

THE CPAP STUDY GUIDE TO VCE ECONOMICS



PART 1 Unit 3
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Economicstutor.com.au

Economicstutor.com.au has been created by Romeo Salla, an Australian economics educator and former federal treasury economist. It offers support to students and teachers of economics, particularly those undertaking a secondary economics course in Australia.

The website is primarily designed to provide students with a series of challenging activities/tests that will take the form of **interactive multiple choice question sets** of 10 (complete with explanations) and **short answer questions** requiring students to fill the gaps to reveal model answers for a typical test/exam questions. Crosswords and other interactive activities will also feature throughout the site and **compact course notes** are included to support texts and other teacher resources.

All of the activities and core notes are categorised into each of the topic areas below. **Note** that most areas of the site are **password protected** with the exception of 'Introductory concepts'. Students and teachers are **free** to access the **course notes** and activities within the 'Introductory concepts' pages of the site, including the interactive activities. Access to other areas of the site requires a password (provided with the purchase of a **membership**).

1. **Introductory concepts**
2. **Market mechanism**
3. **Elasticities**
4. **Market structures**
5. **Market failures**
6. **Macro economic activity/eco growth**
7. **Inflation**
8. **Employment & unemployment**
9. **External Stability**
10. **Income distribution**
11. **Factors affecting economy**
12. **Fiscal/Budgetary policy**
13. **Monetary Policy**
14. **Aggregate Supply Policies**
15. **The Policy Mix**
16. **Course revision**

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The Unit 3 Study Design

Australia's economic prosperity

The Australian economy is constantly evolving. The main instrument for allocating resources is the market but the Australian Government also plays a significant role in this regard. In this unit students investigate the role of the market in allocating resources and examine the factors that are likely to affect the price and quantity traded for a range of goods and services. They develop an understanding of the key measures of efficiency and how market systems can result in efficient outcomes. Students consider contemporary issues to explain the need for government intervention in markets and why markets might fail to maximise society's living standards. As part of a balanced examination, students also consider unintended consequences of government intervention in the market.

In this unit students develop an understanding of the macroeconomy. They investigate the factors that influence the level of aggregate demand and aggregate supply in the economy and use models and theories to explain how changes in these variables might influence the achievement of the Australian Government's domestic macroeconomic goals and affect living standards.

Australia's economic prosperity depends, in part, on strong economic relationships with its major trading partners. Students investigate the importance of international economic relationships in terms of their influence on Australia's living standards. They analyse how international transactions are recorded, predict how economic events might affect the value of the exchange rate and evaluate the effect of trade liberalisation.

Area of Study 1

An introduction to microeconomics: the market system, resource allocation and government intervention

In this area of study students investigate the role of the market in answering the key economic questions of what and how much to produce, how to produce and for whom to produce. They consider the effect of decisions made by consumers and businesses on what goods and services are produced, the quantities in which they are produced, to whom they are distributed and the way they are produced. Students investigate some of the key factors that influence the level of demand and supply in the economy and how these might lead to changing prices and the movement of land, labour and capital to those areas of production that generate the most value for society.

Students use models to make predictions and to consider the role of markets in achieving economic efficiency. Using a case study from the past two years they discuss instances where the market fails to allocate resources efficiently and whether government intervention leads to a more efficient allocation of resources in terms of maximising society's wellbeing.

Outcome 1

On completion of this unit the student should be able to explain how markets operate to allocate resources, and discuss the effect of government intervention on market outcomes.

The Key knowledge includes:

- relative scarcity: needs, wants, resources and opportunity cost
- the nature of, and conditions for, a perfectly competitive market
- the law of demand and the demand curve including movements along, and shifts of, the demand curve
- factors likely to affect demand and the position of the demand curve: changes in disposable income, the prices of substitutes and complements, preferences and tastes, interest rates, changes in population and consumer confidence
- the law of supply and the supply curve including movements along, and shifts of, the supply curve
- factors likely to affect supply and the position of the supply curve: changes in the cost of production, technological change, productivity growth and climatic conditions
- the effects of changes in supply and demand on equilibrium prices and quantity traded
- the role of relative prices in markets on the allocation of resources and the effect on living standards
- the meaning and significance of price elasticity of demand and supply
- factors affecting price elasticity of demand: degree of necessity, availability of substitutes, proportion of income and time
- factors affecting price elasticity of supply: spare capacity, production period and durability of goods
- the meaning and significance of economic efficiency: allocative efficiency, productive efficiency, dynamic efficiency and inter-temporal efficiency
- the effect of competitive markets on the efficiency of resource allocation
- reasons for market failure: public goods, externalities, asymmetric information and common access resources
- the role and effect of indirect taxation, subsidies, government regulations and government advertising as forms of government intervention in the market to address market failure
- one contemporary example of government intervention in markets that unintentionally leads to a decrease in the efficiency of resource allocation.

Area of Study 2

Domestic macroeconomic goals

In this area of study students investigate the Australian Government's domestic macroeconomic goals of low inflation, strong and sustainable economic growth and full employment and why these goals are pursued. They consider the role of key economic agents using a simple circular flow model of the macroeconomy. Students examine how each of the goals is measured and the potential consequences associated with the non-achievement of each goal. They identify and analyse contemporary aggregate demand and aggregate supply factors that may influence the achievement of domestic macroeconomic goals in the past two years, and consider how achievement of the goals may affect material and non-material living standards.

Outcome 2

On completion of this unit the student should be able to analyse key contemporary factors that may have influenced the Australian Government's domestic macroeconomic goals over the past two years and discuss how achievement of these goals may affect living standards.

The Key knowledge includes:

The nature and purpose of economic activity

- the difference between material and non-material living standards
- factors that may influence living standards including access to goods and services, environmental quality, physical and mental health, life expectancy, crime rates and literacy rates
- the circular flow model of income including the role of households, businesses, government, financial institutions and the external sector in an open contemporary macroeconomy
- the nature and causes of the business cycle
- the meaning and importance of aggregate demand and the factors that may influence the level of aggregate demand in the economy: changes in the general level of prices, disposable income, interest rates, consumer confidence, business confidence, the exchange rate and rates of economic growth overseas
- the aggregate demand curve
- the meaning and importance of aggregate supply and the factors that may influence the level of aggregate supply in the economy: changes in the general level of prices, quantity and quality of the factors of production, cost of production, technological change, productivity growth, exchange rates and climatic conditions
- the aggregate supply curve
- the effects of changes in aggregate demand and aggregate supply on the level of economic growth, employment and price levels.

The Australian Government's domestic macroeconomic goals

- the meaning of the goal of low inflation (price stability)
- measurement of the inflation rate using the Consumer Price Index (CPI) including the difference between the headline and underlying (core) rate of inflation
- causes of inflation including demand and cost inflation
- consequences of a high inflation rate: erosion of purchasing power, redistributive effects, resource misallocation, savings and investment and international competitiveness
- the meaning of the goal of strong and sustainable economic growth
- measurement of the rate of economic growth using real Gross Domestic Product (GDP)
- the reasons for pursuing strong and sustainable economic growth including lowering of the unemployment rate, growth in real income and increased ability of government to provide essential services
- the meaning of the goal of full employment and classifications within the labour force: employed, unemployed, hidden unemployment, disguised or under-employed
- measurement of the labour force including the participation rate, the unemployment rate and the labour force underutilisation rate
- types and causes of unemployment: cyclical, structural, frictional, seasonal and hard-core unemployment
- the consequences of unemployment including loss of GDP, loss of tax revenue, reductions in living standards and greater income inequality
- aggregate demand and aggregate supply factors that have influenced inflation, economic growth, the unemployment rate and living standards in the past two years.

Area of Study 3

Australia and the world economy

Australia is an open economy. There has been a gradual reduction in trade barriers with trade making an increasingly greater contribution to Australia's living standards. Students examine the reasons why countries engage in international transactions such as the exchange of goods and services and the movement of savings and investment capital, and evaluate how these transactions might affect living standards. They investigate how international transactions are recorded and the relationships between different sections of the balance of payments. Students apply their knowledge of demand and supply models to explain movements in the exchange rate, and discuss the effects of changing currency values on the achievement of the Australian Government's domestic macroeconomic goals.

Outcome 3

On completion of this unit the student should be able to explain the factors that may influence Australia's international transactions and evaluate how international transactions and trade liberalisation may influence the current account balance, the Australian Government's domestic macroeconomic goals and living standards in Australia.

The Key knowledge includes:

- the relationship between trade and living standards including lower prices for consumers, greater choice for consumers, the ability of businesses to achieve economies of scale and access to more resources for business and government
- the balance of payments and its components
- causes of Australia's current account deficit including cyclical and structural factors
- the relationship between the current account and the capital and financial account
- the composition and cause of net foreign debt and net foreign equities
- the terms of trade: meaning and measurement and the factors that may influence the terms of trade
- the effect of movements in the terms of trade on the current account balance, the domestic macroeconomic goals and living standards
- factors affecting the value of the exchange rate including relative interest rates, demand for exports and imports, capital flows, the terms of trade and relative rates of inflation
- the effect of exchange rate movements on the current account balance, the domestic macroeconomic goals and living standards
- factors that may influence Australia's international competitiveness including productivity, production costs, availability of natural resources, exchange rates and relative rates of inflation, and the effect of these factors on domestic macroeconomic goals and living standards
- the effect of trade liberalisation on Australia's international competitiveness, domestic macroeconomic goals and living standards.

What is an economy?

An economy is a system that allocates scarce resources to satisfy the needs and wants of a society. It is any place or region around the world where production of goods and services takes place, spending on those goods and services occurs and income is made from the selling of those goods and services. Put simply, an economy is a place where production, income and expenditure (referred to as economic activity) occurs. In Australia alone we have several economies: the Australian economy, the Victorian economy, the NSW economy, etc.

What is economics?

Economics is the study of how scarce resources (such as land and labour) are allocated by key participants to best satisfy the needs and wants of society. Decisions must be made because every nation demands countless goods and services that require resources (or factors of production) to produce them. However, a nation's resources are limited when compared to the demands placed upon them, creating an imbalance, typically referred to as **relative scarcity**.

RELATIVE SCARCITY

Demands placed on resources
[unlimited wants] > Resources available to satisfy demands
[limited resources]

Typically, our resources fall into four major categories:

1. Land and natural resources (e.g. forests, minerals, water, etc.)
2. Capital resources (e.g. machinery, robotics, trucks, etc.)
3. Labour resources (e.g. workers such as teachers, managers, etc.)
4. Entrepreneurial resources (e.g. Gina Rinehart, Bill Gates, etc.)

All of these resources exist around us in various forms within our economy. They all have one important characteristic in common: they are all key inputs in the production process. Every business will have examples of all four 'factors of production' working to produce goods and/or services.

Exam Tip: In the 2011 examination, Q4 (a) asked students to explain the following statement: 'Economics studies how scarce resources are allocated among competing uses.' It is easy to read too much into a question like this and to forget that it is simply about scarcity and how this economic problem ultimately defines the study of economics. If asked a similar question this year, all students need to do is explain how the unlimited wants/needs (or 'uses for resources') require decisions about how to allocate resources in the production of goods and services.

Given that all resources (which are relatively limited or scarce) can be valued by money, and all demands for goods and services are typically valued in monetary terms, **scarcity simply means that we don't have enough money to purchase all of the goods or services that we desire**. Accordingly, every one of us encounters the problem of relative scarcity every day. We must therefore make a choice about how we should best use our resources (or money) to satisfy our demand for goods and services.

Exam Tip: Do not be confused about the role of money. It is not a resource in itself and you should not argue that money is one of our scarce resources.

When we decide to use our resources (or money) in some way, it necessarily involves us foregoing, or giving up, the opportunity to use those same resources (or money) in some other way. This is because resources are relatively scarce and have alternative uses. Accordingly, the **opportunity cost** of decision making can be defined as the value that could have been derived if the next best alternative was chosen. For example, the Victorian government has substantial (but limited) funds at its disposal to use for society's benefit. If it chooses to spend \$4b on constructing a water de-salination, it foregoes or sacrifices the opportunity to use that same \$4b for investment in health, education, transport infrastructure or renewable energies. The opportunity cost in this example is the benefit that could have been derived from the investment in health, education, transport infrastructure or renewable energy, whichever was considered the next best option for the State of Victoria.

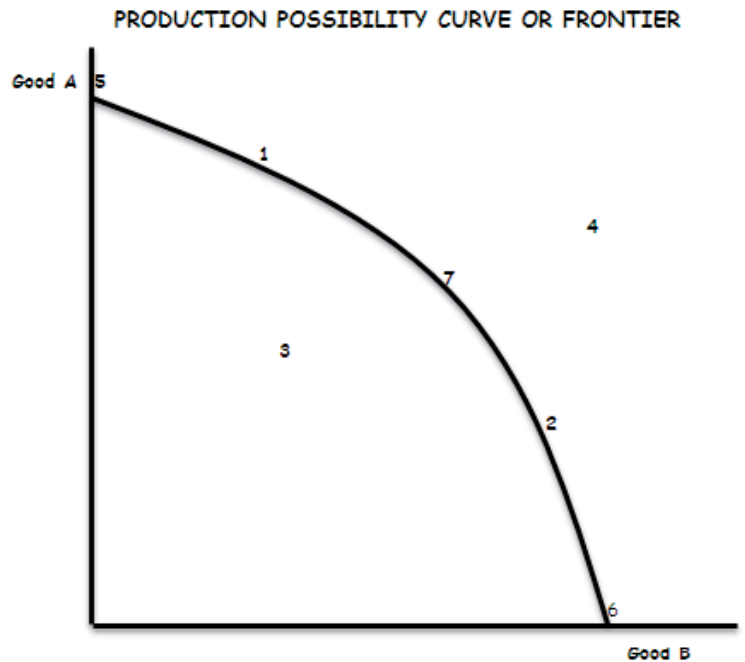
The Production Possibility Curve (PPC)

This is also referred to as the Production Possibility Frontier (PPF). It is an abstract tool used by economists to highlight concepts such as:

- opportunity cost;
- productive capacity;
- productive or technical efficiency (or inefficiency);
- allocative efficiency;
- dynamic efficiency; and
- inter-temporal efficiency.

It relies on a number of simplified assumptions, the key ones being:

- only two goods are being produced in an economy;
- all resources or factors of production can be used in the production of either good; and
- if all resources are being used efficiently, the economy's productive capacity must 'bounded' by the curve (i.e. you cannot produce beyond this point at the current time).



Points to note about the PPC are as follows:

- A movement from one point to another means a country is allocating more to the production of one good and less to another (this happens every minute in economies around the world) which necessarily involves a sacrifice of the production of another good (i.e. opportunity cost).
- Points outside the curve (like point 4) are not achievable today, but are achievable in the future via an increase in the quantity or quality of resources.
- Points inside the curve are neither technically/productively or allocatively efficient.
- Point 1, 2, 5, 6 and 7 are equally efficient in the respect that the economy is producing the maximum volume of goods and services possible with its available resources (that is, technical or productive efficiency is being achieved).
- There are many points (in addition to 1 and 2) along the PPC that are equally efficient in a productive sense.
- Only one point on the curve (it could be 1 or 2 or any other point that is not marked) is efficient in terms of what is best for the economy or country (and this usually represents that point where consumers' aggregate or total satisfaction is maximized typically referred to as the point of **allocative efficiency**).
- The speed or pace at which an economy can move from one point on the PPC to another can reflect the level of 'dynamic efficiency' existing in the economy.
- The point of production on the PPC can also reflect the level of 'inter-temporal efficiency' that exists in an economy

The way in which the PPC can be used to highlight the different types of efficiency is covered under the heading 'An efficient allocation of resources' on [page 27](#).

The basic economic questions

Given that we have relative scarcity it gives rise to three basic economic questions faced by every economy. What to produce, how to produce it and for whom it should be produced for.

What to produce?

This is concerned with how we allocate our scarce resources. Should we produce bananas or oranges? Capital goods (e.g. factory equipment) or Consumption goods? Petrol powered cars or solar powered cars? Military weapons or better hospitals? Coal fired electricity or solar electricity?

How to produce?

Again, this is an allocation question and asks what combination of scarce resources will we use to produce those goods and services that we have decided to produce? Do we use more labour than capital (labour intensive)? More capital than labour (capital intensive)?

For whom to produce?

This is really concerned with how the goods and services are allocated or distributed to society. If left to free markets (i.e. markets without government intervention), those with greater economic power (e.g. the wealthy) will have greater access to goods and services and some members of society (e.g. the poor) will be unable to purchase some essential goods or services (e.g. health care).

The overriding consideration for governments when seeking solutions to the above questions is how do we maximise welfare and living standards? In Australia, we primarily use a market based economy to allocate resources, where buyers and sellers come together to exchange goods and services based on price (a market). Producers that seek to maximise profits will need to produce goods and services that satisfy the needs of consumers (consumer sovereignty). The market will effectively determine the way most resources are allocated in the Australian economy via the market mechanism (also referred to as the price mechanism).

The market mechanism and “Perfect Markets”: An introduction to microeconomics and the role of markets.

A market is a place where buyers and sellers (demand and supply) come together to allocate resources. In an open market economy like our own, the market or price mechanism, is the main instrument for allocating these scarce resources.

In order to better understand how consumer and producer behaviour influences markets and resource allocation, economists typically create theories and models to simplify the real world. The market structure that forms the basis for demand and supply analysis is called “**perfect competition**”.

There is no market in the world that is ‘*perfectly competitive*’. Economists devised the concept of a perfectly competitive market as a tool enabling predictions to be made about how resources are likely to move around in an economy.

A perfectly competitive market requires the following conditions/characteristics or assumptions:

- A large number of buyers and sellers
- Perfectly homogenous products (i.e. no product differentiation – the products in the market are identical);
- Freedom of entry into the market by sellers
- Freedom of exit out of the market by sellers
- Buyers and sellers possess perfect information about the products
- Buyers seek to maximize satisfaction (utility) and sellers seek to maximize profit
- Resources (e.g. labour) are perfectly mobile.

A perfectly competitive market, if one existed, would generally ensure that production takes place at the lowest possible cost (technical efficiency) and that consumers would be able to purchase those goods and services they desired (consumer sovereignty) at the lowest possible prices. Competition would ensure that firms priced their products at their ‘marginal’ costs of production. This means that any further price reduction would result in insufficient profits being earned (or perhaps even losses), thereby encouraging firms to exit the market. This means that a perfectly competitive market structure would see consumers getting the best deal possible, or the lowest possible

prices. This situation in economics is typically referred to (in a narrow sense) as 'allocative efficiency', where the markets do a perfect job at satisfying the demands of consumers. Businesses will be producing the goods and services that consumers want and at the lowest possible prices. Agricultural markets are likely to be the ones most closely approximating perfectly competitive markets.

Exam Tip: In perfectly competitive markets, businesses can only earn 'normal profits' in the long run. This means that the profit is just enough to provide incentive for the business to remain a going concern. Profit levels below 'normal profits' will encourage firms to exit the industry. Profits levels above 'normal profits' (sometimes called 'super normal profits') will encourage entry of firms into the industry, thereby working to reduce industry profits back towards normal levels. Note that students are not required to demonstrate an understanding of normal/abnormal profits in the current VCE Economics course 2017-2021.

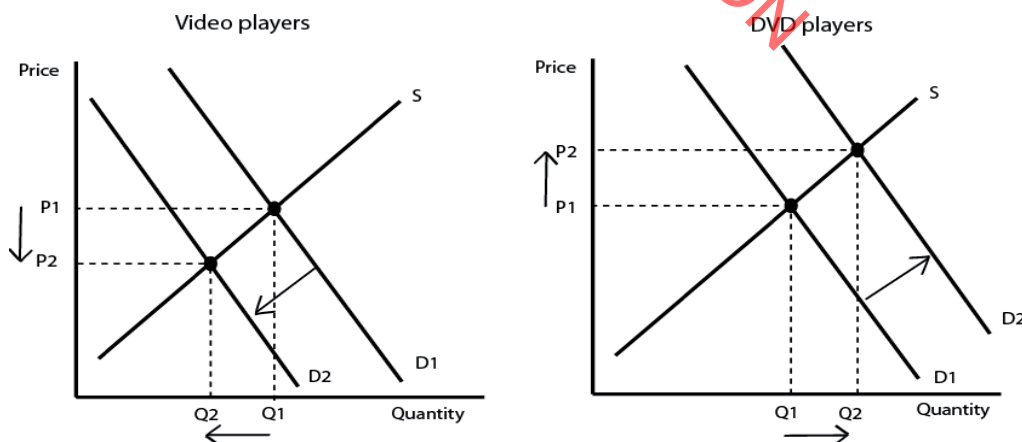
Exam Tip: Question 2a of the 2016 exam required students to outline two characteristics of a perfectly competitive market (2 marks). In the event that a similar question surfaces on the 2017 exam, students need to pay attention to the 'instructional verb' ('task word') used in the question. Many students made the mistake of 'listing' two characteristics rather than 'outlining' two characteristics. The instructional verb 'outline' is a little more demanding than 'List'. The best responses were those that attempted to add some value, such as linking the characteristic to the degree of competitiveness in the market. For example, listing product homogeneity as a characteristic was insufficient. To achieve full marks, students should add something like 'product homogeneity ensures that businesses cannot charge excessive prices [e.g. a price above marginal cost] because consumers would simply purchase from rival firms'.

Exam Tip: The key skills listed in the new Study Design requires students to be able to 'evaluate the role of the market in allocating resources', and 'explain the effect of government intervention in markets'. In addition, the key knowledge points indicate the need for students to demonstrate an understanding of 'one contemporary example of government intervention in markets that unintentionally leads to a decrease in the efficiency of resource allocation'. This highlights that 'unregulated markets' will not always lead to resources being allocated in a way that best satisfies the needs and wants of society. Markets will require government intervention that is designed to rectify these 'market failures'. However, government intervention will, at times, have unintended consequences. We will consider these issues after first examining how markets allocate resources via the price mechanism.

The market or price mechanism and relative prices

The market or **price mechanism** describes how the forces of demand and supply determine (**relative**) prices of goods and services which then ultimately determines the way our productive resources (e.g. labour and capital) are allocated in the economy. As prices change in various markets, for example, because demand (consumer sovereignty) is very strong, it sends a signal to suppliers that profit opportunities exist if they direct resources, such as labour and capital, into those areas experiencing higher demand.

For example, with advances in technology, some products become obsolete relatively quickly. Take for instance DVDs replacing videos (or more recently, blue-ray replacing DVDs). In the market, we would have observed the following:

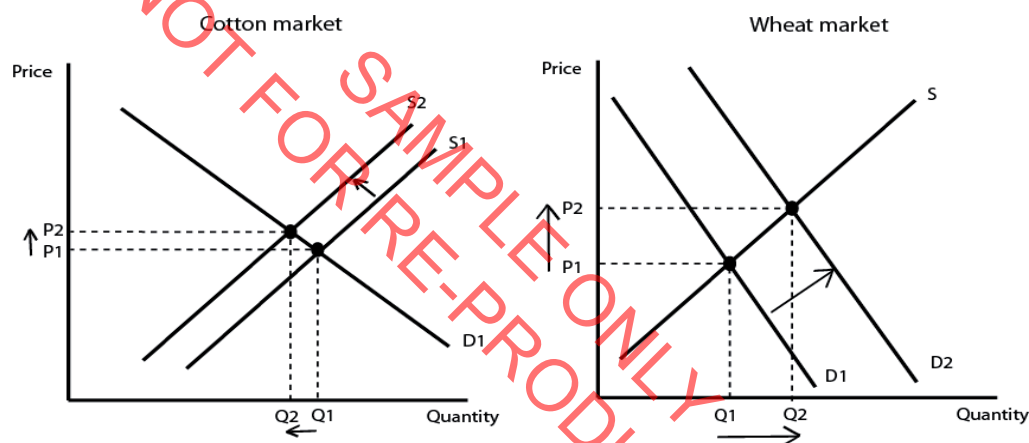


The changing conditions in this market (the invention and demand for DVD players) caused a change in the relative prices of goods and services. The price of video players will fall relative to the price of DVD players because fewer consumers are demanding video players and instead demanding DVD players. This is reflected in the demand curve for video players falling from D1 to D2 and the demand for DVD players increasing from D1 to D2. Suppliers will then devote fewer resources (e.g. labour and capital) to the production of the video players, which is reflected in a contraction along the supply curve and less production (Q1 to Q2). In contrast, suppliers will devote more resources

to the production of DVD players as the demand and price has increased. This is reflected in an expansion along the supply curve for DVD players and more production (Q1 to Q2)

Exam Tip: Students need to appreciate the significance of relative prices as opposed to prices. It is a change in relative prices that causes a reallocation of resources because it results in a likely change in the 'profitability' or 'attractiveness' of one product over another. For example, if the demand for cherries increased, which caused the price of cherries to rise relative to the price of tomatoes, it should result in more resources being allocated to cherry production and less to tomato production as producers will be incentivised by greater profit opportunities in cherry production. However, if the prices of cherries, tomatoes and all other products increased by the same amount (i.e. inflation), there is no change in relative prices and no signal for a change in the allocation of resources. Note that it is possible for the relative price of cherries to increase even if there has been no change in the price of cherries at all!!

Another example relates to the use of crops in fuel production. The growing demand for wheat for use in ethanol (fuel) production has caused resources to be allocated away from the production of other fuels (e.g. petrol) and towards the production of ethanol. This scenario is just like that for videos and DVDs. However, what has happened to prices and resource allocation in agricultural markets? The higher relative price for wheat has encouraged farmers to reallocate their resources (land and water, capital and labour) away from the production of other crops (like cotton) and towards the production of wheat. In the cotton market, the exit of suppliers results in excess demand for cotton, forcing the price to rise, but not by as much as the rise in wheat prices. This results in an overall higher relative price for wheat, but higher overall prices for a range of agricultural commodities, causing higher agricultural prices relative to other prices in the economy. This has placed upward pressure on food prices around the world. This situation is depicted in the D/S diagrams below:



These types of shifts or changes in the way resources are allocated occur every minute of every day in an economy as a result of changes in relative prices, which are in turn caused by shifts in demand or supply.

Take another example relating to the price of labour. Given the recent mining boom experienced in Australia, the demand for mining workers increased. In order to attract mining workers to remote parts of Australia, the mining companies were forced to offer higher rates of remuneration. This resulted in a higher relative price of mining labour (i.e. a higher wage) relative to non-mining labour, causing a re-allocation of labour resources towards the mining industry. For example, a truck driver earning a \$60,000 wage in Victoria may observe that the wage for a truck driver on a Western Australian mine increased from \$90,000 to \$120,000. This increase in the 'relative price' of mining labour may have been enough to entice him to quit his job in Victoria and offer his services to a WA mine. It is the change in relative prices (in this case, the relative price of labour) that ultimately resulted in a re-allocation of the nation's labour resources from non-mining states to mining states during the boom.

Exam Tip: The key skills listed in the new Study Design require students to construct and interpret demand and supply diagrams. It will therefore be important that students can not only draw a D/S diagram, but show and explain how various factors will cause the curves to shift and how a new equilibrium is achieved. Students will need to be able to explain the shifts of curves and the expansion or contraction along the curves required to bring the market back into equilibrium (disequilibrium analysis).

Exam Tip: In the 2010 exam, the question most poorly handled (Q2a and b) required students to explain one factor that might cause a change in relative prices and then how this change in relative prices would result in a reallocation of resources. With the first part, it is important for students to select a factor that will cause a change in the demand or supply for a product (e.g. floods in Australia – see below) and then highlight how this changes relative prices (the price of one good relative to another). Too many students simply referred to changes in prices without referring to relative prices. The second part then requires student to explain how the change in relative prices results in resources moving from one activity to another, with the potential of greater profit for resource owners being the driving force.

Exam Tip: In the 2011 and 2013 examinations, students were once again asked to demonstrate an understanding of the price mechanism's role in allocating resources. It would be helpful for students to refer to the role of relative prices, but more importantly, they need to describe how changes in prices ultimately cause resources to move from one area to another. The use of an example would greatly assist in this regard, such as the example above in relation to the price of labour.

Exam Tip: In the 2014 exam, students were asked to explain how a change in relative prices might result in a reallocation of resources. A useful starting point would be to correctly define relative prices. Students should then build on this with an example (even referring to Good A and Good B as substitutes) to illustrate how the change in one price relative to another will ultimately reallocate resources.

REVIEW/APPLICATION QUESTIONS 1 - Introduction

1. Outline two different ways of explaining the problem of relative scarcity.
2. Distinguish capital resources from labour resources and provide three examples of each.
3. Draw a rough 'production possibility curve' for 'Defence goods' and 'Environmental goods' and answer the following:
 - a) Describe how movement along the PPC from one point to another can highlight the concept of 'opportunity cost.'
 - b) What does it indicate if the economy is producing inside the curve?
 - c) What does it indicate if the economy is producing outside the curve?
4. Outline the basic questions that every economy confronts.
5. What is the main instrument used for answering these basic questions?
6. Discuss four key characteristics of perfectly competitive markets.
7. Explain why in a perfectly competitive market producers are only able to make "normal profits".
8. Define the price or market mechanism.
9. Describe how resources are likely to be reallocated following the negative publicity received by 'solariums' due to their links to skin cancer. In your answer, refer to the role of relative prices.
10. Explain how resources are likely to be reallocated following the repeal of the carbon tax in 2014.
11. Explain how the price mechanism can solve a shortage of mining workers during a mining boom.
12. Explain how the use of crops in fuel production (e.g. ethanol) has contributed to higher global food prices.
13. Explain how the government can use the price mechanism to achieve allocative or inter-temporal efficiency.

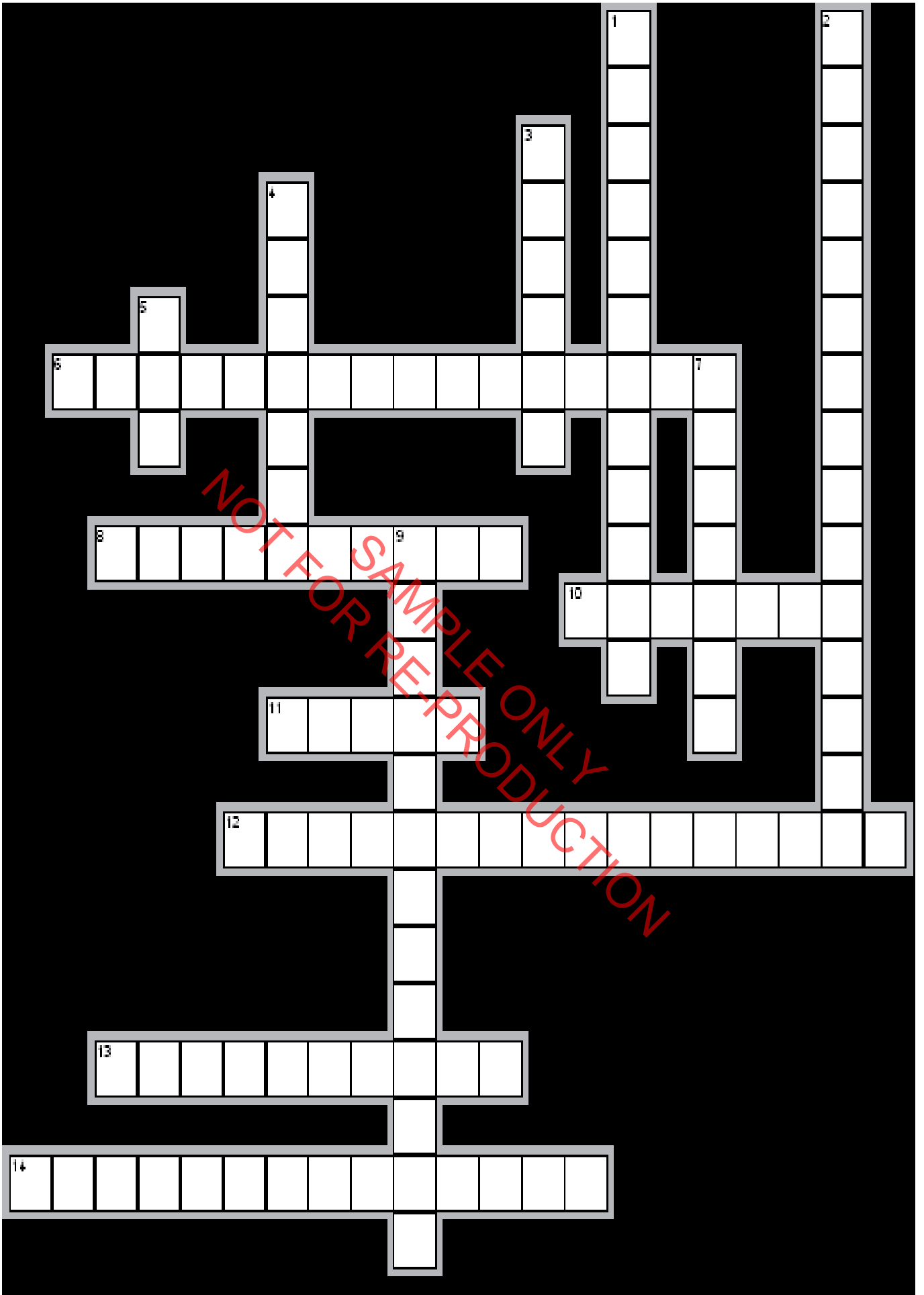
Quick revision crossword No 1: Introduction to economics

Across

6. Items like robotics and machinery used in the production process (2 words)
8. The most important type of efficiency that represents the best combination of goods and services produces such that living standards are maximised
10. any place or region around the world where production of goods and services takes place
11. A 'fuel' that drives our economy (it is also relatively scarce)
12. Demands placed on resources greater than the ability to meet those demands with existing resources (2 words)
13. Investing in this can help to push the PPF outwards over time
14. Describes how the forces of demand and supply determine (relative) prices, which then ultimately determines the way our productive resources are allocated in the economy (2 words)

Down

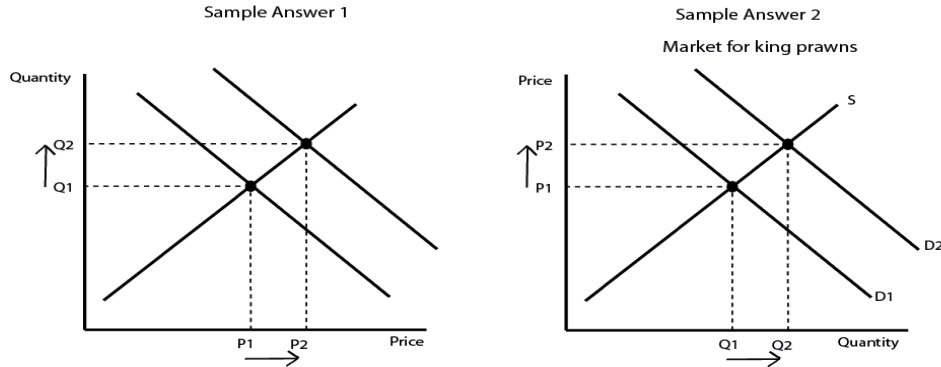
1. What must be occurring when a nation produces inside its production possibility frontier
2. the value that could have been derived if the next best alternative was chosen
3. A factor of production involving human capital
4. The type of efficiency that refers to how a nation's firms or industries are able to respond to changing market conditions or changes in technology
5. An acronym for an abstract tool used by economists that highlights the concepts of opportunity cost and productive efficiency
7. An insufficient volume of this is likely to lead to inter-temporal inefficiency
9. The type of efficiency that refers to a firm, government or indeed the nation having just the right balance between resources used for current as opposed to future use.



YOU BE THE ASSESSOR: UNIT 3 AOS 1

In this section, you are required to assess the responses presented for each of the questions. You should award the responses a score (either full marks or less than full marks) and justify your decision. Once complete, compare your assessment to that of the authors [provided at the rear of the Study Guide on [page 128](#)].

1. **A) Draw a fully labelled diagram below and show how an increase in the demand for king prawns at any given price is likely to be reflected in the diagram.** **2 marks**



Justification _____

- B) Outline and justify two demand factors that would be expected to shift the demand curve for king prawns to the right and interpret how this is likely to influence the equilibrium price and quantity for king prawns.** **4 marks**

Sample 1

Two Demand factors that would be expected to shift the demand curve for king prawns to the right could be a decrease in income tax rates and an increase in immigration that boosts our population. Lower income taxes will increase disposable income, meaning they have more to spend and hence increases the quantity consumers wish to buy at any price, shifting the demand curve to the right. An increase in Australia's population will also shift demand to the right at any given price. This shift in the demand curve will allow producers to increase their prices leading to an expansion in supply and demand at the new equilibrium where more king prawns (quantity rises) are sold at a higher price.

Justification _____

Sample 2

Two demand factors that would be expected to shift the demand curve for king prawns to the right could be lower income taxes increasing disposable incomes and an increase in Australia's population brought about by higher immigration. As disposable income increases consumers have additional money available and their capacity to buy goods and services increases so a "normal" product like king prawns would be expected to see an increase in demand at any given price (ceteris paribus). Equally as Australia's population increases (ceteris paribus) there will be more people to consume prawns at any given price shifting the demand curve to the right at any given price. At the original equilibrium price there will be an excess of demand or a shortage of supply. The producers will observe that they can increase their prices and sell more prawns which will increase the profits available. The higher prices and profits will see more resources allocated to supplying prawns so the supply of prawns will expand towards the equilibrium price. As the price rises the demand will contract along the new demand curve until demand is equal to supply and a new equilibrium with higher prices and quantities of king prawns sold.

Justification _____

YOU BE THE ASSESSOR: UNIT 3 AOS 2

In this section, you are required to assess the responses presented for each of the questions. You should award the responses a score (either full marks or less than full marks) and justify your decision. Once complete, compare your assessment to that of the authors [provided at the rear of the Study Guide on [page 128](#)].

1. Explain how relatively low wage growth can influence the achievement of full employment.

4 marks

Sample 1

Relatively low growth in wages will reduce the costs of production and the rate of inflation, which in turn increases Australia's international competitiveness and lifts aggregate demand (AD). This will result in the AD shifting to the right, leading to an increase in real GDP and economic growth. With greater levels of national output, businesses will require more labour which adds to employment and reduces the rate of unemployment. This means that the government is more likely to be successful in achieving its full employment goal.

Justification _____

Sample 2

Relatively low growth in wages helps to stimulate economic growth and contributes to the achievement of full employment, which occurs when the economy experiences the lowest unemployment rate possible before inflationary pressures become unmanageable (or the NAIRU rate of approximately 5% unemployment). This is because low growth in wages helps to contain labour costs and decreases pressure on the costs of production. Businesses will then be more willing to increase investment and expand capacity, which helps to boost production levels. This should lead to an increase in the demand for labour, raise employment levels and decrease the rate of unemployment towards the full employment level. In addition, the lower price of labour provides an incentive for businesses to demand more labour relative to capital (an expansion along the demand curve in labour markets) which has an additional favourable impact on both jobs growth and the rate of unemployment.

Justification _____

2. Outline why long-term unemployment has increased in Australia over recent years.

2 marks

Sample 1

This has occurred because of technological change in the economy which has altered the structure of Australian industries and increased reliance on capital relative to labour. This has resulted in higher levels of structural unemployment, with many of those structurally unemployed remaining so for more than one year.

Justification _____

Sample 2

A decrease in consumer confidence over recent years has had a negative effect on Australia's unemployment rate. As consumer confidence falls, the demand for goods and services in Australia decreases, meaning that firms become less willing and able to supply, shifting the nation's aggregate supply curve to the left. This results in higher costs of production and prices, which causes producers to decrease their demand for labour and increasing the rate of long term unemployment

Justification _____

3. Describe one cause and one effect of Australia's low rate of inflation over the past two years.

4 marks

Sample 1

A low rate of inflation over the past two years has been caused by the slower rates of economic growth experienced by the USA, Europe and China. This leads to slower growth in export demand and led to deflation in Australia. These lower prices meant that the purchasing power of consumers or households improved, such that material living standards of Australian households will increase.

Justification _____

Sample 2

The relatively low rate of inflation over the past two years has been caused by a number of factors, including the slower rates of economic growth experienced by Australia's trading partners. Slower growth in the USA, Europe and China has reduced export demand and demand inflationary pressures in Australia. Slower growth in export demand means that Australian exporting businesses experienced a reduction in sales, which led to excess capacity which, in itself, eased pressure on prices. In addition, slower growth in export volumes or production meant

Question 8

(2 marks)

Based on the following hypothetical figures for Australia’s balance of payments, calculate both the value of the Balance on Goods and Services (BOGS) and the Current Account Deficit (CAD). You must show your calculations.

	\$b
Exports of goods	80
Imports of goods	-100
Exports of services	30
Imports of services	-20
Net primary and secondary incomes	-30

YOU BE THE ASSESSOR: UNIT 3 AOS 3

In this section, you are required to assess the responses presented for each of the questions. You should award the responses a score (either full marks or less than full marks) and justify your decision. Once complete, compare your assessment to that of the authors [provided at the rear of the Study Guide on [page 128](#)].

1. Outline what is meant by an exchange rate depreciation and explain how a fall in Australia’s terms of trade is likely to affect Australia’s exchange rate. 4 marks

Sample 1

An exchange rate depreciation occurs when the value of a country’s currency (e.g. the value of the AUD) falls relative to the purchasing power it has over another country’s currency. For example, if the value of the AUD falls from USD1.00 to USD0.75 it means that the AUD exchange rate depreciates and one hundred Australian dollars will only be able to purchase seventy five US dollars. A fall in Australia’s terms of trade (average prices received for exports relative to the average prices paid for imports) is likely to contribute to an exchange rate depreciation given that many Australian exporters (e.g. iron ore and coal mining companies) are likely to be receiving lower (global) prices for their exported output. This ultimately causes mining companies to receive less foreign currency for any given volume of exports, which negatively affects the total value of export receipts (price X quantity) and leads to a fall in the demand for AUD on foreign exchange markets and a lower AUD exchange rate

Justification _____

Sample 2

Exchange rate depreciation means that the value of the dollar has fallen. It will tend to fall when our international competitiveness falls as a result of declining rates of productivity growth or rising rates of inflation which decreases our international competitiveness. A fall in Australia’s terms of trade should lead to a decrease in the exchange rate because the value of exports will decline. This reduction in the exchange rate will then help to increase competitiveness and AD as well as promote economic growth and reduce the current account deficit.

Justification _____

2. Explain how a depreciation of the exchange rate is likely to impact on the current account deficit (CAD) and price stability. 5 marks

Sample 1

A depreciating exchange rate will increase the demand for Australian exports because foreigners will need to use less of their own currencies to purchase Australian exports. This will contribute to an increase in the BOMT and reduce the size of both the CAD as well as the size of NFD, given that fewer funds (e.g. debt and equity) will need to be sourced from overseas in order to finance the CAD. The lower exchange rate will also help to increase AD and economic growth, which makes it more likely that the government will achieve its goals for strong and sustainable rates of economic growth and full employment (i.e. the NAIRU – non-accelerating inflation rate of unemployment). However, the lower exchange rate will eventually cause inflation to rise over time because it causes the price of imports to rise, many of which are included in the consumer price index. This means that prices will not be stable and price stability will not be achieved.

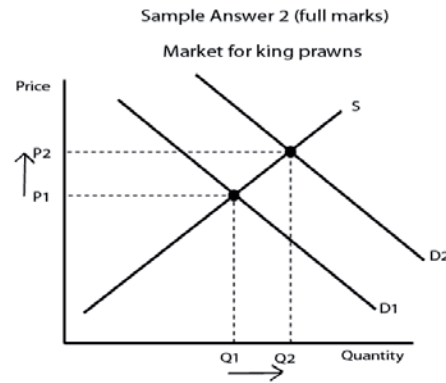
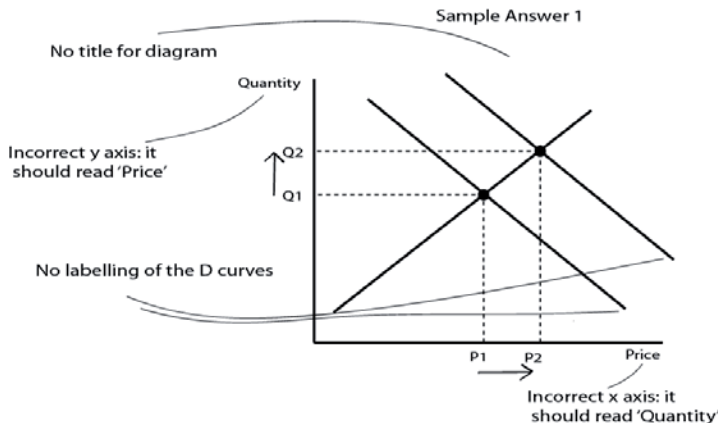
Justification _____

Sample 2

A depreciating exchange rate (i.e. a fall in the value of the AUD on foreign currency markets) is likely to reduce the size of the CAD but make it more difficult to achieve price stability. This is because a lower AUD increases the international competitiveness of Australia’s tradables sector because the price of Australian exports effectively falls for foreigners and the price of imports rises for domestic consumers. This boosts the demand for Australian exports, as well raise the demand for goods and/or services produced by Australian import-competing

YOU BE THE ASSESSOR: CORRECTIONS AND ANALYSIS (U3 AOS 1)

Q1a Draw a fully labelled diagram below and show how an increase in the demand for king prawns at any given price is likely to be reflected in the diagram. **2 marks**



Analysis (Sample 2 full marks)

While Sample 1 actually has the (demand) curve shifting in the right direction, with an accurate depiction of the outcome for prices and quantity (i.e. both increase), it has too many errors and therefore is likely to score zero marks. [Note that it is possible for Sample 1 to achieve 1 mark given that it is superior to a 'blank' response. However, this decision will ultimately be made by the Assessing Panel when determining the type of responses that fail to demonstrate the key skill 'construct...demand and supply diagrams'.]. Response 2 makes no errors and clearly demonstrates that the student has acquired the key skill.

Q1b Outline and justify two demand factors that would be expected to shift the demand curve for king prawns to the right and interpret how this is likely to influence the equilibrium price and quantity for king prawns. **4 marks**

Two demand factors are provided with a brief explanation (outline) of why lower taxes and higher immigration will influence the factors provided, but only one is justified with the link from lower taxes to higher consumption being mentioned but there is no justification of why a higher population will shift demand to the right.

Sample 1

Two Demand factors that would be expected to shift the demand curve for king prawns to the right could be a decrease in income tax rates and an increase in immigration that boosts our population. Lower income taxes will increase disposable income, meaning they have more to spend and hence increases the quantity consumers wish to buy at any price, shifting the demand curve to the right. An increase in Australia's population will also shift demand to the right at any given price. This shift in the demand curve will allow producers to increase their prices leading to an expansion in supply and demand at the new equilibrium where more king prawns (quantity rises) are sold at a higher price.

The shift in demand is linked to higher prices and a higher quantity sold but no explanation as to why producers can charge a higher price is provided nor is it explained how a new equilibrium is achieved via contracting demand along the new demand curve as prices rise

Sample 2

Two demand factors that would be expected to shift the demand curve for king prawns to the right could be lower income taxes increasing disposable incomes and an increase in Australia's population brought about by higher immigration. As disposable income increases consumers have additional money available and their capacity to buy goods and services increases so a "normal" product like king prawns would be expected to see an increase in demand at any given price (ceteris paribus). Equally as Australia's population increases (ceteris paribus) there will be more people to consume prawns at any given price shifting the demand curve to the right at any given price. At the original equilibrium price there will be an excess of demand or a shortage of supply. The producers will observe that they can increase their prices and sell more prawns which will increase the profits available. The higher prices and profits will see more resources allocated to supplying prawns so the supply of prawns will expand towards the equilibrium price. As the price rises the demand will contract along the new demand curve until demand is equal to supply and a new equilibrium with higher prices and quantities of king prawns sold.

Sample answer 2 outlines two demand factors (disposable income and population) and makes explicit why demand at any given price will increase as a result of both factors not just one.

An explanation is then provided of how a new equilibrium is achieved because at the original price a shortage/ excess demand occurs which creates an incentive to charge higher prices and make higher profits so supply will expand along the supply curve and the higher prices will contract demand. New equilibrium has higher quantity

Analysis (Sample 2 full marks)

It is important when you are asked to outline two demand factors that you do more than just state two factors that will shift the demand curve. Equally, when asked to justify these two demand factors, two explanations should be provided. Merely stating that higher demand leads to higher prices is not a justification and an explanation of the impact of excess demand/shortage of supply on price and hence producers willingness to supply is also required. Both answers correctly state the price and quantity increase but, in sample answer 1, there is limited explanation/interpretation of how a new equilibrium is achieved.

Sample 2

A clear explanation of what is meant by an unregulated market

A clear explanation of why unregulated markets will alter resource use to satisfy consumer preferences based on relative price and profit.

Dynamic efficiency is defined and is related to how efficiently resources are being used and why unregulated competitive markets will respond quickly due changes in demand.

An unregulated market is a market free from any regulation and controls. A market is where buyer and sellers come together and in a competitive market where there are many buyers and sellers and easy entry and exit from the market producers will be forced to produce what is in demand or another firm will enter or increase their output to gain market share and higher profits. This occurs because as demand increases producers will observe shortages in the market and will increase their prices to increase their profits and make it worthwhile allocating more resources to its production. This raises relative price compared to alternative uses of resources and hence relative profit increases and more of this output will be created. Dynamic efficiency refers to how quickly resources can be allocated to satisfying consumer needs and the fear of competition and losing market share will mean that firms will quickly alter what and how much they produce to maximise their own profits by satisfying consumer sovereignty. A regulated market with controls and laws may be slow to respond to changing consumer needs for instance government regulation restricting where and how many houses or flats can be built on land will force up prices and reduce the markets ability to satisfy consumer needs for more property. Thus an unregulated market will be best at satisfying consumer sovereignty due to improved dynamic efficiency.

The impact of regulation on how quickly resources can be reallocated is then shown to potentially reduce dynamic efficiency with a good example and linked back to why a regulated market could then be slow to satisfy consumer demand which is then linked to why unregulated markets are more effective at satisfying consumer sovereignty. BUT no discussion of what allocative efficiency means or why satisfying consumer needs alone can and does lead to market failure so the evaluation has led to a false conclusion and therefore should not receive full marks

Analysis: (Sample 1 full marks)

[To evaluate means to explore an issue or topic and reach a conclusion and ideally provide a solution. For evaluation questions, students should attempt to focus on factors such as 'costs (disadv) versus benefits (adv)', 'short versus long run' implications and the implications for various 'stakeholders' (e.g. consumers versus producers, current generations versus future generations).] The key to this question is recognising that resources are best allocated when they are used to maximise the needs and wants of society as a whole and not what individual consumers think is best for them. In other words, allocative efficiency is the most important form of efficiency and just satisfying consumer demands will lead to market failure (where resources are not allocated to best satisfy society's needs and wants). This is the major reason why Sample 2 is deficient. Dynamic efficiency is important in allocating resources but consumers do not always desire what is in their interest. For instance illicit drugs such as "ice" are rising in demand but the negative externalities of their consumption (misery, crime, poor health, death, violence etc) means whilst high profits may be available to producers the resources are not being used to best satisfy the needs and wants of society (market failure). Thus to prevent resources being allocated in a way that creates market failure it is important that governments intervene to regulate the use of some activities within the economy. Sample 1 adequately addresses the question and adds value by specifically exploring an example of a particular market failure (pollution as a negative externality in production) that makes unregulated markets problematic. Note that students could equally choose other market failures, such as public goods or asymmetric information.

YOU BE THE ASSESSOR: CORRECTIONS AND ANALYSIS (U3 AOS 2)

1. Explain how relatively low wage growth can influence the achievement of full employment.

4 marks

While it is true that low wages growth 'can' reduce the effective costs of production and inflation, much more is required from the student on how this occurs. Instead, the student launches into a demand side explanation without consideration of the 'supply side' impact.

Sample 1

Sample answer: Relatively low growth in wages will reduce the costs of production and the rate of inflation, which in turn increases Australia's international competitiveness and lifts aggregate demand (AD). This will result in the AD shifting to the right, leading to an increase in real GDP and economic growth. With greater levels of national output, businesses will require more labour which adds to employment and reduces the rate of unemployment. This means that the government is more likely to be successful in achieving its full employment goal.

Student has not demonstrated an understanding of the FE goal, which is a key part of the question

Student effectively 'signposts' their response (let's the assessor know how where the response is heading)

Student demonstrates an understanding of the FE goal. Reference to NAIRU not required but adds value to the quality of the response

Sample 2

Sample answer: Relatively low growth in wages helps to stimulate economic growth and contributes to the achievement of full employment, which occurs when the economy experiences the lowest unemployment rate possible before inflationary pressures become unmanageable (or the NAIRU rate of approximately 5% unemployment). This is because low growth in wages helps to contain labour costs and decreases pressure on the costs of production. Businesses will then be more willing to increase investment and expand capacity, which helps to boost production levels. This should lead to an increase in the demand for labour, raise employment levels and decrease the rate of unemployment towards the full employment level. In addition, the lower price of labour provides an incentive for businesses to demand more labour relative to capital (an expansion along the demand curve in labour markets) which has an additional favourable impact on both jobs growth and the rate of unemployment.

An effective supply side explanation is required for how lower wages growth (as a supply factor) can reduce the UE rate.

Final sentence adds value and leaves the assessor in no doubt that the student understands how low wages growth helps to create more jobs

Analysis (Sample 2 full marks)

Sample 2 is the superior response because it demonstrates an understanding of the key terms (productivity and participation rate), while Sample 1 has made errors that make it difficult for assessors to award full marks even though definitions of these terms is not specifically required in the question. In addition, Sample 2 elaborates on each of the key links that help to explain why higher productivity and PRs are likely to simulate real GDP. Sample 1 makes basic errors or omissions when attempting to elaborate on the links that prevent the student from achieving full marks.

YOU BE THE ASSESSOR: CORRECTIONS AND ANALYSIS (U3 AOS 3)

1. Outline what is meant by an exchange rate depreciation and explain how a fall in Australia's terms of trade is likely to affect Australia's exchange rate. 4 marks

Sample 1

An exchange rate depreciation occurs when the value of a country's currency (e.g. the value of the AUD) falls relative to the purchasing power it has over another country's currency. For example, if the value of the AUD falls from USD1.00 to USD0.75 it means that the AUD exchange rate depreciates and one hundred Australian dollars will only be able to purchase seventy five US dollars. A fall in Australia's terms of trade (average prices received for exports relative to the average prices paid for imports) is likely to contribute to an exchange rate depreciation given that many Australian exporters (e.g. iron ore and coal mining companies) are likely to be receiving lower (global) prices for their exported output. This ultimately causes mining companies to receive less foreign currency for any given volume of exports, which negatively affects the total value of export receipts (price X quantity) and leads to a fall in the demand for AUD on foreign exchange markets and a lower AUD exchange rate.

Annotations:

- An accurate outline/definition is provided
- An example provided to leave the assessor in no doubt that the student understands what is meant by a depreciating exchange rate
- Student demonstrates an understanding of the terms of trade
- Student clarifies the exchange rate impact of a falling TOT
- Student explains how exporters receive lower prices with a focus on mining companies
- Student connects lower prices to lower values received and then accurately connects this to a lower demand for and value of the AUD

Sample 2

Exchange rate depreciation means that the value of the dollar has fallen. It will tend to fall when our international competitiveness falls as a result of declining rates of productivity growth or rising rates of inflation which decreases our international competitiveness. A fall in Australia's terms of trade should lead to a decrease in the exchange rate because the value of exports will decline. This reduction in the exchange rate will then help to increase competitiveness and AD as well as promote economic growth and reduce the current account deficit.

Annotations:

- Correct outline but too brief
- Providing (accurate) reasons for the depreciation is IRRELEVANT
- Correct but too brief
- Providing (accurate) effects of the depreciation is IRRELEVANT

Analysis (Sample 1 full marks)

Sample 1 accurately outlines what is meant by an exchange rate depreciation without the inclusion of irrelevant information and then provides a thorough explanation for how a lower TOT leads to a depreciation of the exchange rate. Sample 2 provides an accurate but shallow/brief outline that requires the student to add a little more depth to achieve the full marks for this part of the question. An example (like Sample 1) would add significant value to the quality of the response. Sample 2 also includes irrelevant information (e.g. referring to the possible causes of a depreciation) that does not enhance the quality of the response. In relation to the impact of a fall in the TOT, Sample 2 provides the correct direction (i.e. a lower TOT causes a depreciation), it does not adequately explain the reason. While it is true that a fall in the TOT typically causes the value of exports to fall, there is not attempt to explain why this occurs, nor why it leads to a lower exchange rate. Instead, it launches into an unnecessary discussion of the effects of a depreciating exchange rate.

2. Explain how a depreciation of the exchange rate is likely to impact on the current account deficit (CAD) and price stability. 5 marks

Sample 1

A depreciating exchange rate will increase the demand for Australian exports because foreigners will need to use less of their own currencies to purchase Australian exports. This will contribute to an increase in the BOMT and reduce the size of both the CAD as well as the size of NFD, given that fewer funds (e.g. debt and equity) will need to be sourced from overseas in order to finance the CAD. The lower exchange rate will also help to increase AD and economic growth, which makes it more likely that the government will achieve its goals for strong and sustainable rates of economic growth and full employment (i.e. the NAIRU – non-accelerating inflation rate of unemployment). However, the lower exchange rate will eventually cause inflation to rise over time because it causes the price of imports to rise, many of which are included in the consumer price index. This means that prices will not be stable and price stability will not be achieved.

Annotations:

- Brief/limited explanation of the impact on the CAD. The focus is too narrow, ignoring the impact on import competing producers within Australia
- More could be done within the BOP (e.g. reference to BOGS/debits/credits)
- Unnecessary reference to the NFD
- Unnecessary reference to the goals of SSEG and FE
- Accurate, but limited, explanation of the impact on inflation. Student should have at least elaborated on the supply side impact
- Student does not demonstrate an adequate understanding of the PS goal