflow [as Australian interest rates rise relative foreign interest rates], which reduces the competitiveness of

Australia's tradables sector [exporters and import competing businesses], reducing growth in [net exports and] AD, leading to a reduction in demand inflationary pressure [as well as cost inflationary pressures as the higher AUD reduces the cost of imported capital and raw materials].

Note: Square bracketed section is not required for full marks

Question 2 (11 marks)

The majority of Australia's migrants enter the country via the skilled visa stream. This, combined with Australia's embrace of trade liberalisation, has assisted with economic recovery and enhances Australian living standards in the long term.

a. **Analyse how an increase in skilled immigration can boost Australia's productive capacity and contribute to economic recovery. In your answer, refer to the quality and quantity of labour.**

4 marks

- 1 mark for linking skilled immigration to an increase in the quality of labour
- 1 mark for linking skilled immigration to an increase in the quantity of labour
- 1 mark for linking skilled immigration to an increase in productive capacity
- 1 mark for linking skilled immigration/boost in productive capacity to an economic recovery

Advice 1: The Study Design requires students to demonstrate an understanding of the effect of skilled immigration on population, productivity and participation and the subsequent effect on productive capacity, aggregate supply, international competitiveness, the achievement of domestic macroeconomic goals, and living standards. This is a slight departure from the previous Study Design, which focused more broadly on immigration and, in particular, its impact on the labour market, aggregate supply and the achievement of macroeconomic goals. With respect to the impact of immigration on labour markets, students should not expect a question such as Question 3d of the 2022 exam (i.e. 'Examine how changes in Australia's overseas migration, such as the change outlined above, might have affected the labour market and aggregate supply.') given that specific reference to the labour market impact has been removed from the Study Design. However, students are free to refer to the labour market impact (e.g. increased supply and lower wages) when discussing the impact on aggregate supply and living standards.

Advice 2: Students should carefully interpret questions related to (skilled) immigration. While the current question refers to an increase in skilled immigration, the VCAA exam might refer to a decline in (skilled) immigration, as was the case in the 2018 exam (Question 3c). In that question, students were asked to explain one likely effect on the labour market and aggregate supply of decreasing the annual immigration intake from 200,000 to 100,000. Only 7% of students were able to achieve the full 4 marks, with the average score a very low 2.1/4 or 53%. Too many students misread the question and argued on the basis that there was a decrease in the total volume of immigrants living in Australia and a shrinking of the labour market. It was an easy mistake to make, arguing that the total number of immigrants in the country is falling and therefore glossing over the important fact that there remained an additional 100,000 immigrants entering the country each year.

Sample answer: *An increase in the number of skilled migrants entering the country will help to boost both the quality of labour as skill levels within businesses increases, (boosting labour productivity), as well as the quantity of labour via the increase in the size of the labour force. In addition, the increased supply of skilled labour will alleviate skills shortages and exert downward pressures on the price of labour (e.g. lower wages growth). Overall, growth in labour productivity relative to labour costs will contribute to lower unit labour costs, reducing average costs of production for businesses and increasing the willingness and capacity to supply goods and services to markets, This rise in productive capacity, and the associated fall in production costs, contributes to a lower rate of inflation, boosting international competitiveness, stimulating economic growth and therefore assisting with economic recovery.*

b. Explain how trade liberalisation may influence the achievement of the goal of strong and sustainable economic growth and full employment in the short term and in the long term.

7 marks

- 1 mark for demonstrating an understanding of trade liberalisation
- 1 mark for demonstrating an understanding of the goal of full employment
- 1 mark for demonstrating an understanding of the goal of strong and sustainable economic growth
- 2 marks for an accurate explanation of the short term impact of trade liberalisation on both growth and jobs/unemployment
- 2 marks for an accurate explanation of the long term impact of trade liberalisation on both growth and jobs/unemployment

Advice 1: The new Study Design has moved the key knowledge in relation to trade liberalisation from Unit 3 AOS 3 to Unit 4 AOS 2. The wording has also changed from ‘the effect of trade liberalisation on Australia’s international competitiveness, domestic macroeconomic goals and living standards’ [Old Study Design 2017 – 2022] to (the effect of) trade liberalisation and its short-term and long-term effects on Australia’s international competitiveness, the allocation of resources, aggregate supply, and the domestic macroeconomic goals and living standards’ [New Study Design 2023 -]. The key differences are the reference to aggregate supply, as well as reference to the short-term and long-term effects. Students should therefore expect to see a trade liberalisation question that lends itself to an ‘evaluation’ of the short and long term effects on aggregate supply.

Advice 2: Over the life of the former Study Design, most of the exams included a question in Part B that examined student understanding of trade liberalisation in some way. While students performed better on the shorter questions (i.e. questions on the 2019 and 2018 exams), the handling of the 2017 question was less impressive, with only 17% of students achieving the full 6 marks and 45% of students scoring 3 marks or fewer. Common problems included a failure to separate short run impacts from long run impacts (e.g. when discussing the impact of lower protection on full employment/economic growth) and an unpreparedness or inability to ‘step out’ responses to explain why Australia becomes more competitive following trade liberalisation.

Advice 3: Question 3d of the 2022 exam required students to explain how trade liberalisation is likely to affect the inflation rate and living standards. A number of students made the mistake of defining trade liberalisation as the imposition of trade sanctions & barriers, instead of the removal of these barriers and the opening up of trade. In addition, when linking trade liberalisation to inflation, some students surprisingly argued that inflation would increase following trade liberalisation because of an increase in the demand for exports that would occur. This approach is flawed because ignores the important disinflationary effects that stem from access to cheaper consumer imports (e.g. final goods that are in the CPI) and producer imports (e.g. raw materials). In addition, it ignores the beneficial impact on efficiency over time, as Australian businesses are forced to raise productivity in the face of greater imported competition, which helps to exert downward pressure on prices, including the prices of exports.

Sample answer: *Trade liberalisation refers to the breaking down of barriers that impede the free flow of goods and services across international boundaries. It is evidenced by reductions in protection, such as lower tariffs and reduced subsidy support for many businesses and the signing of new free trade agreements with trading partners. The reduction in protection increases the level of imported competition and forces domestic producers to increase efficiency to remain competitive. This often involves large-scale restructuring that can create short term dislocation and unemployment, as businesses substitute out of labour and into capital for example. Some businesses will either experience a significant fall in output, or may cease to exist altogether, in the face of stiffer imported competition.*

In the short to medium term, this detracts from economic growth, making it more difficult to achieve the goal of strong and sustainable economic growth – which is defined as growth in real GDP that is strong enough to create jobs and incomes (e.g. approximately 3.5% per annum) without being excessive to the extent that it leads to excessive inflation and/or environmental/external pressures. In addition, it can make it more difficult to achieve the goal of full employment – defined as the goal to achieve maximum employment growth in the economy such that the unemployment rate is at its lowest possible level before inflationary pressures become too high (e.g. NAIRU of 4.25%).

However, over time, the restructuring helps to raise productivity as businesses are able to produce more from any given level of inputs following investment in technology [e.g. introduction of new robotics] and/or employment of more skilled labour. This helps to reduce costs of production and prices, which improves international competitiveness of

Australian producers. This contributes to a reversal of the negative short term effects and can assist with the achievement of both goals in the long run.

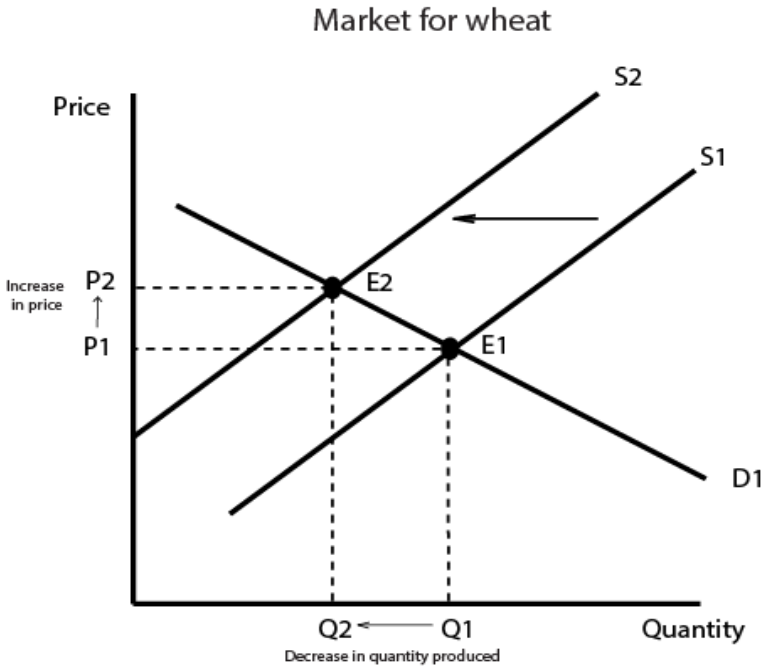
Note: Square bracketed section is not required for full marks.

Question 3 (22 marks)

The value of agricultural production is forecast to fall by 14% to reach \$79 billion in 2023–24. The biggest driver of this decrease is drier climatic conditions brought on by the expectation of El Niño and/or a positive Indian Ocean Dipole, which will reduce crop yields.

Source: <https://www.agriculture.gov.au/abares/research-topics>

a. Based on the information presented above, construct a fully labelled demand and supply diagram to illustrate the predicted impact on the market for a crop like wheat. 4 marks



Advice 1: A key skill in the Study Design is the requirement for students to construct and interpret demand and supply diagrams. When interpreting questions related to the preparation of demand and supply diagrams, students need to ensure that they stay in the ‘micro’ space, paying particular attention to the microeconomic variables that make up a standard demand and supply diagram. For instance, in the 2022 example, many students presented diagrams for Question 4c that were incorrect and/or inappropriate. Students used AD and AS diagram (or a hybrid version such as price and quantity on the axis, but AD and AS curves, or prices and real GDP on the axis and normal D and S curves). In other cases, students failed to label the y or x axis, or the D and/or S curves and drew upward-sloping demand curve and/or a downward-sloping supply curve. For the current question, there is no requirement for students to provide a written response to support the ‘predicted impact on the market’. For this 4 mark question, the emphasis is on the presentation of the diagram, with fully labelled axes and an indication of how price and quantity will move.

Advice 2: In examinations, it is possible that questions elsewhere in the examination provide clues about the approach needed in another question. This is something that should be considered during reading time of the examination. In this example, Question 1d refers to higher wheat prices, which provides a clue to the direction of price in this question.

- 1 mark for accurate labelling of the y and x axis as price and quantity
- 1 mark for accurate drawing and labelling of the demand and supply curve
- 1 mark for shifting the supply curve to the left
- 1 mark for accurately ‘predicting’ the movement in price and quantity via the establishment of a new equilibrium point showing a higher price and lower quantity compared to the initial equilibrium point

Note: Students do not need to identify the initial and final equilibrium points as E1 and E2, nor annotate the diagram (as shown in the diagram above) in order to achieve full marks. However, this approach is preferred in the context of this and the following question.

b. Analyse how the market for wheat will move from a temporary state of disequilibrium to a new equilibrium following the changes outlined above. Illustrate your response with reference to the diagram drawn in Part a.
4 marks

- 1 mark for accurate reference to excess demand (or shortage) at the initial equilibrium price (P1) causing price to rise to (or towards) P2
- 1 mark for accurate reference to the contraction of demand
- 1 mark for accurate reference to the expansion of supply
- 1 mark for meaningful reference to the diagram

Advice 1: A key skill introduced to the new Study Design is the requirement to ‘analyse how the forces of demand and supply effect equilibrium price and quantity traded’. While this skill was implied in the former Study Design (i.e. construct and interpret demand and supply diagrams), the explicit reference to the need to ‘analyse’ lends itself to a question that uses this specific command term. Students should expect a question to appear on the 2023 exam relating to this key knowledge and/or key skill.

Advice 2: In the past examinations, when students have been asked to interpret demand and supply diagrams, they will often spend either too much time or too little time unpacking the diagram. For example, if a question asks students to comment on the impact on price and quantity (or the market for a good) following a shift to the right of the demand curve, it would not be necessary to explore the dynamics of adjustment from one equilibrium to the next (which is the focus of the current question), nor would it be necessary to focus on the change in relative prices and the implications for the allocation of resources. On other occasions, a question might specifically ask for the impact on relative prices and resource allocation, and students will provide insufficient detail by simply referring to the impact on price and quantity. It highlights that students need to read questions carefully to ensure that they answer questions with sufficient detail or don't spend time providing detail that is not required in the question.

Advice 3: The most recent exam requiring the use of a D/S diagram was the 2022 exam, and it highlighted problems that students have when they are asked to use to use these diagrams in support of their responses. Question 4c of the exam required students to use a fully labelled demand and supply diagram to illustrate and analyse how a form of government intervention might lead to a change in relative prices and the allocation of resources. In addition to those issues mentioned in the advice to Part a above, some student responses were inconsistent with the information conveyed in the D/S diagram (e.g. analysing how an excise tax effectively causes a contraction along the demand curve but then producing a D/S diagram with the demand curve shifting to the left). In other cases, students chose government interventions (e.g. the provision of public goods) that were difficult to illustrate using a D/S diagram.

Sample answer: *The temporary state of equilibrium would occur at the original equilibrium price of P1, where a shortage of wheat develops following the reduction in supply from S1 to S2. This shortage (or excess demand) will encourage wheat producers to raise the price above P1 as a means of rationing demand and protecting/maximising profits. As the price increases, consumers of wheat will reduce their demand for the product (i.e. a contraction of demand) which helps to reduce the size of the shortage. The higher price will also incentivize wheat producers to supply more to the market over time in order to take advantage of the anticipated higher profit margins available (i.e. an expansion of supply). Price will continue to increase until the shortage is eventually eliminated at a price of P2, where a new equilibrium price and quantity is restored.*

c. With respect to the demand for wheat, distinguish the ‘substitution effect’ from the effects of a ‘change in the price of a substitute’. In your answer, make reference to the diagram drawn in Part a above.

4 marks

- 1 mark for demonstrating an understanding of the substitution effect
- 1 mark for demonstrating an understanding of the effects of a change in the price of the substitute
- 1 mark for highlighting a clear point of difference between the two terms
- 1 mark for meaningful reference to the diagram

Note 1: While students should be advised to focus on a clear point of difference between the two effects, it is possible for students to achieve full marks by defining the terms, so long as a key difference between effects is made clear. While the use of conjunctions such as ‘whereas’, ‘in contrast’, ‘on the other hand’, etc. is strongly advisable, their absence should not preclude students from achieving full marks.

Advice: As noted in the advice provided in Exam A (Q15, Part A), over many years, students have been taught about the income and substitution effects when examining the reasons for a downward sloping demand curve (or the law of demand). However, the new Study Design now includes specific reference to both effects by requiring students to understand ‘the law of demand and the theory of the law of demand, including the income effect and the substitution effect’. Students should reasonably expect an examination question to test student understanding of the difference between these two effects (income and substitution) or between the substitution effect and a change in the price of a substitute (as per the VCAA Sample Exam).

Sample answer: *The substitution effect refers to one of the reasons that helps to explain why a demand curve is downward sloping. In relation to the demand for wheat, a rise in its price (e.g. from P1 to P2) means that the relative price of substitute products, such as corn or rice, will fall. This results in consumers substituting away from wheat, reducing their demand for wheat (via a contraction along the demand curve from E1 to E2) and towards the demand for rice/corn. [It is therefore one of the reasons explaining the law of demand.] This substitution effect is distinct from a rise in the price of a wheat substitute, such as the effects of a higher price of rice or corn, which would lead an increase in the demand for wheat (shifting the demand curve to the right). A key difference between the two effects is the way that each influences demand, price and quantities. The substitution effect in this example results leads to a higher price and lower demand because of a contraction of demand, whereas the increase in the price of a substitute leads to a higher price and higher demand because of a shift of the demand curve to the right.*

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

d. Describe how the ‘value’ of wheat production might fall despite higher wheat prices. In your answer, refer to the price elasticity of demand (PED).

3 marks

- 1 mark for demonstrating an understanding of the value of wheat in the context of the question
- 1 mark for demonstrating an understanding of the PED (i.e. the meaning of PED)
- 1 mark for logically connecting a high PED for wheat to a decreased value of wheat production (i.e. the significance of PED)

Advice: The Study Design requires students to demonstrate an understanding of the meaning and significance of price elasticity of demand (PED) as well as the factors affecting PED: degree of necessity, availability of substitutes, proportion of income and time. Students typically struggle writing responses to questions testing the meaning and significance of the PED. For example, Question 6 (Part A) of the 2022 was poorly handled, with students struggling to determine which of the following goods had the highest PED: cigarettes, haircuts, soft drinks and international travel. In addition, Question 1c (Part B) of the 2019 exam required students to demonstrate an understanding of PED (in relation to the demand for housing). Only 27% of students managed to score the full 3 marks for that question, with the overwhelming problem being the inability of students to demonstrate a sufficiently clear understanding (e.g. a definition) of PED. While a question relating to the relationship between the PED and the changing ‘value of production’ is unlikely, it is indeed a relevant factor that highlights the ‘significance’ of the PED in relation to price changes of goods and services.

Sample answer: *Given that the market value of wheat [in the context of the question] is derived from multiplying price by quantity (i.e. $P \times Q$), the only way that the value of wheat production can fall in response to a higher price [such as the increase from P_1 to P_2 as indicated in part A above] will be if the higher price of wheat leads to a proportionally larger negative impact on the quantity of wheat demanded by consumers. This means that the price elasticity of demand (PED) for wheat must be sufficiently high such that any given increase in price is met by a proportionally larger negative impact on the quantity demanded. This leads to the value of wheat production at the new higher equilibrium price [e.g. $P_2 \times Q_2$ in the earlier diagram] being lower than the value of wheat production at the initial equilibrium price [e.g. $P_1 \times Q_1$]. [This is highlighted in the diagram via the relatively flat demand curve for wheat, which was responsible for the proportional decrease in QD being higher than the proportional increase in price.]*

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

e. Evaluate the role of free and competitive markets in achieving an efficient allocation of resources. In your answer, make reference to one market failure.

7 marks

- 1 mark for demonstrating an understanding of an efficient allocation of resources
- 1 mark for demonstrating an understanding of free and competitive markets
- 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

Note: Reference in the question is to ‘competitive markets’, not ‘perfectly competitive markets’. Students are therefore not required to list or show recognition of the conditions for a ‘perfectly competitive market’.

Advice 1: The Study Design (U3 AOS 1) requires students to understand and evaluate the role of free and competitive markets in achieving an efficient allocation of 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 arrive at a conclusion or overall judgement). Exams over the life of the previous Study Design did not specifically require students to ‘evaluate the role of markets’, however there were numerous occasions where students were required to discuss or refer to how markets allocate resources and/or why markets fail to allocate resources efficiently (i.e. how ‘market failures’ exist).

Advice 2: Students should recognise that markets play an important role in the allocation of resources and (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 exams reveal that students find market failures one of the most challenging parts of the course to understand, with asymmetric information the most difficult example of market failures to explain. In the event that choice is provided in the examination, it is recommended that only high performing students examine asymmetric information as their example for why or how unregulated markets do not achieve the most efficient allocation of resources. In the 2022 exam, Question 4b asked students to ‘explain one reason why the excess consumption of sugar may cause market failure’. The question was not handled well, with an average score of 47% and only 18% of students attaining the full 3 marks. While many students were able to ‘identify’ that excess consumption of sugar was a market failure in the form of negative externalities in consumption (or even asymmetric information), they could not explain how this excess consumption was an example of a negative externality or asymmetric information.

Advice 3: 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. In relation to strengths and weaknesses more generally, including the strengths and weaknesses of policies (Unit 4), students will often make the mistake of describing how markets/policies work (i.e. they focus on the operation of markets/policies and ignore the need to highlight those factors relating to the potency of markets/policies in terms of how they influence the relevant outcomes (e.g. efficiency/living standards/goals)).

Sample answer: Competitive markets, with many buyers/sellers and freedom of entry and exit for example, can help to achieve efficiency in some respects. However, left unregulated by governments (i.e. free markets), they will not result in the most efficient allocation of resources for a nation like 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, free markets or ones without government regulation, will typically 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 maximized from any given allocation of resources. 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 4 (8 marks)

a. Describe how the government can change the structural component of the budget to increase aggregate demand (AD), stabilise the business cycle and improve living standards. Use one example from the past two years to support your description.

5 marks

- 1 mark for identifying a relevant change to the structural component of the budget
- 1 mark for accurately linking the structural change (discretionary stabiliser) to an increase in AD
- 1 mark for accurately linking the structural change/increase in AD to stability of the business cycle
- 1 mark for accurately linking the structural change/increase in AD to an improvement in living standards
- 1 mark for reference to a relevant example from the past two years

Note: Full marks can be achieved if students focus on a budgetary policy supply side initiative so long as the implications for AD and stabilisation of the business cycle are explored and explained well. See Advice 3.

Advice 1: The Study Design requires students to demonstrate an understanding of discretionary stabilisers (structural component of the budget) in influencing aggregate demand and stabilising the business cycle. Students also need to understand the effect of budgetary initiatives over the past two years and their likely effect on the achievement of the (domestic macroeconomic goals) and living standards.

Advice 2: As noted in Exam A, 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 is actually asking students to explain how these stabilisers impact on the economy (e.g. AD and economic growth).

Advice 3: Question 2c of the 2022 exam required students to ‘explain how a change to one structural component of the 2022–23 Budget may influence aggregate demand and the achievement of the domestic macroeconomic goal of strong and sustainable economic growth’. While students were expected to explain a budgetary policy initiative that was designed to ‘stimulate AD’, it was acceptable to refer to budgetary policy supply-side initiatives so long as the explanation of the supply-side initiatives included reference to the influence on AD (e.g. the reduction in prices and the increase in international competitiveness and net export demand). While the current question is similar, reference to stabilisation of the business cycle somewhat constrains students to stay on the ‘demand side’. However, this does not discount the possibility that budgetary policy supply side initiatives (e.g. government investment in infrastructure) are indeed introduced by the government with the twin aims of boosting productive capacity/aggregate supply as well as assisting AD side measures to stabilise the business cycle. Full marks can also be achieved via this approach if explained well.

Sample answer: *The government can introduce discretionary stabilisers such as tax cuts and increases in spending initiatives which will result in a larger structural budget deficit and the delivery of a more expansionary budgetary policy stance. The larger deficit will contribute to a net injection of funds into the economy [or an increase in injections relative to leakages], stimulating Consumption and/or Investment and/or Government expenditure, boosting AD and stimulating the rate of economic growth. This should help to stabilise the business cycle given that the economy is assumed to be at, or close to, the trough in the cycle, thereby contributing to an economic recovery. The economic recovery would be consistent with growth in employment and incomes, which leads to an increase in material living standards given that Australians on average will be able to purchase more goods and services than before. For example, the provision of tax cuts in 2021, via the extension of the low and middle income tax offsets, was partly designed to boost disposable incomes and stimulate aggregate demand, helping the economy to emerge from the recession and economic downturn.*

b. Describe a strength of budgetary policy compared to monetary policy. Use an example from the past two or three years to illustrate.

3 marks

- 1 mark for an identification of a strength of budgetary policy
- 1 mark for an accurate description of how it boosts the effectiveness of budgetary policy compared to monetary policy
- 1 mark for use of a relevant and recent example

Advice 1: Discussing or evaluating the effectiveness of policies (in terms of strengths and weaknesses related to the way they operate) is a key skill that troubles students. For example, the 2022 exam (Q2d) required students to evaluate the use of budgetary policy in achieving the Australian Government’s goal of full employment, with only 18% of students able to achieve full marks (and an average of 1.8/4). The 2021 exam (Q1d) require students to explain weaknesses associated with monetary policy and the 2020 exam (Q2d) required an evaluation of the effectiveness of monetary policy. The average scores in 2021 and 2020 was a relatively low 55% and 42% respectively. A common mistake made by students is an inability to recognise that an evaluation of the effectiveness of policy requires a discussion of the relative strengths and weaknesses.

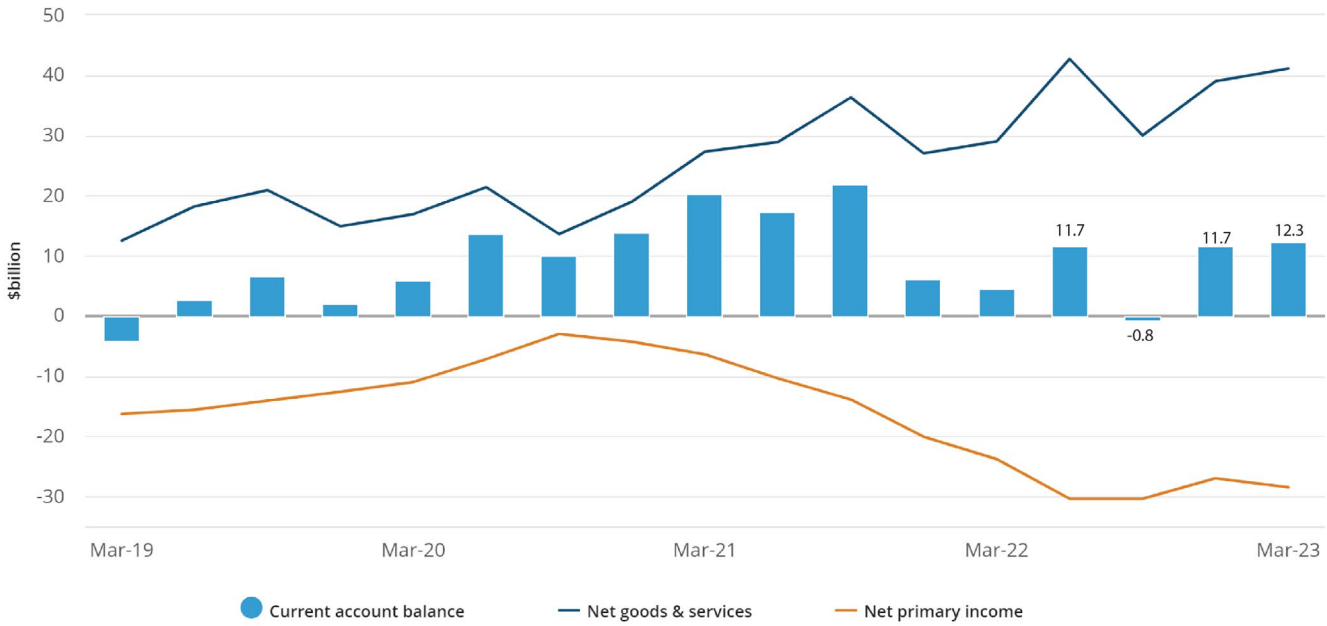
Advice 2: In relation to strengths of policy, too many students simply describe how a policy operates or how it has been used over time to achieve certain goals, when instead they should be examining what makes the policy particularly effective or powerful. The current question makes it clear that the focus is on potency/effectiveness of policy given that it refers to a comparison with monetary policy. However, in the event that a question surfaces on the 2023 exam that simply refers to a strength of policy, students should avoid writing solely about how the policy operates.

Sample answer: *A strength of budgetary policy is its flexibility to target specific sectors, groups or areas in the economy via the use of multiple tools or policy options, unlike monetary policy which effectively has one tool or policy lever at its*

disposal– interest rates. This enables the government to more effectively target specific objectives in its effort to boost living standards for Australians, or indeed to focus on specific goals that cannot be targeted by monetary policy. This includes the ability to specifically focus on initiatives that help to reduce structural unemployment or alleviation of poverty, which are beyond the scope of monetary policy. A recent example includes the use of the 2022-23 Budget to provide cost of living relief to Australians, such as energy subsidies which immediately reduced the price of some energy services for households. This option is not available to monetary policy as RBA action is limited to a tightening of monetary policy (or higher interest rates) as a means of reducing prices, which is only effective in the longer term and can actually add to cost of living pressures in the short term.

Question 5 (7 marks)

Chart 1: Current account balance: main aggregates (quarterly)



Source: Australian Bureau of Statistics, Balance of Payments and International Investment Position, Australia March 2023

a. Based on the data presented in Chart 1, determine the value of the CAFA for the March quarter of 2023 and outline how this figure is determined.

2 marks

- 0.5 marks for identifying that the CAFA must be a deficit
- 0.5 marks for identifying the CAFA deficit as \$12.3 billion
- 1 mark for appropriate justification

Note: Student scores should be rounded up in the event of 0.5 or 1.5 being awarded based on the mark scheme.

Advice 1: Questions requiring students to demonstrate an understanding of the current account and its components (e.g. movements and causes) regularly feature in the examination. This included all of the exams between 2017 and 2021, but excluded the most recent 2022 exam. Students should expect to either describe the trend and/or explain a factor that has contributed to the movement in the current account balance (or its sub-accounts) as well as examine the implications of a change in the current account balance (or its sub-accounts) for other components of the balance of payments (which relates to the current question) or the achievement of Australia's macroeconomic goals/living standards or the capital and financial account in the balance of payments.

Sample answer: The CAFA for the March quarter of 2023 must be a deficit of \$12.3 billion. This is because the balance of payments (BOP) must equate to zero, and if the current account balance is a surplus of \$12.3 billion, then the CAFA must be a deficit of the same value (\$12.3 billion) which ensures that $BOP = 0$

b. Describe the implications for Australia's net foreign equities (NFE) and/or net foreign debt (NFD) given the movement in the CAFA described in part b above.

2 marks

- 1 mark for identifying that NFE/NFD or NFLs increase or become more favourable
- 1 mark for an accurate justification for the movement in NFE/NFD or NFLs

Note 1: If a student focuses on the relationship between the CAFA deficit and NFE, it is sufficient to refer to an increase in NFE or the value of NFE becoming more negative. Students can also achieve full marks if they focus on the movement in NFLs (i.e. NFLs decrease), so long as it is clear that they understand the relationship between NFE/NFD and NFLs.

Advice 1: The Study Design requires students to demonstrate an understanding of the composition and cause of net foreign debt and net foreign equities. This means that students need to be aware that Australia's net foreign liabilities (NFLs) are made up of both net foreign debt (NFD) and net foreign equities (NFE). In other words, $NFLs = NFD + NFE$. It is common for students to confuse NFD and NFLs and students need to remember that NFLs include NFD in addition to the net value of overseas equity (e.g. ownership) in Australia (i.e. NFE).

Advice 2: It is important to remember that a CAD will lead to an increase in NFLs and a higher CAS leads to a decrease in NFLs. But students should avoid saying (as students frequently do) that a higher CAD leads to an increase in NFD. Indeed, it is possible for a country to have a CAD, but experience no increase in NFD because instead of issuing debt to finance a CAD, a country can simply sell off some of its assets (e.g. selling shares in companies to overseas investors). This means that NFD won't increase, but NFLs will, due to the increase in NFE.

Sample answer: *Given that Australia recorded a CAFA deficit [of \$12.3 billion] it means that there is has been net outflow of investment funds from Australia, in the form of debt (e.g. Australian entities repaying foreign debt or lending to foreigners) and/or equity (e.g. Australian entities purchasing foreign shares). This leads to a reduction in the total value of Australia's net foreign liabilities, with either the value of NFD falling and/or the value of NFE becoming more negative [which effectively means Australia increasingly owns more foreign assets than foreigners own Australian assets].*

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

c. Distinguish a budget deficit from a current account deficit.

3 marks

- 1 mark for demonstrating an understanding of a budget deficit
- 1 mark for demonstrating an understanding of a current account deficit
- 1 mark for establishing a clear point of difference between the two deficits

Advice: Knowledge of both the budget deficit in the context of Unit 4 AOS 1, and the current account deficit (CAD), in the context of Unit 3 AOS 3 remain key knowledge in the new 2023 Study Design. Over many years, students have continued to confuse these two deficits when responding to either budgetary policy questions or balance of payments questions in the examination. This was once again the case in the 2022 examination, where Q2a required students to outline how the stance of budgetary policy might be determined, and a number of students erred by making reference to debits and credits, instead of receipts and payments. A common error is for students to make statements like 'the government can finance its CAD by selling bonds', or 'an increase in the CAD will lead to an increase in government debt', 'an increase in the budget deficit will result in an offsetting surplus in the CAFA'.

Sample answer: *A budget deficit refers to the budget outcome that exists when government expenditure exceeds government revenue for any given period of time (typically one year). In contrast, a current account deficit (CAD) refers to an outcome within Australia's balance of payments, and exists when the total debits (current outflows) within the current account for any period exceed total credits (current inflows). A key difference is that the flows of money that result in a budget deficit must all relate directly to government revenue and expenditure, whereas the flows of money that results in a CAD relate to both the private and public (government) sectors in the economy.*

Note 1: Flexibility is recommended when assessing student responses. While students should be advised to focus on a clear point of difference between the terms, it is possible for students to achieve full marks by defining the terms, so long as a key difference between a budget deficit and current account deficit is made clear. While the use of conjunctions such as 'whereas', 'in contrast', 'on the other hand', etc. is strongly advisable, their absence should not preclude students from achieving full marks.

Note 2: Students are free to focus on any meaningful difference between the two deficits in order to achieve full marks.