

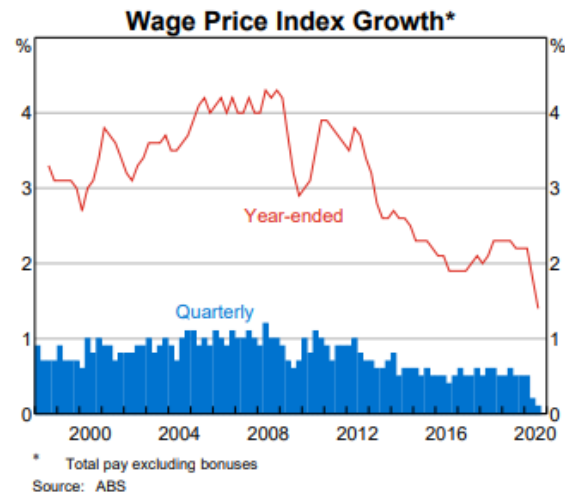
ECONOMICS
UNITS 3&4
2021 Trial Examination

Reading time: 15 minutes

Writing time: 2 hours

SOLUTIONS

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EXTRA Economics Units 3&4 Trial Exam
Question 1


Consider the Wage Price Index growth above. Which of the follow situations would best explain the trend in wages growth over the last 2 years?

- A. a decrease in the unemployment rate
- B. an increase in the underemployment rate**
- C. a decrease in the participation rate
- D. a depreciation of the AUD

We can see on the graph that the trend in the wage growth is **decreasing over the past two years**. You need to find the situation which would best explain this. You should go through each possible answer working out whether there is upward or downward pressure on wage growth. The key to understanding how wages rise and fall is demand and supply. Just like any market changes the price of labour is determined by changes in demand and supply so it could also help to draw a D/S Diagram.

- A. **Incorrect.** A decrease in the unemployment rate would impact the wages in the opposite way to the trend on the graph. A decrease in unemployment actually puts **upward pressure on wage growth** because there is less 'spare' labour available from the pool of unemployed persons. We could shift the supply curve to the left and see the upward pressure on the price of labour (wages).
- B. **Correct.** An increase in the underemployment rate is the correct answer because it indicates that there is spare capacity or 'slack' in the labour market as more people are wanting more hours in their job. The spare capacity in the labour market could lead to a decrease in wages growth because businesses could give their employee extra hours without having to raise wages. You could draw a shift in the supply curve to the right and see that wages/wage growth would fall.
- C. **Incorrect.** A decrease in the participation rate would usually put **upward pressure on wage growth** and lead to a 'tighter' job market. This is because a reduction the labour force size will mean the pool of available labour is smaller leading to shortages and wage pressures. We could shift the supply curve to the left and see the upward pressure on the price of labour (wages).
- D. **Incorrect.** A depreciation in the AUD means Australian exports are cheaper for overseas buyers leading to an increase in X, C and AD which would create a derived demand for labour, decrease cyclical unemployment and put **upward pressure on wage growth**. We could shift the demand curve to the right and see the upward pressure on the price of labour (wages).

Question 2

An appreciation of the Australian dollar is least likely to lead to which of the following?

- A. a decrease in the competitiveness of Australian producers overseas
- B. a decrease in the current account surplus
- C. **the RBA increasing interest rates**
- D. an increase in import spending by Australians

This question is testing your knowledge of the effects of a change in the exchange rate. You need to find the answer that is least likely to occur as a result of an appreciation (e.g. when the value of the AUD increases against other currencies)

- A. **Incorrect.** An appreciation of the AUD **will cause a reduction** in international competitiveness as our exports will be more expensive to overseas buyers.
- B. **Incorrect.** An appreciation of the dollar **will lead to a reduction** in the CAS. It will make exports more expensive and imports cheaper leading an increase in debits and a decrease in debits on the net good and services sub-account of the current account.
- C. **Correct.** This is the **least likely to occur** because an appreciation of the AUD in the short-term will usually lead to a reduction in economic activity and can lead the RBA to take an expansionary stance in order to depreciate the AUD and improve the competitiveness of our exporting sector.
- D. **Incorrect.** An appreciation of the AUD **will lead to an increase in import** spending for reasons above.

Question 3

Consider the market for new cars in Australia.

A shift in the demand curve to the right, is likely to cause the largest increase in price if:

- A. cars are durable
- B. there are many substitutes for a car
- C. a car makes up a large percentage of household income
- D. **there is no or little spare capacity in the car market**

You should draw the demand and supply diagram in the question to help you. You need to identify that each of the possible answers is a factor that determines the elasticity of the demand or supply curve. Given that the demand curve is shifting it's the elasticity of supply which is important to determining the correct answer.

- A. **Incorrect.** If cars are durable this means that the supply curve is elastic (Q_s is responsive to a change in price) and the curve is flat. This means a shift to the right in the demand curve will cause a smaller increase in price compared with an inelastic supply curve.
- B. **Incorrect.** If cars have many substitutes then the demand curve is likely to be elastic (Q_d is responsive to a change in price) and flat. The elasticity of the demand curve is not important to this question since we are shifting the demand curve.
- C. **Incorrect.** If cars make up a large percentage of household income then the demand curve is likely to be inelastic (Q_d is not responsive to a change in price) The elasticity of the demand curve is not important to this question since we are shifting the demand curve.
- D. **Correct.** If there is little spare capacity in the car market then the supply curve is likely to be inelastic (Q_s is not responsive to a change in price) and steep. This means when there is a shift to the right in the demand curve there will be a larger increase in price compared with an elastic curve.

Question 4

Which of the following government interventions will have a different impact to the others?

- A. **an increase in subsidies to producers**
- B. an increase in indirect taxes
- C. restrictions on consumers
- D. rules and regulations for packaging and labelling laws

You should identify that each of the answers is a government intervention to correct a market failure. The key to answering this question is to determine whether more or less resources would be allocated to the respective market **after** the intervention has taken place. You could also draw a D/S diagram and observe whether Q increases or decreases. A is the correct answer because its impact is different to the others.

- A. **Correct.** An increase in subsidies will reduce the costs of production for firms and shift the supply curve to the right. This results in an increase in Q and **more** resources being allocated to this market.
- B. **Incorrect.** An indirect tax works in the opposite way to a subsidy: decreasing costs of production and shifting the supply curve to the left. This results in a decrease in Q and **less** resources being allocated to this market.
- C. **Incorrect.** Restrictions on consumers will shift the demand curve to the left. This results in decrease in Q and **less** resources being allocated to this market.
- D. **Incorrect.** Rules and regulations will have a similar impact to C although the answer doesn't stipulate whether this will impact consumers or suppliers - we can assume both will result in **less** resources being allocated to this market.

Question 5

Consider the following hypothetical Consumer Price Index (CPI) data:

Time period	CPI
Jan. 2019	100
Mar. 2019	101
June. 2019	102.01
Sep. 2019	104.5
Jan. 2020	104

Which of the following statements is **not** true?

- A. the annualised inflation rate for the June 2019 quarter is 4%
- B. **the annual rate of inflation for 2019 is 4.5%**
- C. the annual rate of inflation for 2019 is 4%
- D. the quarterly rate of inflation for June 2019 is less than the annual rate

This question requires you to check the calculations for each answer and identify the incorrect statement. Remember the formula for inflation: $\text{Index at the start of period} - \text{Index at the end of the period} / \text{Index at the start} * 100$.

- A. **True.** In order to calculate the annualised rate of inflation you need to first calculate the quarterly rate of inflation. $102.01 - 101 / 101 = 1.01/101 = 1\%$. To annualise this you times by 4 (quarters) = 4%.
- B. **False.** This answer is designed to trick you. Often students will calculate an annual inflation rate as Jan. to Sept. rather than Jan. to Jan. This is because they see 4 inflation index numbers and assume it's a full year. The annual rate is $104 - 100 / 100 = 4\%$.
- C. **True.** See above.
- D. **True.** We have already calculated the quarterly rate as 1% above which is less than the annual rate of 4%.

Question 6

Which of the following statements about a contraction in the business cycle is true?

- A. It could be caused by a decrease in income tax rates
- B. It is usually characterised by high inflation, higher employment, higher economic activity
- C. It could be caused by an increase in the relative interest rates in Australia**
- D. According to the business cycle it is followed directly by an expansion

A. False. A decrease in income taxes would increase disposable income and increase *C* causing an expansion in the business cycle.

B. False. A contraction is usually characterised by the opposite to this. Low inflation, low employment and low economic activity. Don't confuse the cause of a contraction with what you would see during a contraction (characterised by).

C. True. An increase in relative interest rates would lead to an appreciation in the AUD as more capital flows to Australia increase demand for AUD. This means our exports become more expensive and our imports cheaper. All other things being equal, this would decrease *X* and increase *M*, decreasing *AD* and causing a contraction in the business cycle.

D. False. According to the business cycle a contraction is followed by a trough in economic activity or a recession in extreme cases.

Question 7

Consider the following hypothetical budget data:

Budget Year	2018	2019	2020
Revenue (\$bil)	300	315	315
Expenses(\$bil)	330	320	315
Outcome(\$bil)	-30	-5	0

Which of the following is the most likely to have occurred as a result of the budget over the period 2018-2020

- A. A decrease in government debt and a decrease in economic activity
- B. A decrease in government debt and an increase in economic activity
- C. An increase in government debt and an increase in economic activity
- D. An increase in government debt and a decrease in economic activity**

We can see from the data above that over the 3 years the budget has moved from a deficit of \$30 billion to a balanced budget (\$0). This means that the budget has become less expansionary over the period, which is evident by an increase in revenues (tax) and a decrease in expenses (*G*, welfare). This means that all other things being equal **economic growth is likely to slow over the period.**

We also need to consider how this would impact government debt. Remember that when a government runs a deficit it must be funded by selling bonds (borrowing) this will increase their debt. Only when the government runs a surplus do they have the option of reducing their debt. **Over the period government debt has increased.**

D is the correct answer.

Question 8

Nickel is an input into the production of solar batteries. If there is a slowdown in nickel production due to COVID-19 restrictions which of the following is likely to occur?

- A. An increase in the equilibrium price of solar batteries due to a shift in the supply curve to the right in the market for nickel.
- B. An increase in the equilibrium price of solar batteries due to a shift in the supply curve to the left in the market for nickel**
- C. An increase in the equilibrium quantity for solar batteries due to a shift in the supply curve to the left in the market for nickel
- D. An decrease in the equilibrium quantity for solar batteries due to a shift in the supply curve to the right in the market for nickel

*In this question you need to understand how the statement in the question would impact the market for solar batteries **and** nickel.*

Nickel market

*If there are restrictions on nickel production due to COVID shutdowns this will decrease the productivity of nickel producers. This will shift the supply curve to the left and increase the **price of nickel**.*

Now we have to think about how this will impact the solar batteries market (nickel is an input)

Solar batteries

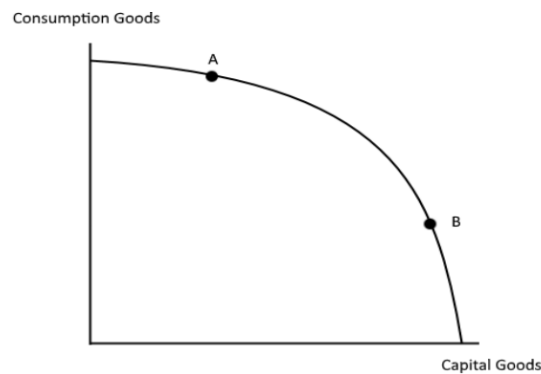
*An increase in the price of nickel, would increase the costs of production for solar battery producers. This leads to a shift in the supply curve to the left causing **an increase in the price** of solar batteries and a **decrease in the quantity**.*

It helps to draw a D/S diagram for both these markets before you attempt answering the questions.

Correct answer is B.

Question 9

Consider the PPF below for a hypothetical economy:



Which of the following statements is least true about the move from Point A to B?

- A. Allocative efficiency is maximized
 - B. Productive efficiency has increased**
 - C. Inter-temporal efficiency has increased
 - D. It illustrates dynamic efficiency
- A. Remember that any point on the PPF is deemed to be allocatively efficient. Where this point is will depend on the forces of demand and supply. Point A to B could mean allocative efficiency is maximized due to a change in market forces. **True.**
- B. In order for productive efficiency to increase we need to either increase the PPF outwards or move closer to the PPF from a point further away. Both these scenarios would imply an increase in productivity and a movement closer to maximum output (as defined by productive efficiency). A movement from A to B would not increase productive efficiency because they are both already productively efficient. **False.**
- C. A movement from point A to point B means that in this hypothetical economy: more resources are being allocated towards capital goods. This means that more consideration is being given to the future than Point A. Whilst inter-temporal efficiency is primarily understood through environmental considerations it also refers to balancing future needs with current needs. Producing more capital goods increases intertemporal efficiency. **True.**
- D. Dynamic efficiency is concerned with the speed at which resources are reallocated. Whilst this answer doesn't make mention of the speed it does show a reallocation of resources. **True.**

Question 10

In Australia, if there is a 10% drop in each of the following components of aggregate demand, which component would have the largest impact on overall economic growth?

- A. Private Investment Spending (I)
- B. Export Spending (X)
- C. Private Consumption Spending (C)**
- D. Public Current spending (G1)

This question is essentially asking which component of AD is the largest and therefore if all fell by the same amount (10%) which would have the largest impact on AD and economic growth (Remember that in the short-term, $AD = \text{Economic growth}$)

The largest component of AD by far is consumption spending (C). Accounting for around 60% of total spending in the Australian economy.

C is the correct answer.

Question 11

A boom in the Chinese economy is least likely to cause:

- A. A decrease in the Balance of Merchandise Trade (Net Goods) surplus
- B. An increase in the price of commodities like iron ore
- C. An appreciation of the AUD
- D. An increase in Australia's terms of trade

A boom in the Chinese economy will impact the Australian economy via an increase in demand for our exports like coal and iron ore.

- a. **Correct.** An increase in exports, would mean an increase in credits on the BOMT and an **increase** the surplus all other things being equal. $BOMT = \text{credits (exports)} - \text{debits (imports)}$. **Least likely.**
- b. **Incorrect.** Increase in demand for iron ore will shift the demand curve in world markets to the right (China is the world's largest consumer of commodities like iron ore) this will lead to shortage in the iron ore market and increase in prices.
- c. **Incorrect.** Assuming that China purchases some commodities in AUD. The increase in demand for Australian exports (all other things being equal) will increase demand for the AUD and lead to an appreciation.
- d. **Incorrect.** The increase in demand for commodities from China is likely to cause increases in prices in commodities that Australia exports. This will increase the export price index and provided there is no change to the import price index will increase the TOT.

Question 12

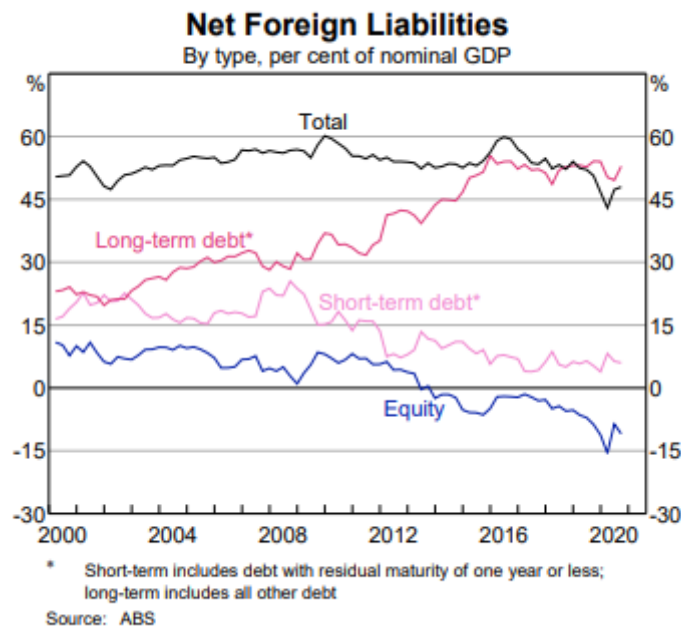
Which of the following is an example of hard-core unemployment?

- A. Jen works in an industry that shuts down over the winter and she becomes unemployed.
- B. Joe is has been trying to get a job for 12 months. He is disheartened by continued rejections and has stopped looking for work
- C. **David has long-term mental health issues that make it hard for him to hold down a job**
- D. Jordan works in the automobile industry in Australia. He has recently lost his job due to factory shutdowns

Remember hardcore unemployment is a type of natural unemployment. People who are unemployed due to personal reasons like, mental health, addiction or other personal issues that preclude them from holding down a job are classified as hardcore unemployed.

- a. **Incorrect.** Jen is **seasonally unemployed** because her work is only during the summer months.
- b. **Incorrect.** Because Joe has stopped looking for work he is no longer in the labour force and therefore not deemed unemployed. Joe would be classified as a **hidden or discouraged unemployed person**.
- c. **Correct.** David is classified as **hardcore unemployed** because he has mental health issues that are stopping him from getting a job.
- d. **Incorrect.** Jordan would be classified as **structurally unemployed** because they have skills that no longer match the skills demanded in the labour market.

Question 13



With reference to the graph above and your knowledge of economics, which one of the following statements is true in 2020?

- A. Australian's owe more overseas than is owed to Australian's
 - B. Long-term debt is less than short-term debt
 - C. Australian's own less overseas than foreigners own in Australia
 - D. Net Foreign Equity is around 45% of GDP
- A. **True.** Remember 'owe' refers to debt, we can see on the graph that total Net Foreign Debt (Short-term + long-term debt) is a positive figure compared to GDP (around 60% of GDP). Net Foreign Debt can be calculated as: **debt owed by** Australian's to the rest of the world – **debt owed to** Australian's from the rest of the world. If the total is a positive figure that means Australian's owe more to overseas countries.
- B. **False.** You can see on the graph that long-term debt is larger than short-term GDP (as a percentage of GDP).
- C. **False.** Remember that 'own' refers to equity so we can see on the graph the Net Foreign Equity (NFE) is a negative figure. NFE is calculated as: ownership of Australian assets by foreigners – ownership of foreign assets by Australian's. A negative figure indicates that Australian's own more overseas than foreigners own in Australia.
- D. **False.** Net Foreign Equity is around -10% of GDP.

Question 14

Which of the following is an example of a discretionary budget policy?

- A. An increase in tax revenue due to an improvement in overseas activity
- B. The RBA buying bonds to reduce interest rates
- C. **The removal of an income tax bracket**
- D. The budget outcome in deficit

Discretionary budgetary policy refers to deliberate changes to the composition of the budget. For example an increase in spending on infrastructure or a change to taxation policy.

- A. **False.** An increase in tax revenue does not refer to discretionary stabilisers as this happens automatically without any government intervention.
- B. **False.** The RBA buying bonds refers to monetary policy.
- C. **True.** The removal of an income tax bracket is a deliberate change by the government.
- D. **False.** This statement alone doesn't tell us enough to determine whether this was due to a discretionary or an automatic change.

Question 15

If the RBA buys government securities (bonds) the effect would be:

- A. An increase in the supply of cash, a decrease in the interest rate and an expansion in economic growth**
- B. An increase in the supply of cash, an increase in the interest rate and a contraction in economic growth
- C. A decrease in the supply of cash, an increase in the interest rate and an expansion in economic growth
- D. A decrease in the supply of cash, a decrease in the interest rate and a contraction in economic growth

*In this question you should draw the D/S diagram for the market for cash to help you find the correct answer. When the RBA buys bonds they are injecting a supply of cash into the market. In the market for cash, the supply curve would shift to the right. Decreasing the interest rates. You should recall that a drop in interest rates reflects expansionary monetary policy. Expansionary monetary policy will increase economic activity as firms and households are encouraged to borrow and spend. **A is the correct answer.***

SECTION B – Written responses

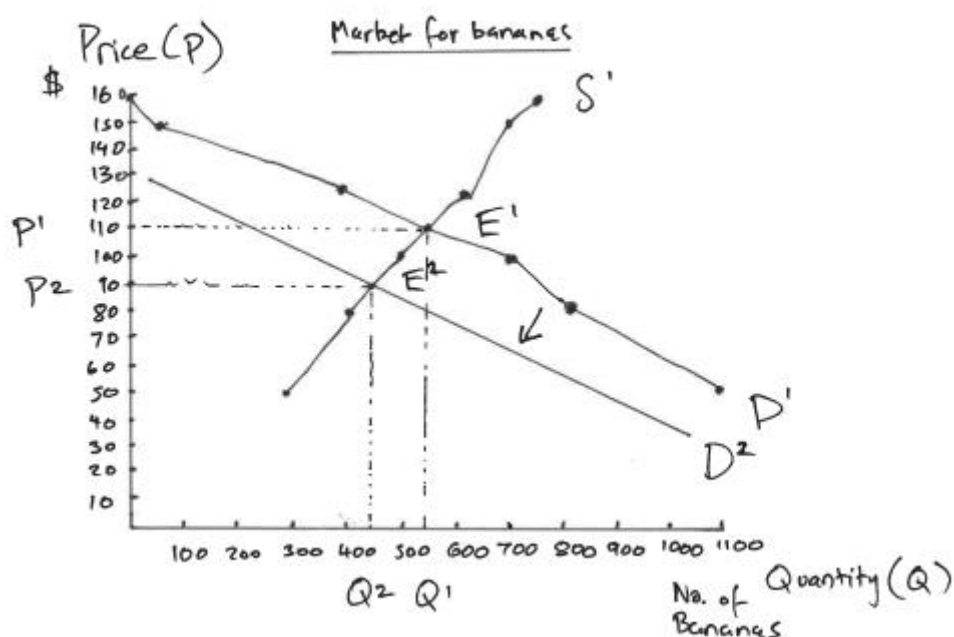
Answer all questions in the spaces provided.

Question 1 (18 Marks)

a. Consider the following market data for bananas:

Price (Per Box)	Quantity Demanded (no. of banana boxes)	Quantity Supplied (no. of banana boxes)
\$50	1100	300
\$80	800	400
\$100	700	500
\$125	400	600
\$150	50	700
\$160	0	750

Using the data above construct a fully labelled demand and supply curve. Ensure all aspects of the graphs are labelled appropriately. **4 Marks**

Marking guide:

1 Mark: Correctly labelling the axes. Because you have been allocated 4 marks to draw a D/S diagram, you need to ensure you label the axes with price and quantity data. (see above)

1 Mark: Correct scaling/ elasticity. You should be conscious of scale and should show a flatter demand curve and or a steeper supply curve. Note: this doesn't have to be perfect.

1 Mark: Correctly labelling P, Q, D and S

1 Mark: Correctly labelling E (p) and E (q). Note: you will not know the exact equilibrium price and quantity.

- b. Assume the price of a substitute product for bananas decreases. Draw this scenario on the graph above (part a) and ensure all aspects of the graphs are labelled appropriately.** **2 Marks**

Marking guide:

1 Mark: Correctly labelling the demand curve. Ensure you have labelled the new demand curve (D), Q, P and E consistently.

1 Mark: Correctly shifting the demand curve to the right

- c. Explain how the banana market moves from the original equilibrium (part a) to the new equilibrium (part b).** **3 Marks**

Marking guide:

1 Mark: Identifying the shift to the right causes a surplus at current market prices

1 Mark: Explain what happens on the demand-side

1 Mark: Explain what happens on the supply-side

Sample:

The shift to the left in the demand curve will cause a surplus (when Q_S is greater than Q_D) at the current equilibrium price (E_1). In order to clear their surplus stock, suppliers will respond by discounting prices (shown as a contraction along the supply curve: S_1). As the market price for bananas decreases more consumers will enter the market (shown as an expansion along the new demand curve: D_2) until demand and supply meets at a new lower equilibrium price and quantity (E_2). The market clearing price and quantity (no shortage and no surplus).

- d. Select one of the market failures below:**

- **Asymmetric Information**
- **Positive Externalities**

Explain how this type of market failure affects the efficiency of resource allocation.

3 Marks

Marking guide:

1 Mark: Demonstrate an understanding of the chosen market failure

2 Marks: Explain why it's a market failure. (You should refer to an over or under allocation of resources and how that reduces the efficiency of the market)

Sample:

Positive externalities occur when a benefit is imposed on third parties not involved in the original transaction. For example high school education provides a benefit to not only the student (private benefit) but also to the wider society (social benefits) through a more educated, skilled and cohesive society. This is seen as a market failure by the free market because markets do not account for the social benefits and under allocate resources to producing goods and services with positive externalities. This means allocative efficiency cannot be achieved by the market as resources are not allocated to producing goods and services to maximised the collective wellbeing of society.

- e. Explain how one possible government intervention to correct the market failure above (part d) will increase the efficiency of resource allocation.** **3 Marks**

Marking guide:

1 Mark: Outline the market failure

1 Mark: Explain how the intervention will correct the failure

1 Mark: Explain how this will impact efficiency

Sample:

One intervention to correct positive externalities are government subsidies. A subsidy is a cash payment to producers to reduce their costs of production and encourage the production and consumption of certain goods or services. A subsidy to schools will reduce their costs of production, shift the supply curve to the right, reduce the price of schooling and increase the quantity of school services consumed. This will mean more students are being educated and more resources are being allocated to producing school education. This corrects the under-allocation of resources caused by the positive externality and ensures that social benefits are taken into account improving allocative efficiency (maximising society's collective wellbeing).

- f. Explain how the intervention from above (part e) or one other contemporary example of a government intervention in markets will unintentionally lead to a decrease in the efficiency of resource allocation. **3 Marks**

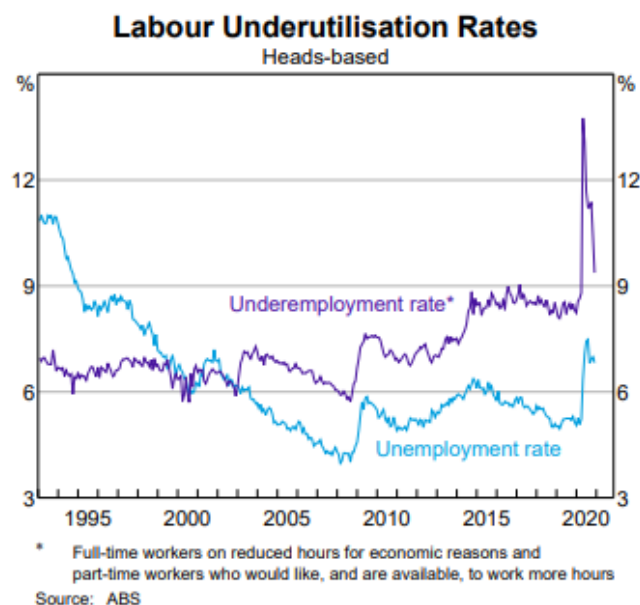
Marking guide:

- 1 Mark:** Outline the example and the intended consequences
1 Mark: Explain unintended consequences as a result of the intervention
1 Mark: Reference to efficiency e.g. less efficient after government intervention

Sample answer:

The Australian government's excise tax on tobacco was designed to increase supplier's costs of production and therefore the cost of purchasing cigarettes in Australia. The intention was then to reduce demand and reduce the negative externalities (costs imposed on third parties) associated with smoking, improving allocative efficiency. In fact, the increase in prices on tobacco and cigarettes incentivises some producers to allocate resources to produce unregulated 'black market' tobacco which has worse health outcomes than regulated tobacco. This increases the negative impacts of smoking.

Overall this can reduce the efficiency of resource allocation as resources are being reallocated to areas of production which do not maximise the collective needs and wants of society (negative externalities are in fact increased)

Question 2 (14 Marks)

- a. With reference to the last 2 years, assess the degree to which the Australian Government has achieved its goal of full employment and explain one economic reason for the trend in the unemployment rate. **4 Marks**

Marking guide:

- 1 Mark:** Referencing the trend in the unemployment rate
1 Mark: Demonstrate an understanding of the goal of full employment
1 Mark: Assess the degree to which the goal has been achieved
1 Mark: Outline one economic reason for the trend

Sample answer:

As seen on the graph above the unemployment rate has increased over the last 2 years from around 5% in 2018 to well above 6% in 2020. The government's goal of full employment is to have the unemployment rate around 4-4.5% which is deemed to be the non-accelerating rate of unemployment (NAIRU). This has not been achieved and the Australian economy has moved further away from full employment over the period. One reason for this could be the slowdown in consumption spending over the COVID lockdown. Which meant a slowdown in AD and a decreased derived demand for labour by businesses.

- b. Explain how the trend in the unemployment rate (over the past 2 years) may have impacted the RBA's stance and focus. 3 Marks**

Marking guide

- 1.5 Marks:** explain how the trend in unemployment would impact the RBA's focus via their secondary goals
1.5 Marks: explain how the trend in unemployment would impact the RBA's stance over the last 2 years

Sample answer:

The trend in unemployment rate would have been concerning to the RBA. Their secondary goal, after achieving price stability, is full employment. Given that high inflation is not a problem in Australia the RBA is likely to have turned its focus on the state of the labour market over the last 2 years. They would be hoping to see a tightening in the labour market to reduce the 'slack'. This would be evident through a decrease in the unemployment, underemployment rate and an increase in wages growth. Over the last 2 years the RBA has taken a more expansionary stance by cutting the cash rate target to (0.1%) in order to stimulate AD and economic activity in the economy.

- c. Explain the limitations the RBA should consider when using the unemployment rate to assess the state of the labour market. 3 Marks**

Marking guide

- 1 Mark:** Outline the limitations of the unemployment rate
2 Marks: Explain how this may misrepresent the true state of the labour market (underemployment or discouraged)

Sample answer:

The unemployment rate is limited in its ability to show the true state of the labour market. An employed person is someone who is over 15 and works at least 1 hour per week, Therefore the unemployment rate does not account for employed persons who would like to work more hours (underemployment) or for discouraged workers who have left the labour force all together. The RBA needs to consider both the unemployment and the underemployment rate together (underutilisation rate) in order to get a complete picture of the labour market.

- d. Explain the role of automatic stabilisers in the budget on the achievement of full employment over the past 2 years. 4 Marks**

Marking guide

- ½ Mark:** Demonstrate understanding of either a slowdown/increase in economic activity (here it depends on which period you focus on, you could refer to the COVID-19 slowdown or the more recent pick-up in economic activity both are correct)
1 Mark: Demonstrate knowledge of automatic stabilisers and how they work without any government intervention

1 Mark: Demonstrate an understanding of how welfare spending will change given the increase or decrease in economy activity

1 Mark: Demonstrate how taxes collected or tax revenue will change

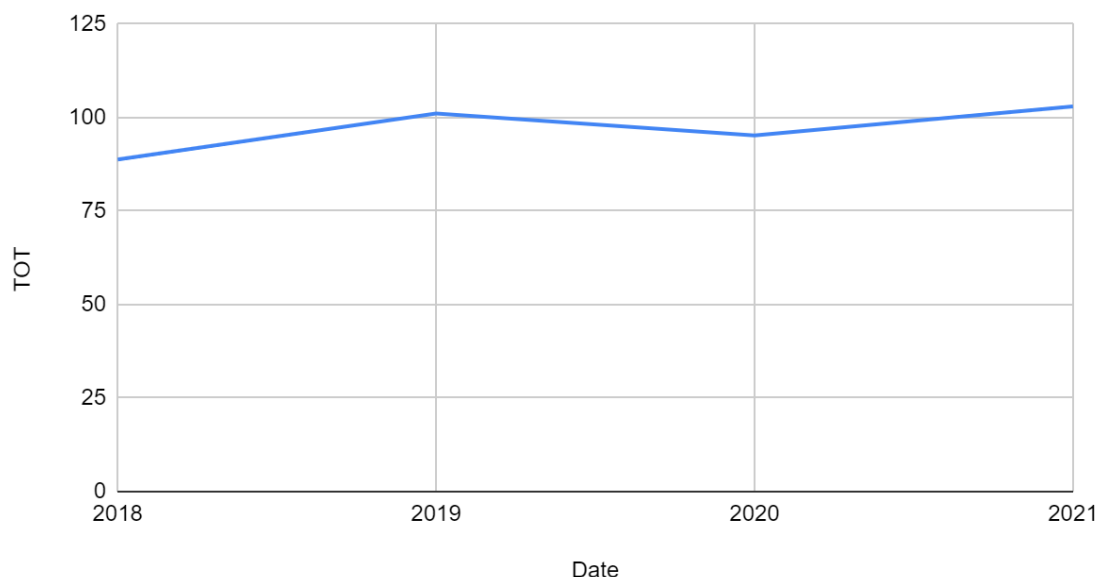
½ Mark: Outline overall impact on economic activity and the goal of full employment.

Sample answer:

Over the past 2 years economic growth has slowed due to the COVID-19 crisis. The automatic stabilisers in the budget work automatically without any government intervention to smooth out the fluctuations in the business cycle (reduce the severity of the downturn in this case). As economy activity slows and the unemployment rate rises more people qualify for unemployment benefits from the government like JobSeeker payments. This increases the government's welfare outlays. At the same time, people who are unemployed will earn less income and therefore pay less income tax to the government (businesses will also pay less tax due to decreased profits). The combination of an increase in spending and a decrease in revenues pushes the budget further into deficit and acts to stimulate activity reducing the impacts on the unemployment rate ensuring the economy is not pushed too far from its goal of full employment (4-4.5% NAIRU).

Question 3 (14 Marks)

Terms of Trade Index Australia



- a. Referring to the chart above, describe the movement in the Terms of Trade (TOT) over the past year and explain one factor which has contributed to this movement. **4 Marks**

Marking guide.

1 Mark: Referring to the chart (% and year)

1 Mark: Outline a correct factor e.g. supply shock due to COVID-19 impacting prices of iron ore and other exports like nickel or copper, increased demand from China for iron ore and other commodities or the Vale mine shutdown.

1 Mark: Explain how this has impacted the price of one of our exports or imports. Include reference to a change in the export or import price index.

1 Mark: Explain how this would impact the TOT overall – Include understanding of how the TOT is measured

Sample answer:

The trend above shows an increase (favorable movement) in the terms of trade over the period from around 90 index points in 2020, to over 100 in 2021. One driver of this has been the increased demand for iron ore from China. As China is the largest consumer of iron ore, an increase in demand shifts the demand curve to the right in global iron ore markets and increases the global price. This has increased the export price index in Australia and caused the favorable movement in the TOT (export price / import price) as iron ore is one Australia's major exports. When export prices received rise relative to import prices paid, there is a favorable movement in the TOT – as shown on the chart above.

b. Explain how this movement in the TOT may impact the following:**6 Marks**

- **The current account balance**

Marking guide:

1 Mark: Identify how an improvement in the TOT would mean an increase in the prices received for exports or a decrease in the prices paid for imports

1 Mark: Explain how this means an increase in credits or a decrease in debits on net goods and services

1 Mark: Identify overall impact on the current account

Sample answer:

An improvement in the terms of trade index means that Australia is receiving higher prices for its exports or a decrease in the prices paid for imports from overseas. In the case of Australia the increase demand for iron ore means an increase in prices received for Australian miners. Assuming quantities remain unchanged this would mean an increase in credits on net goods (BOMT) relative to debits. This would push the Australian current account balance further into surplus (or decrease the deficit).

- **Living standards**

Marking guide:

In this answer you could approach this from the AS or AD side. For example: an improvement in the TOT means importing firms have access to cheaper capital and equipment from overseas which increases AS and improves living standards in the longer term. *It's easier to approach this question from the AD side however both answers are correct.*

1 Mark: Identifying an improvement in TOT is a positive for either AD or AS

1 Mark: Explain how an increase in the TOT means an increase national income (AD)

1 Mark: Link to living standards

Sample answer:

An increase in the TOT is a positive for our exporting businesses and increase the profit they receive from a given basket of goods or services overseas. This increases national income via an increase in profits, dividends and wages. All other things being equal this should increase spending in the Australian economy via C and I which means more economy activity and an increase in material living standards. Higher wages and an increase in activity increase access to good and services in the Australian economy.

c. Explain how a move to freer trade may impact Australia's international competitiveness. 4 MarksMarking guide:

1 Mark: Demonstrate understanding of freer trade (trade liberalization)

2 Marks: Explain the impact of freer trade on Australian businesses

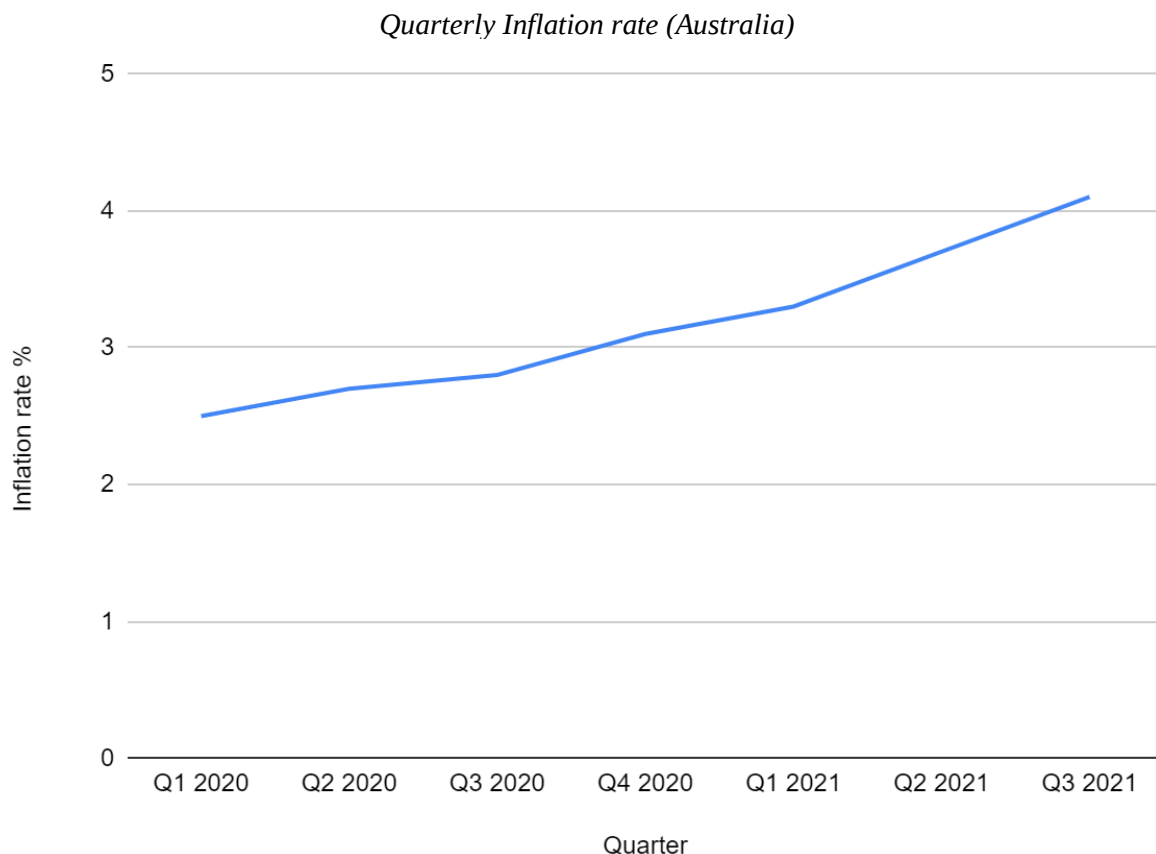
1 Mark: Explain how it impacts Australia's international competitiveness and a demonstration of what international competitiveness means

Sample answer:

A move toward freer trade involves removing protectionist policies like: subsidies to local producers, tariffs or quotas on imported goods and services and the signing of more free trade agreements. This opens up local producers to overseas competitors and forces them to improve their own productivity, use new and improved methods of production and introduce new technology. It also allows them to sell their goods and services to the rest of the world which improves economies of scale (fixed costs can be spread across a larger amount of units sold). Overall this puts downward pressure on the cost of production for Australian firms and means lower prices. This improves Australia's international competitiveness as our business are more able to compete in world markets on both price and quality. (There may be some negative effects on international competitiveness in the short-term as firms restructure their operations).

Question 4 (19 Marks)

Consider the following hypothetical data for Australia's quarterly inflation rate.



- a. Explain how the RBA may respond to the data above and using one transmission mechanism explain how this response would impact the achievement of price stability. 5 Marks**

Marking guide:

1 Mark: Explain how the RBA would be concerned with rising inflation

1 Mark: Explain one transmission mechanism

2 Marks: Explain how the transmission works given an increase in interest rates (referring to AD and its components)

1 Mark: Explain how this would impact price stability

Sample answer:

The RBA would be very concerned to see quarterly inflation rising at such a rate and they would likely take a contractionary stance in order to slow down AD and reduce inflationary pressures. They would do this by increasing interest rates which would flow through the cash flow channel to businesses and households with existing variable loans. The increase in the interest rates would increase their interest repayments and would mean less cash flow for business and less discretionary income for households. This would slow C and I spending and AD overall. Thus pushing the economy away from its productive capacity and reducing inflationary pressures bringing the RBA closer to its goal of price stability (prices rising on average at 2-3% p.a. over the course of a cycle)

- b. Evaluate the effectiveness of budgetary policy over the past 2 years in achieving the government's goal of strong and sustainable growth. 6 Marks**

Marking guide:

1 Mark: Outline one strength of budgetary policy

1 Mark: Outline an example of the policy (that shows its strength) for the last 2 years

1 Mark: Outline the impact on the goal of SSEG / demonstrate an understanding of the goal (this could be done as an overall assessment together at the end)

1 Mark: Outline one weakness of budgetary policy

1 Mark: Outline an example of the policy (that shows its weakness) over the last 2 years

1 Mark: Outline the impact on the goal of SSEG / demonstrate an understanding of the goal (this could be done as an overall assessment together)

Sample:

One strength of budgetary policy is that it can target specific areas of weakness in the economy. For example, during the 2020 COVID-19 crisis budget changes were able to specifically target businesses via the instant asset write-off which encouraged businesses to increase their investment spending (I). This helped increase AD spending and production by firms which in turn helped bring the Australian economy closer to its goal of strong and sustainable growth (3-3.5% real GDP) by increasing real GDP and creating jobs without excessive inflationary pressures.

One weakness of budgetary policy is that it has financial constraints. The budget has an inbuilt medium-term goal to return to surplus (revenues > spending) over the medium term. This restricts the size of the deficit that the current government can run. These financial constraints may reduce the ability to stimulate AD and achieve strong and sustainable growth. For example, recently many of the policies (JobKeeper, and JobSeeker extension) that helped bring the economy closer to its goal of SSEG, expired in the order to ensure that in the medium term the budget does return to surplus. This may mean the economy does not reach its 3-3.5% strong and sustainable growth target.

c. Select one of the aggregate supply policies below:

- **Education and training policy**
- **Tax and welfare reform**
- **Immigration policy**

Using a contemporary example, explain how the government may utilise this policy to help achieve its goal of strong and sustainable growth.

4 Marks

Marking Guide:

1 Mark: Outline one contemporary example and demonstrate how it works

1 Mark: Explain how this policy improves one AS factor e.g. productivity, quality and quantity of resources or decrease in costs of production

1 Mark: Explain the impact on aggregate supply and the ability and willingness of firms to produce at each and every price point

1 Mark: Outline the impact the goal of strong and sustainable growth demonstrating and understanding of the goal

Sample answer:

One contemporary example of education and training funding is the \$24 billion GONSKI 2.0 funding designed to help disadvantaged government schools with extra funding. In the longer term this is designed to improve the skills and knowledge of the workforce and improve labour market productivity (output per hour of work). This will shift the aggregate supply curve to the right and improve the ability and willingness of firms to produce at each and every price point. The improvement in the productive capacity will put downward pressure on prices and mean Australian businesses are more internationally competitive in world markets. Overall this will help achieve the goal of strong and sustainable growth (3% - 3.5% real GDP) as Australia can increase real GDP and create jobs without excess inflationary pressures.

d. Select a different aggregate supply policy from above (part c)**Evaluate the effectiveness of this aggregate supply policy in achieving low inflation.****4 Marks**

Here you could use any number of strengths and weaknesses, it's easier to choose strengths and weakness that relate clearly to the goal of price stability.

Marking guide:**1 Mark:** Outline the strength of the AS policy**1 Mark:** Explain the link to Low inflation**1 Mark:** Outline the weakness of the AS Policy**1 Mark:** Explain the link to low inflation**Sample:**

One strength of immigration policy is its ability to increase the quality and quantity of labour resources in Australia, quickly and with little financial cost. Unlike education policy which can take a long time to increase the skills, knowledge and productivity of the labour force (and billions of dollars). Immigration policy allows AS to shift to the right, increase the productive capacity and ensure the economy can grow into the future without excess inflationary pressures. This means we are more likely to achieve our goal of low inflation (steady price increases between 2-3% on average over the course of the cycle).

One weakness of immigration policy is that if the population growth rate is not managed properly it can lead to overcrowding in cities, overdevelopment and shortages of key infrastructure like schools, roads and public transport. In the long term this could in fact harm productivity (outputs per inputs) and the achievement of low inflation as it could increase costs of productions for firms, restrict the growth in aggregate supply and therefore the potential growth rate of the economy. This would mean cost-push inflation may arise as shortages and bottlenecks occur, pushing us away from our goal of price stability.