COMMERCE PRESENTATIONS AND PUBLICATIONS

VCE ECONOMICS UNIT 3/4

CPAP Practice examination B 2024

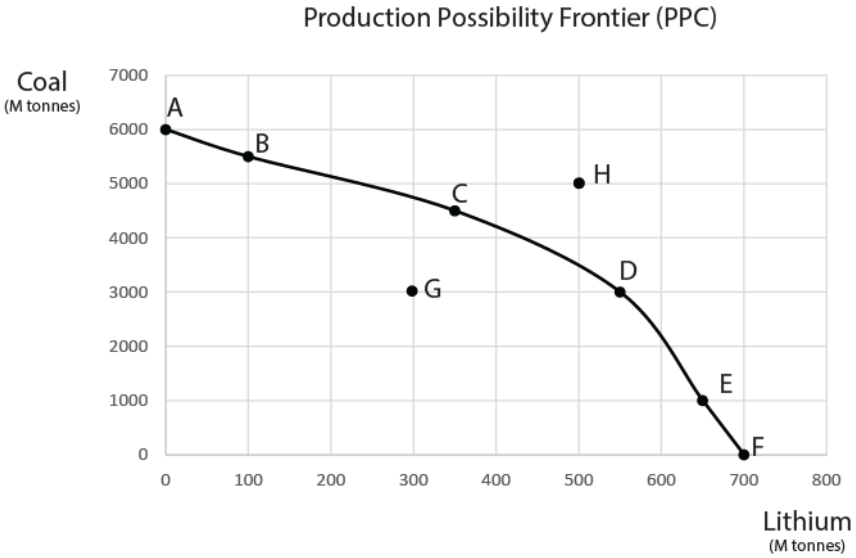
SUGGESTED RESPONSES, MARKING SCHEME AND ADVICE

Answers to MC questions

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 A

Question 1



Analyse the diagram/model above and determine which of the following statements is inaccurate.

A. Production taking place at Point G is inefficient and production at point H is currently unattainable
B. The opportunity cost of moving from D to C are the net benefit(s) associated with the foregone production of 1500 tonnes of coal
C. Given that lithium is used in battery production, the push towards renewable energy that results in a movement away from point A and towards point F is both intertemporally efficient and allocatively efficient
D. An economy can produce at point H if the quality and quantity of factors of production increases over time

The first key knowledge point in the Study Design is the requirement for students to demonstrate an understanding of the concept of opportunity cost and the production possibility frontier (PPF) model. This includes questions 1 and 13 of the 2023 exam. In relation to Question 1 (re opportunity cost), students were afforded the rare luxury of two correct answers (97% of students were rewarded). In relation to Q13, 62% of students selected the correct response, where they were required to analyse the implications attached to a move from a point like point G on the above diagram to a point on the PPF. The current question is slightly more difficult, with ***option B the best response*** *because it is the only inaccurate statement – when moving from D to C it is lithium production that is being foregone (200 tonnes of lithium). All other options are accurate statements.*

Question 2
Which of the following is likely to have an effect on aggregate supply that is different to the other three?

A. An increase in the skilled migration intake
B. An increase in the labour force participation rate
C. A decrease in personal income tax rates
D. An increase in government regulations

The Study Design requires students to understand the operation of aggregate supply policies in improving supply-side conditions through their impact on the quantity and quality of the factors of production, the costs of production and productivity, and the effect on Australia's international competitiveness, productive capacity and aggregate supply. ***Option D is the best response*** *because any increase in government regulations is likely to impose greater burdens on businesses, which effectively increases the cost of production and reduces the willingness to supply (in aggregate). All other options will tend to increase aggregate supply by increasing the quantity and/or quality of the factors of production. With respect to option A, an increase in skilled migration will help to boost both the quality and quantity of human capital. With respect to option B, an increase in the LFPR will tend to increase the quantity of human capital. With respect to option C, a decrease in personal income tax rates will tend to increase the incentives for workers to*

increase intensity of effort at many workplaces (raising productivity and the quality of human capital) as well as encourage others to (re) enter the labour force (raising the quantity of human capital).

Question 3

Which of the following is most likely to be associated with government intervention that has had negative consequences for efficiency?

A. Excessive rises in the indirect taxes on tobacco
B. The incidence of transactions that have been undertaken on the basis of asymmetric information
C. Excessive production of goods that are associated with negative externalities
D. Excessive use of common access resources

The current Study Design requires students to have knowledge of one example of government intervention in markets that unintentionally leads to a decrease in one of allocative, productive, dynamic or intertemporal efficiency. There was no question on the 2023 exam testing this part of the course and this key knowledge was assessed only twice during the life of the previous Study Design, first in 2017 (Q1c) and again in 2022 (Q4d). In both instances, the question was basically a repeat of the key knowledge point from the Study Design, which deliberately gave students scope and choice to focus on any example they had covered during the year. Importantly, only 36% of students achieved full marks for that question in 2017 and only 25% in 2022, with the majority of students demonstrating an inability to move beyond a discussion of the unintended consequence. In the event that Part B of the 2024 examination attempts to test this part of the course, it is important that students are prepared to make the concrete link to at least one type of economic efficiency in order to achieve full marks. Indeed, this point was made in the 2022 Examination Report, where students were advised 'to identify a relevant form of government intervention in markets and then explain how the intervention leads to a reduction in at least one type of economic efficiency'. In relation to the current question, ***option A is the best response*** *because the growing excise on tobacco has caused the relative price of cigarettes to increase by so much that it has encouraged illegal/black market activity (in foreign tobacco from parts of Asia – sometimes called chop chop) that has had undesirable/unintended consequences for allocative efficiency (e.g. criminal activity has increased as evidenced by the prevalence of arson attacks at tobacco stores). All other options are examples of market failure rather than government failure. In this respect, a specific knowledge of the unintended consequences associated with rising excise on tobacco was not required to determine the correct response given that each of the other options were examples of market failures and option A should have been selected by process of elimination.*

Question 4

The price elasticity of supply for electric cars produced in Chinese factories is likely to fall if:

A. productivity at factories increase and it takes half the time to produce any given electric vehicle
B. Chinese electric car manufacturers become monopoly suppliers in the global market
C. the costs of labour for Chinese manufacturers rise
D. there is a war and the Chinese government requires all factories to devote half their resources to military production

Unit 3, AOS 1 requires students to demonstrate an understanding of the factors affecting the price elasticity of supply (specifically spare capacity, production period, and durability of goods). In Section B of the examination, there has only been only one question testing this part of the course during the life of the current and former Study Designs. That question surfaced on the 2021 exam (Q3e) and it was one of the most poorly handled questions on the paper, with an average score of 47%, and only 30% of students achieving the full 3 marks. Students were required to explain one factor that would affect the price elasticity of supply of fish, and the bulk of students could not demonstrate a sufficient enough understanding of PES. Specifically, many erred by inappropriately explaining factors that impact on the price elasticity of demand for fish or they described a relevant factor affecting the PES (e.g. durability or storability) but could not explain how or why an increase/decrease in storability/durability causes the PES to increase/decrease. Question 10 of Section A of the 2023 exam did, however, test student understanding of the factors causing an increase in the PES for avocados. The majority of students (70%) were able to select the correct option (A), which was 'preservatives are invented to extend the shelf life of avocados'. But a surprising 14% of students selected option D ('the cost of fertiliser increases') which involved a shift of the supply curve rather than a changing gradient/slope. When responding to these types of questions, it is useful to recall the factors affecting PES (spare capacity, production period, and durability of goods) and establish a connection between the options in the question and the factor affecting PES. For the current question, ***option D is the best response*** *because this scenario would reduce spare capacity in Chinese manufacturing*

plants and result in producers being less able to respond quickly to higher market prices. Any given price increase will result in fewer cars being produced as there is less spare capacity to produce electric cars (as half the capacity is required to produce military assets). Option A is incorrect because this will not only shift the supply curve to right, it will increase the PES as the production period falls. Option B is incorrect because these companies becoming monopoly suppliers will result in a decrease in the price elasticity of demand rather than the PES. Option C is incorrect because higher labour costs shift the supply curve to the left rather than change the PES.

Question 5
Which of the following is most likely to result in a fall in structural unemployment?

A. The more rapid uptake of technology, such as AI, by the business sector
B. A loosening of monetary policy
C. Budgetary policy tax concessions for firms investing in training and development
D. A rise in the terms of trade

The Study Design requires students to know the difference between cyclical and structural unemployment. This implies a need to know the different influences on each as well as the unique policy prescriptions required for a reduction in both. ***Option C is the best response*** *because these tax concessions incentivise firms to spend more money on the training and development of employees, which therefore helps to reduce the likelihood of workers not possessing the skills required in a dynamic economy, which otherwise could see them become structurally unemployed. Option A is incorrect because advances in technology, or the more rapid employment of technology, is likely to increase the rate of redundancies at workplaces as some skills are no longer required. Option B is incorrect because a loosening of monetary policy is more likely to reduce cyclical unemployment rather than structural unemployment. Option D is incorrect because a higher TOT will help to reduce the rate of cyclical unemployment via the boost to national income and spending.*

Question 6
A structural factor that will increase the current account surplus is

A. Stronger economic growth in the economies of our trading partners
B. A reduction in national savings
C. A reduction in Australian Real Unit Labour Costs
D. A stronger rate of national spending in Australia

The current Study Design requires students to demonstrate an understanding of the cyclical and structural influences on Australia's current account balance. Questions related to the current account (deficit) have proved burdensome for students in the past, with questions related to the difference between the structural and cyclical factors affecting the CA or CAD being particularly problematic, as evidenced by student responses to Q4d of the 2021 exam (See Advice related to Q2f of CPAP 2024 Economics Exam A). Students should remember that structural factors are those unrelated to the economic cycle, and instead relate to the underlying factors (typically related to AS) driving any particular current account outcome. Factors such as an increase in national savings, increased productivity growth, greater technology uptake, higher international competitiveness, discovery of more natural resources and an increase in comparative advantage are all examples of factors that can contribute to a sustained (structural) increase in the CAS. They are quite distinct from cyclical factors which relate to a change in AD or national spending. Accordingly, if the current account balance changes for 'cyclical reasons', it means that it is due entirely to changes in the key macroeconomic variables of production, income and expenditure, which of course are commonly measured by changes in AD, GNE or GDP. The current question is related to one of the most difficult multiple choice questions from the 2023 exam. Question 11 required students to identify a cyclical factor that might cause the current account balance to worsen. Only 28% of students chose the correct option (B: a high rate of economic growth in Australia) with the majority of students (45%) selecting option D (lower productivity growth in Australia than in its major trading partners) which was a structural factor. For the current question, students need to 'focus on any 'non-cyclical' factor, or long-term factor, that has the potential to contribute to a higher CAS over time. ***Option C is the best response*** *because a reduction in RULCs mean that the real cost of employing labour has fallen (i.e. productivity has risen relative to wages) which contributes to an increase in international competitiveness and a reduction in the CAS for non-cyclical reasons (i.e. because of a positive change to the structure of the economy). Option A is incorrect because contribute to a cyclical improvement to the*

current account. Option B is incorrect because this leads to a structural decrease in the CAS. Option D is incorrect because this leads to a cyclical decrease in the CAS.

Question 7
What is the name given to the monetary policy transmission channel that influences aggregate demand via the impact on the willingness to borrow money?

A. Cash flow
B. Savings and investment
C. Exchange rate
D. Asset prices and wealth

The Study Design requires students to demonstrate an understanding of all four key transmission channels of monetary policy that are listed above. In exams, students will often confuse the savings and investment channel (which is also called the cost of credit channel) with the cash flow channel. They have, for example, identified the cash flow channel as the channel that they will explain, but then go on to explain the cost of credit (savings and investment) channel, or vice versa. Students need to remember that in relation to the cash flow channel, lower interest rates positively impact on spending by making it easier to repay existing loans, which improves discretionary income [the RBA refers to this as disposable income] and cash flows, which in turn encourages households to spend more. This is distinct from the ability of lower interest rates to encourage more households/businesses to take on more credit (e.g. increase the use of a credit card or even take out more loans), which of course is the cost of credit/savings and investment channel. Option B is the best response because the savings and investment channel operates via a change to the cost of borrowing, which in turn influences the willingness to borrow (e.g. households are more willing to borrow when interest rates fall) or the willingness to save (e.g. households are less willing to save and more willing to spend when interest rates fall).

Question 8
Excise duties on fuel and tobacco are examples of Australian taxes that are:

A. Indirect and regressive
B. Indirect and progressive
C. Indirect and proportional
D. Direct and regressive

The Study Design requires students to understand the various sources of government revenue, including direct and indirect taxation; progressive, regressive and proportional taxes; as well as revenue from government businesses and the sale of government assets. ***Option A is the correct response*** *because these taxes (also called excise duties) are indirect given that they are levied against products and effectively paid by taxpayers only when they spend money, which is in contrast to income taxes that are levied against income earned by taxpayers. They are also regressive because lower income earning taxpayers will generally be paying a higher proportion of their income in this form of tax compared to higher income earning taxpayers. Option B is incorrect because they are not progressive. Option C is incorrect because they are not proportional. Option D is incorrect because they are not direct taxes.*

Question 9
Which of the following combinations of policy options is most likely to promote non-inflationary economic growth.

A. Expansionary monetary policy and expansionary budgetary policy
B. Personal tax cuts and increased infrastructure spending
C. Increased welfare spending and a loosening of monetary policy
D. A larger budget surplus and a higher target cash rate

The Study Design requires students to understand how aggregate supply policies can be used to complement aggregate demand policies in promoting non-inflationary economic growth over time. In Section B of the 2023 exam, Question 5a asked students to explain how aggregate supply policies might be used to complement aggregate demand policies to promote non-inflationary economic growth. The question was not well handled, with an average score of 43%, as many students erred by not considering the complementary nature of AD and AS policies and therefore made no reference to the role of AD policies. [Refer to Advice provided in Question 4a of this exam.] In the context of the current question, the use of AD/AS diagrams in the border of the exam will generally help to unravel the best response. ***Option***

B is the best response *because both personal tax cuts and increased infrastructure spending have the potential to increase both AD and AS simultaneously, which helps to ensure that the overall impact on inflation is mitigated by the AS side benefits stemming from lower personal tax cuts (e.g. the potential links to productivity and labour supply) and increased infrastructure spending (e.g. the boost to productive capacity once the infrastructure has been rolled out). Option A is less valid because, without additional detail about the nature of the expansionary budgetary policy, it is uncertain whether the budgetary policy expansionary measures are supply side in nature, which could help to minimise the inflationary pressure coming from the expansionary monetary policy. Option C is invalid because increased welfare spending and lower interest rates are likely to be highly expansionary given that they both focus on stimulating AD. Option D is invalid because a larger budget surplus and higher interest rates imply a contractionary impact on AD.*

Question 10
Consider the following hypothetical data relating to the movement in real GDP over time.

Quarter	Real GDP ($m)
Dec 2021	585401
Mar 2022	589801
June 2022	594852
Sep 2022	595314
Dec 2022	600176
Mar 2023	603591
June 2023	606197
Sep 2023	607529
Dec 2023	609521
Mar 2024	610298

The most recent annualised rate of economic growth is:

A. 0.1%
B. 0.5%
C. 4.4%
D. 1.1%

A key skill in the current Study Design is the requirement for students to 'calculate relevant economic indicators using real or hypothetical data' and this skill has been tested in Section A of every exam over the life of the current and former study designs, including one question from the 2023 exam (Q6 relating to the calculation of the labour force underutilisation rate) and two questions from the 2022 exam (Q5 calculating economic growth and Q9 calculating AD). Given that students typically struggle selecting the right response when making calculations from (hypothetical) statistics, it is reasonable to expect at least one question to appear in Section A of the 2024 examination. For the current question, students first need to determine which two GDP figures are relevant. The reference to an 'annualised' rate means that the calculation needs to be made for quarterly growth, which means the from Dec Q 2023 to Mar Q 2024 = 0.127% [i.e.(($610.3b - $609.5b)/ $609.5b) X 100] and then multiply by 4 to arrive at an annualised rate of 0.5%, making ***option B the correct response****. Students should always remember that an annualised figure is distinct from an annual figure, where in this case the annual figure is 1.1%, determined by comparing GDP for the March quarter of 2024 ($610.3 billion) with GDP for the March quarter of 2024 ($603.6 billion).*

Question 11
Which of the following will have an effect on Australia's exchange rate that is different to the other three?

A. A decrease in commodity prices
B. A decrease in Australia's credit rating
C. A loosening of monetary policy
D. A decrease in the Consumer Price Index

Questions relating to causes and/or effects of changes in the exchange rate appear regularly on exams given that changes in the exchange rate are topical and feature heavily in the press every year. This included Part B of the 2023 exam, where questions were asked about both the causes (Q2b) and the effects (Q2c) of a change in the exchange rate. Importantly, when responding to exchange rate questions, students should be careful not to confuse cause and effect – which is relatively common. In the context of the current question, students should focus on the causes - i.e. how each of the relevant factors (A – D) will influence the AUD to change. Given that the factors/events listed in options A-C all contribute to an exchange rate depreciation, it leaves ***option D as the correct option****. A decrease in the CPI (i.e. deflation) will result in a boost to international competitiveness and lead to an increase in net export demand, which in turn leads to an increased demand for and value of the exchange rate.*

Question 12
In relation to the five-sector circular flow model of income

A. The business sector provides resources to the household sector in return for income
B. An increase in savings should contribute to injections rising faster than leakages and a higher level of real GDP
C. An increase in government spending relative to taxation should contribute to leakages rising faster than injections and a higher level of GDP
D. An increase in imports relative to exports should contribute to leakages rising faster than injections and a lower level of GDP

The five-sector circular flow model of income is specifically referred to in the Study Design and reference to this model has rarely been made in past exams. However, students should be prepared for a question testing their understanding of the role of households, businesses, government, financial institutions and the external sector as described in the model, and specifically, how income flows through the model. ***Option D is the best response*** *because it represents the only accurate statement of the four. Imports increasing relative to exports should indeed contribute to leakages from the model increasing relative to injections (i.e. more money flows out of the economy from international trade then is entering the economy) which has a net negative impact on AD and real GDP. Option A is incorrect because the reverse is true. Option B is incorrect be cause an increase in savings contributes to leakage is rising faster than injections which contributes to a lower level of real GDP. Option C is incorrect because an increase in government spending relative to taxation should contribute to injections rising faster than leakages.*

Question 13
Which of the following statements is most accurate in relation to the Australian economy during 2023-24?

A. Interest rates increased, the unemployment rate remained below 4% and the budget was estimated to be in surplus
B. Inflation fell below 4%, the terms of trade index declined and the unemployment rate rose above 4%
C. The exchange climbed above USD0.80, wages growth accelerated and employment growth increased
D. the Balance on Merchandise Trade remained positive, net foreign debt fell below zero, and inflation was in the range of 2-3%

The key skills in the Study Design requires students to gather, synthesise and use economic data from a wide range of sources. There is therefore an expectation that students will have some knowledge of the level and or movement of important economic indicators. Occasionally, VCE exams will include questions in Section A that rely on students having a general (but not a precise) knowledge of contemporary economic statistics. ***Option B is the best response*** *because it is the most accurate statement. The rate of inflation fell to as low as 3.6% during 2024 (March quarter), the terms of trade index has indeed declined in response to declining commodity prices and the unemployment rate climbed above 4% in January 2024, and again in June. All other options contain at least one inaccurate statistic. In relation to option A, the unemployment rate has not remained below 4%. In relation to option C, the exchange rate did not increase above* USD0.80 (despite the appreciation that did occur). *In relation to option D, net foreign debt did not fall below (it is close to $1 trillion) and inflation was above the 2-3% range.*

Question 14
Which of the following will contribute to a decline in Australia's international competitiveness?

A. An increase in the trade weighted index
B. An increase in labour productivity
C. A decrease in business taxes
D. A decrease in the rate of inflation

The Study Design requires students to demonstrate an understanding of international competitiveness and the factors that may affect international competitiveness, including productivity, production costs, availability of natural resources, exchange rates and relative rates of inflation. ***Option A is the best response*** *because an increase in the trade weighted index means that Australia's exchange rate has appreciated, which reduces the price competitiveness of exporters and import competing producers, which therefore translates into a decline in international competitiveness. Each of the other options contribute to an improvement in international competitiveness. An increased level of productivity and a reduction in business taxes both help to reduce production costs, leading to lower prices and greater competitiveness. A decrease in the rate of inflation (assuming that inflation remained the same in trading partner countries) means that our price is, on average, are rising more slowly than our competitors which helps to boost international competitiveness.*

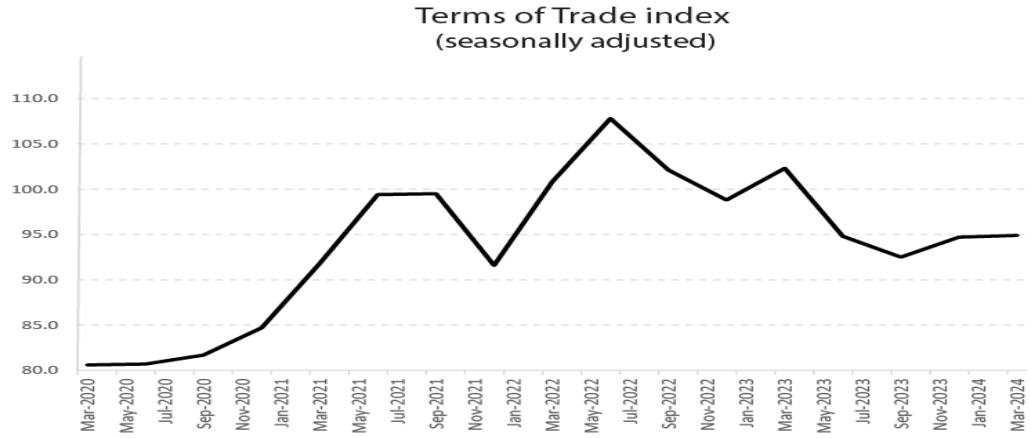
Question 15
Which of the following is likely to be a negative consequence associated with a failure to achieve a strong rate of economic growth?

A. Environmental degradation and pollution
B. A high rate of inflation
C. An increased budget deficit
D. A higher current account deficit

The Study Design requires students to demonstrate an understanding of the consequences of not achieving the goal of strong and sustainable economic growth and its effect on living standards, including environmental degradation, external pressures, high inflation if growth is too high, and high unemployment if growth is too low. ***Option C is the best response*** *because a failure to achieve a strong rate of economic growth is likely to result in a higher rate of unemployment, contribute to an increase in government expenditure in the form of income support (e.g. JobSeeker payments/unemployment benefits) and therefore resulting a higher budget deficit (i.e. students should think about the cyclical component of the budget). Option A is incorrect because a slower or low rate of economic growth will be associated with reduced pressure on the environment (e.g. less pollution than before). Option B is incorrect because lower growth will typically be associated with a lower rate of inflation. Option D is incorrect because lower growth will typically be associated with a lower CAD.*

SECTION B

Exam B 2024
Question 1 (16 marks)



a. Describe the trend movement in the TOT over the past year.

2 marks

- 1 mark for an accurate description of the trend since March 2023
- 1 mark for appropriate use of the data from the chart

Advice: These types of questions are often asked in the examination and relate to the key skill: *'explain and interpret trends and patterns in economic data and other information'*. The marks allocated for these questions (or parts of questions) will usually be 2 marks, with 1 mark for an indication of the trend movement in the relevant variable (e.g. a fall in the TOT since March 2023) and 1 mark for an accurate use of the data/information contained in the chart. It is common for students to err by referring to a period outside that referred to in the question; to spend too much time examining the rises and falls in the relevant variable over the given time period; or including irrelevant information such as the causes or effects of the movement in the relevant variable. Accordingly, students could reasonably expect 2 marks to be allocated for the description of the trend and this should guide students in terms of the depth required in the response (e.g. students should not waste time in this question by writing about the causes or effects of the downward trend in the TOT).

Sample answer: *The TOT has trended down over the relevant period, from an index of approximately 102 in March 2023 to an index of approximately 95 in March 2024.*

b. Predict how higher production costs for iron ore and coal producers overseas might influence Australia's terms of trade.

3 marks

- 1 mark for stating that the TOT is likely to increase
- 1 mark for linking higher production costs to lower supply and higher prices in global markets
- 1 mark for linking higher prices in global markets to a stronger TOT for Australia

Advice 1: The Study Design requires students to demonstrate an understanding of the terms of trade, both its meaning and how it is measured, as well as both the causes (which relates to the current question) and effects of movements in the terms of trade. Questions related to the terms of trade, either definition or the causes/effects, regularly cause students problems in examinations. Students will typically confuse the terms of trade with the trade weighted index (refer to next question); the terms of trade with the balance of trade (or BOMT) and/or inappropriately defining the terms of trade as the value of exports over the value of imports (or even 'exports over imports'). Students need to remember that growth in the TOT means that the prices received for exports are increasing relative to the prices paid for imports and it does not refer to exports over imports; or the value of exports over the value of imports; or the price of imports over the price of exports.'

Advice 2: In the context of the current question, students should be prepared for a question that relates to the impact of rising (or falling) production costs in the countries of our trading partners, as this is a specific factor listed in the Study Design.

Sample answer: *An increase in the production costs for foreign producers of iron ore and coal is likely to increase Australia's terms of trade. This is because the higher production costs should [at least to some extent] reduce the willingness of these producers to supply iron ore and coal to global markets. This will then have the effect of reducing the (global) supply of these commodities, which then results in a higher price. Australian commodity producers will then be able to receive a higher price for any given quantity of iron ore/coal that is sold in global markets.*

c. Distinguish the Trade Weighted Index (TWI) from the terms of trade (TOT).

3 marks

- 1 mark for demonstrating an understanding of the TWI
- 1 mark for demonstrating an understanding of the TOT
- 1 mark for establishing a key point of difference between the two

Note: Flexibility is recommended when assessing student responses. While students should be advised to focus on a clear point of difference between the TWI and TOT, it is possible for students to achieve full marks by defining the terms, so long as a key difference between them is made clear. While the use of conjunctions such as 'whereas', 'in contrast', 'on the other hand', etc. is strongly advisable, their absence should not preclude students from achieving full marks.

Advice: As noted in earlier advice, students will typically confuse the terms of trade index with the trade weighted index. While both indexes attempt to gauge the change in the price of a variable, students should always remember to connect the TWI with the price of a currency (i.e. the price of the Australian dollar compared to the prices of a weighted basket of currencies of our trading partners) whereas the TOT is connected to the price of commodities.

Sample answer: *The TWI is an index containing the price of the Australian dollar compared to the prices of a basket of currencies of our trading partners [weighted by their level of importance as trading partners]. In contrast, the TOT is an index containing the prices received for exports relative to prices paid for imports. A key point of difference is that a higher TOT will increase AD, economic growth and inflationary pressure whereas a higher TWI will have the reverse effects, decreasing AD, economic growth and inflationary pressure.*

d. Describe how the movement in the terms of trade (TOT) over the past year is likely to have influenced both the budget balance and the current account balance.

5 marks

- 1 mark for identifying that both the budget balance and the current account balance deteriorate
- 1 mark for demonstrating an understanding of both the budget balance and the current account balance
- 1.5 marks for an accurate description of the link between a lower TOT and a larger budget deficit (or smaller budget surplus)
- 1.5 marks for an accurate description of the link between a lower TOT and a lower CAS (or higher CAD)

Advice 1: With respect to the effects of a change in the TOT, the key knowledge in the Study Design (Unit 3 AOS 3) specifically mentions the effects on the domestic macroeconomic goals and living standards. In addition, the key skills in the Study Design (Unit 4 AOS 1) requires students to analyse the effects of current factors (e.g. changes in the TOT) on the setting of AD policies. Students should develop a general awareness of a range of factors influencing AD policies over the past couple of years, including the weaker TOT (or lower commodity prices) and a host of other factors, such as movements in wages growth, overseas rates of growth, confidence levels, capacity utilisation, economic growth, productivity growth, global conflict, savings and of course employment growth and unemployment levels.

Advice 2: Students should be aware of the relationship between a change in the TOT and the cyclical component of the budget. In particular, they should be aware that any reduction in the TOT will automatically increase the budget deficit, as government company tax receipts fall, and any rise in the TOT will automatically reduce the budget deficit as government company tax receipts rise.

Advice 3: As noted in the advice provided for the previous question, students will often experience difficulty unpacking the causes and/or effects of a change in the TOT. They will be awarded zero marks in the event that they discuss the causes of a change in the TOT when they are asked to unpack the effects; or if they discuss the effects of a change in the TOT when they are asked to unpack the causes. It should be reasonably clear that the current question relates to the effects of the lower TOT on both the budget balance and the current account balance.

Advice 4: Students should ensure that they do not make the common mistake of confusing the current account balance with the budget balance, which was once again referred to in the 2023 Examination Report. They should also learn from the mistakes made by former students. For example, in the 2020 examination, some students erred by arguing that a 'favourable' movement in the TOT required that the TOT index increases above 100. Students should recognise that a favourable movement in the TOT only requires that the index increases from one period to the next, which is the case for the period 2020 – 2022.

Sample answer: *The reduction in the TOT has occurred primarily because of lower commodity prices. This has resulted in lower export values and reduced incomes received by commodity exporters because any given volume of commodities exported onto global markets will have received a lower price. [Given that value = price X quantity, the lower prices received resulted in lower export values]. These lower incomes then flowed through to reduce profit levels, which in turn resulted in reduced company tax receipts for the federal government and a corresponding increase in the budget deficit (or reduction in the surplus).*

The lower export values will also reduce the Balance on Merchandise Trade (BOMT) surplus given that the BOMT is made up of the value of exports of goods minus the value of imports of goods. [This will also be amplified to the extent that the TOT has risen because of a fall in the prices paid for imports]. As the BOMT is a major sub-account in the current account of the balance of payments, any reduction in the BOMT will cause the current account surplus to fall [or current account deficit to rise].

Note: Square bracketed section is not required for full marks.

e. Describe how the movement in the budget balance, as described in your response to the previous question, is likely to influence the level of public debt.

3 marks

- 1 mark for identifying that public debt will rise
- 2 marks for an accurate description of the link between a higher deficit and growing public debt

Australian Government budget outcomes

	Actual			Estimates		
	2021–2022	2022–2023	2023–2024	2024–2025	2025–2026	2026–2027
Underlying cash balance ($ billion)	**−32.0**	**4.2**	**−13.9**	**−35.1**	**−36.6**	**−28.5**
Per cent of GDP	−1.4	0.2	−0.5	−1.3	−1.3	−1.0

Source: adapted from Commonwealth of Australia, 'Table 3.1' in 'Budget 2023–24, Budget Paper No. 1, Statement 3: Fiscal Strategy and Outlook', <budget.gov.au>

Advice 1: The Study Design requires students to demonstrate an understanding of (the relationship between the budget outcome and) the level of government (public) debt. Questions relating to the relationship between the budget outcome and government debt were asked in the most recent 2023 exam, as well as the 2021 and 2019 exams. In relation to the 2023 exam, the adjacent table was provided as stimulus material and students were free to focus on the lower budget deficit (or return to surplus) between 2021–22 and 2022–23, or the return to larger estimated deficits from 2023–24. Some students erred by misreading the table and assuming that the 'Per cent of GDP' row represented public debt as a percentage of GDP. Others made the mistake of linking the budget outcome to net foreign debt rather than the level of public debt and/or argued that deficits mean that the government *must* sell bonds to overseas investors. For a question such as this, there is no need to draw out any other implications that might stem from higher deficits or higher debt levels (e.g. the implications for credit ratings, the exchange rate, etc.). It is also important not to confuse the budget deficit with the current account deficit (e.g. by talking about any balance of payments implications).

Advice 2: In the 2021 and 2019 exams, students misunderstood what is meant by public debt, often confusing public debt with net foreign debt, public debt (which is the same as gross government debt) with net government debt, or even confusing public debt with budget deficits. Students need to remember that public debt refers to the total 'stock' of government debt in existence at a given point in time, which equates to the total stock or supply of Australian Government Securities (AGS) in existence. [Note AGS = Commonwealth Government Securities = Australian Government Bonds].

Note: In the event that a consequential error has been made when responding to the current question (e.g. a student refers to a lower budget deficit in the previous question), then full marks can still be awarded as long as the student accurately links a lower deficit to slower growth in public debt*, rather than* a decrease in public debt. When discussing the relationship between the budget outcome and public debt, a student should only refer to public debt levels falling when the budget moves into surplus.

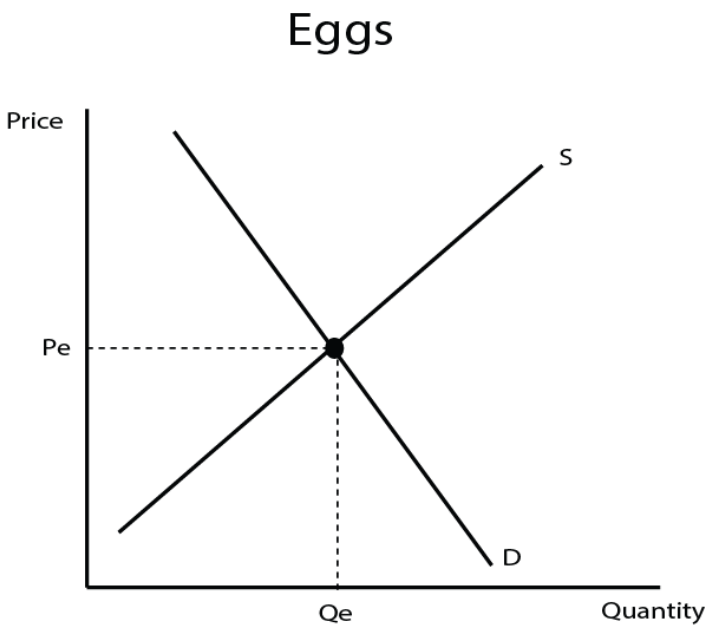
Sample answer: *The increase in budget deficit is likely to result in a rise in the level of public debt. This is because any deficit needs to be financed via sales of bonds [also referred to as the sale Australian Government Securities (AGS)]. The sale of these bonds means that the purchaser of the bonds effectively lends money to the federal government, and as the deficit increases, it means that the total value (or stock) of these bonds on issue must also rise as the government needs to borrow more (i.e. issue more bonds). Given that the total value of bonds/AGS in the market represents the total value of public debt, a higher budget deficit results in higher public debt [which means that the federal government's debt liabilities rise].*

Note: Square bracketed section is not required for full marks.

Question 2 (24 marks)
During the middle of 2024, avian influenza has resulted in many egg farmers being forced to cull birds, which has resulted in a market shortage.

a. Use the area below to construct a fully labelled demand and supply diagram for eggs that includes reference to equilibrium(s).

4 marks

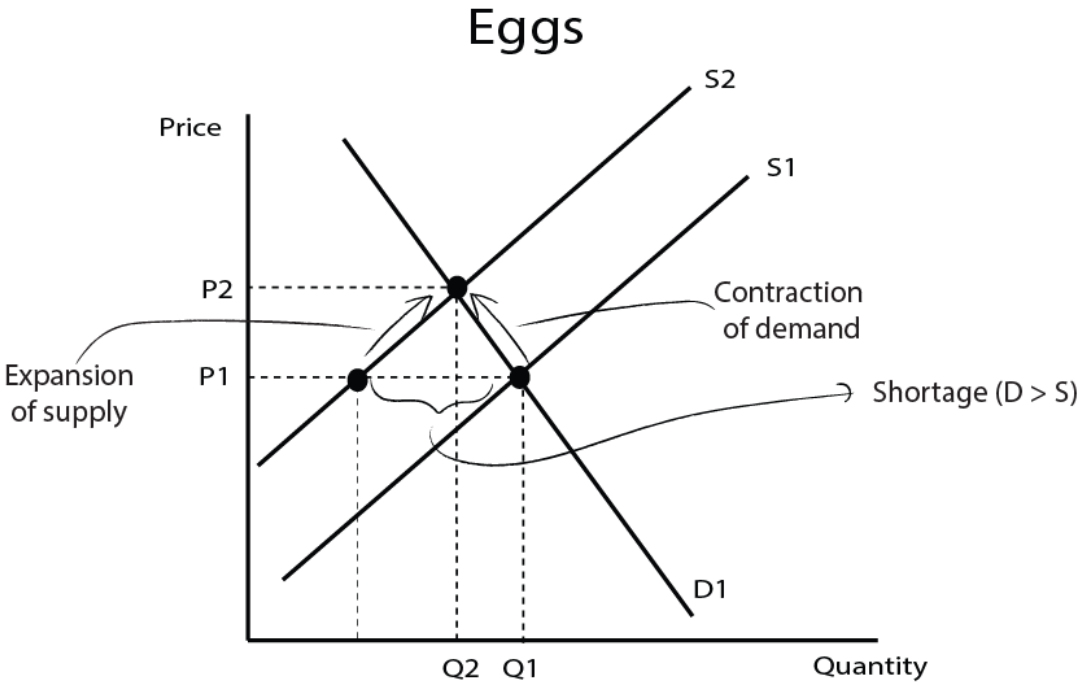


- 1 mark for correctly labelling the Y axis as Price (or P) and the X axis as Quantity (or Q)
- 1 mark for correctly positioning and labelling the demand curve
- 1 mark for correctly positioning and labelling the supply curve
- 1 mark for correctly identifying the equilibrium price (Pe) and equilibrium quantity (Qe)

Advice: A key skill introduced to the Study Design is the requirement to 'analyse how the forces of demand and supply effect equilibrium price and quantity traded'. While this skill was implied in the former Study Design (i.e. construct and interpret demand and supply diagrams), the explicit reference to the need to 'analyse' lends itself to a question that uses this specific command term. It was indeed tested in the 2023 exam (Q4b) and it was perhaps the most challenging question on the paper. While many students misunderstood the wording in the exam, and shifted the wrong curve (See advice provided in Q4c of the CPAP Economics 2024 Exam A), there were numerous errors made when constructing the diagrams. This included drawing AD and AS curves; mislabelling the x and y axes (e.g. referring to prices or inflation on the y-axis and real GDP on the x-axis); confusing the x and y axes (e.g. price on the x-axis and quantity on the y-axis) and drawing upward sloping demand curves and downward sloping supply curves. In light of the errors made in the 2023 exam it is not unreasonable to expect this key skill to be tested once more in 2024.

b. Explain the impact on the market for eggs as a result of avian influenza and describe how the market moves to its new equilibrium. Use the diagram drawn in part a to illustrate your response and refer to market shortage.
6 marks

- 1 mark for reference to a reduction in supply and the creation of a market shortage
- 1 mark for identifying both a higher equilibrium price and lower equilibrium quantity
- 1 mark for reference to both an expansion of supply and a contraction of demand
- 1 mark for reference to the elimination of the shortage and eventual return to equilibrium
- 2 marks for appropriate use of the diagram to illustrate (e.g. shifting the supply curve to the left, annotating the diagram with a higher price lower quantity)



Advice 1: The Study Design requires students to be aware of a number of non-price factors that are likely to affect supply and the position of the supply curve. Students should therefore expect to make use of the factors listed in the Study Design, which are costs of production, number of suppliers, technology, productivity and climatic conditions. However, the exam could include any non-factor price factor (such as a disease influencing livestock for farmers) that influences the willingness and/or ability to supply, which ultimately affects the costs of production and the position of the supply curve.

Advice 2: In the past examinations, when students have been asked to interpret demand and supply diagrams, they will often spend either too much time or too little time unpacking the diagram. For example, if a question asks students to comment on the impact on price and quantity (or the impact on the 'market' for a good or service) following a shift to the right of the demand curve, it would generally not be necessary to explore the dynamics of adjustment from one equilibrium to the next (which is the focus of the current question), nor would it be necessary to focus on the change in relative prices and the implications for the allocation of resources. On other occasions, a question might specifically ask for the impact on relative prices and resource allocation, and students will provide insufficient detail by only referring to the impact on price and quantity. It highlights that students need to read questions carefully to ensure that they answer questions with sufficient detail and/or don't waste time providing detail that is not required in the question.

Advice 3: Students should be prepared for a question that tests their understanding of the difference between shifts of curves and movements along curves. Students should also be prepared for phrasing within questions that could potentially mislead. This was the case for Question 4b of the 2023 exam, where the average score was 48%, and only 22% of students receiving full marks. The question required students to analyse how one non-price factor will cause a leftward movement along the demand curve for new houses, resulting in a new equilibrium P and Q. The wording of the question was rather unique and caused too many students to (mis)interpret it as a 'leftward shift of the demand curve'. This resulted in them shifting the demand curve to the left. Instead, they needed to shift the supply curve to

the left and comment on the contraction of demand (i.e. the movement back/leftward movement along the demand curve). Refer to Question 4c of the 2024 CPAP Economics Exam A which includes this advice and provides students with an equally challenging variant of the VCAA version from 2023.

Advice 4: Responses to Q4c of the 2022 exam highlighted problems that students have when they are asked to use to use D/S diagrams in support of their responses. It required students to use a fully labelled demand and supply diagram to illustrate and analyse how a form of government intervention might lead to a change in relative prices and the allocation of resources. In addition to those issues mentioned in the earlier advice, some student responses were inconsistent with the information conveyed in the D/S diagram (e.g. analysing how an excise tax effectively causes a contraction along the demand curve but then producing a D/S diagram with the demand curve shifting to the left). In other cases, students chose government interventions (e.g. the provision of public goods) that were difficult to illustrate using a D/S diagram.

Sample answer: *The avian flu required farmers to cull infected flocks, which resulted in fewer laying hens and a reduction in the quantity of eggs being supplied to markets. This is represented by a shift to the left of the supply curve for eggs and resulted in a shortage of eggs in Victoria [i.e. excess demand]. With demand exceeding supply it encouraged existing suppliers to raise the price of eggs [as a means of rationing supply and maximising profits]. This is represented by the price increasing from P1 to P2 in the diagram above. As price increased towards P2, it resulted in a contraction of demand as consumers shifted to other alternatives or substitutes [which is consistent with the law of demand] and an expansion of supply as farmers of non-infected flocks (or even backyard egg producers) were motivated by higher profits to supply more eggs to the market. This contraction of demand and expansion of supply naturally works to reduce the shortage, and price continues to rise until it reaches its new equilibrium at P2, where demand equals supply (at Q2) and the shortage is eliminated.*

Note: Square bracketed section is not required for full marks.

c. Explain whether shortages and/or a surpluses in markets are examples of a market failure.

2 marks

- 1 mark for stating that neither represents a market failure (See Note 1)
- 1 mark for additional detail/explanation

Advice: It is important not to confuse market shortages or surpluses with market failures per se, as a number of students did in the 2023 exam. For example, when responding to Q4c, a number of students argued that the construction of too many houses could lead to an excess supply of houses, or that the construction of too few houses will lead to shortages, representing a failure of the market to achieve equilibrium. Students should be reminded that market disequilibrium is typically a feature of properly functioning markets and it does not, in itself, represent market failure. Instead, a focus was required on problems potentially occurring in markets that lead to inefficient outcomes that require some form of government intervention, such as any negative externalities associated with house construction.

Note: Students can achieve full marks if they attempt to argue that a shortage or surplus can be evidence of, or is indicative of, market failure under certain circumstances. For example, instances of 'sticky prices' or downward rigidity of prices, where prices (including wages) do not adjust for a long time and the market remains disequilibrium or excess demand/shortage. However, this angle is not expected.

Sample answer: *A market shortage [or surplus] in itself does not represent an example of a market failure. Shortages [or surpluses] are evidence of markets being in disequilibrium, which is a natural feature of markets and how they function to influence (relative) prices, production volumes and the allocation of resources. In fact, market shortages that lead to higher prices and lower levels of demand and production are typically evidence that markets are functioning properly.*

Note 2: Square bracketed section is not required for full marks.

d. In relation to the laws of demand and supply, distinguish the profit motive from the substitution effect. Illustrate your response with reference to the market for eggs.

4 marks

- 1 mark for demonstrating an understanding of the profit motive in the context of the supply curve
- 1 mark for demonstrating an understanding of the substitution effect in the context of the demand curve
- 1 mark for establishing a key point of difference between the two
- 1 mark for appropriate reference to the market for eggs

Note: Flexibility is recommended when assessing student responses. While students should be advised to focus on a clear point of difference between the terms, it is possible for students to achieve full marks by defining the terms, so long as a key difference between them is made clear. While the use of conjunctions such as 'whereas', 'in contrast', 'on the other hand', etc. is strongly advisable, their absence should not preclude students from achieving full marks.

Advice: The Study Design includes specific reference to both the substitution and income effects in terms of a rationale for the downward slope of a demand curve, as well as the profit motive as a rationale for an upward sloping supply curve. Students should expect an examination question (either in Part A or B of the exam) to test student understanding of the difference between the income and substitution effects (as per the VCAA Sample Exam) or the role of the profit motive. While a question is not likely to ask students to *distinguish* the profit motive from the substitution effect, it is not impossible.

Sample answer: *The substitution effect refers to one of the reasons that helps to explain why a demand curve is downward sloping [e.g. it explains why there is a contraction of demand when price rises]. A rise in the price of eggs for example (e.g. from P1 to P2) means that the relative price of substitute products will fall, which results in consumers reducing demand [contraction] as they shift to relatively cheaper substitutes. In contrast, the profit motive helps to explain why a supply curve is upward sloping [e.g. it explains why there is an expansion of supply when price rises]. As egg prices rise from P1 to P2 it indicates that profit opportunities increase and suppliers [who are always assumed to maximise profits] will be willing to supply more eggs to the market. A key difference is that the substitution effect relates to the demand for a product whereas the profit motive relates to the supply of a product.*

Note: Square bracketed section is not required for full marks.

e. Evaluate the role of free and competitive markets in achieving an efficient allocation of resources. In your answer, make reference to both relative prices and market failure.

8 marks

- 1 mark for demonstrating an understanding of an efficient allocation of resources
- 1 mark for demonstrating an understanding of free and competitive markets
- 1 mark for appropriate reference to relative prices
- 2 marks for discussing how markets can achieve an efficient allocation of resources (i.e. strengths of markets)
- 2 marks for discussing how markets fail to achieve the efficient allocation of resources, making accurate reference to market failure (i.e. weaknesses of markets)
- 1 mark for a reasoned conclusion that makes it clear that unregulated markets will not achieve the most efficient allocation of resources

Note 1: Reference in the question is to 'competitive markets', not 'perfectly competitive markets'. Students are therefore not required to list or show recognition of the conditions for a 'perfectly competitive market'. Nor are students required to specifically tailor their response to the market for eggs.

Advice 1: The Study Design requires students to understand and evaluate the role of free and competitive markets in achieving an efficient allocation of resources. The task word in the question - 'evaluate' - will typically require students to at least examine the pros and cons, or costs and benefits (and arrive at a conclusion or overall judgement). Exams over the life of the previous Study Design did not specifically require students to 'evaluate the role of markets', however there were numerous occasions where students were required to discuss or refer to how markets allocate resources and/or why markets fail to allocate resources efficiently (i.e. how 'market failures' exist).

Advice 2: There was no requirement to evaluate the role of markets in the 2023 exam and it would not be surprising if the 2024 Exam Setting Panel included one of the following two questions on the 2024 exam. 1. *Explain* the role of free and competitive markets in promoting an efficient allocation of resources and improved living standards, or 2. *Evaluate* the role of free and competitive markets in achieving an efficient allocation of resources. These questions are direct copy and pastes from the Study Design. The former is a *key knowledge* point from Unit 3 (AOS 1) and the latter is a *Key Skill* from Unit 3 (AOS 1).

Advice 3: Students should recognise that markets play an important role in the allocation of resources and (competitive) markets can be efficient in many respects, such as the ability for competition to drive prices to very low levels, maximising technical efficiency and increasing consumer satisfaction. However, markets are imperfect in the sense that, left unregulated, they will lead to an inefficient allocation of resources - hence market failures prevail. Past exams reveal that students find market failures one of the most challenging parts of the course to understand, with asymmetric information the most difficult example of market failures to explain. In the event that choice is provided in the examination, it is recommended that students focus on the area of market failure they feel most comfortable explaining as their example for why or how unregulated markets do not achieve the most efficient allocation of resources.

Advice 4: As noted in the advice provided in the CPAP Economics Exam A 2024, students have been required to demonstrate some understanding of 'market failures' in all but one of the exams over the life of the previous Study Design (with no such question in the 2019 exam) and both exams over the life of the current Study Design (i.e. 2023 and 2024). Most recently, Question 4c of the 2023 exam required students to 'explain one type of market failure that may be associated with the construction of new housing'. It was not well handled by most students, with an average score of 50% and only 20% of students receiving full marks. While students were expected to focus on negative externalities, they were free to explain other types of market failures, such as positive externalities (e.g. external benefits associated with higher density living, enhanced street appeal, greater housing affordability), asymmetric information (e.g. new home buyers being duped into contracts on the basis of false or misleading information) or even common access resources (e.g. development that encroaches on natural environment and contributes to resource depletion). Those students who selected 'public goods' struggled to do well in this question.

Sample answer: *Competitive markets will be characterised by the existence of many buyers/sellers, a high degree of product homogeneity and the relative freedom of entry to the market and exit from the market. These markets will generally help to promote (productive) efficiency, but in the absence of government regulations or intervention (i.e. free markets), they will not result in the most efficient allocation of resources for a nation like Australia.*

Markets will usually do an effective job of allocating resources towards the production of goods and services that are needed and/or wanted by consumers (or society), such as eggs. This is particularly the case when markets are highly competitive, where producers will seek to supply goods and services to consumers at the lowest possible prices, which results in the production of goods and services at the lowest possible costs, maximising technical efficiency and resulting in the lowest prices, which in turn maximises consumer satisfaction. In a narrow sense, this promotes the achievement of allocative efficiency because the nation's resources are more likely to be used in those combinations that yield the maximum net benefits or satisfaction for consumers. In other words, unregulated markets generally do a wonderful job at allocating resources to produce goods and services that 'consumers want'.

However, free markets or ones without government regulation, will typically result in undesirable outcomes for society, which are commonly referred to as market failures. In other words, markets will result in an allocation of resources that is sub-optimal, leading to an inability to achieve the most efficient allocation of resources (i.e. allocative inefficiency), which is defined as one where the living standards/welfare of Australians is not maximized from any given allocation of resources. Ultimately, the efficiency with which markets allocate resources to the production of goods and services that consumers want, is what weakens the ability of markets to best serve the community as a whole. Unregulated markets will tend to overallocate resources to the production of some goods and services that are not in society's best interests [e.g. demerit goods such as illicit drugs or goods with negative externalities] and underallocate resources to the production of those goods and services that are in society's best interests [e.g. public goods or goods with positive externalities]. To illustrate, with respect to negative externalities and pollution, unregulated markets will result in the external costs (such as damage by pollution) being passed onto society more generally, which results in the relative price of the polluting product being too low (compared to more environmentally friendly alternatives), which in turn encourages greater consumption and production of the polluting product, and an overallocation of resources to its production.

On balance, markets are very effective at allocating resources to the production of goods and services that people want, but they require government regulation to address the various market failures that ultimately prevent free markets from achieving the most efficient allocation of resources. However, as a means of allocating resources within nations, markets do a superior job compared to the alternatives (e.g. government/central planning).

Note 2: Square bracketed section is not required for full marks.

Question 3 (16 marks)
The use of budgetary policy and monetary policy over recent years have been designed in a way to assist with the achievement of the Australian government's macroeconomic goals and to boost living standards.

a. Explain what is meant by the natural rate of unemployment.

2 marks

- 1 mark for a superficial definition (e.g. the rate that is consistent with full employment/the NAIRU rate)
  or
- 2 marks for a more comprehensive definition

Advice: The current (and former) study designs require students to define key economic concepts and terms and use them appropriately. In relation to the natural rate of unemployment (or NAIRU), this concept has not been specifically referred to in Section B of a VCE Examination. However, it is now prescribed key knowledge in the current Study Design and it is reasonable to expect some reference to the NAIRU or the natural rate of unemployment on the exam, either in relation to their meaning/definition or the (policy) implications (See next question).

Sample answer: *The natural rate of unemployment is sometimes referred to as the Non-Accelerating Inflation Rate of Unemployment (or NAIRU for short). It is defined as that rate of unemployment, below which [wages growth and] inflation becomes excessive or that rate of unemployment that naturally exists when the economy is growing at a strong and sustainable rate and price stability is achieved. [In other words, the natural rate or NAIRU is the lowest rate of unemployment that can be achieved in the economy before wages growth and inflation accelerate to unacceptable levels. The natural/NAIRU rate is commonly considered to be the rate of unemployment that is consistent with the achievement of full employment.]*

Note: square bracketed section is not required for full marks.

b. Discuss one implication that could stem from the rate of unemployment falling below or climbing above the natural rate of unemployment.

2 marks

- 1 mark for identifying a relevant implication
- 1 mark for additional information that effectively draws out the implication in a meaningful way

Advice: The key knowledge (Unit 3, AOS2) in the Study Design requires students to demonstrate an understanding of the consequences of not achieving the goal of full employment, in terms of the effect on living standards, GDP and tax revenue (if unemployment is too high) and the effects on inflation (if unemployment is too low). The key skills (Unit 4, AOS 1) also requires students to analyse the effect of current factors on the setting of aggregate demand policies and living standards. Accordingly, students have significant scope to approach this question from various angles. While the sample answer focuses on the relationship between unemployment and inflation, students are free to focus on any possible implication or consequence associated with a rate of unemployment that is either too low or too high. If students do indeed decide to focus on the policy implications, then it is important to acknowledge the relatively low mark allocation attached to the question and avoid the temptation to go into too much detail. For example, a student might decide to explore the consequences that a higher rate of unemployment (above the natural/NAIRU) will have for the cyclical and structural components of the budget. There is much that could be said here, but it is necessary not waste too much time chasing more than 2 marks when only 2 marks is available.

Sample answer: *If the rate of unemployment falls below the natural rate, by definition, it implies that inflationary pressures will start to build as labour markets tighten and the resulting excess demand for labour exerts upwards pressure on wages growth, costs of production and prices. [Higher wages growth will also contribute to demand inflationary pressures.] The resulting increase in the CPI will then make it more difficult for the RBA to achieve its price stability goal [of 2-3% growth in the CPI on average over time] as inflation increases further above the top end of the RBA's target range.*

Or

Sample answer: *If the rate of unemployment climbs above the natural rate, it implies that spare capacity in labour markets is increasing [i.e. there is an excess supply of labour], resulting in downward pressure on wages growth, costs of production and prices [lower wages growth will also contribute to a reduction in demand inflationary pressures.] The resulting decrease in inflation will then make it easier for the RBA to achieve its price stability goal [of 2-3% growth in the CPI on average over time] as inflation falls back into the RBA's target range.*

c. Explain how the exchange rate channel of monetary policy has influenced the rate of unemployment over 2023-24.

4 marks

- 1 mark for identifying the role of a tightening of monetary policy (and/or the more restrictive monetary policy stance)
- 2 marks for an accurate and comprehensive explanation of the link between higher interest rates and lower AD (making reference to higher relative interest rates/capital inflow/increased demand for the AUD and an exchange rate appreciation)
- 1 mark for linking the appreciation to a higher unemployment rate

Advice 1: The Study Design requires students to demonstrate an understanding of all four key transmission channels of monetary policy and questions related to the channels of monetary policy transmission have featured on all six of the past exams. In relation to Question 4d of the 2023 exam, students were required to refer to the asset price and wealth channel and explain why the fall in house prices might have a negative effect on AD and the achievement of full employment. The average score was only 45%, with many students attempting to explain the channel via the decrease in the construction of houses. For example, that lower house prices discourage further investment in houses therefore decreases AD via a reduction in housing construction. This approach was too micro focused. Instead, students were required to explore the link via the reduction in AD (e.g. consumption demand) occurring as a consequence of homeowners/mortgagees feeling less wealthy and less inclined to spend money on goods and services. Other students erred by neglecting to make the important reference to higher interest rates/tighter monetary policy in the context of the question and others focused solely on the role of consumer confidence in reducing AD, which should be avoided as it is not included as a key transmission channel.

Advice 2: The 2022 exam (Q1f) focused on the exchange rate mechanism and the achievement of one macroeconomic goal, and only 25% of students were able to achieve the full 4 marks. In the 2021 exam (Q1c), only 34% of students were able to achieve the full 5 marks and in the 2020 exam (Q1c) only 28% of students were able to achieve the full 6 marks. The 2019 and 2018 examinations saw relatively low average scores of 55% and 56% for questions related to the transmission channels. In these exams, students continued with the same types of mistakes. In relation to the exchange rate channel (e.g. Q1f of the 2022 exam), students spent insufficient time explaining how higher interest rates actually contribute to a higher exchange rate (e.g. referring to the role of interest rate relativities, capital inflow/outflow and the change in the demand/supply of the AUD on foreign exchange markets). In relation to mistakes more generally, a common point of confusion is the difference between the cash flow channel and the cost of credit/savings and investment channel, with many students naming the channels incorrectly (e.g. naming/identifying the cash flow channel and describing the cost of credit channel or naming/identifying the cost of credit channel and explaining the cash flow channel). Students need to remember that lower interest rates positively impact on spending by making it easier to repay existing loans, which improves discretionary income [the RBA refers to this as disposable income] and therefore improves cash flows (i.e. the cash flow channel). This is distinct from the ability of lower interest rates to encourage more households/businesses to take on more credit (e.g. increase the use of a credit card or even take out more loans), which is the cost of credit/savings and investment channel.

Advice 3: In relation to monetary policy questions more generally, students should be careful to maintain a focus on the question being asked and to avoid making reference to aspects of monetary policy that are not related to the

question. This has been a common problem for students over the years, which can undermine their ability to achieve full marks across the exam. For example, in relation to the current question, the ultimate focus is the relationship between one transmission channel (exchange rate) and its impact on the rate of unemployment. Some students will make the mistake of talking about more than one transmission channel and/or extend the response to focus on the goal of full employment and/or the implications for living standards, which are beyond the scope of the question. Other students will include other irrelevant detail, such as reference to the contents of the RBA's charter, how the RBA actually increases interest rates, the influence on other goals, etc. This unnecessary detail might not detract from the ability to achieve full marks for the question, but it does mean that students might find it difficult to complete the remainder of the paper.

Sample answer: *The continued tightening of monetary policy over 2023 was designed to further reduce AD and inflationary pressures, with the exchange rate channel being one of the four recognised channels by which AD and inflation is reduced. The increase in the target cash rate [to as high as 4.35% in December 2023] resulted in higher market interest rates. This led to higher relative interest rates in Australia [compared to most countries], causing capital inflow as foreign investors chased higher investment returns on offer in Australia [e.g. it becomes more attractive to purchase Australian debt instruments such as bonds, which will be offering a higher rate of return]. This then contributed to upward pressure on the exchange rate as the demand for the AUD on foreign currency markets increased, which then reduced pressure on AD via a reduction in the price competitiveness of Australia's tradables sector [i.e. it triggers an increase in price of exports for foreigners and reduces the price of imports, thereby hurting local producers competing against imports]. The reduction in AD negatively impacted on real GDP [with real GDP growth falling to 1.1% over the past year], which in turn contributed to a lower demand for labour and an increase in the rate of unemployment [to more than 4% by the middle of 2024].*

d. Identify one way that budgetary policy has been used reduce inflationary pressures over the past two years and explain how it helps to reduce the rate of inflation.

3 marks

- 1 mark for identifying a relevant budgetary policy initiative introduced over the past two years
- 2 marks for an accurate explanation of how the initiative may have helped to reduce inflation

Note: A student can also achieve full marks by focusing on the budget surpluses over 2022-3 and 2023-4 and attempting to link these to a more contractionary stance. While the reality is a little more complex, as the budget surpluses were cyclical rather than structural in nature, students are not expected to provide this level of detail for this question. So long as they are able to connect a surplus to a contractionary stance that helps to reduce inflationary pressure, then full marks can be awarded.

Advice 1: The 2022 External Examination Report revealed that many students demonstrated gaps in their understanding of the effects of a cut or rise in excise taxes on prices and inflation. This was borne out in responses to Question 1c, which required students to 'explain how one aggregate demand factor and one aggregate supply factor have influenced the inflation rate over the past 12 months'. It was common for students to argue that the (temporary) cut to excise on fuel would be inflationary given that households will have more discretionary income to spend more on other goods and services, thereby increasing demand inflation. However, they ignored the more immediate downward impact on prices and inflation, which was indeed the government's intention when introducing the excise tax relief in March of 2022. In other words, the government was responding to high fuel prices and was keen to provide cost of living relief to households. The same logic applies in relation to the $300 energy rebates provided to Australian households and small businesses during 2024. The rebates were effectively delivered as a producer subsidy, whereby energy retailers were provided with payments on the proviso that they pass this down to consumers via a reduction in their energy bills.

Sample answer: *The $300 energy rebates provided to Australian households and small businesses during 2024 has helped to reduce inflationary pressures. The rebates were effectively delivered as a producer subsidy, whereby energy retailers were provided with payments on the proviso that they pass this down to consumers via a reduction in their energy bills. This immediately reduced energy bills, resulting in lower energy prices as recorded in the Consumer Price Index and therefore contributed to a reduction in the rate of inflation.*

e. Evaluate the extent to which Australia has achieved the macroeconomic goals of price stability and strong and sustainable economic growth over the past year.

5 marks

- 1 mark for demonstrating an understanding of SSEG
- 1 mark for demonstrating an accurate understanding of the goal of price stability
- 1 mark for demonstrating general/broad knowledge of the rate of inflation and economic growth over the past year
- 1 mark for comparing the inflation rate to the goal and determining the extent to which price stability was achieved
- 1 mark for comparing the rate of growth in real GDP to the goal and determining the extent to which a strong rate of economic growth was achieved

Advice 1: The Study Design includes a key skill: *'evaluate the extent to which the economy has achieved the domestic macroeconomic goals over the past two years'*. There was no question on the 2023 exam that tested this skill (which perhaps makes it more likely to surface in 2024), but it was tested somewhat on past exams despite this skill not specifically being listed in the former Study Design. Students were presented with charts/graphs containing the movement of key macroeconomic variables over a number of years. They were then asked to assess the extent to which Australia achieved specific macroeconomic goals based on the information contained in the charts. For example, in the 2017 exam, Q4a presented a chart showing the quarterly and annual growth in the CPI, and students were asked to assess the extent to which the goal of low inflation (price stability) was achieved. In the 2018 exam, Q4a presented students with charts relating to the unemployment and underemployment rates, as well as the rate of GDP growth and they were asked to assess the extent to which the full employment and strong and sustainable economic growth goals were achieved. Overall, these should have been relatively easy questions, requiring students to demonstrate an understanding of the relevant goal(s) and then simply compare the relevant data/statistics contained in the chart(s) to the key statistic that underpins the achievement of the goal(s), 2-3% growth in the CPI on average over time in the case of price stability, approximately 3 ½% for strong and sustainable economic growth, and approximately 5% for the rate of unemployment (now revised down to 4.25%). A number of students were unable to perform well in these questions, with only 26% of students achieving full marks in 2018 and 36% achieving full marks in 2017. Given that a similar question has not surfaced on an exam since then, it would not be surprising to see one appear on the 2024 exam given the presence of the new key skill.

Advice 2: While this current question does not require an evaluation of the extent to which full employment has been achieved, it is worthwhile for students to consider the recent changes that have occurred in relation to the thinking around this goal. Specifically, following criticism levelled at the RBA over 2022-23 in terms of its perceived over emphasis on price stability (i.e. its determination to raise interest rates aggressively in full knowledge of the potential negative effects on economic growth and jobs), the RBA conducted a review of its policy focus. This led to a change to its *Statement on the Conduct of Monetary Policy* in late 2023. In short, this resulted in the RBA now explicitly having a dual focus on the achievement of price stability and full employment, which is a departure from the past where it was focused on achieving price stability first before targeting full employment. The RBA then loosely defined full employment as *'ensuring that everyone who wants a job can find one without searching for too long and maximising the level of employment that is consistent with low and stable inflation'.*

Advice 3: In the current climate, it would be advantageous for students to demonstrate an understanding of contemporary thinking related to the full employment goal (see Advice 2). Importantly, the RBA does not have a specific numerical target for full employment (like it does with price stability) because any level of employment/unemployment that is consistent with low and stable inflation (price stability) is not fixed. However, this level/rate of unemployment can be implied and RBA/Treasury research over recent years indicates that the full employment rate of unemployment, or the NAIRU), is likely to reside at approximately 4.25%. In this context, given that unemployment has remained at or below 4.1% over the past couple of years it prompted many commentators/economists to suggest that the new NAIRU is even below 4%. For the purposes of the VCE Economics exam, the precise level of NAIRU is less important than what is meant by NAIRU, what it implies about the economy, and the implications it might have for the setting of government policies.

Sample answer: *The goal of price stability (also referred to as low and stable inflation) requires the rate of growth in consumer prices (i.e. headline inflation) to be within the 2-3% range on average over time. Given that the rate of (headline) inflation has been above the top end of the RBA's target range of 2-3% over the past year [to as high as 7% during 2023], it is fair to say that the goal has not been achieved [despite the fact that disinflationary pressures currently exist in the economy and inflation has fallen below 4%.]*

The goal of strong and sustainable economic growth requires that the rate of growth in real GDP is strong enough to create jobs and boost material living standards (e.g. above 3%) but not so strong that it triggers excessive inflation and/or leads to excessive pressures on the environment and/or results in excessive external pressures. Over the past year, given that the annual rate of economic growth has been below 3% [or precisely 1.1% for the year ended 31 March 2024], and quarterly rates of growth on an annualised basis have been averaging less than 1%, it is fair to say that the goal has not been achieved given that growth is insufficient (despite being sustainable) to create jobs and boost material living standards [the decline in real GDP per capita over the past year is also evidence of growth being insufficient]..

Note: Square bracketed section is not required for full marks.

Question 4 (9 marks)

a. Explain how the government can use <u>one</u> of the following budgetary policy supply side initiatives to assist RBA efforts in reducing inflationary pressures. In your answer refer to aggregate supply.

- **training and education**
- **research and development**
- **subsidies**
- **infrastructure**
- **tax reform**

4 marks

- 1 mark for demonstrating an understanding of the relevant policy initiative
- 1.5 marks for accurately linking the relevant initiative/policy to an increase in aggregate supply
- 1.5 marks for accurately linking the initiative to a lower inflation rate

Note: In the event that a student explains more than one of the initiatives from the list, only the first initiative should be assessed.

Advice 1: Questions related to the implementation and/or impact of aggregate supply policies have featured in Section B of every exam over the life of the previous Study Design. This includes the 2023 exam where students were asked to explain how aggregate supply policies might be used to complement aggregate demand policies to promote non-inflationary economic growth. The wording of the question was essentially the same as the key knowledge point in the Study Design ('*the use of aggregate supply policies to complement aggregate demand policies in promoting non-inflationary economic growth over time'*) yet the question was not well handled, with an average score of 43%. Many students erred by not considering the <u>complementary</u> nature of AD and AS policies and therefore made no reference to the role of AD policies. The best responses were from those students who identified that the use of AS policies complemented expansionary monetary (or budgetary) policy because the inflationary effects of expansionary AD policies was countered by the disinflationary effects of AS policies, which together helped to promote a stronger rate of economic growth without an acceleration of inflation (i.e. non-inflationary economic growth).

Advice 2: In the 2023 Examination Report, the chief assessor noted that the use of AD/AS diagrams (despite no longer being specified as key knowledge in the study design) served to add value to student responses. In the context of Question 5a of the 2023 exam (re AS policies to complement AD policies), this involved shifting both the AD and AS curves to the right to illustrate the growth in real GDP (x-axis) occurring alongside low growth in prices (y-axis). The Report also highlighted the error made by students who adopted a micro focus, addressing the balance between demand and supply for a good when attempting to explain non-inflationary growth, rather than AD/AS.

Advice 3: In the 2022 and 2021 exams, questions 3 and 2 respectively focused on how specific budgetary policy supply side measures might influence aggregate supply and the goal of low inflation. [Q2e of the 2021 exam also focused welfare reform, but this area has been removed from the current Study Design.] The errors made by students in relation to BP supply side initiatives mirror the errors made in relation to aggregate supply policies more generally. This includes spending an excessive amount of time describing the initiative and insufficient time on an explanation/description of how the initiative actually influences the target variables in the question (e.g. productive capacity and inflation). Students need to remember that, for a question such as this, the best responses will be those which provide a comprehensive description of how the initiative actually helps to increase aggregate supply and reduce inflationary pressures. Other ongoing issues include the confusion students experience when referring to productivity versus production or focusing on an aggregate demand side explanation as opposed to an aggregate supply side explanation.

Sample answer: training and education

An increase in training and education expenditure might involve increased government investment in training programs for government employees and/or additional budget incentives to boost private sector investment in training of staff. Either initiative is likely to improve the skills of employees and stimulate growth in labour productivity over time. This growth in productivity will help to reduce average costs of production, as more output can be produced per hour of labour employed, which increases the ability (and willingness) of producers to supply (i.e. boosts aggregate supply) and exerts downward pressure on prices and inflation.

or

Sample answer: research and development

R&D grants are typically funds provided by the government to businesses in order to increase incentives to undertake R&D activities, such as investment into new technologies. Given that the grants will raise the level of R&D expenditure in the economy higher than would otherwise occur, it has the potential to lift productivity (i.e. output per unit of inputs) given that some of the expenditure is likely to lead to new production methods or technologies that help businesses to produce more goods and services with the same or fewer inputs. For example, R&D spending on robotics can help to raise output per worker employed within a range of industries. This growth in productivity will help to reduce average costs of production, as more output can be produced per unit of inputs, which increases the ability (and willingness) of producers to supply (i.e. boost aggregate supply) and exerts downward pressure on prices and inflation.

or

Sample answer: subsidies

An increase in subsidies, such as cash support given to businesses designed to incentivise a certain type of business activity, can improve international competitiveness and improve living standards. [However, this is perhaps less true in the longer term if it is considered a form of protection, particularly if it invites retaliation from other countries.] For example, subsidies to educational providers or training institutions is an example of a producer subsidy that is designed to increase the willingness of producers to supply more education or training places; or alternatively, to improve efficiency or quality of the existing training service provided. Ultimately, the subsidies are designed to improve the quality of human capital, allowing the providers to reduce the cost of training or education and/or invest more in capital/technology/labour. To the extent that these institutions produce better quality courses and better-quality graduates, the subsidy helps to increase the quality of human capital as productivity rises. This growth in productivity will help to reduce average costs of production, as more output can be produced per hour of labour employed, which increases the ability (and willingness) of producers to supply (i.e. boost aggregate supply) and exerts downward pressure on prices and inflation.

or

Sample answer: infrastructure

An increase in infrastructure investment, such as investment in new or upgraded roads, bridges, airports, ports, and railways, is likely to improve international competitiveness and improve living standards. With more or better-quality infrastructure in place, the willingness and ability of businesses to produce goods and services will increase as it leads

to an acceleration in the efficiency/speed with which goods and services can move through the economy [e.g. between buyers/consumers and sellers/producers]. For example, better quality ports facilitate a speedier transportation of exports to foreign markets, as well as faster access to capital/intermediate imports, which ultimately improves productivity. This growth in productivity will help to reduce average costs of production, as more output can be produced per unit of inputs, which increases the ability (and willingness) of producers to supply (i.e. boost aggregate supply) and exerts downward pressure on prices and inflation.

or

Sample answer: Tax reform

Tax reform, such as the restructuring of tax system to eliminate inefficient taxes or ones that inhibit entrepreneurialism, can help to improve international competitiveness and improve living standards. The government could, for example, remove the inefficiencies in the current tax system that impose a relatively high effective rate of tax for stay-at-home parents who return to the workforce. Alternatively, it could reduce income tax rates to create additional incentives for individuals to become more entrepreneurial and/or increase their willingness to work harder at some workplaces. This occurs because the after-tax rewards from working and/or business investment it spurs, has the potential to raise output per unit of inputs (i.e. productivity). This growth in productivity will help to reduce average costs of production, as more output can be produced per hour of labour employed, which increases the ability (and willingness) of producers to supply (i.e. boost aggregate supply) and exerts downward pressure on prices and inflation.

b. Analyse how an increase in skilled immigration can increase aggregate supply in the economy. In your response, refer to the influence on productivity and labour force participation.

5 marks

- 1 mark for demonstrating an understanding of skilled immigration, aggregate supply and factors of production
- 1 mark for demonstrating an understanding of productivity and participation
- 1 mark for linking skilled immigration to an increase in productivity
- 1 mark for linking skilled immigration to an increase in labour force participation
- 1 mark for linking the increased participation/productivity to an increase in aggregate supply

Advice 1: The Study Design requires students to demonstrate an understanding of the effect of skilled immigration on population, productivity and participation and the subsequent effect on productive capacity, aggregate supply, international competitiveness, the achievement of domestic macroeconomic goals, and living standards. Accordingly, a question relating to immigration can require students to draw out the connections between skilled immigration and any combination variables/goals referred to above. For example, in the 2023 exam, students were asked to explain how an increase in skilled migration might affect productivity and Australia's international competitiveness. As noted in the 2023 Examination Report, many students were able to link an increase in skilled migration to an increase in the quantity of human capital (or labour supply) and then explain how this reduces pressure on wages and costs of production, before going on to link this to lower prices and an increase in international competitiveness. However, many neglected to make any meaningful reference to the important role played by productivity, which was required to achieve full marks. In the event that a skilled immigration question re-surfaces on the 2024 exam, it is important to establish clear and meaningful link between the key terms in the question.

Advice 2: Students should carefully interpret questions related to (skilled) immigration. While the current question refers to an increase in skilled immigration, the VCAA exam might refer to a decline in (skilled) immigration, as was the case in the 2018 exam (Question 3c). In that question, students were asked to explain one likely effect on …aggregate supply of decreasing the annual immigration intake from 200,000 to 100,000. Only 7% of students were able to achieve the full 4 marks, with the average score a very low 2.1/4 or 53%. Too many students misread the question and argued on the basis that there was a decrease in the total volume of immigrants living in Australia and a shrinking of the labour force. It was an easy mistake to make, arguing that the total number of immigrants in the country is falling and therefore glossing over the important fact that there remained an additional 100,000 immigrants entering the country each year.

Sample answer: *An increase in the number of skilled migrants entering the country [e.g. via the provision of more skilled visas] boosts the quality of labour as the average skill levels within businesses increase once highly skilled*

migrants join the labour force. This therefore helps to increase labour productivity as output per hour worked is likely to rise. In addition, the increase in skilled migrants will increase the labour force participation rate as the size of the labour force increases relative to the working age population. The resulting increase in both the quality and quantity of labour will both alleviate skills shortages and exert downward pressures on the price of labour [e.g. contribute to lower wages growth]. In addition, growth in labour productivity relative to labour costs will contribute to lower unit labour costs and lower average costs of production for businesses, which increases the willingness and capacity to supply goods and services to markets – i.e. boost aggregate supply.