

## GENERAL COMMENTS

Students responded positively to the 2014 VCE Economics examination, with most students attempting all questions. However, in Section B, some students did not plan the use of their time as well as they might have. Some students wrote too much early on and then appeared to rush and/or not fully develop responses to later questions, while others wrote long answers for two-mark questions and did not give themselves enough time to appropriately tackle the questions worth four and six marks. It is essential that students plan the use of their time carefully and use the mark allocation as a guide to the level of detail required in their responses and the amount of time they should allocate to completing parts of questions.

Most students demonstrated sound knowledge of current economic policy and the recent history of the Australian economy. Students who were able to correctly apply economic theory to explain current and recent changes in economic conditions and policies generally earned the highest marks. However, students need to remember that when asked to select a factor and to describe or explain its likely impact (for example, Section B, Questions 1c. and 4b.), they should make sure they have fully answered the ‘how’ or ‘why’ of the selected factor’s impact.

Students’ use of key economic terms and concepts had improved from previous years. However, students need to be careful not to spend too much time defining key concepts and terms, and then not explicitly and fully answer the question.

Students continued to perform strongly when they were able to clearly explain key economic relationships, such as in Section B, Questions 2d. and 4c.

## SPECIFIC INFORMATION

**Note: Student responses reproduced in this report have not been corrected for grammar, spelling or factual information.**

This report provides sample answers or an indication of what the answers may have included. Unless otherwise stated, these are not intended to be exemplary or complete responses.

The statistics in this report may be subject to rounding errors resulting in a total less than 100 per cent.

### Section A – Multiple-choice questions

The table below indicates the percentage of students who chose each option. The correct answer is indicated by shading.

Question	% A	% B	% C	% D
1	3	1	5	90
2	9	4	83	4
3	1	7	1	92
4	30	58	8	4
5	11	5	79	5
6	18	66	7	9
7	83	6	9	2
8	4	77	13	5
9	3	2	3	92
10	57	14	15	15
11	4	16	13	67
12	69	17	3	10
13	21	16	16	46
14	19	12	57	11
15	88	2	7	2

## Section B – Written responses

### Question 1a.

Marks	0	1	2	Average
%	5	15	80	1.8

Most students were able to describe what was meant by a perfectly competitive market, generally providing at least two characteristics of such a market. Any two of the following were accepted:

- no or low barriers to enter the market due to low set-up costs
- homogeneous products – products are identical (no product differentiation)
- many buyers and sellers interacting in the market who possess perfect knowledge of the market.

The following is an example of a high-scoring response.

*This market is characterised by an unlimited number of buyers and sellers, all of whom possess perfect market knowledge. In such a market no single buyer or seller has sufficient market power to be able to affect market price through their own actions. As such all market participants are price takers. In such a market products are homogeneous (identical that is no product differentiation exists) so that firms are forced to compete on price. There are no barriers to exit and enter the market. The structure of relative prices becomes the sole determinant of resource allocation.*

### Question 1b.

Marks	0	1	2	3	4	Average
%	8	12	29	29	22	2.5

Most students were able to define externalities and asymmetric information and provide examples, but often did not link, in sufficient detail, why these resulted in market failure. Students need to examine in more detail what is meant by market failure, appreciating why market failure is a situation in which the allocation of goods and services by a free market may not be efficient. Market failures can be viewed as scenarios where individuals' pursuit of self-interest leads to results that are not efficient, that is, resources may be over- or under-allocated and so wellbeing is not maximised.

Most students focused on negative externalities and were able to correctly identify an example of a negative externality. Most were, however, unable to explain why it led to an inefficient allocation of resources, which is specifically what the question required. For example, students were not able to link negative externalities to a situation where there might be an overproduction of certain types of products.

The following is an example of a response that thoroughly answered the question and demonstrated the required understanding.

*Externalities exist where a cost (negative) is imposed on or a benefit (positive) accrues to a third party not involved in the production or consumption of a product. Negative externalities, for example, will cause an over-allocation of resources to the production of the good because the producer or consumer will not take into account the external costs. For example, when cigarettes are consumed, those who smoke passively may suffer resultant illness and increased medical costs. Therefore, from society's point of view wellbeing is not maximised and there is market failure with too many cigarettes produced and consumed.*

While most students could define asymmetric information, sometimes the examples were not very useful in terms of explaining the misallocation of resources. The examples were not linked to market failure and students were unable to explain why an imbalance in the amount of information could have an impact on efficiencies.

The following is an example of a high-scoring response containing the expected explanation.

*Asymmetric information exists when one party in a transaction knows more about a product than another (that is information is uneven). In an employment contract, for example, the employee knows how hard they work but the employer may not. This might lead to the problem of moral hazard where the employee alters their behaviour because they don't think they will get caught (be observed). The employee might decide to reduce their effort and therefore productivity is lower than it would be if the employer knew what was going on. Technical efficiency is not achieved and the maximum number of goods and services cannot be produced which means society's wellbeing is not achieved and market failure results.*

# 2014 Examination Report

## Question 1c.

Marks	0	1	2	Average
%	36	22	42	1.1

Many students struggled with this question, demonstrating that they have difficulty in understanding the price elasticity of supply. Price elasticity of supply refers to the degree of responsiveness of the quantity of a good supplied to a change in its price. Many students could not identify a factor that influences the price elasticity of supply. A large number of students confused the price elasticity of demand with the price elasticity of supply. Students who did not know the difference gave inappropriate factors. Even students who were able to identify a correct factor were not always able to link it to how it would affect the responsiveness of supply to changes in price, which is what the question required. High-scoring answers stated how the factor helped or hindered supply to respond to changes in price. Examples of factors correctly selected included the durability of the good (storability) and the production period.

The following is an example of a high-scoring response.

*One factor that affects PES is the durability/ability to store goods. If goods can be stored by suppliers/producers in the market place – such as is the case with non-perishable products like tinned fruit – then it is easier to respond to changes in market price with increased or decreased supply. In the case of tinned fruit if the prevailing market price suddenly increased – providing a significant boost to profit margins – suppliers could readily access stockpiled products from storage and increase supply in the market place to take advantage of the changed market conditions. In this scenario we would say that there was a high degree price elasticity of supply for tinned fruit. The easier goods can be stored the higher the PES.*

## Question 1d.

Marks	0	1	2	3	4	Average
%	14	15	21	26	25	2.4

Many students successfully used an example to support their explanation of how a change in relative prices might result in a reallocation of resources.

However, there are still some areas where students remain confused. For example, a number of students argued that suppliers are attracted to supply when prices are lower. Students need to develop their understanding of the relationship between supply, price and profits. Another concern was that a number of students spoke about the price of one good or service rather than relative prices. Furthermore, some students simply stated that higher prices would result in a reallocation of resources to a product without clearly showing why or how; these students did not recognise that the higher prices might be caused by supply-side shocks or rising costs of production. This meant that some students made general statements that were not supported by a realistic example.

The following is an example of a high-scoring response.

*Relative prices refers to the price of one product in terms of another. Whenever there is a change in relative prices – there will be a change in the relative profitability of production (supply) of one product as opposed to another. Relative price changes act as signals to market participants that in the interest of maximising satisfaction, they should perhaps reconsider their market behaviour.*

*For example, if there has been a switch in consumer demand from Product A to Product B as it is announced that there are considerable health benefits in consuming Product B – there will be a short term surplus of Product A on the market resulting in a decrease in its market price. At the same time the increased demand for Product B will result in a short term shortage of Product B in the market and this will result in upward pressure upon the market price. Suppliers in the market will view these price signals as evidence of declining profitability in supplying Product A and improving profitability in supplying Product B to the market – assuming stable production costs for both products. In this scenario a greater quantity of resources (factors of production – land, labour and capital) will now be directed to the supply of Product B and a lesser quantity of resources to Product A – assuming factor mobility is high. In a perfectly competitive market – consumer sovereignty prevails – with suppliers responding directly in their production and resource allocation decision making, to relative price signals caused by changes in consumer spending patterns in the market place.*

# 2014 Examination Report

## Question 2a.

Marks	0	1	2	3	4	Average
%	26	15	20	17	21	1.9

Many students struggled with this question. Responses indicated that many students do not know the difference between budget deficits and current account deficits and so they were unable to answer this question as they responded with reasons for current account deficits rather than budget deficits.

The question assessed students' knowledge of recent economic developments related to the budget and required them to apply economic theory, that is, for example, the impact of automatic stabilisers on the budget outcome.

The highest-scoring students made explicit links between the economic factors and the deterioration in the budget outcome and covered the following points.

- A deterioration in the nation's fiscal position is represented by an increase in the size of the federal budget deficit. This is usually caused by non-anticipated increases in budget outlays and/or decreases in budget revenues.
- Since 2012, there has been a significant deterioration in the cyclical component of the federal budget, this being the component of the federal budget outcome that responds to changes in the level of macroeconomic activity.
- With a significant softening in macroeconomic activity over the past two years, Australia has experienced weaker economic growth, downward pressure on business profitability with significant structural changes within industries such as manufacturing, and upward pressure on the national unemployment rate. Such macroeconomic softening has had an impact on the federal budget components in such ways as:
  - less company tax receipts than anticipated
  - less personal income tax receipts than anticipated
  - increased outlays due to higher unemployment and the need to support the unemployed and their household dependents
  - increased pressure on the government to provide a range of public goods and services to prop up national living standards.
- Some specific local and global factors that may have had an impact on the strength of the budget position may have also included:
  - disappointing levels of receipts from new taxation initiatives including the minerals resource rent tax (MRRT) and the carbon tax
  - a softening of economic growth in China combined with an overvalued Australian dollar, flowing through to lower profitability in the mining sector and subsequent decline in taxation revenue generated for the federal budget by the mining industry
  - the declining competitiveness of Australian manufacturing industries, with a pattern of withdrawal of local investment and subsequent decline in the national taxation base
  - the reduction in Australia's terms of trade has led to lower than anticipated levels of national income; for example, mining company profits were not as big as anticipated and acted 'automatically' to lower government receipts from company tax and the MRRT. This reduces government revenue and, therefore, the budget/fiscal position worsens.

## Question 2b.

Marks	0	1	2	Average
%	32	33	35	1.1

Most students suggested that budget deficits are likely to have negative consequences and made a link to increasing levels of debt. Many were unable to explain why budget deficits require funding and how this may have an impact on levels of net foreign debt.

Some students did not understand the question and wrote about the government having to increase taxes to restore the budget to surplus rather than focusing on the consequences of budget deficits. Raising taxes to restore the budget to surplus was relevant to the following question. Students are advised to read questions very carefully so they understand exactly what is required in the response.

Most students stated that running continued budget deficits is negative for the economy, but students would have been rewarded if they had claimed that budget deficits might be positive for the economy in some circumstances.

# 2014 Examination Report

The highest-scoring responses used one of these implications:

- possible negative economic implications
  - Deficits must be financed by government borrowing, adding directly to the gross public sector debt that must be repaid out of future taxpayers' funds. The living standards of future citizens may be diminished as the pressure of debt servicing and debt repayment inhibits the capacity of governments of the future to allocate sufficient funds to outlays on societal development, such as infrastructure programs and public goods and services.
  - Australia's AAA credit rating might be downgraded, increasing the cost of future debt.
  - The government will be left without a buffer to respond to future economic shocks. Prior to the global financial crisis (GFC), the Howard government managed to achieve 11 successive budget surpluses (except in 2001–2002), meaning that the Rudd government had sufficient financial resources to combat the fallout from the GFC. Moreover, because the government was 'debt free' prior to the GFC, it was also able to borrow at relatively low interest rates to finance the large budget deficits required to stimulate the economy during the GFC.
  - While the most favoured and least damaging means of financing deficits tends to be public sector borrowing through the sale of government securities within financial markets, the difficulty that can arise is 'crowding out', whereby competition for scarce savings tends to place upward pressure on general interest rates.
  - A situation of deficit dependency might arise, whereby the private sector becomes accustomed to the large role of the federal government in driving economic activity. The sheer presence of large government expenditure as a percentage of Gross Domestic Product (GDP) can inhibit private sector initiatives. Social welfare dependency can also have very significant long-term negative economic implications for the national economy and general living standards.
  - Given that approximately 25% of Australia's net foreign debt is public sector debt and is projected to increase, this might lead to growing external instability.
- possible positive economic implications
  - From a Keynesian position, these large and continued budget deficits may be viewed as necessary to prop up aggregate demand sufficiently in order to maintain stability in key macroeconomic variables, such as economic growth.
  - A key underlying element of the large and continued budget deficits may be seeing through to completion a number of major infrastructure projects that are essential to structural readjustment of the Australian economy, and so necessary for improving Australia's competitiveness as a global economy. Such initiatives may be necessary to strengthen the supply side of the Australian economy, to enhance our capacity to improve our trade balance, and to maintain both local and foreign investment confidence in the Australian economy.

## Question 2c.

Marks	0	1	2	Average
%	21	27	53	1.3

Most students were able to attempt this question successfully. However, students struggled to explain explicitly the link between the government's actions and the possible effect on the goal. There were too many generic statements and little specific reference made to the effect on equity, such as the gap between high-income and low-income earners and/or the ability to access necessities.

There was also some evidence of confusion. A number of responses simply stated the government would need to raise taxes but did not distinguish between the progressive or regressive effects of tax increases and the impact on equity.

The following points were central to the answer:

- The concept of 'living within its means' implies that the government may choose to make discretionary decisions to cut budget outlays or to increase government revenues in order to move the budget back towards a surplus result.
- Low-income earners and, consequently, equity in income distribution in the Australian economy may be adversely affected if:
  - cuts occur in outlays on social welfare/income support payments
  - cuts occur in the provision of public goods and services, such as access to health and public housing
  - as announced, a co-payment may be required to visit the doctor, which increases the cost of visiting the GP and this would have a regressive effect in that the co-payment would represent a higher proportion of low-income earners' income
  - the goods and services tax (GST) is raised or extended to tax fresh food, for example. This tax tends to have a regressive effect as it represents a greater proportion of low-income earners' income.

# 2014 Examination Report

- If the following decisions are made, middle-income and high-income earners may be affected and, consequently, equity in income distribution in the Australian economy may be improved if:
  - cuts occur or stricter qualification limits apply to the so-called range of ‘middle-income welfare’ that may exist, such as the Paid Parental Leave scheme
  - adjustments are made to the rules associated with such systems as negative gearing and family trusts that tend to benefit middle-income and high-income earners with a legitimate means of income tax ‘avoidance/minimisation’
  - adjustments are made to marginal Pay As You Go (PAYG) tax rates at the top end only, to attempt to raise more taxation revenue from high-income earners and to make our PAYG system more progressive in nature.

## Question 2d.

Marks	0	1	2	3	4	5	6	Average
%	10	4	9	13	21	24	18	3.8

The number of students who were able to discuss current, deliberate/discretionary budgetary policies announced in the 2014–2015 Budget was impressive and highlights that students have taken note of previous examination reports, which have emphasised the need for students to be able to talk about current policies and economic conditions. However, while many students were able to select an appropriate policy and explain it, they often did not explain how it would affect equity in income distribution. Some students also forgot to link the answer to living standards and/or explain what living standards mean. Without paying attention to all of the question’s requirements, students could not expect to score high marks.

Again, there was some evidence of confusion. For example, some students thought that imposing a stricter means test on welfare payments (for example, tightening eligibility for Family Tax Benefit [FTB] B was ‘bad’ for equity). This demonstrates misunderstanding of the purpose of means testing. Means testing is about ensuring that those who are most in need receive government assistance, rather than assistance being misdirected to those groups without a genuine need. Indeed, the point of changing the means test for FTB-B from \$150 000 to \$100 000 is to address the issue of so-called ‘middle-class welfare’ and government largesse.

Students had to select two discretionary budgetary policies. The following are examples of some of the policies announced in the 2014–2015 Budget that students selected:

- tax increases
  - budget deficit repair levy of 2% on incomes of \$180 000 or more (for three years)
  - reintroduce indexation of the fuel tax excise
  - abolish mature age workers tax offset and the dependent spouse tax offset
- welfare cuts
  - family payment reform
  - gradually reduce eligibility for government payments
  - cease funding to states to provide concessions to pensioners and seniors card holders
  - tighten eligibility for unemployment benefits for under 30s
- health
  - co-payment of \$7 when visiting a general practitioner (GP)
  - increase co-payments and safety net thresholds for the Pharmaceutical Benefits Scheme (PBS)
- education
  - higher-education loan program (increase interest rates and lower repayment thresholds).

To answer this question successfully, students had to cover the following areas:

- Students had to correctly identify either a new policy of relevance or an adjustment to a past policy of relevance on either side (revenues or outlays) within the 2014–2015 budget statement. Some awareness of the nature or intended operation of the discretionary policy was expected.
- Students could have chosen discretionary policy changes that might have either a positive or a negative impact on equity. It was expected that students would explain how the discretionary policy selected was likely to have an impact on equity and the gap between high-income and low-income earners. Credit was given to students who were able to correctly use the terminology in the equity section of the study design, such as gross income, disposable income, marginal income tax rates, Gini Coefficient, Lorenz Curve, progressive effect and regressive effect, as appropriate to enhance their explanation.
- Some link to the possible effect(s) on either material or non-material living standards in Australia needed to be mentioned as a result of the discretionary policy change selected.

# 2014 Examination Report

Using the budget deficit repair levy, a response such as the following scored high marks.

*To assist with the government decision to achieve a reduction in the budget deficit over the next few years, a Budget deficit repair levy is to be introduced from 1 July, 2014. This represents a 'tax increase' for high income earners (earning over \$180K pa) as their income tax rises by 2% pa. This does not affect middle and low income earners. This tends to make the income tax system more progressive, thus reducing the gap between high and low income earners which means equity is improved. High income earners disposable incomes are reduced and so in this way this might be considered a policy that will reduce their material living standards.*

### Question 3ai.

Marks	0	1	2	Average
%	16	38	46	1.3

The question asked for the difference between cyclical and structural unemployment. A number of students struggled to define these two types of unemployment, which made it difficult to explain how the two types of unemployment were different. Many provided an example of what might cause each type of unemployment. Too many students mixed up cyclical unemployment with seasonal unemployment.

A response such as the following scored high marks.

*Cyclical unemployment arises due to a decline in macro-economic activity whereby a slow down or decline in aggregate demand results in business decisions to cut back production resulting in less derived demand for labour. This may lead to retrenchments and/or a lack of new advertised jobs.*

*Structural unemployment arises due to the structural changes that occur within industry sectors over time – creating a mis-match between the skills required by businesses and the skills being offered by job seekers. Structural change within industries can arise due to advances in technology; global pressures for industry reform, as a result of the introduction or withdrawal of government initiatives/policies; changes in resource availability and changes in factors affecting global competitiveness (e.g. changes in the exchange rate).*

*The key point of difference between the two types of unemployment is that the level of cyclical unemployment is linked to the strength or weakness of macro-economic activity whereas structural unemployment can exist independent of the health of the macro-economy.*

### Question 3aii.

Marks	0	1	2	3	4	Average
%	13	11	26	25	26	2.4

Most students were able to identify a relevant industry sector (for example, car, manufacturing, mining, retail) and demonstrate current knowledge.

The following is an example of a high-scoring response.

*The Australian car manufacturing industry is an industry sector that has been affected and is in decline. There were a number of announcements in the first half of 2014 indicating Australian car manufacturers such as Holden and Ford will cease operation entirely in the next couple of years.*

*A demand side factor that may be responsible for the demise of the Australian car industry could have been the high value of \$AUD in recent years. This led to the cost of imported vehicles (Audi, BMW, VW, etc) becoming far more affordable (change in relative prices compared to domestically produced cars), resulting in these vehicles taking a greater market share.*

*On the supply side – the slowdown in productivity improvements in Australia in recent years, including in the Australian car making industry, may have been a factor in contributing to a lack of price competitiveness in Australian made cars compared to imported cars.*

### Question 3aiii.

Marks	0	1	2	Average
%	33	32	34	1

A number of students performed poorly on this question because they did not appear to know the causes of structural unemployment and, therefore, selected any discretionary policy that might reduce unemployment in general rather than specifically targeting ways to reduce structural unemployment.

# 2014 Examination Report

The following is an example of a high-scoring response.

*The government may allocate increased funding for retraining programs and further education so that the structurally unemployed learn new skills which would allow them to find work in other industries.*

### Question 3b.

Marks	0	1	2	3	4	5	6	Average
%	18	9	11	16	18	14	14	3.1

The highest-scoring answers to this question were those where students structured their answer carefully and responded to all aspects of the question. Students could not be awarded high marks if they did not address all aspects of the question. Some students did not use two transmission channels or the likely impact on levels of economic growth and employment were omitted. While some short definitions related to key concepts in the question may be appropriate, it was often the case that students spent far too much time defining concepts and not nearly enough time addressing the requirements of the question.

The majority of students were able to accurately sum up the monetary policy stance in 2014, making comments such as the following.

*During 2014, the cash interest rate has not been changed. The Reserve Bank of Australia (RBA) has maintained an accommodative monetary policy stance with the cash rate of interest being maintained at an historically low rate of 2.5 percent. In fact the stance may be considered very expansionary because the cash rate of 2.5% is well below what many consider to be monetary policy neutrality of 4.25%. This stance has been possible and necessary as inflation rates have been maintained within the target zone of 2–3% over the medium term and there is a need to support demand and help strengthen levels of economic growth and employment growth – consistent with the RBA Charter.*

However, a number of students did not seem to know what the transmission channels are and wrote about open market operations. The study design requires that students understand how monetary policy operates to affect aggregate demand and domestic economic activity, and it is through the various transmission channels that monetary policy operates to affect aggregate demand and economic activity.

Some transmission channels that students could have referred to and that were in play during 2014 through the maintenance of such an accommodative monetary policy stance included:

- cost of credit channel – The relatively cheap finance on consumer credit and finance for home loans has seen consumers continue with their willingness to borrow and spend, resulting in higher levels of aggregate demand and, consequently, strengthened economic growth along with somewhat lower levels of cyclical unemployment. The benefits of new borrowing for macroeconomic activity are felt in the economy over a sustained period through the credit multiplier effect.
- cash flow channel – The lower interest rates help households and businesses to service existent debt more comfortably, enabling households or businesses to have more discretionary income to satisfy other needs and wants. If such discretionary income is spent domestically, then this will likely boost aggregate demand and create a higher level of economic growth and more employment opportunities.
- exchange rate channel – Relatively low interest rates in Australia will often lead to withdrawal of speculative investment from within Australia, resulting in an increase in supply of the Australian dollar on the foreign exchange market. This pushes the exchange rate down (depreciation of the Australian dollar) and improves the price competitiveness of Australian exports and import-competing products. Increased demand for such products tends to boost injections and reduce leakages of domestic activity and helps to sustain, if not increase, economic growth. Employment opportunities are likely enhanced in the Australian manufacturing and exporting sectors and lower unemployment should follow. A multiplier effect should also sustain the benefits of this boost to domestic economic activity.

### Question 3c.

Marks	0	1	2	3	4	5	6	Average
%	4	7	12	15	21	24	17	3.8

Most students recognised how immigration policy might boost the ability of firms to supply but there was little evidence that students knew what the term ‘productive capacity’ meant. An explanation of the relationship between productive capacity and economic growth was also missing from most responses.

# 2014 Examination Report

The same problem was present in students' explanations of microeconomic reform policy, where they were able to explain how microeconomic reform policy might increase productivity but they did not effectively link this to productive capacity and economic growth.

The highest-scoring responses in relation to immigration policy made the following points. Increasing skilled migration aims to:

- increase the quantity of labour resources (the participation rate)
- increase the quality of labour resources (labour productivity)
- raise the economy's productive capacity or supply potential
- enable the economy to achieve higher rates of non-inflationary economic growth.

Most students chose trade liberalisation as their microeconomic reform policy. However, regardless of the area of microeconomic reform policy selected by the student, the highest-scoring responses made links to boosts in productivity and economic growth through the use of such terms as:

- increased competitiveness
- improved cost efficiency/lower costs of production
- increased labour productivity/multi-factor productivity
- enhanced productive capacity
- improved international price competitiveness
- enhanced profitability
- deregulation/removal of impediments to free market forces
- enhanced willingness and ability to produce
- increased rates of economic growth.

#### Question 4a.

Marks	0	1	2	Average
%	33	22	45	1.1

Most students answered this question satisfactorily. Some students did not mention that these were measurements of price changes, but most knew that underlying inflation excluded volatile items.

The following is an example of a high-scoring response.

*The headline rate of inflation is measured by estimating the average annual change in retail prices across a regimen or 'basket' of goods and services.*

*The underlying rate of inflation is an alternative measure of core inflation pressures which is calculated using the headline CPI as a starting point but then excluding from the calculation price changes in volatile items and also excluding any price changes in items as a direct consequence of government policy initiatives (e.g. increased excise duties on alcohol).*

*Both are measures of inflation. However, the headline rate is an 'all inclusive measure' whereas the underlying rate reveals the longer term trend in the base (core) inflationary pressures within the economy.*

#### Question 4b.

Marks	0	1	2	Average
%	28	26	46	1.2

Although there was a large amount of media attention given to the reasons for the changing value of the Australian dollar, many students struggled to describe a factor that may have explained the change in the value of the Australian dollar in 2013 and 2014.

Other weaknesses in responses were that some tried to use the trade-weighted index (TWI) as the cause of the fall in the Australian dollar and did not recognise it as another measure of the Australian dollar.

Some students achieved half the marks available because they could correctly identify a factor but were unable to link it to the demand or supply of the Australian dollar in international currency markets.

High-scoring responses clearly explained the trend shown in the table, that is, stating that there has been a trend of depreciation in the Australian dollar on both the cross rate (AUD:US) and on the more general TWI (an average indicator of trend movement against a basket of currencies) throughout the latter half of 2013 and into 2014 (as shown

# 2014 Examination Report

in the data in the question). The broad explanation for a depreciation of the Australian dollar is that there must have been an increase in supply and/or a decline in demand for the Australian dollar in the foreign exchange market. As the Australian dollar is now freely floating, its global price – the exchange rate – is set by the free interaction of demand for it and supply of it in the foreign exchange market.

Once the trend had been described, the highest-scoring responses then used one of the following factors as a way of explaining the trend. Specific factors that may have induced changes in demand and supply of the Australian dollar might include the following:

- demand declining
  - a slowdown in economic activity in China resulting in less demand for mining resources and consequently less demand for the Australian dollar
  - a deterioration in Australia’s terms of trade resulting in lower export prices of commodities and consequently less demand for the Australian dollar in order to purchase the same or similar quantities of exports from Australia
  - declining interest by offshore investors to invest (direct or portfolio) in Australia due to lower perceptions of profitability
- supply increasing
  - overseas investors may be withdrawing their investments from Australia as perceptions of more profitable investment options in other regions of the global economy arise
  - Australian financial institutions are looking to reduce exposure to offshore debt and are paying large sums of existent foreign debt in the short term
  - the trade balance may have shifted into deficit, implying that Australian consumers and producers may have increased their demand for imports, thus flooding the foreign exchange market with Australian dollars in exchange for the currency of the nations from which the imports are being sourced.

#### Question 4c.

Marks	0	1	2	3	4	Average
%	20	14	18	20	27	2.2

Some very good answers were written in response to this question. High-scoring responses defined the meaning of the goal of external stability and then chose one way in which the depreciation may likely affect that goal. Low-scoring responses did not describe in sufficient detail the likely effect of the depreciation on the economic goals.

The goal of external stability is said to be achieved when the Australian economy is able to improve the strength of its position in the global economy, as evidenced by the ability to continue to pay its own way in international trade transactions. External stability is measured by:

- the degree of stability in the exchange rate
- the size of the current account deficit as a percentage of GDP (measuring the affordability of the net leakage through trade)
- the size of the net foreign debt as a percentage of GDP (measuring the capacity of the domestic economy to service its net foreign debt).

Students who scored high marks then described one of the following effects. A depreciating Australian dollar may have a number of effects on the achievement of external stability:

- A depreciation means Australian exports become more affordable in global markets while turning domestic demand to locally made import-competing goods and away from imports. On balance this should reduce the size of the current account deficit.
- However, a depreciation may not have this effect if Australian households have a price inelastic demand for imports. In such a case, the depreciation will simply add to the cost of imports and result in a further deterioration in the trade balance.
- A depreciation can also have a negative effect on the current account deficit through the valuation effect on the size of the net foreign debt and the size of the debt servicing costs that appear as a debit in the net primary incomes component of the current account deficit. This arises when the debt and the debt servicing costs are denominated in the foreign currency.

The following is an example of a high-scoring response to the second part of the question.

*The goal of low inflation is about ensuring that the general level of price increases are held at between 2–3% per annum over the business cycle. A depreciation in the AUD may result in making it more difficult to achieve the goal of low inflation. With the value of the dollar depreciating, the price of imports increases in terms of the AUD because each AUD buys less foreign*

# 2014 Examination Report

currency. This means that the cost of imported component parts for businesses increases. So in order to maintain profit, businesses may increase the price of their good or service as a result of this increased cost of production. This may result in cost inflationary pressures.

## Question 4d.

Marks	0	1	2	3	4	5	6	Average
%	19	11	15	16	15	14	10	2.8

This question required students to explain how the 2014–2015 Budget is likely to influence aggregate demand and the goal of low inflation, as well as aggregate supply and the goal of external stability.

The highest-scoring responses referred to the anticipated change in the budget outcome from –\$49.9b (2013–2014) to –\$29.8b (2014–2015), and noted that the budgetary policy stance is mildly contractionary, that is, the government is injecting less stimulus (by increasing tax revenues and decreasing government outlays) into the economy compared to the previous year, which slows the rate of growth in aggregate demand and thus places downward pressure on prices.

Some students also discussed how specific budgetary policy actions, such as the introduction of the Temporary Budget Repair Levy and tightening eligibility for a host of transfer payments, are likely to lower the consumption component of aggregate demand and thus lower aggregate demand. Ultimately, this should help to keep demand inflation in check.

The following is an example of a high-scoring response.

*The budget in 2014/15 is generally seen as contractionary as the size of the budget deficit is forecast to fall from around \$50bn to \$30bn. This is to be achieved by increasing revenue (such as by the introduction of the Temporary Budget Repair Levy) and reducing expenses (such as indexing pensions to the Consumer Price Index (CPI) rather than wages and making it unlikely those under 30 will receive unemployment benefits in the first 6 months they are unemployed). These actions will increase leakages from the economy and decrease injections so income is likely to decrease. The contractionary stance of the budget compared to the previous year will therefore reduce AD (disposable income falls so private consumption expenditure C decreases and so does Government spending G as well so AD falls). This means the economy is likely to move further away from its productive capacity so shortages (which would cause prices to be bid up) would be less likely to occur. Therefore it will help to achieve low inflation (that is, keeping a 2–3% increase in average prices over the course of the business cycle).*

*One aspect of the budget that might affect aggregate supply (AS) is the decision to increase spending on infrastructure (allocation of \$11.6bn infrastructure growth package). Spending on for example improving roads and highways is likely to lead to a reduction in travel times on road networks meaning for example more deliveries can be made and less petrol consumed. This might lower the costs of production for Australian producers so they may be able to lower prices. This may increase their international competitiveness and raise export sales. This means the balance of trade may improve and the balance of payments on current account will decrease. Keeping the size of the current account deficit as a % of GDP (Gross Domestic Product) at an appropriate level as it measures the affordability of the net leakage through trade is an important part of achieving external stability.*