

ECONOMICS
Unit 3&4 Examination 1
MARKING GUIDE

SECTION A – Multiple-choice questions**Instructions for Section A**

Answer **all** questions in pencil on the answer sheet provided for multiple choice questions

Choose the response that is correct of that best answers the question

Correct answers score 1, while incorrect answers score 0

No marks will be deducted for incorrect answers

No marks will be given if more than one answer is given for any question.

Question 1

According to the circular flow model, which of the following would lead to the largest increase in the level of income in the circular flow of income for an economy?

- A. Equal increases in injections and leakages.
- B. A large increase in injections and a small increase in leakages.
- C. A small decrease in injections and a large increase in leakages.
- D. A large increase in injections and a large decrease in leakages.**

Question 2

Imagine Australian households experience a decrease in disposable income. Which of the following effects is most likely to occur?

- A. An increase in economic growth
- B. A decrease in net export demand
- C. A decrease in consumption demand**
- D. A decrease in the unemployment rate

Question 3

Which of the following is most likely to have caused a decrease in interest rates in Australia?

- A. The Reserve Bank of Australia (RBA) implements contractionary monetary policy.
- B. The RBA buys government securities in the overnight money market.**
- C. The Australian Federal Government introduces tax offsets for low-income earners.
- D. The Victorian Government invests \$500 million in new infrastructure projects.

Question 4

Which of the following is an argument for trade protectionism rather than for free trade?

- A. Specialisation and trade can lead to more production and consumption in total.
- B. Larger markets enable firms to experience greater economies of scale.
- C. Cooperation between countries has political benefits.
- D. Infant industries need support to grow to a size to compete internationally.**

Question 5

Which of the following scenarios could possibly lead to a rise in equilibrium price but no change to equilibrium quantity in a market?

- A. An increase in demand and a decrease in supply.**
- B. A decrease in demand and a decrease in supply.
- C. An increase in demand and an increase in supply.
- D. A decrease in demand and an increase in supply.

Question 6

Which of the following accurately describes an effect of the saving and investment channel of monetary policy transmission when contractionary policy is implemented?

- A. Businesses will increase their volume of lending, leading to demand inflation.
- B. Households will have greater incentive to save, limiting demand inflation.**
- C. Households will have more disposable income to spend on goods and services, leading to demand inflation.
- D. Businesses will make larger profits, leading to less cost inflation.

Question 7

Which of the following statements is **incorrect**?

- A. Without government intervention, products with negative externalities will be oversupplied by the market.
- B. Governments can influence supply of products with positive externalities by offering subsidies to suppliers.
- C. Governments can influence demand of products with positive externalities by offering subsidies to suppliers.
- D. An indirect tax on a product with negative externalities will encourage its production and consumption.**

Question 8

Christine and Alex buy a newly-built home to live in together. This spending would be included in Gross Domestic Product (GDP) as:

- A. Household consumption
- B. Private investment**
- C. Non-market activity
- D. Both B and C

Question 9

If the price elasticity of supply for a product is highly inelastic, it could be that:

- A. the product is extremely durable.
- B. there is a very long timeframe available.
- C. firms do not have sufficient spare capacity.**
- D. the price of the product is too high.

Question 10

A deterioration in Australia's terms of trade:

- A. will result in a smaller current account deficit or a larger current account surplus.
- B. means less of Australia's exports must be sold to purchase the same quantity of imports.
- C. will likely lead to an improvement in economic growth.
- D. can be caused by falling global demand for Australia's major exports.**

Question 11

Which of the following combinations of policies would likely have the largest positive effect on the goal of full employment?

- A. An increase in subsidies for infant industries and a decrease in research grants for private industries.
- B. Removal of training subsidies for firms and trade liberalisation policies.
- C. Increased spending on training and education and increased subsidies for infant industries.**
- D. An increase in research and development grants and decreased spending on infrastructure.

Question 12

Which of the following is most likely to help return Australia's budget to surplus?

- A. An increase in export prices**
- B. Slow wages growth
- C. Higher interest rates
- D. Lower business confidence levels

Question 13

A situation in which society's scarce resources are utilised to produce the goods and services most desired by consumers is best known as:

- A. Comparative advantage
- B. Allocative efficiency**
- C. Intertemporal efficiency
- D. Maximum productive capacity

Question 14

Refer to Table 1.

Table 1: Population, labour force and employment data for a hypothetical economy

Working age population	6 million
Labour force	4.3 million
Employed people	4.1 million
Underemployed people	0.8 million

Which of the following statements is **incorrect** in relation to the above hypothetical economy?

- A. The labour force participation rate is greater than the unemployment rate
- B. The underutilisation rate is 28%**
- C. The unemployment rate is approximately 4.6%
- D. There are more underemployed people than unemployed people.

Question 15

A decrease in net export demand could possibly cause:

- A. An increase in a current account deficit.
- B. A decrease in a current account surplus.
- C. A decrease in net total accumulated foreign debt.
- D. Both A and B.**

SECTION B – Written responses**Instructions for Section B**

Answer **all** questions in the space provided

Question 1 (15 marks)

In March 2020, the World Health Organisation (WHO) declared COVID-19 a pandemic. The WHO recommended people wash their hands regularly and use hand sanitiser when soap was not available. In Melbourne and other cities around the world, hand sanitiser became scarce and businesses tried to increase its production.

- a. Using a fully labelled demand and supply diagram, explain the effect of the above scenario on resource allocation, and on the price and quantity traded of hand sanitiser. 6 marks

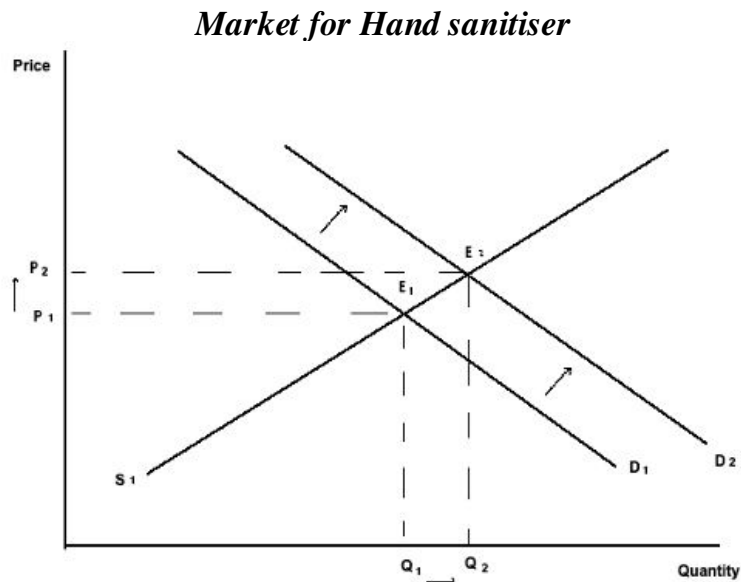
Suggested answer

Diagram showing increase in demand and higher equilibrium price and quantity (2 marks)

The pandemic and the WHO's recommendations led to an increase in demand for hand sanitiser, which caused a shortage at the prevailing equilibrium price (1). A shortage leads to upward pressure on prices as buyers need to compete for scarce products (1). Producers are motivated to allocate more resources (1) towards the production of hand sanitiser, since they are able to change a higher price for it. The quantity supplied will increase as more resources are allocated to hand sanitiser, until the shortage is eliminated. The end result is a higher equilibrium price and larger quantity traded in the market (1).

[Mark allocations are approximate. Marks can be achieved using alternative statements by demonstrating a similar level of detail and complexity within the response.]

- b.** Outline **two** reasons why the demand for hand sanitiser is likely inelastic.

4 marks

Suggested answer

Products have inelastic demand when a given percentage change in price results in a smaller percentage change in quantity, meaning buyers are not sensitive to price changes [1]. Sanitiser might have inelastic demand during the pandemic since consumers deem it as a necessity [1] and are therefore willing to buy it even if the price rises significantly [1]. Also, as a proportion of income, sanitiser is a relatively small outlay, so even large rises in price don't amount to a huge proportion of a person's income [1].

[For full marks students need to show knowledge of the meaning of inelastic demand and apply two factors that influence demand elasticity to hand sanitiser within their answer]

- c.** Explain the market failure in relation to hand sanitiser and outline **one** suggestion for government intervention that could help minimise the problem.

5 marks

Suggested answer

Products with positive externalities are products that have benefits for third parties, not just the producer or consumer. (1) Hand sanitiser has positive externalities because even those who don't use the sanitiser will benefit when a consumer uses hand sanitiser as they are less likely to spread the virus to others. (1) There is market failure in this situation because the free market will not produce a socially efficient quantity of hand sanitiser (1). Governments can intervene in this situation by providing a subsidy to either the producer or consumer of hand sanitiser (1) which will result in more resources being allocated towards hand sanitiser and a greater quantity being consumed (1).

[Mark allocations are approximate. Marks can be achieved using alternative statements by demonstrating a similar level of detail and complexity within the response.]

Question 2 (17 marks)

‘The economic recovery in Australia is well under way and is stronger than had been expected. The unemployment rate fell to 5.8 per cent in February and the number of people with a job has returned to the pre-pandemic level... Nevertheless, wage and price pressures are subdued and are expected to remain so for some years. The economy is operating with considerable spare capacity and unemployment is still too high. It will take some time to reduce this spare capacity and for the labour market to be tight enough to generate wage increases that are consistent with achieving the inflation target. In the short term, CPI inflation is expected to rise temporarily because of the reversal of some COVID-19-related price reductions. Looking through this, underlying inflation is expected to remain below 2 per cent over the next few years.’

*Source: statement by Philip Lowe, Governor of the Reserve Bank of Australia, ‘Monetary Policy Decision’, media release, 6 April 2021.
<www.rba.gov.au>*

- a. Outline which phase of the business cycle Australia was likely in during February 2021 by referring to the above statement from Philip Lowe. 2 marks

Suggested answer

Lowe states that the recovery is under way and that unemployment fell in February (1). Australia was likely in expansion or recovery stage of the business cycle, following a trough. At this stage the level of economic activity (production and consumption) is increasing and unemployment is falling (1).

[Mark allocations are approximate. Marks can be achieved using alternative statements by demonstrating a similar level of detail and complexity within the response, but students should refer to the stimulus material for full marks.]

- b. Describe two types of unemployment that likely existed in Australia in 2020. 4 marks

Suggested answer

Cyclical unemployment likely existed due to the downturn associated with the COVID-19 pandemic. This is the loss of jobs due to weak aggregate demand and a downturn in economic activity [2]. Frictional unemployment likely also existed as this is an unavoidable type of unemployment, present even during peak economic activity. It is caused by the normal search time required for someone to transition between jobs, or from study to a job [2].

[Any two types of unemployment can be described for full marks if enough knowledge is shown.]

- c. Explain how the economy can still be operating with significant spare capacity even though the unemployment rate fell in February. 2 marks

Suggested answer

Even though the unemployment rate fell to 5.8% this is still higher than 'full employment' (1) which is estimated to be approximately 4 or 4.5%. This indicates there are spare labour resources available to add to the production of the economy (1).

[Alternatively, students may approach this question by referring to reasons why the unemployment rate doesn't necessarily indicate the true extent of spare capacity, due to underemployment and hidden employment.]

- d. By referring to a specific channel of transmission, explain how an expansionary monetary policy stance influences aggregate demand and the value of the Australian dollar. 4 marks

Suggested answer

When the RBA lowers the cash rate this means interest rates in Australia are less attractive for investors when compared with interest rates in other countries. This reduces the demand for Australian assets such as securities and foreigners shift their funds to foreign assets and currencies instead. This reduces demand for the Australian dollar, and all else being equal - leads to its depreciation. A lower exchange rate increases the demand for Australian exports and decreases the demand Australians have for imports, having a positive effect on aggregate demand.

[This question should be marked globally. Marks can be achieved using alternative statements by demonstrating a similar level of detail and complexity within the response. If students approach this question by referring to a separate channel, they may still receive partial marks if they accurately describe the effect on AD.]

- e. Discuss the reasons for the Reserve Bank of Australia's (RBA's) monetary policy stance since the start of 2020, with reference to the RBA's charter. 5 marks

Suggested answer

During the first half of 2020 the RBA has taken an expansionary stance, lowering the cash rate from 0.75 at the beginning of 2020, to currently being 0.1, which is historically the lowest cash rate ever for Australia. The RBA's charter outlines its objectives to contribute to the stability of the currency by keeping inflation within 2-3% on average over the course of the business cycle; and to contribute to full employment and the economic prosperity and welfare of the people of Australia. Given that inflation has been lower than target, an expansionary stance was appropriate. Likewise, Australia suffered a contraction and an increase in unemployment during lockdowns and uncertainty related to the COVID-19 pandemic in 2020, so an expansionary stance was necessary to help the economy recover. Whilst unemployment has fallen and growth has improved, the economy is still not at full employment so the RBA has continued to hold the cash rate at an historic low, in order to stimulate aggregate demand and jobs growth.

[This question should be marked globally. Marks can be achieved using alternative statements by demonstrating a similar level of detail and complexity within the response.]

Question 3 (15 marks)

‘Growth in resource exports, in both value and volume terms, have been led by iron ore exports. Robust demand from Chinese steel producers and supply disruptions in Brazil have supported high prices and export volumes over 2020 and the start of 2021.’

Source: RBA Submission to the Inquiry into the Prudential Regulation of Investment in Australia's Export Industries

Joint Standing Committee on Trade and Investment Growth

23 March 2021

<www.rba.gov.au>

- a.** Outline how two factors have led to changes in Australia’s iron ore export volumes and prices.

4 marks

Suggested answer

Robust demand from China amounts to an increase in demand in the global iron ore market (1). Supply disruptions in Brazil mean that global supply of iron ore has decreased (1). A combination of an increase in demand and a decrease in supply in a market will lead to higher prices (1). Australia is likely supplying more volume to the global market, since Brazil’s supply has been disrupted (1).

[Marks can be achieved using alternative statements by demonstrating a similar level of detail and complexity within the response. For full marks, students should identify the two factors from the stimulus material; link this to market equilibrium price and identify that Australia’s share of the global supply has likely now increased.]

- b.** Explain how the changes in the market for iron ore would likely influence the following for Australia.

6 marks

- (i) The balance of payments
- (ii) The exchange rate
- (iii) The terms of trade

Suggested answer

- (i) *Higher prices and volumes of exports will increase the net flow of income from trade, since more money will be received from foreigners (1), and if outflows from imports remain the same, this will have a positive effect on the current account (increasing the current account surplus) (1).*
- (ii) *Assuming all else remains equal, a greater demand for Australian exports has an appreciation effect on the Australian currency (1). This is because foreigners require Australian dollars to purchase Australian exports. An increase in demand for Australian dollars leads to an appreciation of the currency (1).*
- (iii) *Australia’s terms of trade are a ratio of the index of export prices to the index of import prices. Terms of trade are influenced when the value of the products Australia exports changes, and/or when the value of the products Australia imports changes (1). Therefore if one of Australia’s major exports becomes more valuable in the global market, this has a positive effect on the index of export prices and leads to an improvement in the terms of trade (1).*

- c. Discuss the effectiveness of trade liberalisation in achieving improvements in living standards for Australians. 5 marks

Suggested answer

Trade liberalisation can have positive effects on living standards for Australians as they are able to access lower priced imports and a greater variety of products from foreign producers. Greater competition forces local producers to become more efficient and produce at a lower cost in order to be internationally competitive. Businesses can access a larger market and thus grow to larger sizes and achieve economies of scale, which further assists in driving costs and prices down. Since it leads to countries producing products for which they have a comparative advantage, international trade can help achieve economic growth, and thus assist in improving material living standards overall for Australians. We have seen this in recent years when Australia has benefited from a mining boom (selling exports for which we have a competitive advantage). However, trade liberalisation can have some negative effects, such as when competition drives Australian businesses to shut down due to their inability to compete with foreign imports. This may result in job losses for Australians, such as has been seen in recent years in Australia when car and other manufacturing firms have failed to compete with cheaper foreign imports. The job losses associated with business closures negatively affects material and non-material living standards due to loss of income and the negative health effects of job losses. Further, there are negative environmental impacts associated with physical international trade, due to the transportation of goods and resources. This can lead to a decrease in non-material living standards.

[This question should be marked globally. Marks can be achieved using alternative statements by demonstrating a similar level of detail and complexity within the response. For full marks, students should have considered both positive and negative effects of trade liberalisation on living standards.]

Question 4 (18 marks)

- a.** Explain how each of the following factors can possibly influence Australia's goal of strong and sustainable growth. 4 marks

- (i) An improvement in business confidence
- (ii) A decrease in skilled migrants

Suggested answer

- (i) *Business confidence is an economic indicator that measures predictions businesses make regarding future production and profits. An improvement in confidence, or an optimistic outlook, can lead to businesses increasing their investment spending and/or bringing forward plans for expansion (1). This leads to an increase in the Investment component of aggregate demand and increasing economic growth compared to the previous quarter or year. This can help achieve the goal of strong and sustainable growth (1).*
- (ii) *A decrease in skilled migrants can negatively affect Australia's productive capacity, leading to a decrease in aggregate supply (1). This will decrease the labour force participation rate and overall there will be fewer labour resources available for production. This can have a negative effect on the goal of strong and sustainable growth (1).*

[Marks can be achieved using alternative statements by demonstrating a similar level of detail and complexity within the response.]

- b.** Outline the role of budgetary policy in Australia and describe two specific examples of how the Australian government has used budget initiatives during the COVID-19 pandemic. 6 marks

Suggested answer

Budgetary policy's role is to plan the level and composition of federal government revenues and expenditures, to stabilise the business cycle, and achieve the goals of full employment and strong and sustainable economic growth. (2)

One of the major policies implemented during 2020 was the JobKeeper wage subsidy. The government effectively paid some of the wages of employees. This was designed to both assist businesses to retain workers during the pandemic-related lockdowns and downturn, but also to support households' income and spending. This meant that a strong level of Consumption demand was maintained, supporting aggregate demand and helping to assist in achieving an economic recovery post-lockdowns. This ensured that the economy was able to achieve growth in 2021 while the unemployment rate decreased. (2)

Another policy implemented in 2020 was the change to the instant-asset write-off scheme. This scheme enables eligible businesses to claim an immediate tax deduction for the cost of an asset in the year the asset is first used, rather than depreciating this asset over a number of years. The threshold for the value of each asset was increased from \$30,000 to \$150,000. Being able to write off the cost of these large assets as expenses effectively decreases the amount of tax payable for the business. This means businesses have more funds available for investment and production, hopefully leading to increased economic activity and more jobs. (2)

[Marks can be achieved using alternative statements and/or policies by demonstrating a similar level of detail and complexity within the response.]

- c. Describe two specific aggregate supply policies announced or implemented by the Australian government during the past two years. 4 marks

Suggested answer

In 2020, the Australian government announced the JobTrainer package, involving \$1 billion of funding for an additional 300,000 courses in areas like health, aged and disability care, IT and trades. This funding is designed to improve the skills of Australia's labour resources, leading to productivity growth, increasing aggregate supply and helping to achieve the goals of full employment and strong and sustainable growth (2).

In 2021, the Australian government announced a plan to increase childcare subsidies for families with more than two children under 5; and to remove a cap on subsidies for higher income earners. This policy is designed to increase workforce participation among parents, which aims to increase aggregate supply, helping to achieve the goals of full employment and strong and sustainable growth (2).

[Marks can be achieved using alternative statements and/or policies by demonstrating a similar level of detail and complexity within the response.]

- d. Evaluate the use of budget deficits to avoid recessions. 4 marks

Suggested answer

A budget deficit in any particular year will lead to an increase in the total government (public) debt that a government owes through borrowing. However, sometimes it is necessary for governments to stimulate the economy through borrowing, in order to avoid recession or minimise a downturn. Increased government spending can help to stabilise the business cycle. Budget deficits can also lead to greater economic growth in the future, and the achievement of the goal of full employment if borrowing is used to improve productive capacity. For example, if the government borrows to fund improvements in infrastructure, this will lead to more production in the future for the country, and thus more jobs and sustainable growth. However, increasing public debt represents a greater burden on future generations to pay back the debt, who may have to pay higher taxes in the future. Generally, budget deficits can be very useful if used to avoid recession or to invest in productive capacity rather than to fund current consumption, because the increased productive capacity can lead to higher GDP in the future and thus enables the government to pay down the debt with the increased income generated.

[This question should be marked globally. Marks can be achieved using alternative statements and/or arguments by demonstrating a similar level of detail and complexity within the response. Students should consider both pros and cons of budget deficits and debt, for full marks.]