BONUS EXAMINATION
CPAP STUDY GUIDE TO VCE ECONOMICS
PART 2 17th edition
SUGGESTED RESPONSES

Multiple choice answers (15 marks)

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

Structured response/short answer sample responses (65 marks)

Question 1 (20 marks)

(a) Australia's rate of economic growth has trended down since June 2021 from approximately 10% to a forecast 2% for the year to end June 2023, while the unemployment rate trended down over the same period, from close to 5% in June 2021 to 3.5% (forecast) by June 2023.

(b) It is possible that Australia experienced a recession based on the information presented in the chart because a recession requires the rate of economic growth to fall below zero for two consecutive quarters. Australia actually did indeed record a recession in the first two quarters of 2020, but this is not observable in the chart (it only shows annual rates of growth). The June quarter growth was approximately -28% (which followed a smaller contraction in the March quarter) which effectively accounts for the negative growth of 6% in year end terms to June 30 2021.

(c) i. A recession in both the USA and China (negative growth in real GDP for both countries for more than 6 months) should result in both a decline in the demand for Australian exports and a general loss of confidence amongst investors, consumers and the business community. These factors result in lower levels of Consumption, Investment and Net Exports and a consequent reduction in the growth of AD, real GDP and therefore economic growth is likely to fall in Australia.

ii. Relatively high interest rates in Australia results in lower levels of Consumption and Investment demand as it results in both an increase in the cost of new loans (increased cost of credit) and the cost to service existing loans

(which reduces cash flow of economic agents) . This results in reduced pressure on AD, further slowing the rate of real GDP in the future.

(d) Very low rates of economic growth (e.g. less than 2% pa), is likely to reduce inflationary pressure and cause a reduction in the current account balance.

- Inflation rates are likely to be lower because the low levels of AD that accompany low growth will create additional spare capacity in the economy and limit the ability of businesses to raise prices compared to when capacity constraints exist and demand is high. In addition, these lower prices work to further reduce cost pressures facing other businesses (via input costs), interest rates and costs should fall, and pressure from labour costs should ease (as unemployment should increase).

- The current account balance is likely to rise because the lower rates of inflation caused by low growth tends to improve the international competitiveness of Australia's exporters (and import competing businesses), boosting the Balance on Goods and Services in the current account and improving the current account balance as credits rise relative to debits. In addition, the lower levels of AD or GNE in the economy are likely to reduce demand for imports and further improve the current account balance.

(e) Large falls in economic growth experienced in Australia did not significantly increase the unemployment rate for a number of reasons. These include:

- o In response to lower demand levels, many businesses have been hoarding labour (rather than reducing the size of the workforce) at rates one would expect. This results in both underemployment of labour and even a further casualisation of the labour force as businesses move more workers from full time to part time or casual. Whilst this clearly represents an increase in the economy's underutilization rate, it has minimal effect on the unemployment rate.
- o Similarly, the falls in economic growth have resulted in some people dropping out of the labour force altogether. This includes those who lose their job and do not seek alternative employment as well those in the pool of unemployed who stop looking for work given that their chances of securing employment are now reduced. These factors result in a drop in the participation rate, which tends to place less pressure on the unemployment rate.

(f) An increase in the tax free threshold will, in isolation, reduce the tax burden for all taxpayers, but in particular low income earners who will experience a much lower average rate of tax. This is likely to increase the participation rate and reduce the unemployment rate over time.

- o Once the threshold is increased, it tends to encourage people to (re)enter the labour market seeking employment because the net returns from working are now relatively higher. This causes the number of people looking for work to increase, swelling the number of unemployed in the short term and boosting the participation rate.

- o Over time, the higher unemployment level and participation rate tends to place downward pressure on the real wage (or costs of labour) because there is more competition for jobs. The more competitive real wage should increase the demand for labour by businesses, increase employment and reduce unemployment. This is supported by the demand side effect of tax cuts, where higher disposable income will tend to boost consumption, AD, real GDP, demand for labour and employment.

Question 2 (21 marks)

(a) Tobacco excise is an indirect tax because those persons consuming tobacco products are paying the tax only when they purchase tobacco products, unlike a direct tax which is levied against the actual income earned by individuals or groups. With indirect taxes, income earners are not taxed directly on the income they earn, but indirectly when they purchase goods and services. Income earners can therefore avoid the tax by not consuming those goods and services subject to indirect taxes. It is much more difficult to avoid paying direct taxes.

(b) An increase in excise on tobacco is likely to increase the headline rate of inflation but have no impact on the underlying rate. This is because the underlying rate tends to exclude 'one off' price increases as well as the price changes of volatile goods and services (such as fruit and vegetable) whereas the headline rate includes the price changes that have occurred for all goods and services within the consumer price index. The June quarter CPI headline rate was inflated by the excise tax, whereas the underlying rate (as measured by the RBA trimmed mean for example) was unaffected.

(c) An increase in excise taxes is likely to cause resources (such as labour and capital) to be allocated away from the production of tobacco products and towards some other activity. This is because higher excise (which is a cost of production) results in higher tobacco (cigarette) prices as producers seek to protect profit margins. The higher prices then results in a decrease in the consumption of cigarettes, which then causes lower production volumes. With lower production, fewer resources are needed in the tobacco industry and they either become idle (e.g. land and capital) or unemployed (e.g. labour) before eventually moving to another sector of the economy that is experiencing growth in demand and production.

(d) The price elasticity of demand (PED) is defined as the responsiveness of the quantity demanded to a change in the price of a product. In technical terms, it is the percentage change in quantity demanded divided by the percentage change in price. With respect to cigarettes, they have a low PED because they are addictive. Accordingly, price rises for cigarettes (as a result of a bigger excise tax) tend to have a minimal impact on consumption. However, the higher excise tax will tend to boost government tax receipts and improve the budget outcome by increasing the surplus or reducing the deficit. This is despite the fact that cigarette sales will fall. The higher price for cigarettes does cause fewer consumers to pay the excise tax, but the low PED means that this loss in revenue is outweighed by the gain in revenue coming from those consumers who continue to purchase cigarettes at the inflated prices (and therefore paying a higher excise).

(e) Indirect taxes, such as those applying alcohol, including the alcopops tax (a tax on ready to drink alcoholic beverages) can lead to an unintentional decrease in efficiency because it can perversely encourage drinkers (particularly young budget conscious party drinkers) to purchase relatively cheaper party drugs. As the price of alcopops increase due to the imposition of the tax, it results in a higher relative price of alcopops and a lower relative price of party drugs, such as ecstasy and speed. This results in consumer demand switching towards the consumption of these more dangerous drugs. As more resources flow to the production of party drugs and away from alcopops, it results in a less efficient allocation of resources because the outcome for society is negative and allocative efficiency will not be achieved.

(f) Asymmetric information occurs when one party to a transaction (e.g. a business) has more information about the characteristics of a product than another (e.g. the consumer). For example, market failure can occur when a business is able to entice consumers to purchase a product based on claims that are known by the business to be misleading or deceptive. In general, the fact that businesses possess more information about their products than consumers means they are able to make these false claims about the quality and/or price, which therefore distorts consumer decision making and leads them to make inefficient/misinformed choices. In this respect, the market fails to protect consumers from purchasing products that they would not ordinarily purchase, which leads to an initial over allocation of resources to the production of products that are sold on the basis of false information. In the long run, however, it could actually result in an under-allocation of resources to the production of certain products if consumers become particularly cautious about being 'ripped off' by unscrupulous producers. For example, to the

extent that some operators in financial markets (e.g. share markets) trade on the basis of insider information or provide spurious financial advice, this has the potential to deter consumers (i.e. investors) from investing their savings in the financial system. This is inefficient and results in an under-allocation of resources to the financial sector, with negative implications for productive investment and economic growth. This means that, in the presence of asymmetric information there is a market failure. An unregulated market will be inefficient because it will fail to ensure that all of the nation's resources are allocated to the production of goods and services that provide the maximum benefits to society.

Question 3 (12 marks)

(a) The two factors are as follows:

- Factor 1: An increase in global commodity prices, in particular the prices of iron ore and coal, will typically result in a higher terms of trade and increased income for Australian mining exporters. This leads to an increased value of the dollar due to the higher demand for the AUD on foreign exchange markets as foreign currency (such as USD) is ultimately exchanged for Australian dollars by mining companies and/or purchasers of mining exports.
- Factor 2: Relatively high interest rates in Australia compared to those applicable in Europe and the USA contributes to growth in capital inflow and/or reduction in capital outflow, as international investors (lenders) are increasingly attracted to the higher returns on offer in Australia. This creates an increase in the demand and/or a reduction in the supply of AUD on the foreign exchange market, thereby increasing its value.

(b) The higher value of the AUD is likely to make it easier to achieve the government's price stability goal, which is to achieve a low rate of inflation in the order of 2-3% growth in the CPI on average over time. This is because a high AUD makes imports cheaper, directly reducing the prices of consumer imports, as well as reducing the costs of production for businesses importing intermediate or capital goods). In addition, the demand for exports falls, further reducing net exports (X-M) and decreasing demand inflationary pressure as exporters' income are lower and price discounting to maintain sales volumes become more widespread.

The higher AUD is therefore likely to be a factor that makes it increasingly likely that the RBA will adopt a more expansionary monetary policy stance (or less restrictive stance). This is because with inflation falling, or more likely to be under the RBA's control, the RBA will have the flexibility focus more on its secondary goals of economic growth and employment. It will therefore be more likely to loosen monetary policy, by lowering the target cash rate, without being too concerned about the inflationary impact

(c) More expansionary monetary policy, evidenced by a much lower target cash rate (below MP neutrality) results in the general structure of interest rates falling to lower levels which stimulates demand for goods and services, including housing, via a number of transmission mechanisms. In particular, the looser monetary policy helps to fuel growth in the demand for housing, as lower mortgage rates work 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. This can lead to a credit-fuelled boom in housing prices, such as that which occurred in recent years up to 2019 in Melbourne and Sydney.

Question 4 (12 marks)

(a) The terms of trade is defined as a ratio of average prices received for Australia's exports to the average prices paid for Australia's imports [or the export price index divided by the import price index]. It effectively represents the volume of imports that can be purchased with a given volume of exports. In contrast, the current account (CA) balance refers to the balance (deficit or surplus) that exists in one of the two major accounts within Australia's balance of payments. The TOT is simply a ratio of 'prices' and does not reflect values of exports or imports, whilst the CA balance is what 'value' remains after deducting all current outflows (debits) for items such as imports, from all current inflows (credits) for items such as exports.

(b) The TOT index must increase by 50%, or from 100 to 150. This has been calculated as follows:

TOT year 1 = (100/100) X 100 = 100

TOT year 2 = (150/100) X 100 = 150

(c) Fiscal consolidation involves the government seeking to reduce the size of the budget deficit and return it to balance (or surplus) over time. The growth in the TOT over 2022-23 contributed to a rise in government revenue and therefore helped to return the budget to an (estimated) surplus of $4.2B, which is consistent with budget repair and fiscal consolidation. This is because the higher prices received for commodity exports like iron ore and coal led to growth in incomes (e.g. company profits), which increase (company) taxation revenue for the government. To the extent that the rising TOT contributes to jobs growth (or more hours of work) individual income tax revenue should also rise and income support/welfare payments should fall, further accelerating a return to surplus. [This represents an example of a cyclical improvement to the budget outcome which makes it easier difficult for the government to 'repair its budget position'.]

(d) Those businesses finding it difficult to attract skilled labour will typically experience upward pressure on labour costs and downward pressure on productivity. An increase in skilled migration (including the use of TSS visa applicants) can help to relieve these pressures by enabling employers to source skilled foreign labour, boosting productivity levels (owing to an increase in skilled employees at workplaces) and helping to contain unit labour costs (as the supply of labour increases). Skilled immigration can therefore help to improve both the quality and quantity of labour available to Australian businesses, boosting their capacity (or willingness and ability) to supply goods and services and increasing the nation's aggregate supply/productive capacity. This reduces inflationary pressures, which in turn improves competitiveness and results in an increase in AD (e.g. an increase in net export growth) and real GDP (i.e. economic growth).