



Units 3 and 4 Economics

Practice Exam Solutions

Stop!

Don't look at these solutions until you have attempted the exam.

Any questions?

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Section A – Multiple-choice questions

Question 1

The correct answer is B. When consumers become pessimistic about the global economic outlook, they are likely to reduce private consumption expenditure (C), which leads to a period of contraction.

Question 2

The correct answer is D. An oligopolistic market is likely to have few buyers and sellers, some product differentiation and difficult entry and exit.

Question 3

The correct answer is C. When unemployment increases, more people are reliant on transfer payments. Unemployment benefits are set deliberately below the minimum wage, thus increasing inequity which is represented by a higher Gini coefficient. (REMEMBER: a Gini coefficient of 0.0 represents perfect equality whilst a Gini coefficient of 1.0 represents perfect inequality)

Question 4

The correct answer is C. Increasing production costs only affect aggregate supply.

Question 5

The correct answer is D. A decrease in the terms of trade index is referred to as 'unfavourable'. This decrease in the ToT may reduce inflationary pressure in the economy as less income from exports feeds into consumer spending.

Question 6

The correct answer is A. The running of a successful advertising campaign for solar panels may encourage consumers to switch from alternative energy sources to solar panels.

Question 7

The correct answer is D. A recession is likely to increase unemployment rates, which decreases the amount of tax revenue received by the government. At the same time, in order to stimulate demand, the government is likely to increase current and capital expenditure to support full employment and economic growth.

Question 8

The correct answer is B. The price elasticity of supply of a good are influenced by three factors: spare capacity, length of the production period and durability of goods. An increase in redundancies means there are now fewer workers in this industry, and therefore a reduction in spare capacity which would lower the price elasticity of supply.

Question 9

The correct answer is C. The balance on goods and services can be calculated by subtracting merchandise imports from merchandise exports and adding net services. This gives a balance of

-\$15b. The balance on the capital and financial account will be the opposite of the balance on the current account (as it is the other section in the balance of payments). By adding net goods, net services, net income and net current transfers together, the balance on the current account is found to be -\$45bn. Therefore, the balance on the capital and financial account will be \$45bn.

Question 10

The correct answer is B. Real GDP statistics may overstate improvements in living standards if leisure time is decreasing. This is because leisure time is not included in GDP calculations. As a result, GDP could indicate an improvement in living standards, but this may be because people are working longer hours at work (which acts to diminish non-material living standards).

Question 11

The correct answer is C. If the government cuts spending to public hospitals those people on lower incomes, who cannot afford private healthcare, may suffer. This worsens equity in income distribution.

Question 12

The correct answer is D. In the long term, trade liberalisation forces local firms to engage in more efficient production practices in order to compete with cheaper imported substitutes.

Question 13

The correct answer is A. When the price of a good rises, consumers are likely to switch to cheaper substitute, increasing demand for the substitute product.

Question 14

The correct answer is A. When the RBA sells securities in the short-term money market, this is because they want to decrease money supply held by banks in their Exchange Settlement Accounts and increase the official cash interest rate. An increase in taxes by the government would stifle consumer spending and depress economic activity. They would not engage in this practice when inflation is below the target band of 2 – 3% CPI over the course of the business cycle.

Question 15

The correct answer is D. An ageing population occurs when the median age of the population rises and more people are leaving the workforce than are entering it. One of the major concerns over an ageing population in Australia is that this will place a greater strain on Australia's shrinking workforce.

Section B – Short-answer questions

Marks allocated are indicated by a number in square brackets, for example, [1] indicates that the line is worth one mark.

Question 1a

Market failure is a situation which occurs when the market fails to allocate resources in the most efficient way, ultimately causing material and non-material living standards to diminish. In 2005, economist, Nicholas Stern, stated that “climate change is the greatest market failure the world has ever seen”. This is because climate change is a form of negative externality (costs of economic activity imposed on a third party not directly involved in the transaction) associated with production. Production which has resulted from the burning of fossil fuels contributes to worsening air quality and rising sea levels, among other factors. This lowers non-material standards of living and results in market failure because the unregulated market has failed to put a price on these costs to the planet and its inhabitants.

Mark allocation:

- Definition of market failure [1]
- Explanation of how climate change is an example of a negative externality [2]

Question 1b

There are a number of environmental policies that have been implemented or could be implemented in the future to reduce the effects of climate change. Some examples include:

- **Renewable Energy Target**
The RET involves the issuing of solar credits, investment in wind and geothermal energy so as to ensure that 20 per cent of Australia’s electricity supply will come from renewable sources by 2020.
- **Carbon Tax** (came into effect in July 2012, repealed 2014)
Designed to set a price for each tonne of carbon (\$23), the carbon tax is designed to internalise environmental costs of production and encourage a movement away from carbon intensive production into investment in renewable energy alternatives.
- **Emissions Reduction Fund**
Designed to provide incentives (usually financial) to businesses in order to encourage the private development of clean energy methods of production, which would improve business efficiency and also help reduce emissions.

In order to gain full marks for this question, students must explain how the chosen policy might be used to reduce the effects of climate change and give consumers and producers an incentive to change their behaviour.

Mark allocation:

- Correct identification of one environmental policy [1]
- Explanation of how the policy might operation to correct the market failure of climate change [3]

Question 1c i

Environmental policies are designed to induce behavioural changes away from carbon intensive energy sources and into cleaner alternatives. As a result, in the short-term, firms may not immediately switch to more efficient energy sources, and instead pass this increased cost of production onto consumers in the form of higher prices. When prices rise, our ability to purchase goods and services is diminished and material standard of living suffers.

Mark allocation:

- Explanation of how a rise in prices in the short-term could diminish material standard of living [2]

Question 1c ii

In the short-term, inefficient Australian manufacturers which are heavily reliant on carbon for production may pass this increased cost of production onto consumers in the form of higher prices. This could make Australian exports less attractive against imported substitutes, reducing international competitiveness until Australian industries can adapt by investing in cheaper renewable energies.

Mark allocation:

- Explanation of how a rise in prices in the short-term may diminish international competitiveness [2]

Question 1d i

Environmental policies aim to internalise environmental costs of production, eliminating negative externalities. As a result, the social and environmental consequences associated with emitting greenhouse gases should be minimised. In the long-term, increased investment in cleaner, greener alternative energy sources should act to support the environment and significantly reduce health concerns arising out of poor air quality. This should improve the overall wellbeing of society, thus increasing material standard of living.

Mark allocation:

- Explanation of how environmental policies reduce negative externalities and support improvements in non-material standard of living [2]

Question 1d ii

Environmental policies should add to the nation's long-term economic prosperity as they may reduce the incidence of natural disasters, drought and water shortages, which act as a drag on growth. Further, environmental policies encourage investment in new alternative energies. This increased investment should add to economic growth in the long-term.

Mark allocation:

- Definition of strong and sustainable economic growth [0.5]
- Explanation of how investment in the renewable energies sector could enhance growth prospects [1.5]

Question 2a

In a competitive market economy, consumers are sovereign and send signals to suppliers on how resources should be allocated through their demand for particular products. Prices of goods and services may fluctuate depending on changes in the conditions of demand and supply. A natural disaster, such as the floods experienced in Queensland earlier this year, may act to significantly reduce supply of agricultural products. This reduction in supply creates a market shortage and increases the price of agricultural products.

Mark allocation:

- Explanation of how resources are allocated in a competitive market economy [1]
- Explanation of how a natural disaster will affect price signals and relative prices [2]

Question 2b

Price changes are the market's way of communicating information to suppliers and demanders. An increase in the price of a good or service tells demanders to economise on their use of the good or service, and tells suppliers to bring more of it to market. But, in the presence of inflation, prices are affected not only by changes in the supply and demand for a product but also by changes in the general price level. Inflation creates static, or 'noise', in the price system, obscuring the information transmitted by prices and reducing the efficiency of the market system.

Mark allocation:

- Explanation of how the price mechanism would operate without inflation [1]
- Explanation of how inflation reduces the efficiency of the price mechanism [1]

Question 2c

Inflation has overall decreased between 2011 and 2015. Consumer price inflation fell from a high of approximately 3.5% in 2011 to approximately 1.8% in 2015, with some fluctuation in 2012 and 2013.

Mark allocation:

- Correct identification of trend, including approximations of numerical CPI values in 2011 and 2015 [2]

NOTE: In a question which asks you to identify a trend in a graph, students do not need to provide reasons for this trend.

Question 2d

Small amounts of inflation allow for there to be reductions in the real prices of some goods and services which is beneficial to consumers (particularly those on lower incomes), and also helps to account for improvements in the quality of goods and services produced.

Mark allocation:

- Correct identification of possible effect on real prices [1]
- Discussion of how it may also capture improvements in goods/services' quality [1]

Question 2e

Weaknesses of monetary policy which could be discussed include:

- Monetary policy is a blunt instrument which cannot discriminate between which sectors of the economy it wants to target, making it less effective in dealing with a two-speed economy.
- Less effective in reducing cost inflation compared to demand inflation
- The impact lag can be up to 2 years, forcing decision making to be very forward looking and may be pro-cyclical when it should be anti-cyclical

Mark allocation:

- Correct identification of weakness [1]
- Explanation of weakness [1]

Question 3a

Consequences which could be discussed include:

- A slow in productivity growth would only act to exacerbate the skills shortages and capacity constraints brought about by an ageing population. In this situation, the economy may struggle to produce the goods and services necessary to support the domestic population.
- An extra strain would be placed on the working population, who would have a greater percentage of their income taxed so the government could support the elderly.

Note: other consequences exist, and could be successfully discussed in response to this question.

Mark allocation:

- Explanation of first consequence [2]
- Explanation of second consequence [2]

Question 3b

Since productivity is a measure of output per unit of resources, a supply-side budgetary policy initiative needs to be selected. Recent initiatives which could have been discussed include:

- The National Broadband Network
- National Workforce Development Fund
- DisabilityCare Australia
- \$3 billion investment to skill Australia's future workforce, including reform of the training system
- National Plan for School Improvement
- Infrastructure projects including Melbourne Metro

Note: this list is only a sample. Other budgetary measures exist and could be successfully related to improving productivity.

AS budgetary policy measures invest in skills, training and infrastructure which act to increase efficiency and boost productivity.

Mark allocation:

- Identification of correct budgetary policy initiative (must be from the past 4 years) [1]
- Explanation of how the chosen initiative acts to improve productivity [2]

Question 3c

- Immigration policy is a strategic supply side approach to managing the number and composition of migrants to Australia and overseas. The Federal Government's current immigration program particularly tries to attract young, English-speaking and suitably skilled migrants who can make a valuable and on-going contribution to the labour force and increase our productive capacity.
- As a result, immigration policy which targets young and skilled workers should act to increase labour force participation.

Mark allocation:

- Explain the government's current immigration policy [1]
- Explain how immigration of skilled workers can increase labour force participation [2]

Question 3d

Note: In preparation for the exam, students need only learn one of the four microeconomic reforms listed in this question.

- **Labour market reform** aims to link productivity with pay increases through wage decentralisation and deregulation of enterprise bargaining. Theory suggests improved labour force productivity leads to slower wage growth, reducing cost pressures to business, lifting productive capacity.
- **Trade liberalisation** involves the removal of protectionist trade practices such as tariffs, subsidies and quotas which were designed to make domestically produced goods and services more attractive against imported substitutes. This forces Australia to direct resources into production where we are most efficient. As a result, uncompetitive businesses will be forced to cut costs of production and improve productivity and efficiency. This accelerates sustainable growth, reduces prices, increases variety and supports low inflation and improved international competitiveness.
- **National Competition Policy** seeks to ensure that buyers will buy from the cheapest source and that sellers will seek to maximise profits by selling at the best price they can. In this way, sellers try to minimise production costs and maximise efficiency. The Australian Competition and Consumer Commission (ACCC) and the National Competition Council (NCC) aim to maximise competition between firms, reduce market power and eliminate anti-competitive practices. Ultimately, more competition promotes low inflation and strong and sustainable growth, which in turn helps to support the achievement of other goals and living standards.
- **Deregulation of key markets** is an attempt by governments to remove any unnecessary and inefficient regulations which supported the formation of oligopolistic industries. Deregulation supports a move to stronger competition which allows for the entry of rival sellers into markets. Ultimately, the government's five goals and living standards should improve as a result of this policy reform.

Mark allocation:

- Clear link between chosen reform and how it may act to influence each aspect of domestic economic stability: low inflation, strong and sustainable economic growth, full employment [3 x 2 = 6]

Question 3e

- The Australian government and the RBA aim to manage the Australian economy in order to achieve domestic economic stability. Ideally, they try to pursue all five government goals.
- The statement is wrong to suggest that AD policies are more important than AS policies in managing the Australian economy.
- Neither AD (macroeconomic budgetary and monetary policies designed to regulate economic activity) or AS policies (government strategies aimed at specific sectors of the economy to create more favourable supply-side conditions) can promote all five goals in isolation.
- AD and AS policies have different purposes and, when implemented in a complementary manner, their effectiveness is maximised and living standards rise.
- During 2005 – 2008, the economy was booming; high rates of economic growth, together with labour shortages were leading to both cost and demand inflationary pressures. In an attempt to control inflationary pressures and avoid the economy entering into a dangerous wage-price spiral, the government implemented AD policies to tackle demand inflation while it used AS policies to restrain cost inflation. Monetary and budgetary policies were contractionary, acting to slow AD. This was complemented by AS policies, such as increased immigration (155,000 migrants in 2007-08) and labour market reform which assisted in expanding the pool of labour resources, whilst keeping wages in line with inflation.
- During the GFC, AD and AS policies again worked in tandem to support the cyclical and structural components of the economy. The government implemented timely, temporary and targets cash transfers to boost demand whilst they also invested in nation building AS initiatives such as the Building Education Revolution.
- Although it is sometimes difficult to achieve a complementary policy mix (for instance, AS policies such as trade liberalisation may lead to structural unemployment, undermining the efforts of AD policies to attempt to lower unemployment and redistribute incomes more equitably), both AD and AS are equally crucial in management of the Australian economy.

Mark allocation:

- Recognition that AD and AS policies are both essential to the management of the Australian economy [1]
- Brief definitions of how AD and AS policies differ in nature and purpose [2]
- Specific examples of how AD and AS policies have complemented each other to support the Australian economy and achieve the five government goals [5]

Note: In an extended response question, examiners like to see a structured answer. A good way to tackle an 8 mark question such as this could be to start by briefly explaining how AD and AS policies differ and then state whether you agree or disagree with the statement by discussing how both policy types have been used over the past four years. This question requires students to incorporate recent, relevant examples and statistics into their discussion.

Question 4a

The exchange rate (the rate at which the AUD is exchanged for a given amount of foreign currency) closely follows the terms of trade (a ratio of import prices to export prices). For example, an increase in the terms of trade increases the demand for the AUD and decreases its supply in the FOREX market. Usually, a favourable movement in the terms of trade will be followed by a rise in the value of the AUD.

Mark allocation:

- Understanding that the exchange rate follows the terms of trade, including definitions [1]
- Example of how this might operate (e.g. discussion of how an increase in the ToT may lead to an increase in the value of the AUD) [1]

Question 4b

The two-speed economy in Australia has resulted in uneven growth between states. Robust demand from China and India for our natural resources, together with favourable interest rate differentials between Australia and the rest of the world have acted to keep the value of the AUD above its “fundamental value”. Mining sector exporters have benefited from the higher exchange rate because demand for coal and iron ore is relatively price inelastic (it is largely unaffected by price increases). Australian tourists travelling overseas have also benefited from the higher exchange rate as the AUD now buys more units of foreign currency. Many people lose from the high exchange rate, including most exporters, such as the Australian tourism industry and the Education Industry. These industries are struggling to attract tourists and people to come to Australia, as travelling here is now much more expensive than touring or studying elsewhere.

Mark allocation:

- Explanation of why some groups (provide specific examples) benefit [1.5]
- Explanation of why some groups (provide specific examples) suffer [1.5]

Question 4c

- Price elasticity of demand measures the degree to which demand will respond as a result of changes in price. Demand elasticity is extremely important in determining the attractiveness of Australian exports in world markets. If our exports are demand inelastic (that is, a change in price will lead to a smaller change in quantity demanded), then regardless of price increases, overseas buyers will continue to purchase our exports. Australia’s coal and iron ore exports to China are extremely price inelastic. China continues to demand our commodities regardless of changes in price. Exports which are demand elastic, such as education services, have suffered due to the rise in the value of the Australian dollar. Overseas students would prefer to switch to a substitute market (such as universities in the United States), rather than pay the higher fees in Australia.

Mark allocation:

- Definition of demand elasticity [1]
- Explanation of why demand elasticity is important for Australia’s export sales [1]

Question 4d

- Net foreign debt consists of public and private debt. To finance budget deficits, governments borrow money from overseas. Remaining in deficit means that the government is needing to continue to borrow in order to finance the budget deficits, which would overall increase net foreign debt.

Mark allocation:

- Explanation of the relationship between the government deficit and public debt [2]
- Explanation of how remaining in a budget deficit is likely to further increase public debt and NFD [1]