



2008

Economics GA 3: Examination

GENERAL COMMENTS

It appeared that the examination was generally well received by students as the results for Section A were strong and the majority of students attempted all questions in Section B.

The examination provided plenty of scope for students to display knowledge and awareness of current economic trends, conditions, issues and events. There were a number of excellent papers; these students had clearly developed a thorough understanding of the current and recent performance of the Australian economy. They were able to apply this knowledge to accurately answer questions in both sections of the examination. They were also able to provide relevant and appropriate examples to illustrate the theoretical responses required in Section B.

Students should be reminded of the following general points.

- While students must use pencil on the multiple-choice answer sheet, students are strongly recommended to use pen when writing answers to Section B.
- Students need to know and use definitions of key economics concepts as appropriate. Many questions required students to define or explain key terms. These are the sorts of questions that students should find most accessible and be able to score high marks on.
- Students must read the questions carefully and do what is required. For example, many students did not write a response for both parts of Section B, Question 4d. and were marked out of three rather than six. In Section B, Question 3c., students were required to discuss the likely impact of an increase in the size of the federal (Commonwealth) government's budget surplus (as a percentage of GDP) on full employment or external stability. Some students answered the question by discussing how full employment impacted on the budget outcome and therefore did not answer the question.
- Many students suggested that changes in interest rates are part of budgetary policy when interest rate changes specifically relate to monetary policy.

SPECIFIC INFORMATION

Section A – Multiple-choice questions

The table below indicates the percentage of students who chose each option. The correct answer is indicated by shading.

Question	% A	% B	% C	% D	Comments
1	96	1	1	2	
2	16	2	81	2	
3	6	15	11	69	
4	77	7	12	4	
5	87	8	3	2	
6	3	3	16	79	
7	10	76	6	8	
8	6	3	66	25	
9	4	90	4	2	
10	12	11	64	13	
11	69	4	20	6	
12	10	33	34	23	Students appeared to find this question challenging because they needed to be able to distinguish between the factor that causes a movement along the existing curve (changes in price – option C) and factors that cause a movement in the curve (options A, B and D)
13	85	4	8	4	
14	1	2	8	90	
15	7	7	19	67	



Section B – Written Responses

For each question, an outline answer (or answers) is provided. In some cases the answer given is not the only answer that could have been awarded marks.

Question 1a.

Marks	0	1	2	3	4	Average
%	9	13	22	26	31	2.6

The sort of influences likely to put pressure on inflation include:

- private consumption expenditure (C) remained at relatively strong levels through the second half of 2007 and into 2008 due to, for example, high levels of consumer confidence. These higher levels of consumer confidence appeared to be as a result of lower unemployment rates, the positive impact of wealth effects from a rising stock market and rising house prices, continuing strong commodity prices leading to higher export incomes.
- high capacity usage and shortages of suitable labour were likely inhibiting businesses from expanding production to meet growing demand. The result of demand outstripping supply is likely to see increased prices (port and other infrastructure costs, labour costs) putting pressure on the inflation rate.
- another example of a supply side cost pressure used included the increasing cost of oil in the first half of 2008, leading to increasing petrol prices, a cost factor in the production of a large number of goods and services.

In most cases students were able to identify and describe factors influencing the inflation rate in 2008. However, it appeared that a number of students did not read the question carefully. These students chose theoretical factors that influence inflation rather than selecting influences from the demand side or the supply side operating in 2008 that were likely to put upward pressures on prices and increase inflationary pressures. Students needed to describe how the influence chosen may have operated to put upward pressure on prices and increase inflationary pressures. If students selected a demand side factor, they needed to describe how the factor was likely to influence the behaviour of a component of aggregate demand (C + I + G, etc.), which may then increase aggregate demand beyond supply capacity thus putting upward pressure on prices and therefore inflation. If students selected a cost pressure they needed to describe how the cost pressure might affect the willingness of producers to supply and how this pressure may add to costs that may be passed on in terms of higher prices, thus adding to inflationary pressure.

Question 1b.

Marks	0	1	2	3	4	Average
%	12	16	25	24	23	2.3

Most students answered this question reasonably well. Many appeared to have studied relationships between the economic performance objectives and impacts of poor performance on other objectives to good effect. Students were required to discuss two problems for the Australian economy when inflation rates are higher than desired levels. The sorts of problems selected included:

- achieving low inflation and price stability is an economic objective. An inflation rate that is sufficiently low, stable and predictable so as not to be a factor in household and business decision-making (current target as measured by CPI of 2–3% per annum) is desirable in order to secure strong and sustainable economic growth. Consumers and businesses are better able to make medium to long term plans because they know their money is not losing purchasing power when there is little risk of inflation. So if inflation rates remain at higher than expected levels, then we risk setting off inflationary expectations, which will lead to lower consumer and business confidence and may slow economic and employment growth
- this situation may set off a wages/prices spiral as workers in a situation of low unemployment and skills shortages pressure for higher wages. If wages growth becomes excessive, this will set off a wages/prices spiral
- interest rates are higher because of the need to lower inflation and bring it back into the target range. This poses a risk to the achievement of strong and sustainable economic growth, consumer and business confidence
- lowers international competitiveness, which may have a detrimental impact on export demand
- if inflation is contained, a more favourable climate exists for longer lasting and sustained economic growth, job creation and international competitiveness
- continuing high levels of inflation have a detrimental impact on the distribution of income. For example, those holding monetary assets see the value of their assets eroded in real terms.

Question 1c.

Marks	0	1	2	3	4	5	6	Average
%	14	8	12	16	21	17	12	3.2

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A number of students spent too much time defining each policy rather than explaining how examples of the operational features of each policy would be applicable to the reduction of inflationary pressures. However, it was very pleasing that the majority of students appeared to understand that monetary policy tightening and a contractionary budgetary policy stance are appropriate and complementary in addressing excessive demand side inflationary pressures. Typically students made the following points:

- monetary policy will usually adopt a contractionary stance – the Reserve Bank of Australia will signal an increase in the cash interest rate. As interest rates rise, this may, for example, lower private consumption expenditure (C) as the cost of credit and mortgages rise. Consumers then have less cash available for discretionary spending. This is likely to lead to less demand, less spending and therefore reduced aggregate demand. Lower private investment expenditure (I) is likely to occur as the cost of credit, loans and overdrafts rise. Businesses are less likely to undertake expansion and new investment, thus reducing I, aggregate demand and therefore demand pressures
- budgetary policy will adopt a contractionary stance – increase the size of the budget surplus (or reduce the size of the deficit) where taxes may be raised or outlays reduced. This is likely to have a contractionary impact as more is taken out of the economy through raised levels of taxation than is pumped back through government spending.

Better students were able to also make reference to the suitability of supply side initiatives within budgetary policy to address such matters as capacity constraints.

Better students were also able to show that they had a sophisticated appreciation of how budgetary and monetary policy may complement each other when attempting to reduce inflationary pressures, by making reference to the need for the government to address issues related to:

- short, medium and long-term pressures
- domestic and overseas pressures
- demand and supply side pressures.

Question 2a.

Marks	0	1	2	3	4	5	6	Average
%	20	14	15	16	15	12	7	2.6

Better answers defined market failure as occurring when individuals' (consumers or producers) pursuit of self-interest leads to a situation where resources are allocated in ways that do not maximise the economic welfare of all members of society and national living standards. Some students also suggested that the belief that markets can 'fail' – that is, that markets may have inefficient outcomes – is a common justification for government intervention in free markets.

Aspects of this question were quite poorly handled by a number of students. Students are expected to be able to accurately define/explain key economic concepts such as market failure. Some students struggled to define or explain market failure, with many believing that it constitutes a situation of market disequilibrium. This suggests that too many students are confused between the process of competitive market adjustment and a situation of market failure. Other weaknesses in students' responses to this question included:

- an inability to explain the meaning and significance of the concept of a negative externality
- while many students were able to broadly identify a further example of market failure (the third part of the question), other students were unable to clearly discuss why the example provided impacts upon third parties/society as a whole and why the example chosen provided an illustration of market failure. Other students simply referred to an example of government intervention but did not actually say why this example of government intervention was required as a response to market failure
- a number of students did not address all three parts of the question. Students need to check that they have answered all question requirements.

The majority of students recognised that climate change might be an example of market failure as it could be considered a negative externality. However, a large number of students made this statement without explaining the meaning of the concept of a negative externality and why a negative externality is an example of market failure. A negative externality is a cost associated with the production or consumption of goods and services where these activities have negative 'spillover' effects/costs which are passed onto others. For example, producers and consumers contribute to the build up of CO₂ emissions through their daily economic activities. This build up of greenhouse gas is not factored in as a cost of the production or consumption activity, however, the resultant climate change will have spillover or third party effects/costs for future generations.

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Question 2b.

Marks	0	1	2	3	4	Average
%	18	15	22	22	23	2.2

This question was generally well handled with most students showing sound current understanding of suggested government policy action on climate change. However, some students described a possible policy but then did not discuss how the policy response might combat the issue of climate change.

The best answers discussed one of the following policy responses.

- Carbon pricing, through taxation, emissions trading or regulation such as through 'polluter pays' taxes, the introduction of carbon taxes and emissions trading schemes or regulation, such as prohibiting some production techniques or the use of some materials (for example, CFCs).
- Technology policy, where investment in research and development should drive large-scale development and use of a range of low carbon technologies and high-efficiency products. Governments could provide subsidies and other incentives to businesses and consumers who use these technologies (for example, subsidising the use of solar panels).
- Other research and development funding could be subsidised by the government, such as researching new crop varieties that will be more resilient to drought.

Question 3a.

Marks	0	1	2	3	4	Average
%	17	14	17	24	28	2.3

This question again required students to provide definitions of key economics concepts. While most students were able to provide appropriate examples of automatic and discretionary stabilisers, many struggled to demonstrate adequate understanding of the concepts of discretionary stabilisers and automatic stabilisers. Very few students were able to explain these concepts as being 'operational features' of budgetary policy with the difference being that automatic stabilisers result from the economy having an effect on the budget and that discretionary stabilisers are budgetary changes designed to have an explicit effect on the economy.

More successful students were able to explain that both automatic and discretionary stabilisers are designed to assist with stabilisation of the pace of macro-economic activity. Automatic stabilisers respond without the need for conscious and deliberate government action as government revenues and outlays automatically are influenced by the state of the economy and these automatic stabilisers function in a counter-cyclical manner to soften or moderate the magnitude of swings in the business cycle. In this sense, automatic stabilisers are permanently fixed operational aspects of budgetary policy. Discretionary stabilisers are specific budgetary policy changes to government revenues and outlays implemented periodically in response to emerging instabilities in economic activity in order to influence the pace of economic activity.

The following are examples of responses that explain the difference between automatic (cyclical) and discretionary (structural) budgetary stabilisers and give examples of each.

Automatic stabilisers are those components of the budget related to tax receipts and welfare outlays that automatically assist in smoothing out cyclical rises (booms) and falls (recessions) in economic activity in a counter cyclical way.

Automatic stabilisers work to change the level of economic activity without the need for government to alter budgetary policy through the implementation of specific discretionary changes in their tax and spending policies. For example in a boom tax receipts automatically rise as there is stronger economic activity and therefore employment levels and welfare outlays fall as less people are unemployed; thus the budget outcome is likely to be a stronger surplus (or smaller deficit) which will act to have a contractionary impact on aggregate demand and economic activity. Discretionary budgetary stabilisers relate to the specific changes made in tax or spending decisions by the government. For example when the government announces there will be the introduction of a new tax or a change in tax rates or when they announce new spending projects such as the building of a new airport.

Question 3b.

Marks	0	1	2	3	4	Average
%	21	16	21	23	19	2.1

2008 Assessment Report



This question required students to have current knowledge of discretionary budgetary policy changes and to be able to examine the likely impact that this change in policy may have for equity outcomes. The likely impact could be positive or negative, i.e. support improved equity outcomes or cause greater levels of inequity.

The most common weaknesses in answers included:

- choosing a budgetary policy measure that was not relevant to 2008–09
- choosing changes in interest rates as a budgetary policy. This is incorrect as changes in interest rates are related to monetary policy
- making very general assertions, such as stating that the 2008–09 Budget saw an increase in the rates of tax imposed upon high income earners, without then explaining the significance of this for equity
- examining more than one example of a policy measure. This does not earn students extra marks and usually means that insufficient detail and/or time is applied to the examination of the single measure required.

Better students selected measures such as: the changes to the rates and thresholds of PAYG Income tax, the low income tax offset or the changes made to funding of child care and were able to examine the likely intended impact of these measures on equity. Better students also displayed understanding of the relative impact of measures chosen upon low, middle and high income earners and made reference to either the Gini coefficient or the Lorenz curve in their discussion.

Question 3c.

Marks	0	1	2	3	4	Average
%	31	15	16	18	21	1.9

Many students did not read this question carefully and spent time discussing the impact on both economic objectives. Other students discussed how full employment is likely to impact on the budget, however this was not the requirement of the question. Students need to make sure they respond to the question asked in order to secure the most marks.

Most students displayed a good grasp of the contractionary significance of an increase in the size of the budget surplus and some referred back to and utilised the data from the table provided.

The following are examples of good answers.

The impact on full employment

In theory, an increase in the size of a budget surplus means more is being taken out of the economy through increasing taxation receipts than is put back into the economy through government spending. Theory suggests that this reduces aggregate demand thus restraining growth and therefore it is likely this may lead to higher levels of unemployment with full employment less likely to be achieved.

The impact on external stability

As surpluses usually act as a restraint on aggregate demand through the government collecting more in revenues (example higher taxes) than they outlay, it is likely that demand for imports may be reduced. This may have a positive impact on the size of the Current Account Deficit (CAD) and lead to better external outcomes.

There were also a number of good answers in response to the impact on full employment that acknowledged that a contractionary budgetary policy stance may be necessary to dampen aggregate demand and to curb excessive demand-pull inflationary pressures. As a result this may be helpful in achieving sustainable economic growth, therefore maintaining healthy employment growth.

Question 3d.

Marks	0	1	2	3	4	5	6	7	8	Average
%	16	8	11	13	13	12	13	9	5	3.6

In general, better students framed their responses by providing brief definitions of budgetary and microeconomic reform (MER) policies and the meaning of economic efficiency and its effect on economic growth.

The following is an example of a high-scoring response.

Budgetary policy is about changes the government makes to the size and composition of its taxation and spending policies.



MER policies are supply side measures which seek to alter the way particular industries are structured and organized so that they become more efficient and internationally competitive.

An efficient allocation of resources is achieved when resources are allocated in such a way that they maximize the welfare or living standards of all citizens. The most efficient allocation of resources implies that all types of efficiency are at their maximum.

Greater efficiency in the way resources are allocated will normally result in more output being produced from the same quantity or fewer inputs (higher productivity). Our productive capacity grows and the speed limit governing how fast GDP (economic growth) can increase is lifted.

Better students went on to suggest that recent budgetary policy measures have been targeting the supply side, and the achievement of a more efficient allocation of resources through encouraging efficiency promoting measures and higher productivity and participation in the workforce. Examples of budgetary policy selected included:

- lower tax rates and taxation reform to lift personal motivation – workers may be prepared to work more overtime and earn higher levels of income without concern about moving into higher tax brackets
- promoting efficiency through cost-cutting measures such as privatisation, for example, the sale of T3 (Telstra) (this could be an example of budgetary policy or MER)
- the Rudd Government's three new nation building funds announced in 2008–09 (for example, The Building Australia Fund) in time will increase productivity and promote more efficient outcomes by easing bottlenecks and overcoming the infrastructure backlog, as these funds, for example, will be used to build transport and broadband infrastructure
- incentives to older Australians to encourage them to stay at work in order to increase the size of the labour force, thereby increasing Australia's productive capacity to allow greater economic growth
- increased education spending to, amongst other things, increase skills of workers, thus increase productivity and efficiency and create stronger growth. For example, capital works programs in higher education institutions from the Education Investment Fund.

Students selected a range of microeconomic reform policies. Examples included:

- since 2006, the National Reform Agenda was the name given to carry forward reforms in three key areas – human capital, competition and reduced regulation. These reforms are about improving efficiency. Reforms related to human capital were aimed at boosting the proportion of the working-aged population that is able to work with incentives provided to older Australians to encourage them to stay at work. Governments are also working to improve education and skills through policies which increase retention rates, set national literacy and numeracy targets, devise a national curriculum, invest in early childhood education and access to computers. Competition reforms are targeted at introducing proper price signals for vital infrastructure. For example, water reforms have been a major emphasis of COAG reforms this year, aimed towards creating a national market for water, with prices that accurately reflect its scarcity. Regarding reduced regulation, 10 areas of overlapping state and federal laws which impede the ability of business across state boundaries have been identified as areas for action. For example state and federal governments this year agreed to harmonise laws on occupational health and safety, the multiplicity of which has been an irritant for business and a barrier to producing across state boundaries. The Rudd Government has indicated it will carry on with these reforms and add extra areas for action including for example climate change and indigenous reforms.
- Changes to labour market through WorkChoices to improve labour efficiency and thus increase economic growth.
- Privatisation, for example, sale of T3 – these policies believe markets exert more pressure on businesses to be more efficient, thus allowing for stronger economic growth.

A number of common weaknesses were evident in student responses.

- Students are advised to read the whole question and to interpret the full significance of all instructions. Many students appeared to launch into their responses as if the question had simply read 'Select and discuss one example of budgetary policy and one example of MER policy and how this might impact on economic growth', ignoring the need to discuss this impact via the supply side and the impact on efficiency.
- A number of students chose examples of budgetary policy and MER policy that were not relevant to the time frame prescribed in the question. Students generally provided better responses on budgetary policy than on MER policy, with many students finding it difficult to examine specific areas of MER that related to the time frame prescribed.
- There appeared to be a lack of sufficient understanding of the relationship between economic efficiency and the rate of economic growth.

2008 Assessment Report



Question 4a.

Marks	0	1	2	3	4	Average
%	34	16	21	12	17	1.7

This question required students to define two key concepts, which most students attempted. The question also asked students to explain the difference between the two concepts, however a large number of students did not fulfil this requirement.

Most students appeared to understand that the balance of (merchandise) trade is part of the current account in the balance of payments and that it measures the difference between exports and imports. However, many students believed that the balance of (merchandise) trade related to the difference between the import and export of goods and services, when it is about the difference between the import and export of goods only.

Large numbers of students struggled to clearly explain that the terms of trade are a measure of the relative change in export prices compared to import prices over a given period of time and that it is measured as an index value. Many students also tried to argue that the terms of trade is a concept that relates to our trading relationships with other nations, perhaps confusing this term with the concept of free trade.

The following is an example of a strong answer to this question.

The terms of trade is a ratio of export prices relative to import prices for a selected basket of each. An improvement in the terms of trade means that a given basket of exports is able to purchase a greater quantity (or bigger basket) of imports. The terms of trade will improve when the prices of exports increase and/or the price of imports decrease. As shown on the graph in Australia's case this has happened between 2003 and 2007.

The balance of trade is equal to the total value (price times quantity) of merchandise exports minus the total value of merchandise imports.

The difference between the two is that the terms of trade measures relative prices of exports and imports and the other – the balance of trade, the total value of the difference between exports and imports.

Question 4b.

Marks	0	1	2	Average
%	31	29	40	1.1

The majority of students recognised that Australia's terms of trade have risen strongly across 2003–2007. Most students outlined the reason that there had been a large increase in demand and therefore prices for commodity exports such as iron ore and coal due to the booming economies and strong economic growth of China and India over this period. As Australia is a large producer of commodities, our export prices have risen strongly.

Question 4c.

Marks	0	1	2	3	4	Average
%	36	20	16	15	13	1.5

A number of students struggled with this question. Many students made the assumption that if export prices rise more quickly than import prices this will then lead to a decreased demand for exports and greater demand for imports, thus contributing to a worse current account deficit (CAD). Most students who scored well on this question were able to make reference to the fact that Australia's terms of trade has strengthened greatly over the last four years on the back of global commodity price increases, but coincidentally we have observed historically high CADs. They then suggested that the strong terms of trade had served to soften what would have been even greater deterioration in the CAD.

Question 4d.

Marks	0	1	2	3	4	5	6	Average
%	24	11	16	27	9	7	6	2.3

2008 Assessment Report



Most students interpreted the trend in the \$AUD correctly as an appreciation. The majority of students argued correctly that a higher \$AUD will make exports less attractive on global markets (because they are relatively more expensive) and imported goods relatively attractive (because they are relatively less expensive) causing some deterioration in the balance on goods and services. However, many students did not answer the second part of the question. Students are again advised to carefully read the instructions given in the question.

Students who did attempt the discussion of the likely impact on net income appeared to struggle to explain it clearly, often confusing net income with capital and investment flows or with service flows. Better answers talked about the valuation effect of an appreciating \$AUD and were able to say that an appreciation of the \$AUD will reduce net foreign debt to the extent it is denominated in foreign currencies. In turn, this will reduce the interest payments recorded in net incomes, thus improving the net incomes deficit.