

# ECONOMICS

## Unit 3 & 4 – Written examination



## 2023 Trial Examination

### SOLUTIONS

#### SECTION A: Multiple-choice questions (1 mark each)

##### Question 1

*Answer:* C

*Explanation:*

Expansion or contraction relates to a movement or change in price. A shift relates to changing conditions. The answer is, therefore, C.

##### Question 2

*Answer:* B

*Explanation:*

Subsidies provide an incentive to producers to increase production. Direct payments from the government achieve this purpose.

##### Question 3

*Answer:* C

*Explanation:*

If worker's wages increase faster than productivity, this means that demand will be growing at a faster rate than production (assuming higher wages spills over into higher levels of consumption)

**Question 4**

*Answer:* A

*Explanation:*

Public goods are non-excludable. For example, if the government builds street lighting, it's impossible to exclude people who don't pay from using the service.

**Question 5**

*Answer:* C

*Explanation:*

$$104 - 4 = 100 \quad 4/100 = 4\%$$

**Question 6**

*Answer:* B

*Explanation:*

Import prices are rising faster than export prices. This means it's an unfavourable term of trade.

**Question 7**

*Answer:* A

*Explanation:*

Australia has been recording a current account surplus since September 2019. The only plausible answer here is an increase in export prices and lower debt servicing costs. An increase in export prices leads to increased credits, and lower debt service costs have been associated with lower global interest rates.

**Question 8**

*Answer:* A

*Explanation:*

Interest rates influence asset prices, which then ripples onto household wealth.

**Question 9**

*Answer:* A

*Explanation:*

68% of immigrants are skilled. Higher levels of immigration lead to an increase in the labour force participation rate (these people have a much more significant change of working or looking for work) and an increase in labour productivity (due to the vast majority of immigrants being skilled).

**Question 10**

*Answer:* B

*Explanation:*

$120 - 100 = 20$  balance of trade surplus. The only option here is C (remember the current account must balance with capital and financial account).

**Question 11**

*Answer:* C

*Explanation:*

All the other options would lead to a fall in aggregate supply.

**Question 12**

*Answer:* D

*Explanation:*

Sell government securities to reduce the supply of finance, leading to an increase in the cash interest rate to lower consumption and investment.

**Question 13**

*Answer:* B

*Explanation:*

RBA is responsible for changing interest rates. So, options C & D can both be ruled out. Higher tax rates lead to an increase in leakages and lower levels of aggregate demand. Decreased government spending compared to the previous quarter/year also signals a contractionary budgetary policy stance.

**Question 14**

*Answer: A*

*Explanation:*

Interest rates are part of unit 4 area of study 1: aggregate demand policy/tool.

**Question 15**

*Answer: C*

*Explanation:*

An increase in interest rates, assuming *ceteris paribus*, leads to an appreciation of the Australian dollar. An appreciation of the Australian dollar makes our exports less attractive to overseas buyers.

**SECTION B Short-answer questions**

**Question 1** (19 marks)

- a. A shift in the supply curve occurs from a change in market conditions. For example, the floods in Northern NSW in March 2022 led to a fall in the availability of resources and a lower supply. A movement stems from a price change, leading to an expansion or contraction along the supply curve.

*Mark Allocation:*

*1 mark- Linking a movement along the supply curve to a price factor.*

*1 mark- Linking a shift of the supply curve to a non-price factor.*

- b. A perfectly competitive market occurs when there are many buyers and sellers, perfect information, no government intervention and when people are rational. The law of demand dictates that as the price of a product rises, the demand for that product falls. The law of supply dictates that as the price of a product rises, the supply of that product will increase. This apparent conflict is resolved in the market by achieving an equilibrium quantity and cost of a product determined by the interaction of supply and demand (sellers and buyers) in the market. An efficient outcome has been achieved at the equilibrium price and quantity because all that has been supplied will have been bought. For example, in the market for fresh apples, if there is a change in a demand factor such as consumer preferences, which causes an increase in demand for apples at all possible prices (for example, during summer when people eat more salads), then, at the original equilibrium price, there will be a shortage of fresh apples. This signals to the market that insufficient resources have been allocated to this purpose. The shortage will pressure prices to rise (in a perfectly competitive market). As prices rise, there will be an expansion of supply as producers are encouraged to produce more fresh tomatoes, or new producers are attracted to the market by the higher relative prices available. As prices rise, demand will contract until a new higher price, and higher quantity is reached. This will result in the reallocation of resources to produce fresh apples as rising prices in the market for tomatoes signal to suppliers that there is a shortage or underproduction, and they will be attracted to producing tomatoes for higher prices, higher incomes and better profits available.

*Mark Allocation:*

*1 mark- Outlining a perfectly competitive market*

*2 mark- Explanation of demand signals and higher relative prices*

*1 mark- Link to suppliers allocating resources to satisfy society's wants and needs (allocative efficiency)*

- c. A negative externality involves a situation in which there is a spill over benefit for a person who was not involved in the original transaction. A positive externality consists of a situation in which there is a spill over cost to a person who was not involved in the transaction. Negative externalities can be a result of production or consumption. The critical difference between the two is that society benefits from increased education and healthcare compared to pollution, which would leave society worse off.

*Mark Allocation:*

*1 mark- Defining positive externality*

*1 mark- Defining negative externality*

*1 mark- State the difference between them (social cost vs. benefit)*

- d. Positive externalities represent an example of when the market has not allocated enough resources to produce this item. Living standards could be higher by allocating more resources to this market. For instance, if the Australian Government gave more funding to state education, this would lead to higher literacy levels among the population contributing to allocative efficiency.

*Mark Allocation:*

*1 mark- Outlining why positive externalities leads to an under allocation of resources*

*2 marks- Use of an example to demonstrate this*

- e. Public goods involve a situation in which the free market will not allocate resources to the production process because the product is deemed non-excludable and non-rivalrous. Examples of public goods include roads, footpaths and street lights. One government action to overcome the private sector's lack of incentive to build these goods and services might involve the government using taxation revenue to fund new infrastructure projects. This would help address the initial misallocation of resources and help to improve allocative efficiency.

*Mark Allocation:*

*1 mark- Outlining Public goods as a market failure*

*1 mark- Suggestion of a relevant government intervention*

*1 mark- Link to how the intervention corrects a market failure*

- f. An increase in the minimum wage by 5.2% is designed to tackle issues of affordability, brought on by an increased cost of living. Its intention is to provide workers with a higher disposable income; however it creates a price floor. An increase in the minimum wage could therefore lead to a fall in derived labour demand and consequently, higher unemployment rates. Higher rates of unemployment could lead to a fall in allocative efficiency and unintentionally lead to a decrease in resource allocation.

*Mark Allocation:*

*1 mark- Acknowledgement of the market failure which the government tried to address*

*1 mark- Explanation of how the increase in the minimum wage attempts to correct the failure*

*2 marks- Explanation of how the intervention unintentionally promotes inefficiency and can lead to a surplus of labour*

## **Question 2**

- a. Over the last 2 years, Australia's inflation rate has been well above the desired goal of 2-3% over the medium term. The start of 2021 saw the rate sit just above 3% but over the following year, it has gradually risen to approximately 6%.

*Mark Allocation:*

*1 mark- Link to sitting higher than the desired zone for inflation*

*1 mark- Description of the movement in the trend*

- b. Australia's immigration largely stems from our skilled occupation list. 68% of Australia's immigration stems from areas where Australia has identifiable skills shortages. An increase in Australia's immigration will lead to higher labour productivity rates (as they are bringing over the world's best practices) and an increase in the labour force participation rate. A higher labour force participation rate will lead to a rise in the availability of resources and an increase in aggregate supply. An increase in aggregate supply will reduce the number of shortages developing in markets and assist in reducing these excessive inflationary pressures present.

*Globally marked.*

*Suggested Mark Allocation:*

*1 mark- Brief outline of the chosen policy*

*2 marks- How the policy operates and its' impact on aggregate supply*

*1 mark- Link to how improving supply/supply conditions will reduce inflationary pressure*

- c. One strength of immigration policy is that it typically leads to a higher labour force participation rate. A higher labour force participation rate will assist in reducing the number of shortages occurring in various labour markets and help prevent wage-price spirals from developing.

One weakness associated with immigration policy is that it might take time to a triage situation. Since 2020, the Australian Government has dramatically reduced the amount of immigration. There could be a significant time lag between the timing of policy decisions. This means it could take a great deal of time before changes in immigration assist in reducing inflationary pressures.

*Globally marked (based on previous answer)*

*Suggested Mark Allocation:*

*2 marks- Outlining a strength of the chosen policy in relation to addressing inflation*

*2 marks- Outlining a weakness of the chosen policy in relation to addressing inflation*

- d. Aggregate demand policies include both monetary and budgetary policies. The Reserve Bank of Australia implements monetary policy while the budgetary policy is focused on the Australian Government.

In 2022 the Reserve Bank of Australia increased the cash rate in May, June, July, August and September. The RBA increased the cash rate to create a greater incentive for people to save (increasing leakages) and reduce people's discretionary income. Lower levels of consumption and investment will result in lower aggregate demand and fewer shortages developing in markets. More occasional shortages developing in markets will lead to less demand inflation.

The Australian Government announced various procyclical policies, such as a fall in Australia's income tax rate for low and middle-income earners. This resulted in increasing different people's disposable income and provided increasing consumption when inflationary pressures were already high. This meant that an argument could be made that budgetary and monetary policy had mixed impacts on inflation over the last two years.

*Globally marked.*

*Suggested Mark Allocation:*

*2 marks- Outlining monetary policy as an aggregate demand policy*

*1 mark- Example of recent monetary policy*

*2 marks- Outlining budgetary policy as an aggregate demand policy*

*1 mark- Example of recent budgetary policy*

*2 marks- Links to how each policy has impacted inflation*



- e. One strength of budgetary policy in reducing inflation is that the Australian Government can target specific groups of people. For example, the Australian Government could increase income tax rates for people with very high incomes. This would lead to a fall in disposable income for these people and lower consumption and aggregate demand. Lower aggregate demand would reduce shortages in markets and lower inflationary pressures.

One weakness of budgetary policy is political constraints. The Australian Government provided people with tax relief or lower income tax in 2022 despite excessive levels of aggregate demand. This compounded the existing problem and led to even more significant shortages in markets and higher inflationary pressures.

One strength of monetary policy is the frequency of the RBA meeting. The RBA increased the cash rate five months in a row during 2022. This meant the RBA could continually study lead and lag indicators and make decisions quickly in response to these changes. Given that Australian households have record-high debt levels, the RBA's lever is even stronger.

One weakness of monetary policy is that it cannot fix the global supply chain issues that have caused havoc since the onset of COVID. The RBA increased the cash rate repeatedly to reduce discretionary income and consumption. However, they cannot solve supply-side issues such as the labour shortage, which has led to significant cost inflation.

*Globally marked.*

*Suggested Mark Allocation:*

*2 marks- Explaining the strengths associated with using budgetary policy to reduce inflation*

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*2 marks- Explaining the weaknesses associated with using monetary policy to reduce inflation*

**Question 3**

- a.** Long-term unemployment refers to someone actively looking for full-time work for more than 12 months. This group of people are particularly vulnerable as long-term unemployment significantly impacts people's quality of life. For example, prolonged unemployment is linked with a lower life expectancy, increased risk of mental health illnesses, loneliness and lower levels of self-esteem. Essentially lower rates of long-term unemployment will lead to an improvement in non-material living standards as the quality of for these people will get better. In the data, we can see a declining rate of long-term unemployment rates as the percentage of unemployed people starts to drop to almost pre-pandemic levels, (0.35 – 0.26). While this is positive movement, it is still relatively high when compared to the last decade.

*Mark Allocation:*

*1 mark- Demonstrates an understanding of long-term unemployment*

*1 mark- Link to data (dates/figures)*

*1 mark- Impact on living standards*

- b.** Australia's record-high iron ore prices have led to an increase in our national income and greater exports. This increase in export demand has led to a rise in aggregate demand, increased production levels, increased derived demand for labour and lowered cyclical unemployment.

*Mark Allocation:*

*1 mark- Outline of a recent economic factor*

*1 mark- Explanation of how the factor has impacted the goal of full employment*

- c. Australia's falling labour force underutilisation rate reflects an improvement in labour market conditions. A fall in Australia's labour market underutilisation rate means fewer people are looking for full-time work and are under-employed. This means Australia now has a tighter labour market with less spare capacity. This has contributed to a shortage of labour and a shortage of labour at the old price/wage level. This will likely lead to upward pressure on wages and cost and demand inflation increases. Low inflation is a precondition to achieving Australia's other macroeconomic goals. Therefore, higher inflation levels will lead to the RBA reacting by increasing the cash rate to lower discretionary income and reduce consumption and investment, reducing aggregate demand and leading to fewer shortages developing in markets. This stance and focus will support the RBA's achievement of low inflation.

*Mark Allocation:*

*1 mark- Identifying a decrease in the underutilisation rate*

*1 mark- Linking the reduction in spare capacity to growing inflation rates*

*2 marks- Explaining that the RBA is likely to increase the cash rate in order to compensate for the rising inflation*

- d. A falling labour force underutilisation rate and an increase in employment will increase government revenue. This is because the increase in employment will likely see the increase in income tax and government revenue; therefore, a higher number of people working means more income tax revenue for the Australian Government.

Social security or transfer payments are the most significant expenditure for the Australian Government. A fall in both the number of people unemployed and under-employed will lead to falls in the number of transfer payments. Lower transfer payments will lead to lower government expenditure.

*Mark Allocation:*

*1 mark- Explanation that the growing numbers of employed Australians translates to higher tax revenue*

*1 mark- Explanation that the growing numbers of employed Australians translates to lower welfare outlays*

*2 marks- Link to a higher surplus/ lower deficit budget depending on the context of the current budget*

**Question 4**

- a. A budget deficit occurs when government expenditure is greater than government revenue. This relates to the amount of money the Australian Government receives vs the amount they spend in a particular period. A current account deficit relates to the balance of net goods, net services, net incomes and net transfers. The existing account measures Australia's external stability (mainly focused on exports and imports), while a budget deficit relates specifically to the revenue and outlays of the Australian Government.

*Mark Allocation:*

*1 mark- Defining a budget deficit*

*1 mark- Defining a current account deficit*

*1 mark- Stating the difference*

- b. Australia's terms of trade relate to export prices divided by import prices. Favourable terms of trade mean Australia's export prices are increasing relative to import prices. Higher export prices will lead to an increase in credits and improve our balance of trade.

*Mark Allocation:*

*1 mark- Link to the data, highlighting the relationship between the Trade Balance and the Terms of Trade*

*1 mark- Outlining the TOT and TB*

- c. An increase in terms of trade leads to higher national income. Increasing national income can lead to higher material living standards for the population. An increase in national income will ripple through or trickle down through the economy and potentially make it easier for people to access essential goods and services.

*Mark Allocation:*

*1 mark- Explanation of what a higher Terms of Trade means*

*1 mark- Link to economic impact*