

Economics Units 3 and 4 practice exam and suggested answers

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The following practice exam for VCE Economics Units 3 and 4 consists of two sections: Section A – multiple-choice questions and Section B – written responses. Section A is worth 15 marks and Section B is worth 65 marks. Suggested answers to this practice exam follow the question and answer book.

All questions are compulsory. The command/task words in each question, the corresponding number of marks allocated and the number of lines provided after each question give a guide to the appropriate length of responses. Additional space is provided at the end of the question and answer book.

Please note that the questions and suggested answers have no official status. Teachers are advised to preview and evaluate all practice exam material before distributing it to students.

Name: _____ Teacher: _____

ECONOMICS UNITS 3 AND 4

Practice written examination 2023

Reading time: 15 minutes

Writing time: 2 hours

QUESTION AND ANSWER BOOK

Structure of book

<i>Sections</i>	<i>Number of questions</i>	<i>Number of questions to be answered</i>	<i>Number of marks</i>
A	15	15	15
B	5	5	65
			Total 80

- Students are permitted to bring into the examination room: pens, pencils, highlighters, erasers, sharpeners and rulers.
- Students are NOT permitted to bring into the examination room: blank sheets of paper and/or white-out liquid/tape.
- A scientific calculator is allowed in this examination.

Materials supplied

- Question and answer book
- Answer sheet for multiple-choice questions
- Additional space is available at the end of the book if you need extra paper to complete an answer. Clearly label all answers with the appropriate question number.

Instructions

- Write your name and your teacher's name in the spaces provided above on this page.
- All questions in both sections of this practice exam are compulsory.
- The multiple-choice questions in Section A are to be completed in pencil on the sheet provided.
- All written-response questions are to be completed in blue or black pen in the spaces provided.
- All written responses must be in English.

Students are NOT permitted to bring mobile phones and/or any other unauthorised electronic devices into the examination room.

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** or that **best answers** the question.

A correct answer scores 1, an incorrect answer scores 0.

Marks will **not** be deducted for incorrect answers.

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

Question 1

Jet skis are likely to have a high price elasticity of demand (PED). Which of the following factors would be **most likely** to cause the PED value to be greater than 1?

- A. a short production period
- B. increased preferences and tastes towards jet skis
- C. the degree of necessity of jet skis
- D. spare capacity in the production of jet skis

Question 2

In the five-sector circular flow model of income, an increase in import expenditure will result in:

- A. an increase in leakages relative to injections, a reduction in aggregate demand and a decrease in production.
- B. an increase in injections relative to leakages, a reduction in aggregate demand and a decrease in production.
- C. an increase in leakages relative to injections, an increase in aggregate demand and an increase in production.
- D. an increase in injections relative to leakages, a reduction in aggregate demand and an increase in production.

Question 3

Which of the following is **not** a potential benefit of the government increasing spending on training and education?

- A. An increase in Australia's labour productivity
- B. An increase in Australia's labour force
- C. An increase in Australia's budget deficit
- D. An increase in Australia's international competitiveness

Question 4

Which of the following is an example of a transfer payment by the Australian Government?

- A. Payment of the aged pension to Frawley living in Noosa.
- B. Payment of wages to James who works at a nursing home in Yarraville.
- C. Payment of rent by the Australian Defence Forces for use of an office building in Springvale.
- D. Payment of interest to Australian Government Security bond holders.

Question 5

In the market for apples, if there was a successful advertising campaign by apple growers it would be expected that:

- A. demand curve would shift to the right resulting in a higher equilibrium price and quantity.
- B. demand curve would shift to the left resulting in a lower equilibrium price and quantity.
- C. supply curve would shift to the left resulting in a higher equilibrium price and quantity.
- D. supply curve would shift to the right resulting in a lower equilibrium price and quantity.

Question 6

Which of the following would **not** result in an increase in non-material living standards?

- A. reduction in greenhouse gas pollution from the production of electricity
- B. increase in students successfully completing the VCE in Victoria
- C. reduction in Melbourne's crime rate
- D. increase in out-of-pocket costs to visit a general practitioner

Question 7

Which of the following would **not** be described as a gain from international trade?

- A. increased levels of structural unemployment in the short run.
- B. greater choice for consumers.
- C. increased access to resources for producers.
- D. lower prices for consumers.

Question 8

Which of the following is a **not** a long-term effect of Australia's policy of trade liberalisation?

- A. Improvement in the dynamic efficiency of the Australian economy
- B. Downward pressure on Australia's inflation rate
- C. Increased taxation revenue from tariffs
- D. Increased variety of goods and services available to Australian consumers

Question 9

Which of the following factors would be **most likely** to cause a depreciation of the \$A?

- A. an increase in the price of mineral commodities such as iron ore and coal
- B. an increase in Australia’s interest rates relative to the rest of the world
- C. an increase in the economic growth of Australia’s major trading partners
- D. an increase in Australia’s inflation rate relative to trading partners’ inflation

Question 10

During the boom phase of the business cycle the government aims to slow inflation and achieve more sustainable economic growth. The most appropriate stance of budgetary and monetary policy to achieve this aim would be:

- A. contractionary budgetary and monetary policy stance
- B. contractionary budgetary policy stance and an expansionary monetary policy stance
- C. expansionary budgetary and monetary policy stance
- D. expansionary budgetary policy stance and contractionary monetary policy stance

Question 11

Unemployed persons	5,000
Employed persons	95,000
Persons aged 15 or more	150,000
Underemployed persons	10,000
Retired persons	20,000

Referring to the above table, the participation rate for the hypothetical economy of Blueeyville would be:

- A. 5%
- B. 57%
- C. 67%
- D. 95%

Question 12

The asset prices and wealth channel of the monetary policy transmission mechanism operates to slow aggregate demand by:

- A. Discouraging consumption due to lower discretionary incomes of borrowers
- B. Discouraging borrowing to consume due to higher interest repayments on loans
- C. Discouraging expenditure on Australian exports due to an appreciating A\$
- D. Discouraging consumption due to a reduction in value of investments like property

Question 13

Economic variable	Year 1 (Annual % change)	Year 2 (Annual % change)
Real GDP	5%	2%
Inflation	6%	4%
Unemployment	4%	5%

Examine the above table for the hypothetical economy of Banditville, which has a similar economic system to Australia. Referring to the table, what is the **most likely** impact of the change in economic variables on the automatic stabilisers of income tax and unemployment benefits in Year 2?

- A. Increase in income tax collections and increase in unemployment benefit payments
- B. Increase in income tax collections and decrease in unemployment benefit payments
- C. Decrease in income tax collections and increase in unemployment benefit payments
- D. Decrease in income tax collections and decrease in unemployment benefit payments

Question 14

	Year 1 (\$/kilo)	Year 2 (\$/kilo)
Apples	\$3	\$4
Oranges	\$2	\$4
Passionfruit	\$10	\$15

Referring to the above table, in Year 2 the relative price of oranges has:

- A. increased relative to apples but not passionfruit
- B. increased relative to both apples and passionfruit
- C. fallen relative to passionfruit but not apples
- D. fallen relative to both passionfruit and apples

Question 15

Taxation reform can improve the supply side of the Australian economy by:

- A. Reducing costs of production for Australian firms
- B. Increasing protection for import competing industries
- C. Encouraging consumption expenditure by households
- D. Assisting the government to stabilise the business cycle

END OF SECTION A

SECTION B: WRITTEN RESPONSES

Instructions for Section B
 Answer **all** questions in pen in the spaces provided.

Question 1 (12 marks)

The following table identifies the production possibilities for the hypothetical economy of Ecoville.

TABLE 1: PRODUCTION POSSIBILITIES FOR ECOVILLE

	A	B	C	D	E
Coal powered electricity	0	30	50	80	100
Solar panels	200	140	100	50	0

- a. Referring to Table 1, construct a fully-labelled production possibility frontier (PPF) model for the economy of Ecoville. 3 marks

- b. With reference to the PPF constructed in part a. above, explain how the PPF model

illustrates the concepts of allocative and productive efficiency.

3 marks

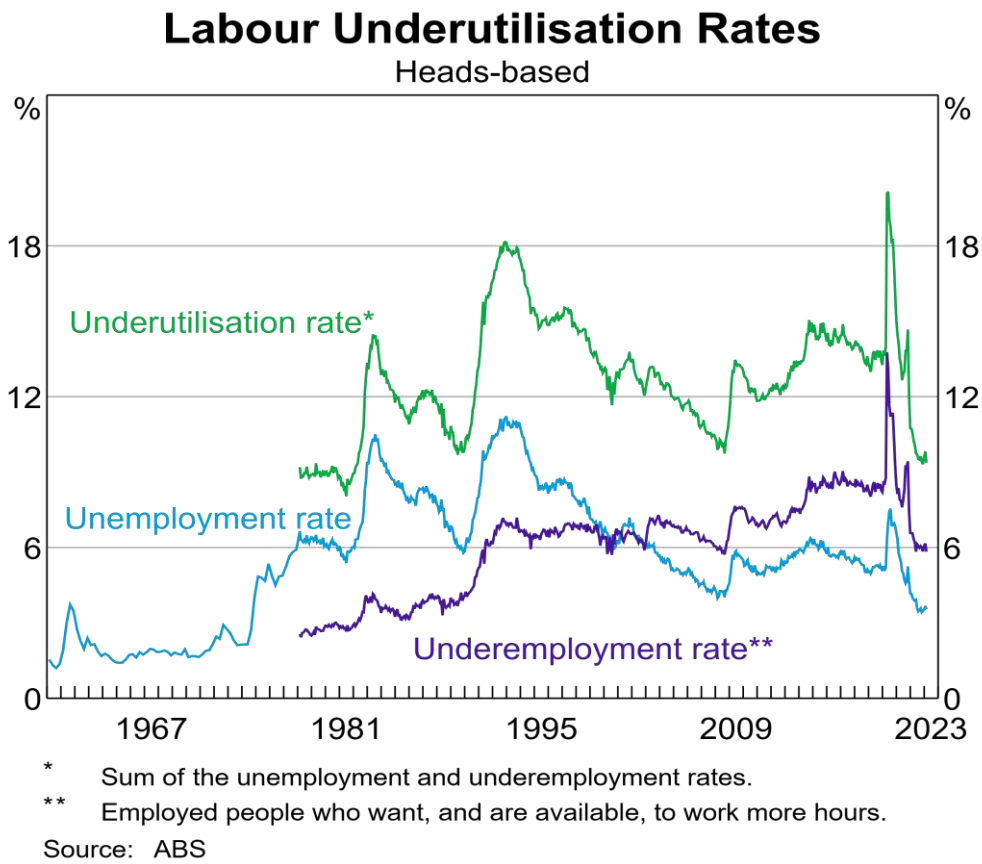
c. Explain how the production of coal powered electricity can be a cause of market failure for the Australian economy. In your response, identify the type of market failure caused.

3 marks

d. Explain one form of government intervention that could be used to address the market failure identified in **part c**. 3 marks

Question 2 (12 marks)

FIGURE 1: LABOUR UNDERUTILISATION RATES



Source: 'Labour Underutilisation Rates', *Chart Pack*, Reserve Bank of Australia, 13 April 2023, <https://www.rba.gov.au/chart-pack/factors-prod-labour-mkt.html>

TABLE 2: MEASURES OF LABOUR FORCE

Month	Labour force total	Unemployment rate	Underemployment rate
Feb-21	13,755.1	5.8	8.4
Mar-21	13,808.4	5.6	7.9
Apr-21	13,757.9	5.4	7.9
May-21	13,802.4	5.1	7.6
Jun-21	13,821.4	5.0	7.9
Jul-21	13,780.9	4.7	8.3
Aug-21	13,624.5	4.6	9.3
Sep-21	13,506.6	4.7	9.2
Oct-21	13,546.9	5.2	9.4
Nov-21	13,845.3	4.6	7.5
Dec-21	13,868.3	4.2	6.6
Jan-22	13,909.9	4.2	6.6
Feb-22	13,983.5	4.0	6.6
Mar-22	14,007.1	3.9	6.3
Apr-22	14,032.7	3.9	6.2
May-22	14,100.0	3.9	5.8
Jun-22	14,144.0	3.6	6.1
Jul-22	14,109.4	3.5	6.1
Aug-22	14,172.2	3.5	6.0
Sep-22	14,194.3	3.6	6.1
Oct-22	14,217.3	3.4	6.0
Nov-22	14,285.0	3.5	5.8
Dec-22	14,275.1	3.5	6.1
Jan-23	14,285.7	3.7	6.2
Feb-23	14,333.7	3.5	5.8

Source: '1.2 Labour Market', *Key Economic and Social Indicators*, Parliament of Australia, 13 April 2023, https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/MSB

a. Distinguish between structural and cyclical unemployment. 3 marks

b. With reference to the data in Figure 1 and Table 2 above, evaluate the extent to which the

Australian Government achieved its domestic macroeconomic goal of full employment
between February 2021 and February 2023.

6 marks

c. Outline **one** consequence for living standards if the unemployment rate is too low. 3 marks

Question 3 (17 marks)

FIGURE 2: AUSTRALIAN BUDGET AGGREGATES

Table 1.2: Budget aggregates

	Actual		Estimates				Total(a)	Projection
	2021-2	2022-23	2023-24	2024-25	2025-26	2026-27	2033-34	
	\$b	\$b	\$b	\$b	\$b	\$b	\$b	
Underlying cash balance	-32.0	4.2	-13.9	-35.1	-36.6	-28.5	-109.9	
Per cent of GDP	-1.4	0.2	-0.5	-1.3	-1.3	-1.0	-0.2	
Gross debt(b)	895.3	887.0	923.0	958.0	1,015.0	1,067.0		
Per cent of GDP	38.8	34.9	35.8	36.3	36.5	36.5	32.3	
Net debt(c)	515.6	548.6	574.9	620.6	665.2	702.9		
Per cent of GDP	22.3	21.6	22.3	23.5	24.0	24.1	19.9	

- a) Total is equal to the sum of amounts from 2022–23 to 2026–27.
- b) Gross debt measures the face value of Australian Government Securities (AGS) on issue.
- c) Net debt is the sum of interest-bearing liabilities (which includes AGS on issue measured at market value) less the sum of selected financial assets (cash and deposits, advances paid and investments, loans and placements).

Source: 'Statement 1' Budget Overview, *Budget 23-24*, Commonwealth of Australia, Page 7, 9 May 2023

- a. Describe one type of direct and one type of indirect tax, and explain each tax's impact on Australia's income distribution, in terms of whether it is a progressive, regressive, or proportional tax. 4 marks

Direct tax: _____

Indirect tax: _____

b. With reference to Figure 2 identify the stance of the 2023/24 Budget, justifying your conclusion. 3 marks

c. Identify and discuss two methods of financing a budget deficit. 5 marks

Method 1: _____

Method 2: _____

d. Analyse one strength and one weakness of using budgetary policy to achieve the goal of low and stable inflation (price stability). 5 marks

Strength: _____

Weakness: _____

Question 4 (10 marks)

TABLE 3: AUSTRALIA’S TERMS OF TRADE (TOT) (SEASONALLY ADJUSTED)

Quarter	Terms of Trade (TOT) (index points)
Dec 20	95.6
Mar 21	103.3
Jun 21	109.6
Sep 21	111.1
Dec 21	104.2
Mar 22	113.0
Jun 22	118.1
Sep 22	111.1
Dec 22	111.7

Source: '6.3 Terms of Trade', *Key Economic and Social Indicators*, Parliament of Australia, April 2023, https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/KESI

- a. With reference to Table 3, describe the trend in the Australia’s terms of trade from December 2020 to December 2022. 2 marks

- b. Explain how one factor may have influenced the trend in Australia’s terms of trade identified in part a. 3 marks

- c. Discuss how the trend in Australia's terms of trade identified in **part a** can influence the Australian Government's goal of strong and sustainable economic growth, and material living standards. 5 marks

Question 5 (14 marks)

Aggregate supply policies are used to complement aggregate demand policies in promoting non-inflationary economic growth over time.

- a. Analyse how immigration policy could be used to complement monetary policy in promoting non-inflationary economic growth. 8 marks

- b.** Explain the impact of an environmental policy on aggregate supply, intertemporal efficiency and living standards. 6 marks

END OF QUESTION AND ANSWER BOOK

Extra space for responses

Clearly number all responses in this space.

Economics Units 3 and 4 practice exam 2023

ANSWER SHEET FOR SECTION A

Student name: _____

Use a **pencil** for **ALL** entries. For each question, shade the box that indicates your answer. All answers must be completed like the example below.

1 B C D

Marks will **NOT** be deducted for incorrect answers.

NO MARK will be given if more than **ONE** answer is completed for any question.

If you make a mistake, **ERASE** the incorrect answer – **DO NOT** cross it out.

ONE ANSWER PER LINE

1. A B C D

2. A B C D

3. A B C D

4. A B C D

5. A B C D

6. A B C D

7. A B C D

8. A B C D

9. A B C D

10. A B C D

11. A B C D

12. A B C D

13. A B C D

14. A B C D

15. A B C D

Suggested answers

SECTION A: MULTIPLE-CHOICE QUESTIONS

Question	Answer	Question	Answer
1	C	9	D
2	A	10	A
3	C	11	C
4	A	12	D
5	A	13	C
6	D	14	B
7	A	15	A
8	C		

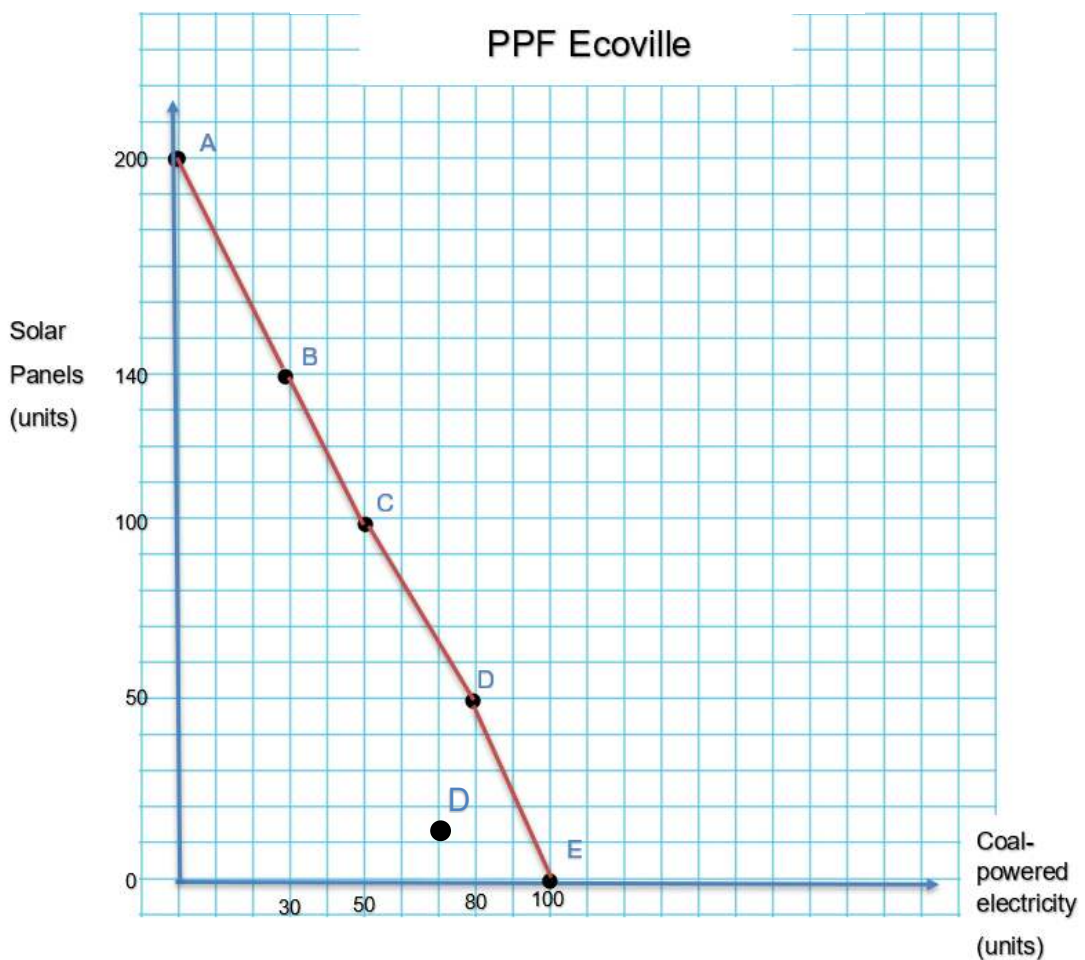
SECTION B: WRITTEN RESPONSES

Note: When making judgements about the quality of student answers to questions, teachers could be guided by some or all of the following factors (depending on the question): accuracy, relevance, completeness, breadth/depth of treatment, logic of connections, clarity, substantiation of claims, level of coherence.

Note: The following are suggested answers only.

Question 1 (12 marks)

- a. Referring to Table 1, construct a fully labelled production possibility frontier (PPF) model for the economy of Ecoville. 3 marks



Marking guide:

1 mark for correctly labelling each axis and providing a title for the diagram

1 mark for plotting each of the five points

1 mark for accurately drawing the PPF

- b. With reference to the PPF constructed in part a. above, explain how the PPF model illustrates the concepts of allocative and productive efficiency.

3 marks

The production possibility frontier (PPF) model demonstrates the production possibilities for the economy of Ecoville based on the assumption that the economy can only produce two products. The PPF demonstrates productive efficiency by demonstrating the maximum amount of solar panels and coal powered electricity that can be produced based on using all Ecoville's factors of production (natural, labour and capital) to their maximum efficiency assuming a given level of technology. All points (A-E) along the PPF can be described as being productively efficient. Allocative efficiency can be described as being achieved when no other combination would produce a higher level of living standards for the citizens of Ecoville. Only one point on the PPF can be described as being allocatively efficient (e.g. Point A). This point can only be determined by taking into consideration the needs and wants of all members of Ecoville.

Marking guide:

1 mark for accurately explaining how the PPF illustrates productive efficiency.

1 mark for accurately explaining how the PPF illustrates allocative efficiency.

1 mark for accurately referring to the PPF model in part a.

- c. **Explain how the production of coal powered electricity can be a cause of market failure for the Australian economy. In your response, identify the type of market failure caused.**

3 marks

Market failure occurs when the operation of the market fails to allocate resources in a way that maximises living standards for the citizens of an economy. The production of electricity by burning fossil fuels such as coal releases greenhouse gases into the atmosphere, and these contribute to increased adverse weather events, such as droughts, floods and bushfires in addition to causing damage to the natural environment as a consequence of rising sea levels. Third parties such as Australia's tourism and agricultural industries experience a cost (they are negatively impacted) despite not being a party to the transaction, resulting in the market failure of a negative externality. Because those who benefit from the burning of fossil fuels do not pay the full cost of the production, this results in an overallocation of resources to the production of coal powered electricity relative to the allocation that would maximise living standards.

Marking guide:

1 mark for demonstrating an understanding of market failure and identifying the market failure as a negative externality.

1 mark for explaining how coal powered electricity can cause negative externalities in production.

1 mark for explaining why the existence of negative externalities results in an overallocation of resources to the coal powered electricity market.

- d. **Explain one form of government intervention that could be used to address the market failure identified in part c.**

3 marks

The Australian government could implement production subsidies for 'green' energy alternatives such as wind and solar. The subsidy would act to reduce the costs of production for the green energy alternatives and increase the profitability of green power generation, encouraging more resources to be allocated to the greener substitutes. This would shift the

supply curve to the right and reduce the price of green energy. This would have the benefit of reducing resources allocated to the production of coal powered electricity and therefore the negative externalities associated with climate change.

Marking guide:

1 mark for describing a logical type of government intervention.

1 mark for explaining how the government intervention impacts on resource allocation.

1 mark for explaining how the negative externality of climate change is reduced.

Question 2 (12 marks)

a. Distinguish between structural and cyclical unemployment. 3 marks

Cyclical unemployment is caused by an insufficiency of aggregate demand causing the economy to not operate at full capacity, as occurs during troughs and recessions in the business cycle. During these times the derived demand for labour from production falls leaving surplus people unemployed as wage rates are unlikely to fall. Unemployment caused when there is a mismatch between the skills of the unemployed and the skills required by industry is referred to as structural unemployment. A key point of difference is that cyclical unemployment is caused by slower levels of spending in the economy (and only during particular periods in the business cycle), whereas structural unemployment is caused by the mismatch in the skills of available labour and what's required by firms which is independent of the level of expenditure in the economy and can happen at any stage in the business cycle.

Marking guide:

1 mark for demonstrating an understanding of structural unemployment.

1 mark for demonstrating an understanding of cyclical unemployment.

1 mark for describing a relevant point of difference.

b. With reference to the data in Figure 1 and Table 2 above, evaluate the extent the Australian Government achieved its domestic macroeconomic goal of full employment between February 2021 and February 2023. 6 marks

The Australian Government's domestic macroeconomic goal of full employment is to achieve the level of unemployment that exists when the government's economic growth objective is achieved and where cyclical unemployment is non-existent. This is estimated to be at the non-accelerating rate of unemployment (NAIRU) which is estimated to be around 4.25% - the lowest rate of unemployment possible without causes inflation to accelerate. In 2021 the Australian economy was recovering from the COVID-induced recession of 2020. On the demand side, government stimulus continued to support the economy while growth in consumers spending returned. At the same time, the impact of disruptions to Australia's skilled migration program meant significant labour shortages were being experienced in many industries. This was reflected in a falling unemployment rate from 5.8% in February 2021 to 4% in February 2022. At the same time, the underemployment rate also fell - from 8.4% in February 2021 to 6.6% in February 2022. This data suggests that, at that time, the Australian economy had reached full employment.

Since February 2022, the labour market has remained tight. Although emergency government stimulus has reduced, strong consumption expenditure and export incomes have continued to support aggregate demand, while the slow return of skilled migrants has maintained a tight labour market. This very tight labour market was reflected in the

unemployment rate falling to 3.5% by February 2023, alongside the underemployment rate falling to 5.8% over the same period. As the unemployment rate is below the government's target, and there has been an acceleration of inflation over the period, it can be concluded that the goal of full employment was not achieved in 2023.

Marking guide:

1 mark for demonstrating an understanding of the goal of full employment.

1 mark for reference to relevant factors influencing the labour market between February 2021 and February 2023.

2 marks for accurately using data from Figure 1 and Table 2 to conclude that the goal of full employment had been achieved between February 2021 and February 2022.

2 marks for using data from Figure 1 and Table 2 to conclude that the goal of full employment was not achieved between February 2022 and February 2023.

c. Outline one consequence for living standards if the unemployment rate is too low. 3 marks

An unemployment rate below the NAIRU would likely be accompanied by both unacceptable levels of demand and cost pressures on inflation (as producers bid up wages to attract relatively scarce employees in a tight labour market). This would lead to high inflation, which is associated with the loss of purchasing power for those individuals whose income does not keep up with the inflation rate. Loss of purchasing power leads to a reduction in the ability to purchase goods and services and therefore a fall in material living standards for affected individuals.

Marking guide:

1 mark for accurately identifying a consequence of the unemployment rate being too **low**

2 marks for making a logical connection between too-low unemployment, high inflation, loss of purchasing power and reduction in material living standards.

Question 3 (17 marks)

a. Describe one type of direct and one type of indirect tax, and explain each tax's impact on Australia's income distribution, in terms of whether it is a progressive, regressive, or proportional tax. 4 marks

A direct tax is a tax that is usually incurred on the income of economic agents. In Australia, individual taxpayers are required to pay income tax on taxable income earned during a financial year. The impact of the tax is progressive in nature as the marginal tax rates increase as the taxable income increases. Therefore, those individuals deriving a higher taxable income will be taxed at a higher marginal rate as their income increases. This has the effect of reducing income inequality as high-income earners will pay a higher proportion of their income as tax than lower income earners.

The Goods and Services Tax (GST) is an example of an indirect tax paid by all consumer on the purchase of most goods and services. Other than for a few exclusions, all goods and services are levied with the same 10% tax regardless of the income of the consumer. This causes the GST to have a regressive impact on income distribution as lower income earners pay a larger proportion of their income in GST than those on a higher income.

Marking guide:

2 marks for description of one type of direct tax, identification of whether it is progressive or proportional, and a logical explanation of the impact on Australia's income distribution.

2 marks for description of one type of indirect tax, identification that it is regressive, and a logical explanation of the impact on Australia's income distribution.

- b. With reference to Figure 2, describe the stance of the 2023/24 budget, justifying your conclusion. 3 marks**

The stance of the 2023/24 budget could be described as expansionary in its impact on aggregate demand in comparison to the previous period, meaning it will create more demand across the economy than would otherwise occur. The underlying cash balance for 2023/24 is estimated to be a deficit of \$13.9b which is greater than the estimated 2022/23 budget surplus of \$4.2b highlighting that the Australian Government is increasing its stimulus to the economy by \$18.1b or -0.2% to 0.5% of GDP.

Marking guide:

1 mark for accurately describing the budget deficit for 2023/24.

1 mark for describing the stance of the budget as expansionary relative to the previous period.

1 mark for accurate use of relevant statistics from Figure 2.

- c. Identify and discuss two methods of financing a budget deficit. 5 marks**

The government or Treasury can borrow from overseas. This would involve the Federal Government selling Australian Government Securities (AGS) to overseas investors. This adds to Australia's public foreign debt, as well as increasing overseas interest payments. This will worsen Australia's primary net incomes deficit and worsen the current account balance. It can also cause the Australian dollar to appreciate, due to increased demand for AUD on the foreign exchange market, to enable overseas buyers to purchase the AGS. However, this method does avoid creating the issue of 'crowding out' for Australian firms and households.

The government could also borrow from the Australian public via the financial sector by selling AGS to domestic investors. This possibility is a fairly sound method a financing a deficit, since the money is withdrawn from the economy's private sector by the sale of government securities and is usually returned when the government uses the money to fund its budget outlays. However, this approach could put pressure on domestic interest rates because the government is also competing against the private sector for access to limited savings. In turn interest rates may cause 'crowding out' and depress private sector borrowing, investment spending and economic activity.

Marking guide:

1 mark for identification of two methods of financing a budget deficit

2 marks (x2) for a logical discussion of an advantage and disadvantage of financing a budget deficit through either selling AGSs to either overseas investors, domestic investors or the RBA

- d. Analyse one strength and one weakness of using budgetary policy to achieve the goal of low and stable inflation (price stability). 5 marks**

The goal of low and stable inflation entails achieving an increase in average prices (as measured by the Consumer Price Index) by between 2% to 3% on average over time. A strength of using budgetary policy to achieve the goal is that budgetary policy can have a relatively short impact lag. For example, as the economy increases in strength and aggregate demand increases this reduces cyclical unemployment and therefore increases income in the

economy. To counter this, the automatic stabilisers in the budget work to slow aggregate demand and increase the leakages in the economy via taxation, while reducing injections of welfare payments. This can assist to slow demand inflation and assist the government to achieve its low inflation goal. This makes it more effective than monetary policy, which can experience a delay of up to 2 years in terms of its full impact on AD and inflation.

However, one weakness of budgetary policy in achieving the goal of low inflation is its relatively long implementation lag. In comparison to monetary policy, which is reviewed monthly, the Australian budget is usually only announced on an annual basis making it slow to respond to changes in inflation. Policies to slow growth in demand inflation such as tax increases and cuts to government spending may take some time to be implemented (via parliamentary legislation), and then take further time to have an impact on the inflation rate. They may, in fact, become pro-cyclical in their impact due to a length of time required to implement them, ultimately accelerating aggregate demand, and making it more difficult to achieve the low inflation target.

Marking guide:

1 mark for demonstrating an understanding of the goal of low and stable inflation (price stability)

2 marks for a logical explanation of a relevant strength of budgetary policy in achieving the goal of low inflation

2 marks for a logical explanation of a relevant weakness of budgetary policy in achieving the goal of low inflation

Question 4 (10 marks)

- a. With reference to Table 3, describe the trend in the Australia’s terms of trade from December 2020 to December 2022. 2 marks**

Table 3 above shows that Australia’s terms of trade trended upwards between December 2020 and December 2022, representing an increasing in Australia’s average export prices relative to average import prices over the period. The improvement in the TOT index was from 95.6 index points in the December 2020 quarter to 111.7 index points in the December 2022 quarter.

Marking guide:

1 mark for highlighting an increase in Australia’s TOT

1 mark for supporting the description of the trend with relevant data from figure 5

- b. Explain how one factor may have influenced the trend in Australia’s terms of trade identified in part a. 3 marks.**

Over the past two years Australia’s major exports of minerals such as coal, iron ore and natural gas have experienced a significant increase in price driven by a combination of strong demand and weak supply side conditions. The rise in commodity prices has been driven the demand side by China’s growth in demand for iron ore and other raw materials, while, since early 2022 the Russian invasion of Ukraine and subsequent war has disrupted supply chains for commodities such as crude oil, natural gas, coal and wheat, which also contributed to rising prices. The net result has been upward pressure on the export price index leading to upward pressure on Australia’s terms of trade.

Marking guide:

1 mark for identifying a relevant factor positively influencing Australia's TOT

2 marks for logically explaining how the relevant factor either increases the export price index or decreases the import price index

- c. Discuss how the trend in Australia's terms of trade identified in part a. can influence the Australian Government's goal of strong and sustainable economic growth and material living standards. 5 marks**

An increase in Australia's terms of trade driven by an increase in commodity prices is compatible with the achievement of the 'strong' component of the goal of strong and sustainable economic growth, which is to achieve the highest rate of economic growth possible without causing unacceptable inflationary, external or environmental pressures. It's estimated this would be achieved when there is growth in real GDP of 3% to 3.5% p.a. An increase in Australia's terms of trade would be linked to an increase in export incomes as exporters, *ceteris paribus*, would generate greater profits and therefore households would benefit from increased wage and dividend incomes. This would lead to an increase in consumption, investment and export incomes and therefore an increase in aggregate demand, reduction in inventories, increased derived demand for factors of production and economic growth. *Ceteris paribus*, this would lead to both an increase in employment and real GDP per capita for Australians leading to an increase in material living standards as they gain increased access to goods and services.

However, strong increases in economic growth can lead to both unacceptable inflationary pressure and resource depletion. For example, inflation is currently at an unacceptable rate of 7.8% which is well above the acceptable range of 2% to 3% p.a. on average over time. The additional income generated from the sale of commodities is contributing to this problem, as aggregate supply struggles to meet growth in aggregate demand. Additionally, the sale of significant quantities of finite natural resources could arguably lead to unsustainable growth if the proceeds from sale are not reinvested into industries that can support the generation of income for future generations. In both of these instances, material living standards can fall for the current generation due to loss of purchasing power for those individuals unable to benefit from the growth in sales revenue from commodity exports. Additionally future generations could suffer a loss of material living standards if alternative forms of export income are not created by the windfall from the sale of finite natural resources.

Marking guide:

2 marks for logical discussion of how an increasing TOT can positively impact on the 'strong' element of the goal of strong and sustainable economic growth.

2 marks for logical discussion of how an increasing TOT can adversely impact on the 'sustainable' element of the goal of strong and sustainable economic growth.

1 mark for a logical discussion of how an increasing TOT can impact upon material living standards.

Question 5 (14 marks)

- a. Analyse how skilled immigration policy could be used to complement monetary policy in promoting non-inflationary economic growth. 8 marks.**

Australia's skilled immigration program in concert with monetary policy can operate to achieve non-inflationary economic growth over time.

Australia's skilled migration program involves priority being given to overseas immigrants

with the desired skills that are deemed to be in demand by Australian industries, but which cannot be satisfied by the existing labour force. By providing visas to these migrants, this helps to increase the supply of labour and therefore put downward pressure on labour costs for industries that are suffering from a shortage of supply. For example, in response to past shortages of skilled labour in the mining industry, Australia's skilled migration program prioritises those individuals with those requisite engineering and related skills. This benefits the industry as it helps to lower wage costs and therefore improve the competitiveness of these firms and in some cases allow certain projects to commence, hence increasing Australia's productive capacity and overall aggregate supply. Ultimately reduced wage growth can reduce pressure on cost push inflation.

Immigration policy can act complementary to monetary policy in its attempt to achieve its goal of low inflation which in CPI growth of 2% - 3% on average, over time. The operation of monetary policy is aimed at managing aggregate demand. During periods of rapid growth (during the expansionary and boom phases of the business cycle), monetary policy acts to dampen down inflationary pressure by reducing aggregate demand, and the reverse is the case when the economy is entering a contractionary phase or during a decrease in economic activity. Monetary policy works to stimulate or slow aggregate demand via the conventional use of the cash rate target and the transmission mechanism channels. For example, during a period of high inflation, the RBA can lift the cash rate target to decrease the discretionary income of existing borrowers with variable interest rate loans, which helps to slow consumption expenditure and aggregate demand, reducing demand inflationary pressures.

Because skilled immigration enhances the productive capacity of the Australian economy, it can be used to complement monetary policy in achieving non-inflationary growth. Through expanding the supply side of the economy, skilled immigration enables growth in aggregate demand to occur without significant inflationary pressures. And during times of excessively rapid expansion of demand or insufficient demand, the RBA can use monetary policy to influence the level of demand to ensure that the level of aggregate demand does not exceed Australia's aggregate supply and therefore assist the achievement of non-inflationary economic growth over time.

Marking guide:

3 marks – for making a logical analysis of how Australia's skilled migration program operates to lower costs of production, increase the quantity and quality of Australia's labour force, productive capacity, and aggregate supply.

1 mark for linking increased aggregate supply to lower cost inflation to assist in the promotion of non-inflationary economic growth.

3 marks for making logical analysis of how conventional monetary policy alters the target cash rate to influence the transmission mechanisms in order to smooth high or low levels of aggregate demand.

1 mark for adequately explaining how the two policies can complement each other to achieve non-inflationary economic growth.

b. Explain the impact of an environmental policy on aggregate supply, intertemporal efficiency and living standards. 6 marks

Australia's Recycling Modernisation Fund (RMF) is an environmental policy aimed at improving Australia's capacity to manage recyclable waste and ultimately avoid recyclable waste from entering landfill. The RMF encourages more products to be reused, recycled, and remanufactured in order to support the circular economy. This has the benefit of improving Australia's intertemporal efficiency as arable land and other recyclable inputs can continue to be available for future generations.

The RMF works through the Australian and State and Territory governments providing financial support to businesses to support investment in new infrastructure to recycle materials such as glass, paper and mixed plastic. By providing financial support through grants and other financial support this can ultimately reduce the cost to recycle waste materials, therefore providing for cheaper inputs for Australian producers. Additionally, this can provide more arable land for farming and other uses that would otherwise be used for landfill. This can increase Australia's productive capacity as lower production costs will increase the willingness and ability of firms to produce, leading to an increase in aggregate supply. Living standards can be positively impacted as more land and inputs will be available to produce goods and services in the future while non-material living standards will be supported as individuals will be able to enjoy the benefits of a less damaged natural environment.

Marking guide:

2 marks for outlining the operation of a relevant Australian environmental policy

2 marks for explaining the impact of the environmental policy on aggregate supply and intertemporal efficiency

2 marks for explaining the impact on living standards

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