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**Year 12 ATAR Course Examination - Economics 2017**

**Marking Key**

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| **Sections** | **Questions** | **Total Marks** |
| Section 1 | 1–24 | 24 |
| Section 2 | 25–27 | 36 |
| Section 3 | 28–31 | 40 |

**100 marks total**

**Section 1 (24 marks)**

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| **Question** | **Answer** |
|  | C |
|  | D |
|  | C |
|  | D |
|  | A |
|  | C |
|  | D |
|  | D |
|  | A |
|  | B |
|  | B |
|  | C |
|  | A |
|  | B |
|  | D |
|  | B |
|  | A |
|  | C |
|  | D |
|  | B |
|  | C |
|  | B |
|  | D |
|  | C |

**Section 2 (36 marks)**

**Question 25 (12 marks)**

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| a i. Commodity price index – measures changes in the prices of Australia’s commodity exports, mainly resources such as iron ore & coal ii. The commodity price index fell  Due to the decline in China’s growth rate  | 1 mark1 mark1 mark |
| b. There is generally a direct or positive relationship between the commodity price index & the $A The $A is known as a ‘commodity currency’ – this is because nearly 65% of Australia’s exports are commodities (resources + rural) - this means that changes in commodity prices will be reflected in the demand for $A | 1 mark1-2 marks |
| c. Due to other factors that influence the exchange rate such as Australia’s interest rate differentialIf other countries such as the US raised their interest rates relative to Australia, then this would reduce demand for $A & offset the commodity price effect | 1 mark 1 mark |
| d. The $A depreciated from around $US1.10 in 2011 to around $US0.75 by the beginning of 2017.Effects – any **three** effects:i. Competitive advantage to Australian exporters – by reducing prices of Aust goods & services to overseas buyers ii. An increase in aggregate demand due to rise in net exports – expansionary effect on economic activityiii. Higher import prices will reduce spending on imports & increase spending on domestic output iv. An increase in the trade balance as exports rise & imports fall due to the price effectsv. An increase in CPI due to higher import prices | 1 mark1-3 marks |

**Question 26 (12 marks)**

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| a. i. The budget balance is expected to increase by $8.2 billion (or budget deficit is expected to decrease by $8.2 billion)ii. $29.4 billion | 1 mark1 mark |
| b. Any **two** reasons:1. To reduce government debt – this will reduce interest payments **OR**
2. To reduce ‘crowding out’ – less govt borrowing will enable greater private investment **OR**
3. 3. Returning budget to balance may help to boost business/ household confidence
 | 1-2 marks |
| c. There is a direct or positive relationship between the budget balance and GDP growth – as GDP growth increases, the budget deficit falls. This is due to the effect of automatic stabilisers – as the economy expands, govt tax revenue (income tax, company tax) automatically rises while government spending on transfer payments automatically falls  | 1 mark1-2 marks |
| d. The key is to identify aspects of Govt spending & tax rates that will affect productivity to promote growth. A simple answer of increasing G & cutting T to increase aggregate demand is not sufficient (mark of 0)Fiscal policy can increase productivity & economic growth through Need to discuss **three** of the following:1. government investment spending on infrastructure (roads, bridges, NBN) – this will add to the economy’s capital stock & increase aggregate supply.
2. Government spending on research & development – this will increase innovation & technology which will boost productivity & innovation and increase aggregate supply
3. Government spending on education which will increase human capital & boost productivity
4. Reductions in income tax & corporate tax can also increase both labour supply & private investment which will increase aggregate supply

Diagram showing shift of the AS curve (both SR & LR) to the right, increasing potential GDP.NOTE: An increase in AD does not affect productivity and is not worth a mark | 1-3 marks1-2 marks |

**Question 27 (12 marks)**

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| a. i Dec 2016 **and** Mar 2017 (need both for the mark)ii. 25% (+/- 1%) ToT increased from 88 to 110, an increase of 25%iii. ToT = export price index / import price index x 100iv. A favourable movement refers to an increase in the ToT which can be caused by either an increase in the XPI or a decrease in the MPI | 1 mark1 mark1 mark1-2 marks |
| b. There is a positive relationship – as ToT increase (decreases), the trade balance increases (decreases) Important to understand that the ToT measures changes in the **prices** of exports & imports, while the trade balance measures changes in the **value** of exports & imports The change in Australia’s terms of trade in this period is dominated by changes in the XPI – when the XPI increases this increases the value of exports and increases the trade balance.  | 1 mark1-2 marks |
| c. A rise in the terms of trade will increase net exports and shift the AD curve to the rightThis will increase national income boosting consumption and have an expansionary effect on economic activity – increasing production and employment, reducing the unemployment rateDiagram showing an increase in AD, increasing real GDP & the price level  | 1 mark 1-2 marks1 mark |

**Section 3 (40 marks) – Answer TWO questions**

**Question 28** **(20 marks)**

a. Discuss the reasons why Australia records a current account deficit and why it fluctuates over time. (10 marks)

b. Explain the link between the current account, the financial account and foreign liabilities.

 (10 marks)

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| a. Reasons why Australia records a CAD – split into structural causes and cyclical causes – 3 marks each **Cyclical** factors that affect the trade balance * Changes in world business cycle affecting demand for Aust’s exports
* Changes in Aust’s business cycle affecting demand for imports
* Changes in terms of trade (e.g. commodity prices)
* Changes in $AUD – affecting X & M prices

**Structural** factors that affect the net income deficitAust has a CAD due to total investment exceeding total savings. This means that Australia must import savings which is foreign investment. This reliance on net capital inflow means that the income balance must be always in deficit due to the servicing costs – interest and dividend payments**Why it fluctuates over time**This is the effect of the cyclical component – the CAD fluctuates with the business cycle. When economic activity expands, investment increases which increases imports, reducing the trade balance which increases the CAD. When the economy contracts, national income falls, reducing both investment and consumption which reduces imports.  | 1-3 marks1-3 marks1-4 marks |
| b.6 marks – 2 marks each for explanation of the current account, the financial account and foreign liabilities 1. The current account and the financial account must sum to zero given that every transaction has an offsetting entry. If the CAD is $20 billion, then the capital/financial account must have a $20 billion surplus.
2. The **current account** records transactions in goods, services and income while the **financial account** records financial flows (borrowing and foreign investment)
3. **Foreign liabilities** are the accumulation of financial account surpluses (or CADs) and are divided into foreign debt and foreign equity

**4 marks** - explain links between the threeAn increase in foreign investment (net capital inflow) will increase the financial account surplus & increase the stock of foreign liabilities (foreign debt and foreign equity). The income transactions associated with foreign liabilities (interest payments and dividends) are recorded in the current account and increase the net income deficit  | 1-2 marks1-2 marks1-2 marks1-4 marks |

**Question 29** **(20 marks)**

*International trade and foreign investment are vitally important to the Australian economy. Barriers to trade and investment pose a risk to economic growth and living standards.*

a. Discuss the ways in which international trade and foreign investment are important to the Australian economy. (10 marks)

b. Explain why barriers to trade pose a risk to growth and living standards. (10 marks)

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| a. **Importance of international trade – 5 marks**Trade is esp significant for the Australian economy – Australia’s resources sector & agricultural sector are both dependent on global tradeExports + imports each account for over 20% of GDP. It is estimated that around 1 in 5 jobs is related to tradeWhen countries specialise & export goods & services in which they have a comparative advantage & import goods & services in which they have a cost disadvantage, the country gains. Both exports & imports increase economic welfare - exports increase national income while imports increase consumption & living standards**Importance of foreign investment – 5 marks**Foreign investment (esp. FDI) adds to the pool of domestic savings to supplement Australia’s investment needs. Australia has for most of its history relied on foreign investment to develop its economy – agriculture, manufacturing & mining industries. Foreign investment enables Australia to have a higher rate of economic growth & higher real incomes | 1-5 marks1-5 marks |
| b. **The risks to growth and living standards from barriers to trade** Perhaps 7 marks for explanation and 3 marks for use of model – some flexibility Define/provide example of barrier to trade e.g. tariff Need to explain why trade barriers are a risk to growth & living standards – discuss the economic arguments against protection – raises costs, increases inefficiency, lowers real income, reduces living standards, reduces productivity & economic growth Use a tariff model to demonstrate how protection raises prices & costs, reduces consumption, decreases total welfare (DWL)  | 1 mark1-6 marks1-3 marks |

**Question 30** **(20 marks)**

a. Explain the key differences between the aggregate expenditure (AE) model and the aggregate demand/aggregate supply (AD/AS) model. (12 marks)

b. Use the AD/AS model to explain a business cycle contraction. (8 marks)

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| a. Both models show macro equilibrium and changes in economic activity**The AE model – 5 marks**2 marks – correctly labelled model3 marks - discuss differences* Vertical axis shows aggregate expenditure (not the price level); horizontal axis shows real GDP (total output/income)
* Equilibrium occurs where aggregate expenditure equals total production (AE line intersects the 45 degree line)
* Changes in C, I G or NX shift the AE line & change equilibrium

**The AD/AS model - 5 marks**2 marks – correctly labelled model3 marks - discuss differences* Vertical axis shows the price level; horizontal axis shows real GDP (total output/income)
* Equilibrium occurs where aggregate demand equals aggregate supply (AD curve intersects AS curve)
* Changes in either the AD or the AS curves will change equilibrium

2 marks – emphasise that AE model does not include the supply side of the economy, can only show changes in spending but not changes in technology, input costs or productivity | 1-2 marks1-3 marks1-2 marks1-3 marks1-2 marks |
| b. 2 marks - explain a business cycle contraction – a decrease in level of economic activity, decrease in real GDP, employment, rise in unemployment, fall in inflation3 marks - A contraction could be caused by a decrease in ADA decrease in investment or net exports could cause the AD curve to shift to the left causing real GDP & the price level to fall3 marks - A contraction could be caused by a decrease in ASAn increase in oil prices or a natural disaster could cause the AS curve to shift to the left causing real GDP to fall & the price level to rise (cost inflation)Note: should include diagrams showing shifts of AD and AS curves | 1-2 marks 1-3 marks 1-3 marks |

**Question 31** **(20 marks)**

a. Explain the circumstances under which the RBA would increase the cash rate

 and how this change would affect the level of economic activity. (10 marks)

b. Discuss the strengths and weaknesses of monetary policy. (10 marks)

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| a. 5 marks - discuss circumstances the RBA would increase the cash rate: basically to contract the economy and reduce inflationi. The economy is growing too fast (‘overheating’) – real GDP has increased above potential GDPii. Inflation rate has increased above the 3% upper boundiii. the unemployment rate has fallen below the natural rate of 5%iv. Housing market ‘bubble’ – house prices have increased to excessive levels5 marks – effects of a rise in the cash rate on the economyA rise in the cash rate would cause other interest rates to rise which would have a contractionary effect on spending (AD). Need to describe the impact on **three** channels of the transmission mechanismi. a rise in i/rs would increase cost of borrowing reducing the demand for credit & decrease C & Iii. a rise in i/rs would increase repayments & decrease cash flow of households & firms decreasing C & Iiii. a rise in i/rs would appreciate the $A which would reduce net exportsAs a result, aggregate demand would decrease reducing real GDP, employment and the price level | 1 mark1-4 marks1 mark1-3 marks1 mark |
| b. discuss **at least three** strengths 1. Very flexible – RBA board meets monthly so MP can be changed relatively easily & frequently
2. No political bias – RBA is independent of the government
3. Complements a free exchange rate – e.g. a rise in i/rs will also increase $A so that both will have a contractionary effect
4. Short decision making (implementation) lag
5. MP is most effective when economy is in a boom

discuss **at least three** weaknesses 1. Very indirect – MP affects i/rs which then have to effect C & I
2. ‘Blunt’ instrument – i/rs cannot be used selectively for different states or industries
3. Long effect lag – MP may take 12-18 months to work by which stage the economy may have changed
4. MP may have little effect when economy is in contraction/recession – can’t force people to borrow
 | 1-5 marks1-5 marks |