VCE® ECONOMICS

Practice Written Examination

SOLUTIONS

Solution Pathway

Section A – Multiple-Choice Questions (15 marks)

	A	B	C	D
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**

Section B: Written Responses (65 marks)

Below are sample answers. Please consider the merit of alternative responses.

Question 1 (16 marks)

Graph 1: Annual change in Gross Domestic Product (GDP)

a. **Referring to the above graph, describe the current phase of Australia's business cycle.**

3 marks

- **1 mark** for an accurate reference to the graph.
- **2 marks** for high level description of the contractionary phase of the business cycle with reference to slowing economic growth, rising unemployment and fall demand inflation.

Sample high level response:

As demonstrated by the graph, towards the end of 2022 the Australian economy began to experience a slight slowdown in economic activity as measured by real GDP growth as the rate of growth quickly slowed from 5.9% to 2.7% for the year ended 31 December 2022. A slowdown in growth would be associated with the contractionary phase of the business cycle which usually coincides with rising levels of cyclical unemployment and slowing levels of demand inflation.

b. **Explain how one domestic aggregate demand and one global aggregate demand factor that may have contributed to the current phase of Australia's business cycle identified in Part a.**
4 marks

- **1 mark** for outline of relevant domestic aggregate demand (AD) factor.
- **1 mark** for logical explanation of how the domestic AD factor influenced AD, rate of Australia's economic growth and the business cycle.
- **1 mark** for outline of relevant global aggregate demand (AD) factor.
- **1 mark** for logical explanation of how the global AD factor influenced AD, rate of Australia's economic growth and the business cycle.

Sample high level response:

Domestic aggregate demand factor – Consumer confidence

Falling levels of consumer confidence during 2022 may have been a significant factor in slowing aggregate demand and leading to a contractionary phase of the business cycle. Consumer confidence measures household expectations of income, job security and inflation. The measure also indicates consumer willingness to purchase local and imported goods. As the measure deteriorated in 2022 to historically low levels this is likely to have reduced household consumption and investment expenditure leading to a slowdown in aggregate demand, resulting in the business cycle becoming contractionary.

Global aggregate demand factor – Rates of Growth in Overseas economies

A slowdown in rates of economic growth in Australia's major trading partners such as China, Japan and South Korea can have negative impacts on aggregate demand. For example, a reduction in production in China can lead to a reduced derived demand for Australian iron ore exports which can then lead to a reduction in aggregate demand.

Overall, a slowdown in the growth of consumption, investment and export expenditure can lead to a slowdown in aggregate demand and ultimately the rate of production in the Australian economy as measured by the percentage change real GDP which is congruent with the contractionary phase of the business cycle.

c. **Evaluate the extent to which the government has achieved the goal of strong and sustainable economic growth in the past two years.** **5 marks**

- **1 mark** for demonstrating an understanding of the goal of strong and sustainable economic growth.
- **2 marks** for a logical evaluation concluding that the 'strong' element of the goal of strong and sustainable economic growth had been achieved.
- **2 marks** for a logical evaluation concluding that the 'sustainable' element of the goal of strong and sustainable economic growth had not been achieved.

Sample high level response:

The Government's goal of strong and sustainable economic growth refers to the highest rate of economic growth possible without causing unacceptable levels of inflationary, external, and environmental pressures (approximately 3 – 3.5% p.a.). Over the past two years the Australian economy has bounced back strongly from the Covid induced recession of 2020. An average growth rate of 10.3% was reached in June 2021 before dropping back to a range of between 2.7% to 5.9% over the past two years. It can therefore be concluded that to a large extent the goal of strong economic growth has been achieved over the past two years. However, during this time period inflationary pressures have become apparent. The consumer price index (CPI) has steadily risen from 3.8% for the year ended 30 June 2021 to an unacceptable 7.8% by the year ended 31 December 2022. This suggests although the economy has grown at a strong rate of economic growth this could not be described as sustainable as apparent from the inflationary pressures that have become apparent as the economy reaches its productive capacity and therefore the goal has not been achieved over this time period.

d.   Discuss the consequences of low rates of economic growth on material living standards.

4 marks

- **2 marks** for a logical discussion of an advantage of low rates of growth for material living standards.
- **2 marks** for a logical discussion of a disadvantage of low rates of growth for material living standards.

Sample high level response:

Low rates of economic growth could be described as growth rates below the desirable 3% to 3.5% growth in real GDP. Low rates of growth are associated with lower levels of production and consequently rising levels of cyclical unemployment. As unemployment rises, impacted individuals suffer a reduction in incomes as they fall from an earned income to reliance on the much lower JobSeeker transfer payments as a source of income. This loss of income leads to a reduction in purchasing power and therefore lower material living standards for affected households.

Slowdown in production can be associated with a reduction in pollution associated with the production of particular goods and services. For example, relatively lower rates of growth may mean less demand for energy produced from fossil fuels and therefore the release of greenhouse gasses into the atmosphere. A reduction in greenhouse gasses will help slow the damaging impacts of climate change which are associated with rising temperatures and more frequent damaging natural disasters such as cyclones, droughts, floods, and bushfires. All of which can help to limit damage to the natural environment, as well as the productive capacity of the economy, making it less difficult for rates of economic growth to be achieved that can maintain or increase material living standards.

Question 2 (27 marks)

a. Distinguish between progressive and regressive taxes. Use examples in your response.

3 marks

- **1 mark** for demonstrating an understanding of progressive taxes with a logical example.
- **1 mark** for demonstrating an understanding of regressive taxes with a logical example.
- **1 mark** for a logical point of difference.

Sample high level response:

Progressive taxes can be described as taxes that have the impact of reducing income inequality amongst the citizens of an economy. Income tax is an example of a progressive tax as the marginal tax rates increase as an individual's taxable income increases. Alternatively regressive taxes have the opposite impact, whereby their imposition increases income inequality amongst members of an economy. Goods and Services Tax (GST) is an example of a regressive tax as high income earners pay a proportionately smaller amount of their income as tax than low income earners. The main point of difference is that progressive taxes reduce income inequality whereas regressive taxes have the opposite impact.

b. Explain the role of one automatic stabiliser and one discretionary stabiliser in influencing aggregate demand and the rate of economic growth in the past two years.

6 marks

- **1 mark** for demonstrating an understanding of an automatic stabiliser.
- **2 marks** for a high level, logical explanation of how the automatic stabiliser has influenced aggregate demand and economic growth in the past two years.
- **1 mark** for demonstrating an understanding of a discretionary stabiliser.
- **2 marks** for a high level, logical explanation of how the discretionary stabiliser has influenced aggregate demand and economic growth in the past two years.

Sample high level response:

Australia's income tax system is an example of an automatic stabiliser that has influenced Australia's aggregate demand and rate of economic growth. In the past two years Australia has experienced a significant reduction in its unemployment rate, falling from 5.8% in March 2021 to a record low of 3.5% in February 2023. This has resulted in a significant increase in newly employed individuals shifting from receiving JobSeeker to an earned income. This increase has resulted in an increase in taxable income and therefore income tax receipts representing a leakage from the circular flow of income. Ceteris paribus, an increase in taxation collections should place downward pressure on consumption and investment expenditure acting to moderate the growth in aggregate demand because of the increase in earned incomes. Slower aggregate demand should put upward pressure on inventories, decrease in derived demand for factors of production and ultimately slow the rate of output, putting downward pressure on the rate of economic growth.

A discretionary stabiliser introduced in the 2022/23 Budget was the extension of the low-to-middle income earner tax offset (LMITO) by $420 so that it is now worth up to $1500 for individuals and $3,000 for households. This discretionary stabiliser was a deliberate policy announcement and worked to increase the household disposable incomes of taxpayers, which could then support consumption and investment expenditure. Therefore, these measures supported Australia's aggregate demand, leading to a decrease in inventories, increase in demand for factors of production and ultimately an increase in output that would have put upward pressure on the rate of economic growth.

c.   Identify the stance of monetary policy in 2023. Justify your response.   2 marks

- **1 mark** for describing the stance as contractionary or neutral.
- **1 mark** for justification relative to the neutral range using relevant statistics.

Sample high level response:

The RBA has arguably adopted a slightly contractionary stance by March 2023. From May 2022 the RBA has rapidly lifted its cash rate target from the ultra-low 0.1% to 3.6% which is slightly above what's considered neutral stance at around 3% to 3.5%.

d.   Analyse the strengths and weaknesses of monetary policy in 2023 in achieving the goal of low inflation.   6 marks

- **1 mark** for identification of a relevant strength of monetary policy.
- **2 marks** for logical analysis of the strength of monetary policy.
- **1 mark** for identification of a relevant weakness of monetary policy.
- **2 marks** for logical analysis of the weakness of monetary policy.

Sample high level response:

In the past 12 months monetary policy has been applied to slow aggregate demand in the Australian economy in an effort to curb high levels of inflation that are exceeding the RBA's target of 2% to 3% p.a. increase in the CPI on average over time.

A strength of monetary policy is its short implementation lag. The ability of the RBA to meet monthly, assesses available economic data and then alter the cash rate target allows the RBA to quickly signal to the economy its intention to target high levels of inflation. This then allows commercial banks and other financial institutions to quickly pass on higher interest rates to its borrowers. The short implementation lag is much quicker than budgetary and aggregate supply policies which are generally only announced on an annual basis.

A weakness of monetary policy is that although it has a relatively short implementation lag it has a relatively long impact lag, meaning that it can take up to two years for the full effect of any target cash rate decision to fully impact the Australian economy. This means there is a risk that decisions taken in 2023 to slow inflation may overshoot the mark and cause the policy to become 'pro-cyclical' in 2024 and

contribute to a slowdown in economic activity and rising unemployment should the Australian economy grow at a slower rate than expected.

e. **Explain how one aggregate supply policy can complement aggregate demand policies to promote non-inflationary economic growth over time.** **4 marks**

- **1 mark** for identification of a relevant aggregate supply policy.
- **2 marks** for logical explanation of how the policy operates to increase aggregate supply.
- **1 mark** for linking higher levels of AS to a higher rate of non-inflationary economic growth.

Sample high level response:

Investment in training and education is an aggregate supply policy that can improve the productivity of the Australian economy in the medium- to long-term. For example, through funding an additional $2.8 billion to support Australian apprenticeships in the 2022–23 Budget, this aims to improve the quality and quantity of skilled workers in the labour force. This can improve productivity, place downward pressure on labour costs and overall increase the productive capacity of the economy and as a result increase Australia's aggregate supply. Improvements in aggregate supply can place downward pressure on cost inflation, assisting to reduce overall inflationary pressures in the economy. This can allow aggregate demand policies to stimulate aggregate demand and therefore economic growth to a higher rate before inflationary pressures emerge.

f. **Discuss the short-term and long-term impacts of the government's policy of trade liberalisation on the government's goal of full employment and material living standards.** **6 marks**

- **3 marks** for a high level of logical discussion of short-run impacts of trade liberalisation on the goal of full employment and living standards.
- **3 marks** for a high level of logical discussion of long-run impacts of trade liberalisation on the goal of full employment and living standards.

Sample high level response:

Trade liberalisation is the government policy aimed at promoting free trade through the reduction of trade barriers such as tariffs, subsidies, quotas, and other trade restrictions.

In the short term, a reduction in trade barriers will expose domestic firms to increased levels of international competition. This will force local exporters and import competing firms to improve levels of productivity to remain profitable in the wake of increased competition. Firms that are unable to adapt may go bankrupt leading to rising levels of structural unemployment for effected employees. These employees will likely face a reduction in material living standards as they rely on JobSeeker transfer payments rather than an earned income. On the other hand, increased levels of international competition can lead to lower prices for consumers and therefore an improvement in their purchasing power which can contribute to positive material living standard changes.

In the long run, resources in the economy should be reallocated to internationally competitive industries that will be able to sell goods and services into an international marketplace. These firms will likely expand and require additional labour resources helping to assist in the achievement of the goal of full employment being the lowest rate of unemployment possible without the creation of unacceptable inflationary pressures. In addition to creating employment, internationally competitive firms will also contribute to society through taxation on profits which can be used by the government to provide public goods and services to improve material living standards for the population.

Question 3 (9 marks)

Month	US cents per $Aus
Mar-22	74.8
Apr-22	71.5
May-22	71.9
Jun-22	68.9
Jul-22	70.1
Aug-22	69.0
Sep-22	65.0
Oct-22	64.2
Nov-22	67.0
Dec-22	67.8
Jan-23	70.4
Feb-23	67.3

Source: https://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/KESI

    a.   **Referring to the table, describe the trend in the A$/US$ from March 2022 to February 2023.**
           2 marks

- **1 mark** for describing the declining trend in the A$ v US$.
- **1 mark** for relevant use of statistics from the table.

Sample high level response:

From March 2022 to February 2023 there has been a depreciation in the Australian dollar (A$) relative to the US dollar (US$). The A$ has fallen from 74.8c to 67.3c.

b.   Referring to the trend identified in Part a., explain how two factors from the past year could have contributed to the trend.   4 marks

- **1 mark** for describing a relevant factor influencing the A$/US$ from the past year (x2).
- **1 mark** for logical explanation of how the factor contributed to the trend in **Part a** (x2)**.**

Sample high level response:

Relative interest rates refer to the differential between Australian interest rates and the rest of the world. In the past year the United States has increased interest rates in an effort to slow inflationary pressures in the US. As US interest rates have risen higher than that of Australian rates of interest, this has meant Australian and US investors are less inclined to invest in Australian debt securities and more inclined to invest in higher yielding US debt securities. The result is net capital outflow from Australia leading to downward pressure on the A$.

A small slowdown in prices of some of Australia's commodity exports in the second half of 2022 can also contribute to a fall in Australia's terms of trade, which is another factor that could contribute to the depreciating trend. Falling commodity export prices can lead to reduced value of Australian exports and therefore reduced demand for A$ leading to downward pressure on the A$.

c. **Explain how the trend identified in Part a. may impact on Australia's international competitiveness.**   **3 marks**

- **1 mark** for demonstrating an understanding of international competitiveness.
- **2 marks** for explaining how a depreciation in the A$ v US$ will improve the price competitiveness of Australian exporters.

Sample high level response:

A depreciation of the Australian dollar against one of Australia's major trading partners and a currency in which Australia exporters sell a significant proportion of its exports will be beneficial for Australia's international competitiveness. Depreciation of the A$ will make Australian exports denominated in US$ relatively cheaper and therefore improve the price competitiveness of Australian exports when competing against overseas firms. Additionally, Australian firms repatriating income earned in US dollars will receive a windfall when converting back to Australian dollars and therefore make Australian exporters more profitable.

Question 4 (13 marks)

a. **Referring to the above, identify and outline one non-price demand factor that may have impacted the market for salmon.**   **2 marks**

- **1 mark** for identifying changing consumer preferences and tastes as the relevant demand factor.
- **1 mark** for describing the increase in demand for salmon at all prices.

Sample high level response:

The change in consumer preferences and tastes towards salmon and away from red meat alternatives would have increased demand for salmon at all price levels.

b. **Construct a demand and supply diagram to illustrate the impact of the change in one non-price demand factor on the equilibrium price and quantity for salmon.**   **3 marks**

- **1 mark** for accurately labelling the demand and supply diagram (including title, axis, and curves).
- **1 mark** for drawing a shift to the right in the demand curve (D1 to D2).
- **1 mark** for accurately labelling the new higher equilibrium price (P2) and quantity (Q3).
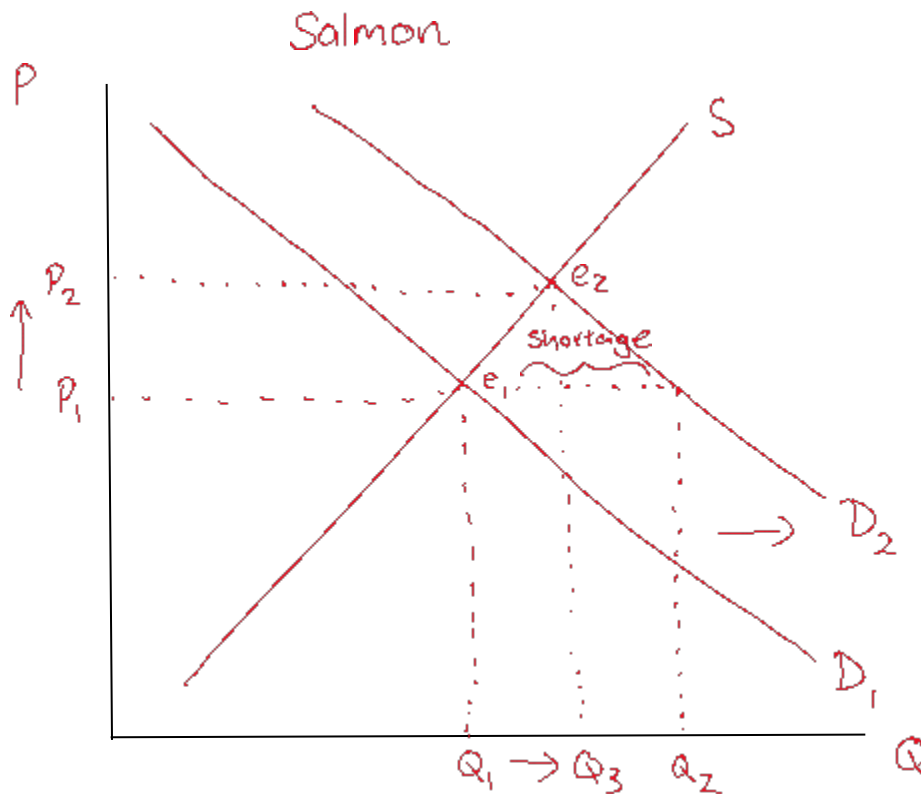
c. **Explain the impact of the change in equilibrium price and quantity in the salmon market as identified in Part a. Analyse the impact of the change on relative prices and resource allocation in the Australian economy.**   **5 marks**

- **1 mark** for explaining a how a change in a non-price factor of demand has caused a shortage at the original price (Q2 to Q1).
- **1 mark** for explaining how sellers react to a shortage by increasing the price of salmon at all price levels and for explaining how buyers react to the higher price by decreasing quantity demanded (along demand curve).
- **1 mark** for identifying a higher equilibrium price and quantity (P2Q3).
- **2 marks** for analysing how the higher relative price for salmon signals to producers to reallocate more resources to the production of salmon relative to beef and lamb in order to maximise profitability.

Sample high level response:

An increase in demand for salmon at all prices would cause a shift in the demand curve to the right (D1 to D2) leading to a shortage at the initial price level of P1. Salmon sellers would respond to the shortage by raising the price in order to maximise revenue and clear the shortage. Buyers would react to the higher price by reducing quantity demanded along the D2 curve. Quantity demanded and supplied would ultimately converge at the new higher equilibrium price and quantity (P2Q3). The increased profitability of the salmon market, as signalled by the higher relative price for salmon, would attract more economic resources (natural, labour and capital) to the salmon industry and away from relatively less profitable industries such as beef and lamb.

d. **Explain how the Australian salmon industry could cause market failure in the Australian economy.**   **3 marks**

- **1 mark** for demonstrating an understanding of market failure.
- **2 marks** for a high level explanation of how negative externalities may cause an overallocation of resources to the salmon industry leading to market failure.

Sample high level response:

Market failure occurs in the Australian economy when resources are allocated in a such a way that it fails to maximise living standards. In the salmon industry this may occur due to the existence of negative externalities impacting on third parties because of the farming of salmon. As outlined above, governments have become concerned that intensive salmon farming has contributed to water pollution that could negatively impact on third parties such as the local tourism industry and other users of the marine environment. Consequently, as salmon farmers are not currently required to take into consideration the negative impacts (costs) of production there could be an overallocation of resources to the industry leading to market failure.