

THE CPAP STUDY GUIDE TO VCE ECONOMICS



PART 2 (UNIT 4)

11th edition

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The Unit 4 Outline: Economic Management

The focus of this unit is the study of the management of the Australian economy, which concentrates on Budgetary/fiscal, monetary and microeconomic reform policies.

AREA OF STUDY 1: Aggregate demand policies and domestic economic stability

In this area of study students examine how the Australian Government and its statutory authority, the RBA, can utilise budgetary and monetary policy respectively to influence the level of aggregate demand in the economy. They evaluate the relative effectiveness of each policy by focusing on their strengths and weaknesses and explain how each policy has been utilised by the Australian Government in the past two years.

Outcome 1

On completion of this unit the student should be able to discuss the nature and operation of aggregate demand policies and analyse how the policies may influence the Australian Government's domestic macroeconomic goals and living standards.

Key knowledge

- the need for aggregate demand policies in terms of stabilising the business cycle.

Budgetary policy

- sources of government revenue including direct and indirect taxation, revenue from government businesses and the sale of government assets
- types of government expenses including government current and capital expenditure and transfer payments
- the budget outcome: balanced, deficit or surplus
- the ways government may finance a deficit or utilise a surplus
- the relationship between the budget outcome and the level of government (public) debt
- the role of automatic stabilisers (cyclical component of the budget) in influencing aggregate demand and stabilising the business cycle
- the role of discretionary stabilisers (structural component of the budget) in influencing aggregate demand and stabilising the business cycle
- the effect of automatic and discretionary changes in the budget on the budget outcome and government (public) debt
- the stance of budgetary policy: expansionary or contractionary
- the effect of budget initiatives from the past two years on the Australian Government's domestic macroeconomic goals of strong and sustainable growth, full employment and low inflation
- the strengths and weaknesses of using budgetary policy to achieve the Australian Government's domestic macroeconomic goals and how these goals may affect living standards

Monetary policy

- the role of the RBA with respect to monetary policy as outlined in its charter
- the role of open market operations in altering interest rates
- transmission mechanisms of monetary policy and their influence on the level of aggregate demand including savings and investment, cash flow, availability of credit, exchange rate movements and asset prices
- the stance of monetary policy: expansionary or contractionary
- the focus of monetary policy from the past two years on the levels of aggregate demand and the Australian Government's domestic macroeconomic goals of strong and sustainable economic growth, full employment and low inflation
- the strengths and weaknesses of using monetary policy to achieve the Australian Government's domestic macroeconomic goals and how these goals may affect living standards.

Key skills

- define and use key economic concepts and terms relating to the Australian Government's aggregate demand policies
- gather relevant data and information about the nature and operation of aggregate demand policies in Australia
- discuss and analyse the effect of contemporary factors on the setting of aggregate demand policies
- evaluate the strengths and weaknesses of aggregate demand policies in achieving the Australian Government's domestic macroeconomic goals.

CHAPTER 1: BUDGETARY/FISCAL POLICY

Budgetary policy refers to the government's use of its **budget** to achieve specified outcomes in the country, where the **budget** is the major fiscal document released each May, outlining information for the next financial year plus the following three or more years. It contains details of all income (or revenue) and expenditure (outlays) of the federal government.

Budgetary policy is, therefore, the manipulation of federal government receipts and outlays in order to assist in the achievement of its economic and social objectives for Australia. As with all policies, the overriding objective is to improve the welfare or living standards of all Australians, and/or to achieve the most efficient allocation of the nation's resources.

While the **budget** is released on an annual basis, the government can (and does) attempt to change the level (or composition) of income or expenditure at any time. These measures that are introduced between budgets (i.e. within the year) are sometimes referred to as 'mini budgets'.

Exam Tip: Always remember that there are two general types of budget figures or statistics: Budget figures that look ahead (i.e. estimates of income and expenditure) and budget figures that look backward (i.e. actual income and expenditure that has taken place).

Objectives of Budgetary Policy

Budgetary policy is used to assist in the achievement of the following economic goals:

- Internal Stability (Economic Growth, Low inflation and Full Employment)
- External Stability
- Greater equity in the distribution and wealth
- Improvement in overall living standards

Exam Tip: The budget plays a major role promoting a more equitable distribution of income, primarily via the implementation of a progressive tax system combined with welfare spending designed to minimise poverty and promote a more dignified standard of living for Australians. However, in the current revised VCE Economics study design, students are no longer required to demonstrate an understanding how the budget can, or has, been used to achieve a more equitable distribution of income (or external stability). Despite this, any budgetary policy initiative that is designed to achieve greater equity can easily be linked to living standards. Accordingly, in the event that a question asks for how the budget can be used to lift living standards, it is feasible to refer to initiatives that are designed with 'equity' in mind (e.g. tax breaks for lower income earners). But it is important to link the initiative to material and or non material living standards rather than remain focused on measures of equality (e.g. the gini-coefficient).

The achievement of these economic goals will help to boost **living standards** and welfare for all Australians – which of course is the overriding objective of governments. In addition to these economic goals, the federal government also details its **medium term fiscal objectives** in the budget each May. We will review this shortly, but first we need to focus on the structure and nature of the budget itself.

Budget outcomes

With every budget there can be three possible outcomes. To simplify, assume that the government raised exactly \$300B in taxes in order to fund the provision of the services which cost \$300B. This would result in a 'balanced budget'.

budget balance

Receipts (revenue) = outlays (expenses)



However, if the government raised \$290B from taxes, but still wanted to spend \$300B on government services, then it would result in a 'budget deficit'.

budget deficit

Receipts (revenue) < outlays (expenses)



Alternatively, if the government raised \$310B from taxes, and only spent \$300B on government services, then it would result in a 'budget surplus'.

budget surplus

Receipts (revenue) > outlays (expenses)



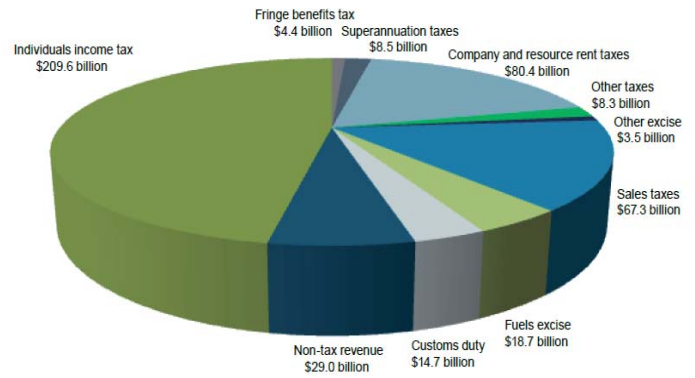
Sources of Government receipts (revenue) and expenditure (outlays)

As highlighted in the chart and table below, the federal government collects/earns approximately \$433B (2017-18), with the vast majority of receipts/revenue coming in the form of taxation (93% or \$404B). The three major sources of taxation revenue are individuals income tax (\$210B), company tax (\$80B) and sales taxes (primarily the GST) of approximately \$67B. Non-taxation receipts/revenue includes dividends from the RBA, earnings from the Future Fund as well as the sale of Commonwealth government assets, such as the sale of spectrum licenses in the communications industry.

Where revenue comes from (2017-18)

Table 1: Australian Government general government receipts

	Actual		Estimates		Projections	
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Total taxation receipts (\$b)	362.0	377.2	404.3	430.7	463.2	492.5
Growth on previous year (%)	2.4	4.2	7.2	6.5	7.5	6.3
Per cent of GDP	21.9	21.5	22.2	22.8	23.4	23.7
Tax receipts excluding GST (\$b)	304.6	318.0	342.0	365.2	395.5	420.9
Growth on previous year (%)	1.8	4.4	7.5	6.8	8.3	6.4
Per cent of GDP	18.4	18.1	18.8	19.3	20.0	20.3
Non-taxation receipts (\$b)	25.0	28.5	29.2	31.8	33.7	33.8
Growth on previous year (%)	0.6	14.3	2.3	8.8	6.2	0.4
Per cent of GDP	1.5	1.6	1.6	1.7	1.7	1.6
Total receipts (\$b)	386.9	405.7	433.5	462.5	496.9	526.3
Growth on previous year (%)	2.3	4.9	6.6	6.1	7.4	5.9
Per cent of GDP	23.4	23.2	23.8	24.4	25.1	25.4



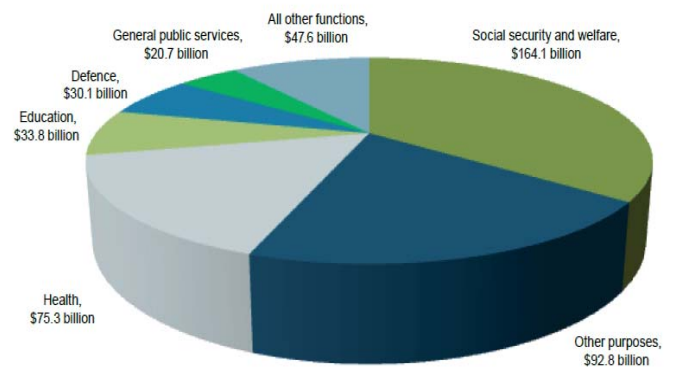
Types of government expenses (outlays)

As shown in the chart and table below, the government provides in excess of \$450B worth of services to Australians. The major 'identifiable' expenditure category is Social Security/Welfare, accounting for more than one-third (35%) of total government. This spending is designed to provide support for the aged; families with children; those with disabilities; veterans; carers and unemployed persons. Approximately, one-sixth (16%) of all spending expenses occur in health, including Medicare Benefits Schedule (MBS) and Pharmaceutical Benefits Scheme (PBS) payments. The next major identifiable expenditure item is education (7.3%), which includes funding support for government and non-government schools, as well as higher education and vocational education and training. The transfer of revenue to the States and Territories, which also includes further spending on education and health, is included in the 'Other purposes' category. This latter category (\$92.8B) also includes the payment of interest on government debt as well as spending for natural disaster relief.

Table 3: Estimates of expenses by function

	Estimates			Projections	
	2016-17	2017-18	2018-19	2019-20	2020-21
	\$m	\$m	\$m	\$m	\$m
General public services	27,172	20,703	21,207	21,887	20,820
Defence	28,464	30,051	29,877	31,708	33,865
Public order and safety	5,162	5,042	4,940	4,927	4,572
Education	33,237	33,800	34,997	36,161	37,856
Health	73,820	75,277	77,511	80,007	82,590
Social security and welfare	155,698	164,059	178,122	184,975	191,206
Housing and community amenities	4,700	5,351	4,876	4,638	4,088
Recreation and culture	3,609	3,632	3,449	3,344	3,469
Fuel and energy	6,790	6,940	7,080	7,426	7,764
Agriculture, forestry and fishing	2,843	2,972	2,845	2,493	2,408
Mining, manufacturing and construction	3,559	3,825	4,188	4,425	4,583
Transport and communication	9,394	10,420	8,592	7,470	6,545
Other economic affairs	9,840	9,411	8,894	8,569	8,426
Other purposes	86,468	92,780	100,285	105,167	114,715
Total expenses	450,757	464,262	486,863	503,198	522,907

Where taxpayers' money is spent (2017-18)



Current versus capital expenditure of the federal government

Table 3 on the previous page provided detail on the major expenditure categories for the federal government. However, of the estimated \$464B in expenditure, there is no detail provided on the type of expenditure taking place within each category. For example, of the \$30B to be spent on defence over the course of 2017-18, there is no indication of how much (or what proportion) of this money will be spent on physical assets (such as tanks and planes) compared to the proportion spent on consumables (such as the day to day running expenses of the relevant government department, such as wages, advertising, energy costs, etc.). The money spent on physical assets that will continue to provide benefits for Australia well into the future is referred to as capital spending, whereas the money spent on consumables is referred to as current or recurrent expenditure.

While the Budget papers have always included information on the split between current expenditure and capital expenditure, the situation changed somewhat in the current 2017-18 Budget. The government decided to focus on its budget outcome in a way that more clearly distinguished the relationship between budget deficits and what has become known as 'good debt' versus 'bad debt'. In simple terms, the government now focuses on a type of budget outcome (referred to as the 'operating budget outcome - see next section) that excludes capital expenditure from its calculations. This means that the 'operating' budget deficit for any given year will be lower than the headline/underlying deficit by the amount of net capital expenditure made during that year. It therefore means that the government is freer to invest in 'nation building' capital (such as buildings, roads, rail, or infrastructure more generally - all of which have the potential to contribute to social and economic benefits well into the future) without being criticised for increasing the (operating) deficit and generating an increase in 'bad debt'.

This change in the way the budget outcome is now reported followed pressure from economists and other government agencies, including the RBA, on the need for the federal government to switch its preoccupation with deficit reduction (or fiscal consolidation) and to embrace the need for much needed investment in national infrastructure assets, particularly transportation infrastructure. The consensus of opinion is that it is okay for the government's budget deficit to increase provided that any additional spending was put to good use, such as investing in assets (capital spending) as opposed to spending on the 'day to day' running of the government (recurrent spending). These thoughts were expressed by the RBA Governor in late 2016 in the following way:

...it is important that we ensure our public finances are on a sustainable track. This requires a better balance to be established, over time, between recurrent spending and revenue. It is worth pointing out that this does not preclude government spending on infrastructure, where this is backed by a strong business case. Such spending can provide support for the economy and can help generate the productive assets that a prosperous economy needs. Done well, infrastructure spending is not inconsistent with establishing a better balance between recurrent spending and revenue.

Source: RBA Governor (P.Lowe) speech at the Committee for Economic Development of Australia (CEDA) Annual Dinner (15 /11/2016)

Recent budget outcomes

The latest budget figures appear in the table below:

Table 3: Australian Government general government sector budget aggregates

	Actual		Estimates		Projections		Total(a)
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	
	\$b	\$b	\$b	\$b	\$b	\$b	\$b
Receipts	386.9	405.7	433.5	462.5	496.9	526.3	1,919.2
Per cent of GDP	23.4	23.2	23.8	24.4	25.1	25.4	
Payments(b)	423.3	440.5	459.7	480.4	495.6	518.9	1,954.6
Per cent of GDP	25.6	25.1	25.2	25.4	25.0	25.0	
Net Future Fund earnings(c)	3.2	2.8	3.2	3.5	3.7	na	10.5
Underlying cash balance(d)	-39.6	-37.6	-29.4	-21.4	-2.5	7.4	-45.9
Per cent of GDP	-2.4	-2.1	-1.6	-1.1	-0.1	0.4	
Revenue	395.1	412.1	444.4	476.1	510.8	540.4	1,971.7
Per cent of GDP	23.9	23.5	24.4	25.2	25.8	26.0	
Expenses	428.7	450.8	464.3	486.9	503.2	522.9	1,977.2
Per cent of GDP	25.9	25.7	25.5	25.7	25.4	25.2	
Net operating balance	-33.6	-38.7	-19.8	-10.8	7.6	17.5	-5.5
Per cent of GDP	-2.0	-2.2	-1.1	-0.6	0.4	0.8	
Net capital investment	3.8	2.0	0.5	4.8	4.9	6.0	16.2
Fiscal balance	-37.5	-40.7	-20.3	-15.5	2.7	11.4	-21.7
Per cent of GDP	-2.3	-2.3	-1.1	-0.8	0.1	0.6	
<i>Memorandum items:</i>							
Net Future Fund earnings(c)	3.2	2.8	3.2	3.5	3.7	4.0	14.5
Headline cash balance	-49.1	-51.1	-48.4	-37.1	-14.8	11.7	-88.7

(a) Total is equal to the sum of amounts from 2017-18 to 2020-21.

(b) Equivalent to cash payments for operating activities, purchases of non-financial assets and net acquisition of assets under finance leases.

(c) Under the *Future Fund Act 2006*, net Future Fund earnings will be available to meet the Government superannuation liability in 2020-21. From this time, the underlying cash balance includes expected net Future Fund earnings.

(d) Excludes expected net Future Fund earnings before 2020-21.

Source: www.budget.gov.au

The table reveals that the receipts (revenue) and payments (expenses) can be calculated and reported in a number of different ways to result in a range of possible budget outcomes/balances.

The **Headline cash balance**: in very simplified terms is the total cash received by the federal government less the total cash paid. For 2017-18 this is estimated to be a deficit of \$48.4B.

The **Underlying cash balance** is the Headline cash balance, but excluding future fund earnings (\$3.2b for 2017-18) and net asset purchases (\$22.2B for 2017-18 and referred to as 'net cash flows from investments in financial assets for policy purposes', but not specifically identified in the previous table).

Exam Tip: The previous table can be confusing. In recognition of this fact, the examination setting panel is extremely unlikely to ask students to interpret or 'unpack' the detail. Ensure, however, that you know the difference between a surplus, deficit or balanced budget. In addition, be prepared to demonstrate an understanding of the three different ways a budget outcome can be calculated (i.e. the difference between the Headline, Underlying and Fiscal outcomes). See next section.

For 2017-18, you should recognise that once 'net asset sales' (which is actually net asset purchases of \$22.2B) and future fund earnings of \$3.2B are extracted from the Headline cash balance (-\$48.4B), we arrive at a figure for the underlying cash balance of -\$29.4B (-1.6% of GDP). This is summarised below:

	\$B
Headline Cash Balance	-48.4
Less Future fund earnings	<u>3.2</u>
	-51.6
Add Net cash flow from investment in financial assets for policy purposes	<u>22.2</u>
Underlying cash balance	-29.4

Source: www.budget.gov.au (2017-18 Budget) Statement 3 table 5

This basically means that the relatively large estimated headline deficit of \$48.4B would have been larger (\$51.6B) were it not for the expected inflow of receipts in the form of future fund earnings. But it would have been \$22.2B smaller were it not for the large expected net outflow of cash used to purchase non-financial assets. Of the two cash outcomes or balances, the **Underlying cash balance** provides a better indicator of the position and impact of budgetary policy. This is primarily because:

- The Future Fund earnings are mandated to be reinvested into the Future Fund and not to be used for general government expenditures. This should worsen the deficit because 'theoretically' these funds are unavailable for use by the government until well into the future (when the ageing public sector workforce retires).
- Net proceeds from asset sales or purchases are 'one off', non-recurring, transactions that simply represent a transfer of ownership between the public and private sectors. Accordingly, any proceeds from asset sales make any budget outcome look better than it really is in 'core' or 'underlying' terms. Similarly, any asset purchases (such as the huge equity investment in the National Broadband Company and the government's equity investment in the Australian Rail Track Corporation) make the budget outcome look worse than it is in 'underlying' terms.

Exam Tip: The Underlying cash balance was the outcome most often referred to in budget documents and the Financial Press. However, since the release of the current 2017-18 Budget, there is increasing focus on the net operating balance for reasons outlined above. Given that the VCE Economics examination was most likely written before May 2017, students should reasonably expect reference in the exam to 'budget outcome', 'headline budget outcome' or 'underlying budget outcome' rather than *net operating balance*.

The **fiscal balance** relates to revenue that has been earned over the relevant period compared to expenses that have been incurred over the period (i.e. expenses). It is different to the headline and underlying cash outcomes in that these outcomes record receipts and payments when the money is actually received or paid rather than when the money was earned or incurred. The fiscal outcome also excludes net capital investment (e.g. purchase or sale of capital items) but includes both future fund earnings and asset sales. It is more like a 'profit and loss statement' for the federal government and is the most accurate outcome in terms of measuring the financial performance of the federal government or the longer term 'economic' consequences of budget decisions.

As noted in the previous section, the government has a renewed focus on the **net operating balance** when reporting the budget outcome. It now showcases the net operating balance with the underlying cash balance to provide a guide to the change in budgetary policy settings from one year to the next. The rationale for the new emphasis was noted in the 2017-18 Budget papers as follows:

Objectives of monetary policy and the role of the Reserve Bank of Australia (RBA)

Monetary policy is a policy operated by the RBA, on behalf of the government, that is designed to manipulate key financial variables in the economy (primarily interest rates) in order to achieve specific objectives. These objectives are outlined in the RBA's charter, which requires the Bank to implement monetary policy in a way that best contributes to:

- the stability of the currency of Australia [price stability];
- the maintenance of full employment in Australia; and
- the economic prosperity and welfare of the people of Australia.

Exam Tip: In the exam, students should not say that the RBA's goal is to maintain stability in the value of the Australian dollar (or the Australian currency). Even though the RBA's charter refers to 'stability of the currency of Australia', the RBA has made it clear that it is interpreting 'currency' to mean 'prices' and that its principal medium-term objective is to control inflation. However, any monetary policy action will take into account its effect on value of the Australian dollar.

The RBA's overriding objective is to increase the economic prosperity and welfare for all Australians. However, the RBA's medium term objective is to achieve price stability, which the RBA currently defines as *consumer price inflation between 2 and 3 per cent, on average, over time*. Once price stability is achieved, the RBA will then focus on policy decisions that assist in the attainment of other economic goals (in particular, full employment and economic growth), so long as these measures pose no threat to low inflation.

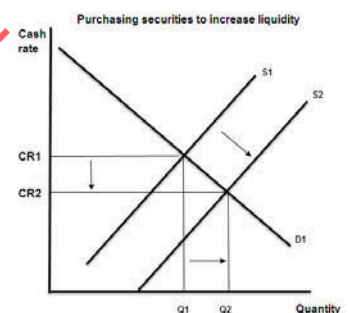
Monetary policy is the key macroeconomic policy that is designed to achieve stability in the level of domestic economic activity (i.e. internal stability), where it will generally be used in a counter-cyclical way to boost activity when inflation and growth are low and restrain activity when inflation and growth are high.

Implementation of monetary policy (open market operations)

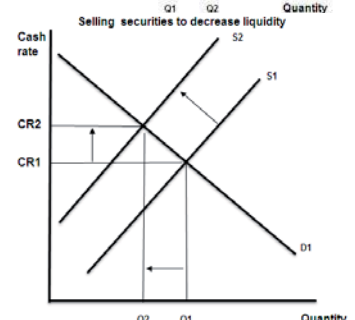
The RBA implements monetary policy primarily via the manipulation of interest rates. Whilst the RBA has no *direct* control over all interest rates in the economy, its ability to directly manipulate the 'cash rate' enables it to indirectly affect all other interest rates. The **cash rate** is the interest rate that applies to borrowing and lending in the overnight money market (also called 'cash market'). The RBA directly manipulates the supply of cash in the cash market by buying and selling Commonwealth Government Securities (CGS) or repurchase agreements (repos) to participants in the cash market (e.g. banks). This manipulation of the cash market is commonly referred to as **open market operations (OMOs)** or domestic market operations.

Exam Tip: In the exam, you are unlikely to be expected to know the difference between government securities and repurchase agreements. Simply remember they are both financial instruments and means by which the RBA injects cash into the market (via buying CGS or repos) or reduces cash in the market (via selling CGS or repos).

If liquidity in the cash market has fallen (i.e. the market is short of cash) and the RBA wished to prevent a rise in the cash rate, it would increase liquidity in the market by buying CGS or repos. This places downward pressure on the cash rate and can be depicted by a standard demand/supply diagram. The injection of liquidity in the market increases the supply of cash and pushes the S curve from S₁ to S₂. This creates an excess supply of cash in the market, forcing the cash rate down towards the desired level (CR₂). Note that liquidity increases in the market because cash market participants received *cash* in exchange for the *CGS* or *repos*. The cash can now be lent to other market participants, thereby increasing the supply of cash in the market.



If liquidity in the cash market has increased (i.e. the supply of cash is higher) and the RBA wished to prevent a fall in the cash rate, it would decrease 'liquidity' in the market by selling CGS or repos. This places upward pressure on the cash rate. Note that liquidity decreases in the market because cash market participants received *CGS* or *repos* in exchange for the *cash*. Again, intervention can be depicted by the shift to the left of the supply curve in the cash market, creating excess demand for cash and forcing the cash rate towards CR₂.



Exam Tip: The RBA directly manipulates the supply of cash in the cash market via its control over exchange settlement accounts (ESAs), which are accounts held by all the commercial banks with the RBA. These accounts are set up to facilitate the transfer of funds between banks after settling amounts owing following interbank transactions. However, an understanding of the importance of these accounts is not crucial to the development of a solid understanding of how the RBA manipulates the cash market.

Exam Tip: When examining how the RBA changes the cash rate, do not say that '.....the RBA increases/decreases the money supply.....'. Instead, refer to the RBA increasing or decreasing liquidity (or cash) in the overnight money market. Reference to the money supply is more appropriate when referring to the way monetary policy was implemented in the past when the government focused on and targeted the actual volume of money existing in the economy (e.g. Broad Money or M3). This is no longer the way monetary policy is implemented.

The role of the target cash rate

The RBA sets a target cash rate (currently 1.5% as at May 2017) that is consistent with monetary policy settings as determined at the RBA's monthly Board meetings. Once the target is set, the RBA will operate in the cash market on a daily basis via OMOs to ensure that the actual cash rate is as close as possible to the target cash rate. The actual cash rate will always be hovering very close to the target and every morning the RBA will determine whether it has to increase liquidity (if the actual cash rate is above the target) or decrease liquidity (if the actual cash rate is below the target).

Tightening and loosening of monetary policy

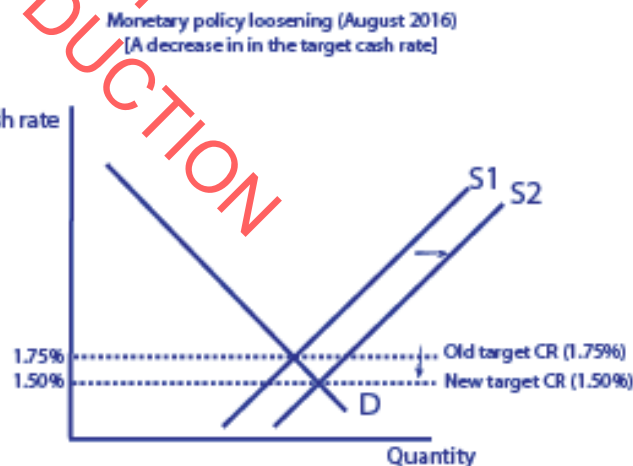
A **tightening** of monetary policy involves the RBA announcing a higher target cash rate the afternoon of its monthly Board meetings. If it decides to increase the target cash rate from 4.5% to 4.75% (as it did in November 2010) it will intervene in the market via OMOs to ensure that at the start of each day, the actual cash rate is as close as possible to the new higher target cash rate. This will involve the RBA acting swiftly to reduce liquidity (via the selling of CGS or repos) in order to increase the cash rate. The RBA will thereafter need to focus once more on narrowing or eliminating any gap between the actual cash and the new target cash rate.

A **loosening** of monetary policy involves the RBA announcing a lower target cash rate at one of its monthly Board meetings. The last time this occurred was in August 2016, when the RBA reduced the target cash rate from 1.75% to 1.50%. It intervened in the market via OMOs, purchasing securities and increasing liquidity, to ensure that at the start of each day, the actual cash rate is as close as possible to the new lower target cash rate.

The most recent tightening (Nov 2010) and loosening (August 2016) of monetary policy is depicted by the use of D/S diagrams below:



Supply shifts to the left from S1 to S2 because of a reduction in liquidity caused by the sale of securities by the RBA. Cash that was previously available in the market is now withdrawn and sitting in the RBA. The reduction in supply or liquidity forces the CR up to the new TCR



Supply shifts to the right from S1 to S2 because of an increase in liquidity caused by the purchase of securities by the RBA. Cash that was previously held by the RBA market is now circulating in the cash market. The increase in supply or liquidity forces the CR down to the new TCR

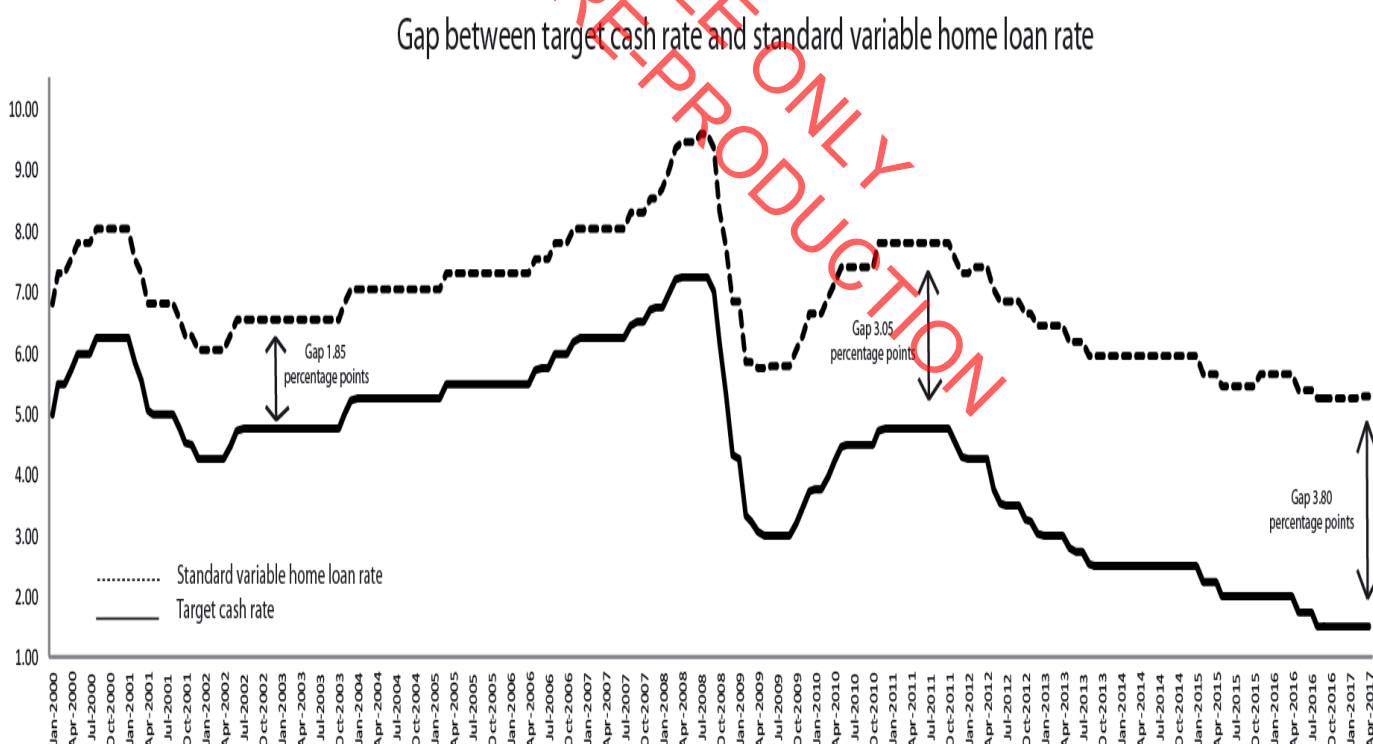
How other interest rates respond to a change in the cash rate

Assume that the RBA has tightened monetary policy and the cash rate increased. The price of money that is close to cash (e.g. 30 day bank bills or deposits) will also increase, otherwise lenders (or depositors) will be less inclined to invest in Bank Bills (or bank deposits) and more inclined to invest in the cash market. Similarly, other interest rates will also move up in order to retain market share. Accordingly, the *competition for funds* forces other rates to increase in line with the increase in the cash rate. Similarly, if the cash rate increases, the cost of funds increases for lenders of money in the 30 – 90 day market. As they essentially face higher costs of production, they pass on this increase in the form of higher interest rates. This process continues to affect longer term rates in the economy.

Given that market rates of interests are determined primarily by the demand and supply for funds in each particular debt market, their movement will not always coincide precisely with movements in the target cash rate (sometimes referred to as the policy rate). For example, over 2009-10, banks increased average interest rates more than the corresponding increases in the target cash rate, while over 2011-12 the banks reduced their rates by less than the reduction in the target cash rate. More recently, in early 2017, the major banks increased their commercial lending rates despite the cash rate remaining at 1.5%. This has occurred because the banks (allegedly) experienced higher wholesale funding costs (e.g. they are paying more to source funds from abroad) and the banking regulators (including the RBA) urged banks to tighten up on lending to residential property investors (in an effort to address housing affordability and the booming property market). It illustrates that the RBA has only indirect control over interest rates, as noted by the previous RBA Governor:

'The cash rate is still powerful, but it is not the only factor at work. On occasion we are going to see banks move their rates a little bit differently to what we did, or maybe move a little bit when we did not move. I do not find that terribly surprising given the sort of funding environment that the whole banking system of the world has faced in this time.'

The chart below highlights the relationship between the cash rate and the home loan rate since 2000. It clearly shows the almost perfect correlation between changes in the cash rate and the home loan rate up until 2008. Since then, a widening of the gap between the home loan rate and cash rate began to emerge (from 1.85 percentage points to 3.80 today), highlighting the fact that market rates of interest rates can and do move independently of changes to monetary policy. This necessarily has implications for monetary policy settings, which will be explained shortly.



Exam Tip: Careful when talking about a change in interest rates. Higher interest rates do not necessarily mean a tightening of monetary policy has occurred, and similarly, lower interest rates do not necessarily mean a loosening of monetary policy has occurred. Competitive market pressures (movements in demand or supply) can cause a change in interest rates without a change in monetary policy settings.

The transmission mechanism/channels of monetary policy

The transmission mechanisms (or transmission channels) refer to the way a change in interest rates affects economic activity. There are five generally recognised ways in which a change in interest rates will impact on economic activity. The transmission occurs via the effects on:

- 1. The cost of credit (savings and investment)**
- 2. Cash flow**
- 3. Availability of money and credit**
- 4. Asset values/prices**
- 5. Exchange rate**

Assuming that interest rates increase, the **cost of credit** channel works by making it more costly to borrow money (and more attractive to save). This higher cost of credit should reduce the willingness of households to borrow money for the purchase of goods and services. In particular, it reduces the demand for consumer durables, and overall, it is likely to reduce Consumption in the economy. Similarly, businesses are likely to reduce or delay Investment as higher borrowing costs make any investment spending less viable. The reduction in Consumption and Investment then works to reduce Aggregate Demand and Economic Growth.

The **cash flow** channel works to impact on the spending power of those economic agents with existing levels of debt. In particular, householders with mortgages will immediately suffer a fall in their *cash flow* (or discretionary income) as more of their disposable income is required to repay the interest component of their mortgage. The business sector will also experience a drop in cash flow as they spend more to service their debt. These factors will result in a fall in Consumption and Investment, further reducing Aggregate Demand.

Exam Tip: Students are highly unlikely to be asked to explain all five transmission mechanisms. However, you should expect to be able to draw upon two mechanisms when discussing how a change in monetary policy is likely to affect AD. (The first two mechanisms are the most common and easiest to discuss.) The nature of the question will generally provide one with a guide as to how many mechanisms to discuss. If the question directly asked students to explain how 'looser MP can help to increase AD,' then a discussion of two transmission mechanisms would be a minimum. However, if the question was more general in nature (such as 1d of the 2013 exam where students were asked to explain how MP might be used in the policy mix to influence AD and reduce U/E), then one transmission channel would be a minimum.

Exam Tip: When discussing the 'cash flows' transmission mechanism, it is common for students to refer to a change in 'disposable income' when discussing the impact of a loosening or tightening of monetary policy. This is incorrect because neither Gross Income nor tax rates are directly altered when interest rates change. Instead, students should have referred to discretionary income. This was once again a common mistake made by students when completing the 2015 exam (Q3b).

Exam Tip: To the extent that there is any price rise in response to higher interest rates, it will only prevail in the short term, and will be reversed once the demand side effects of higher interest rates set in over time. Indeed, businesses are less likely to pass on the cost increase if they anticipate that higher interest rates will start to negatively impact on their sales level. Accordingly, avoid saying that higher interest rates will increase inflation!

Exam Tip: Question 3(b) of the 2014 exam required students to use two transmission mechanisms to explain how the 2014 MP stance impacted on the goals of strong and sustainable economic growth and full employment. While students were expected to demonstrate a (brief) understanding of the relevant goals, the focus of the question was essentially how the low interest rate setting helped to stimulate AD, real GDP and jobs growth. A relatively detailed explanation of two transmission mechanisms was required.

The **availability of money and credit** in the economy is likely to fall in times of higher interest rates because it makes it less likely that some households or businesses will meet the lending criteria established by financial institutions because the risk of default increases. In short, financial institutions are more likely to reduce the number of loan approvals when interest rates rise.

Higher interest rates are likely to induce a fall in **asset values or asset prices**. This is because the demand for property, shares and other investment assets should decrease when the costs of borrowing rise. This reduces *wealth*, Consumption, AD and economic activity. For example, to the extent that relatively high interest rates cause less demand for housing and lower house prices, it is fair to expect a slowdown in the rate of spending by some property owners who experience a decline in the value of (perhaps) their biggest asset. In the event that there is a tightening of monetary policy over 2017-18,

growth in the demand for housing, as lower mortgage rates worked to increase the availability of credit. This is because lower interest rates have made it easier for borrowers to meet the repayment requirements of lenders, which then results in the provision of more housing loans (i.e. increased credit for housing) and an increased demand for and price of housing. Along with the lower cost of credit (i.e. the operation of the cost of credit channel), the lower interest rates resulted in large increases in housing prices, particularly in Sydney and Melbourne, where these markets are generally considered to be in boom territory. This has been a major factor behind the housing affordability crisis that is affecting younger Australians in particular.

Justification _____

3. Discuss the likely implications for both the budget outcome and the target cash rate (TCR) if Australia enters a recession in 2017-18. 5 marks

Sample 1: The budget outcome is likely to deteriorate and the TCR is likely to fall if the economy experiences two quarters of negative economic growth over the course of 2017-18.

In relation to the budget outcome, the budget deficit is likely to rise due to the impact of both automatic and discretionary stabilisers. Negative growth will result in lower income tax revenue for the government as households and businesses earn less. In addition, higher unemployment and/or underemployment will result in more government expenditure in the form of income support (e.g. unemployment benefits). As a consequence, less revenue and more expenditure means that deficits will automatically increase. In addition, the government is also likely to implement discretionary changes to the budget, such as tax relief measures and additional infrastructure expenditure, further increasing the surplus in an effort to support economic growth and jobs.

In relation to the TCR, it is likely to fall as the RBA will adopt a more expansionary monetary policy stance, by loosening policy via a further reduction in the TCR below the current 1.5%. This is because negative economic growth for 6 months suggests that inflation becomes even less of a problem (in fact deflation becomes the risk) and the RBA will focus once more on stimulating economic growth and jobs in accordance with its charter. The lower TCR therefore becomes the means by which the RBA reduces general interest rates, which in turn stimulates AD, boosts both economic and employment growth and therefore helps to stabilise the economy and protect against the negative effects of a recession.

Justification _____

Sample 2: if Australia enters a recession, then the most likely outcome is that the Commonwealth government will adopt a more expansionary budgetary policy stance in order to stimulate economic activity. The government is likely to provide tax relief for businesses and households, which might include the delivery of more tax concessions as well as the provision of tax bonuses such as those provided to taxpayers during the global economic downturn of 2008-9. In addition, the government is likely to increase government expenditure, including expenditure on infrastructure such as the additional spending on school buildings that was provided during the economic downturn of 2008 – 9. The combined effect of a lower tax burden and an increase in stimulus spending will help to counter the effects of the recession, preventing economic growth from falling too far and helping to limit the rise in unemployment. Interest rates are also likely to fall in the economy which will help to stimulate AD via a number of different mechanisms. For example, householders will have more cash available given that their mortgages will be easier to service (this is the cash flow channel) which stimulates consumption. In addition, households and businesses will be encouraged to borrow more money given that the cost of borrowing will be lower. This further stimulates consumption and also leads to more investment, lifting AD once more, increasing economic growth and helping to prevent a decrease in real GDP.

Justification _____

AREA OF STUDY 2: Aggregate supply policies

In this area of study students examine the important role of aggregate supply policies in creating a stronger macroeconomic environment so that domestic macroeconomic goals can be more easily achieved. They investigate the different approaches that government may take to promoting competition and efficiency. Should the Australian Government intervene in the market? Is it better to rely more on the market to promote productivity growth and improvements in the quality and quantity of the factors of production? Students evaluate each of these approaches, highlighting their strengths and weaknesses and drawing conclusions about the short-term and long-term consequences in terms of the domestic macroeconomic goals and living standards.

Outcome 2

On completion of this unit the student should be able to discuss the nature and operation of aggregate supply policies and analyse how the policies may influence the Australian Government's domestic macroeconomic goals and living standards.

To achieve this outcome the student will draw on knowledge and related skills outlined in area of study 2.

Key knowledge

- the nature, operation and aims of aggregate supply policies and their relationship to the domestic macroeconomic goals, international competitiveness and living standards
- the relationship between the efficient allocation of resources and aggregate supply
- how the following aspects of budgetary policy are designed to influence aggregate supply and the achievement of domestic macroeconomic goals:
 - spending on training and education
 - research and development grants
 - subsidies
 - investment in infrastructure
- how welfare and tax reform policies are designed to influence aggregate supply and living standards
- the effect of immigration policies on the labour market and aggregate supply, and the way in which this influences the achievement of domestic macroeconomic goals
- the strengths and weaknesses of using aggregate supply policies to achieve the Australian Government's domestic macroeconomic goals and how these goals may affect living standards

Key skills

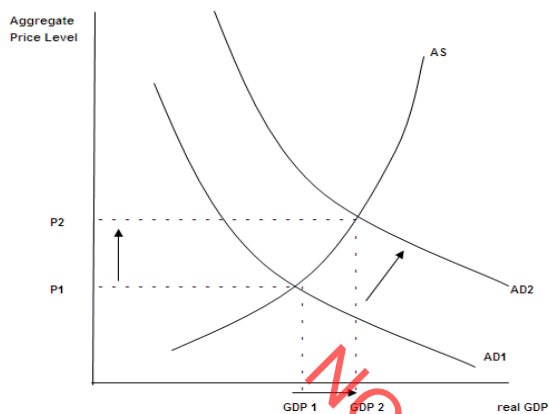
- define key economic concepts and terms and use them appropriately
- describe the aims of aggregate supply policies in terms of the domestic macroeconomic goals and living standards
- gather relevant data and information about the nature and operation of aggregate supply policies in Australia
- analyse the effect of aggregate supply policies on the domestic macroeconomic goals and living standards
- discuss the strengths and weaknesses of aggregate supply policies.



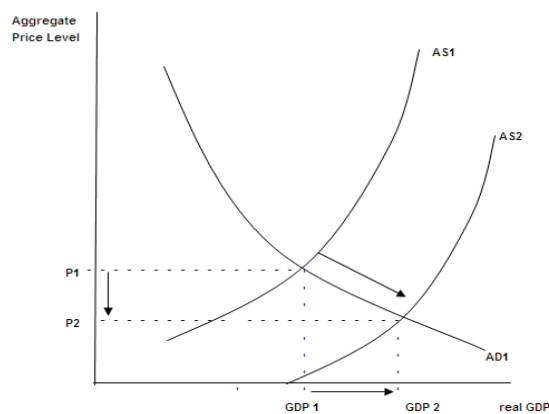
The nature, operation and aims of aggregate supply policies

Aggregate Supply represents how much supply producers in total are willing and able to produce at any given price and is effectively the sum of all supply markets across the economy. Aggregate supply (AS) policies refer to any measure designed to reduce the costs of production and/or improve supply conditions for businesses. This includes measures that directly reduce business costs, such as a reduction in business taxes or measures that are designed to improve the productivity or efficiency of businesses, such as government incentives for investment in new technology (immediate deduction for capital investment up to \$20,000 per item.) AS policies work on the supply side of the economy and involve a shift to the right of the AS curve. This is in contrast to AD policies that work on the demand side of the economy and involve a shift of the AD curve. This is highlighted in the AD/AS diagrams below:

Macroeconomic demand management policy actions to boost activity



Aggregate supply policy actions to boost activity



Governments are increasingly paying attention to the need for AS policies in an effort to expand the nation's productive capacity and ensure that our resources can continue to meet the growing needs of our population. By raising the nation's productive capacity (or improving supply conditions for industries), AS policies facilitate higher output and employment, alongside lower inflation. This occurs because lower production costs enable firms to reduce prices for any given output level, or increase output at any given price level – all without sacrificing profits. Alternatively, a bigger productive capacity facilitates greater national output before capacity constraints (and inflation) become a problem. In this respect, AS policies allow **strong growth** rates to be more **sustainable** into the future as inflationary pressures are minimised.

The growing importance of aggregate supply policies

Governments announce new measures in most budgets that are designed to boost AS and ultimately enhance Australian living standards. With an ageing population and an end to the mining boom (which has provided significant boosts to Australia's income since the early 2000s), the role of AS policies becomes all the more important. Well targeted AS policies that ultimately boost Australia's productivity over time are needed to fill the void. Without productivity enhancements, Australia's future rates of economic growth will be limited and average living standards will be compromised. The importance of productivity is summarised in the latest Intergenerational Report:

'Productivity has consistently been the most significant driver of income growth. Growth in productivity enables more or better goods and services to be produced with the same, or fewer resources, which can result in higher profits and wages, and lower prices for consumers... Continuing to encourage entrepreneurship and innovation, enhancing resource allocation, investing in and using infrastructure efficiently, facilitating trade with other countries and improving physical and human capital investment will all be critical to Australia's future productivity performance.'

This sentiment was also summed up by the Deputy Governor of the RBA, Philip Lowe, in his address to the **UDIA National Congress March 2016**:

'There is no escaping the fact that future growth in the average income of Australians relies largely on our ability to lift our productivity. While the rebalancing and resilience of our economy is certainly something to welcome, the longer-term challenge is to lift our living standards through finding new things to do and better ways of doing what we currently do... Ultimately, productivity growth is heavily reliant on decisions made by businesses. But policy decisions can also make a difference. Here, there is no shortage of ideas. They cover strengthened competition policy, better provision and pricing of transportation infrastructure, developing a strong innovation culture, creating strong incentives for entrepreneurship and hard work, and investing in high-quality education. The task we collectively face, then, is to identify the right specific policies in each of these areas and then find ways of implementing them. Clearly, this is not an easy task, but neither is it an impossible one'

Productivity, efficiency and Aggregate Supply?

Broadly speaking, increases in AS or productive capacity will be achieved if a nation improves the quantity and/or the quality of its factors of production. Improving the quantity of scarce resources that are available for production remains a key focus of government efforts to expand the nation's productive capacity. This includes government initiatives that attempt to increase the amount of capital in the economy (i.e. capital widening); find new sources of productive land (e.g. incentivise exploration of mineral resources); or measures designed to increase the size of the labour force (e.g. a baby bonus and/or continued immigration). Increasing the quantity of resources means that a greater volume of production can occur which shifts the AS curve to the right. However, as mentioned on the previous page, the key to achieving long-lasting gains to living standards is the ability of the nation to improve the quality of its resources or factors of production by lifting productivity or efficiency.

In a broad sense, **productivity** relates to the efficiency of our factors of production (primarily labour and capital) when producing goods and services. In a more technical sense, productivity refers to the volume of output (e.g. goods or services) that is produced from a given number of inputs (e.g. labour and capital resources). From Unit 3 you should recall that **Labour productivity** is best defined as output over the number of labour hours worked; **capital productivity** is best defined as output over the number of capital hours used; and **multi-factor productivity** is defined as output over a combination of inputs, such as labour and capital.



When productivity increases across the economy it will result in firms being able to produce more goods and services, which therefore leads to an increase in efficiency, productive capacity and AS (e.g. the AS curve shifts to the right). In this respect, an increase in efficiency will typically lead to an increase in AS, where the improvement in efficiency can manifest in a number of different ways, including an improvement in technical (productive), intertemporal and/or dynamic efficiency.

- **Technical or productive efficiency** involves firms producing at the lowest possible long run (average) costs. It will usually mean that productivity is at a maximum.
- **Intertemporal efficiency** refers to a firm, government or indeed the nation having just the right balance between resources used for current as opposed to future use.
- **Dynamic efficiency** refers to how a nation's firms or industries are able to respond to changing market conditions. If the response is quick, then dynamic efficiency is said to be high

'.....a focus on actual productivity means a focus on efficiency – dynamic, allocative, and technical (or cost) efficiency – as a means of getting the most out of our resources and of enhancing the material living standards of Australians.'

'The Importance of Productivity' David Gruen, Productivity Perspectives Conference, November 2012

Exam Tip: A new key knowledge point in the current Study Design is the need for students to demonstrate an understanding of the relationship between the efficient allocation of resources and AS. The term 'relationship' implies that students need to know how an increase in efficiency is likely to impact on AS (as described above). This should be reasonably straightforward, particularly given that the relationship between productivity and economic growth was explored in Unit 3. However, students should be prepared to demonstrate an understanding of how the relationship works in the opposite direction. Students can refer to the impact that an increase in AS can have on average production costs across the economy (and therefore technical efficiency), but it is also possible to make a link to allocative efficiency (see below).

While it is true that improvements in efficiency or productivity will contribute to an increase in AS, it is also true that an increase in AS can help to boost efficiency. For example, assume that the nation's productive capacity has been expanded because of an increase in the size of the labour force (i.e. an increase in the quantity of factors of production). This will necessarily help to reduce the average costs of production for Australian businesses and therefore achieve a boost in rates of technical efficiency (e.g. because the real costs of employing labour should be lower).

In addition, recall from Unit 3 that the most efficient allocation of resources requires that our resources are allocated in the best way possible in terms of providing the maximum net benefits (or greatest 'value') for Australians (i.e. allocative efficiency). Any improvements to AS or productive capacity that have the potential to increase material living standards as measured by real GDP per capita will therefore help to achieve a more efficient allocation of resources. In this respect, an increase in AS contributes to an improvement in (allocative) efficiency.

MINI EXAM NO. 2: AREA OF STUDY 2

UNIT 4

Total marks = 80

Section A

Multiple choice (total marks = 30)

Section B

Short answer questions (total marks = 50)

Section A: multiple choice

Answer the following fifteen multiple choice questions. You must **shade** in the most correct response below:

1	A	B	C	D
2	A	B	C	D
3	A	B	C	D
4	A	B	C	D
5	A	B	C	D
6	A	B	C	D
7	A	B	C	D
8	A	B	C	D
9	A	B	C	D
10	A	B	C	D
11	A	B	C	D
12	A	B	C	D
13	A	B	C	D
14	A	B	C	D
15	A	B	C	D

- Microeconomic reforms implemented over the past four years have been designed to:**
 - reduce levels of productivity, lower inflationary pressure, increase economic growth and lower unemployment
 - increase levels of productivity, increase inflationary pressure, increase economic growth and lower unemployment
 - reduce levels of productivity, increase inflationary pressure, decrease economic growth and increase unemployment
 - increase levels of productivity, decrease inflationary pressure, increase economic growth and decrease unemployment
- The need for Aggregate supply policies in Australia would be least likely to be explained by the need to:**
 - compliment the traditional macroeconomic weapons in attempting to achieve domestic economic stability
 - generate a reduction in relative poverty and welfare dependency
 - improve Australia's economic performance via improvements in efficiency and productivity
 - alleviate capacity constraints in the economy
- Which of the following is least likely to be considered to be an example of an Aggregate Supply policy?**
 - A drop in personal income tax rates
 - Increased spending by the federal government on infrastructure.
 - Further tariff reductions
 - Further deregulation of the labour market
- The government's decision to invest more in Australian ports is most likely to be an example of**
 - spending on training and education
 - investment in infrastructure
 - the provision of government subsidies
 - spending on research and development grants
- Which of the following initiatives highlighted in recent budgets is least likely to be a considered supply side initiative?**
 - More generous tax concessions for small business
 - An increase in road and rail infrastructure
 - Additional funding for child care
 - Increased funding for national security and defence

6. Reducing government spending on training and education by 50% will tend to:

- (a) Raise productivity growth
- (b) Create employment in the short term
- (c) Lead to a less efficient allocation of resources
- (d) Reduce cost inflationary pressure

7. Which of the following policies is least likely to assist with the achievement of a more sustainable rate of economic growth over time?

- (a) Increased expenditure on training and education
- (b) An increase in the skilled migration intake
- (c) An increase in expenditure on transportation infrastructure
- (d) An increase in welfare payments

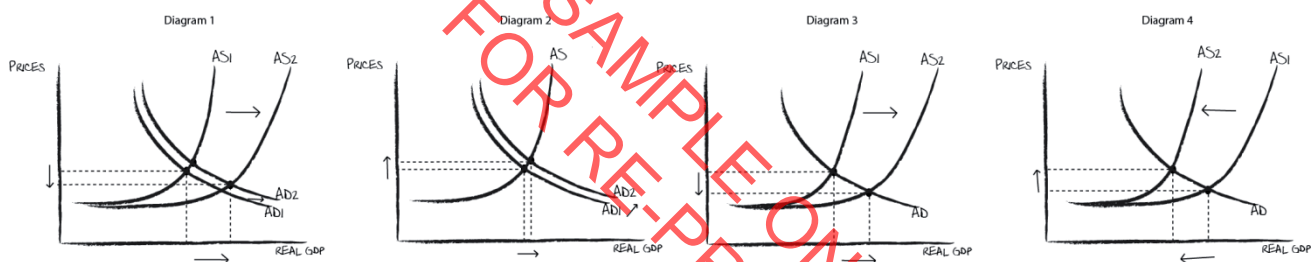
8. Which of the following government economic goals is the least likely to be a target of AS policies

- (a) Full Employment
- (b) Price Stability
- (c) Equity in the Distribution of Income
- (d) Strong rates of economic growth

9. Which of the following is not one of the 3Ps that is important for growth in productive capacity over time?

- (a) Privatisation
- (b) Productivity
- (c) Participation
- (d) Population

10. Which of the following diagrams best illustrates how a budgetary policy supply side initiative, such as the continued investment in the broadband network, stimulates the economy?



- (a) Diagram 1
- (b) Diagram 2
- (c) Diagram 3
- (d) Diagram 4

11. A reduction in company taxes and increases in infrastructure spending, should help to achieve which of the following in the longer term?

- (a) Higher growth, lower employment and higher inflation
- (b) Lower growth, lower employment and lower inflation
- (c) Lower growth, greater employment and higher inflation
- (d) Higher growth, greater employment and lower inflation

12. Which of the following is likely to be a factor contributing to a fall in the international competitiveness of Australian manufacturers over recent years?

- (a) Lower real unit labour costs
- (b) The repeal of the carbon tax
- (c) Growth in productivity
- (d) Increased subsidies given to some overseas manufacturers

13. Which of the following recent policy initiatives is unlikely to be considered an aggregate supply policy?

- (a) An increase in skilled immigration
- (b) An increase in Government spending on military hardware
- (c) An increase in Government spending on rail infrastructure
- (d) An increase in Government spending on the national broadband network

YOU BE THE ASSESSOR: UNIT 4 AOS 2

In this section, you are required to assess the two responses presented for each of the questions. You should assess each response and determine which one is likely to receive full marks. You should then justify your decision by annotating the responses, making it clear what was done well in the better response and what was deficient in the relatively poor response. Once complete, compare your evaluation to that of the authors [provided at the rear of the Study Guide].

1. Explain how a subsidy that is used to improve environmental outcomes might influence aggregate supply.

4 marks

Sample 1

A subsidy given to producers who commit to protecting the environment in some way will help to influence the nation's aggregate supply levels. As the environment improves, evidenced by cleaner air, less polluted rivers and oceans, more pristine roads and highways and/or less litter more generally, it will help to attract more tourists to Australia. As a consequence, net exports will increase (X minus M), which acts as a net injection into the circular flow model of the economy, resulting in more aggregate demand for goods and services ($AD = C + X + I + X - M$) and a corresponding increase in real GDP. As production increases in the economy, this effectively means that the supply of goods and services in total (i.e. aggregate supply) will also increase. This highlights that a subsidy that is designed to improve environmental outcomes can influence aggregate supply in a positive way.

Justification _____

Sample 2

A subsidy is the provision of money or some other form of assistance to economic agents (e.g. a business) to encourage a particular form of economic activity to take place. For example, the current government's 'Direct Action' policy involves the provision of subsidies to businesses which undertake activities that help to reduce carbon emissions. Providing a subsidy to businesses which invest in cleaner technologies (e.g. away from coal fired electricity and towards more renewable energies) or which invest in programs that are designed to clean up the environment (e.g. the planting of trees as part of carbon farming initiatives) will help to reallocate resources towards production methods that are less damaging to the environment. To the extent that this successfully mitigates the effects of climate change in the future, including the intensity and severity of natural disasters such as floods and cyclones, it will help to protect aggregate supply levels in the future. The willingness and ability of producers to supply goods and services in the future will be enhanced compared to the situation that would have evolved without government intervention because the negative supply shocks to the economy will be less intense. In this respect, the overall net effect on aggregate supply should be positive given that the long term benefits are expected to outweigh any short term costs in the form of higher taxes (to pay for the subsidy) and the higher costs of energy more generally.

Justification _____

2. Describe how investment in government infrastructure might influence aggregate supply and the achievement of price stability

4 marks

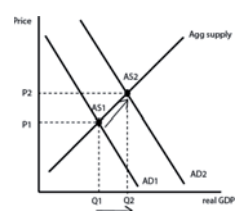
Sample 1

Investment in government infrastructure (such as improved telecommunications networks) is likely to increase aggregate supply and assist with the achievement of price stability. The government's continuing investment in the rollout of the broadband network will increase aggregate supply and expand the nation's productive capacity over time because the cost and speed of telecommunications for businesses and households will improve. Faster broadband speeds will enable businesses to cut production costs as communications with clients, staff, suppliers, etc will be more efficient and/or the speed of downloads should fall significantly. This leads to greater productivity levels over time and an increase in technical efficiency, resulting in businesses being able to produce more goods and services over any given time period (i.e. increase in aggregate supply/productive capacity) and/or reduce prices without suffering a drop in profit margins. This exerts downward pressure on the rate of inflation in the economy and therefore makes it easier for the government (RBA) to achieve its goal of 2-3% growth in the CPI on average over time.

Justification _____

Sample 2

An increase in the government's willingness to invest in infrastructure will lead to an increase in the G_2 component of aggregate demand (AD), which will increase the overall level of AD. This could be shown by an increase to the right of the AD curve as shown in the diagram to the right. With more AD for goods and services, producers will respond by increasing their supply of goods and services to the marketplace. As shown in the diagram, the movement from equilibrium 1 (AS_1) to equilibrium 2 (AS_2) highlights this increase in supply and it shows that the nation's aggregate supply has increased. As the diagram clearly shows, this increase in investment demand will lead to an increase in inflation, with prices increasing from P_1 to P_2 which means that price stability is less likely to be achieved in the economy.



EXAMINATION PREPARATION STRATEGY

THE EXAM STRUCTURE

Description

Examination time – 2 hours

Contribution to study score – 50%

Approved materials and equipment – Pencil to use on multiple-choice answer sheet and pen for written responses.

All of the key knowledge and skills from Units 3 and 4 are examinable. The weighting of examination questions will reflect approximately the weighting of the outcomes in the study design.

The examination paper will consist of two sections:

Section A (15 marks)

Section A will consist of 15 multiple-choice questions which require students to apply their understanding of economics to identify the correct response. The questions will assess the student's knowledge of key concepts as well as the ability to analyse and synthesise material covered in all areas of study and outcomes in Units 3 and 4. Students should note that MC questions are now worth only 1 mark and not 2 marks, which was the case in previous years!

Section B (65 marks)

Section B will consist of short-answer and extended-answer questions which require students to complete written responses. The examination may include questions that refer to visual and/or written material, including scenarios.

THE STRATEGY

Your overall strategy for exam preparation to **KAP** off a good year should be to:

1. **Know** the course and **know** how to interpret examination questions.....
2. **Anticipate** examination questions....
3. **Practice**, practice and practice writing responses to questions.....

Knowing the course shouldn't be too difficult if you have followed this Study Guide closely and supplemented it with teachers' notes, your textbook and other resources. General things to do to help you *know the course* are:

- Prepare a summary of the course;
- Condense your notes;
- Prepare a glossary of terms;
- Prepare concept maps to highlight relationships and links;
- Teach parts of the course to friends and family;
- Complete interactive multiple choice and short answer questions at www.economicstutor.com.au;
- Complete questions and carefully read explanations on the economicstutor app;
- Attend student programs held by various bodies over September and October. For example visit the CPAP website (www.commpap.com) for details about the Economics Workshop in September and the Course Revision + Exam Preparation programs in October.

Knowing how to interpret questions will come with practice and after you have done your job of 'anticipating' questions. The interpretation of questions should be done in the 15 minutes you are given for reading time. During this time you should:

- Read over the structured questions relatively quickly and develop a general feel for what the questions are asking you.
- Read over the structured questions a second time; this time much more carefully. During this time you should:
 - Mentally re-phrase the questions and/or break the question up into parts to make them more familiar to you. Often, questions can be worded in ways that are unfamiliar and this can unsettle students. By re-wording or 'unpacking' a question you might realise that it is much more straightforward than first appearances suggest.
 - Prioritise the questions according to the ease with which you can answer them. Then be prepared to attempt these questions first.

Anticipating questions is a little more difficult. In the past (up until 2009), the panel relied on the use of the key knowledge and skills in the study design, as well as the examination criteria published in the VCAA Assessment Handbook.

Examination criteria are no longer produced and the panel will therefore rely on the use of the key knowledge and skills (re-produced in the introductory pages of this Guide). The skills, such as 'define key economic concepts and use them appropriately' or 'analyse the impact of, ' provide a basis for how questions might be asked in relation to the key knowledge. For example, a required skill is the ability to 'analyse the impact of aggregate supply policies in the current

YOU BE THE ASSESSOR: CORRECTIONS AND ANALYSIS (U4 AOS 1)

1. Explain how the increase in the terms of trade over 2016-17 is expected to impact on the ability of the government to achieve its medium term fiscal strategy. 4 marks

Demonstrating an understanding of the terms of trade

Demonstrating an understanding of the government's medium term fiscal strategy

Demonstrating an understanding of the causes of the improved TOT

Sample 1

The increase in the terms of trade (prices received for exports relative to the prices paid for imports) over 2016-17 has helped the government in its attempts to achieve its medium term fiscal strategy for a budget surplus on average over the economic cycle. In particular, the higher prices received for commodities like iron ore and coal should be helping to raise mining company revenue (and profits) as miners receive more for any given quantity of mineral exports. This should help to boost wages and national income which ultimately lead to an increase in government tax revenue as well as a possible reduction in government expenditure as income/welfare support is likely to fall as the economy improves. This leads to a cyclical improvement in the budget outcome with the underlying cash deficit falling over time which helps to return the budget to surplus and make the medium term fiscal strategy more achievable.

Highlighting why revenue increases.

Linking higher revenue/wages to tax revenue.

Adding value by linking to government expenditure.

Referring back to the impact on the budget outcome and the medium term strategy.

Sample 2

Failure to demonstrate an understanding of the key terms in the question (TOT and medium term fiscal strategy).

Reference to exporters making more money is vague as assessors will be looking for students to demonstrate an understanding that exporters make more money because of higher prices received for exports (rather than higher volumes sold).

While this is okay, the failure to make reference to personal income tax as well as the possible automatic decrease in expenditure is not ideal.

The increase in the terms of trade is likely to reduce the budget deficit and/or increase the surplus. This occurs because commodity exporters will be making more money and therefore paying more company tax to the government. As the government receives more taxation revenue it is likely that existing government expenditure would be more easily covered by government revenue which allows the deficit to decrease. As the deficit decreases over time this means that the government will be more likely to achieve success in achieving its medium term fiscal strategy. In addition, the government will be in a better position to introduce discretionary stabilisers that further help to reduce the size of the budget deficit. This might include higher tax rates or the introduction of new levies (such as the new bank levy announced in the 2017-18 Budget) and/or decreases in government expenditure.

This sentence adds little value and potentially robs the student the opportunity to add more meaningful value to other parts of the response or the examination paper.

Again, little value add. It merely asserts that the lower deficit will assist with the medium-term fiscal strategy (without highlighting what the strategy is).

While not untrue, it is not directly related to the question as the student should be focusing on the cyclical, rather than discretionary, impact. Reference to an initiative from the current budget is a nice touch but not entirely relevant in the context of the question.

Analysis (Sample 1 full marks)

Sample 1 has an excellent structure in that the student demonstrates an understanding of the key terms in the question nice and early in the piece. The assessor is left in no doubt that the student understands what is meant by the terms of trade as well as the government's medium term fiscal strategy. In addition, the student provides an outline of how the higher terms of trade impacts on the ability to achieve the fiscal strategy. All of this is done in the 1st line. In contrast, Sample 2 neither demonstrates an understanding of the terms of trade or the medium term strategy - this is costly. While the student does get the direction of the relationship correct (i.e. higher terms of trade reducing the deficit), the assessor is likely to be left wondering whether the student understands why this occurs. Reference to 'exporters making more money' is rather vague and in no way clarifies that the additional money made has occurred because of higher prices (rather than higher volumes). Sample 1 on the other hand makes it clear why the deficit falls, making accurate reference to the income side of the budget as well as adding value by referring to the possible expenditure side impact.

Sample 2 does not finish well. The student merely asserts that the lower deficit will assist with the medium-term fiscal strategy (without highlighting what the strategy is) before going on to add information about discretionary stabilisers that is not that relevant to the question [as the question is really about the operation of automatic rather than discretionary stabilisers]. In contrast, Sample 1 does an excellent job of closing out the response in the last line by making it clear that the improvement in the budget outcome is due to the operation of automatic stabilisers (i.e. by referring to the cyclical improvement in the budget outcome) before linking it back to the greater likelihood of achieving the medium term fiscal strategy.