2007 VCE Economics GA 3: Written examination

GENERAL COMMENTS

Students' performance on the Economics examination continues to improve. This was evidenced by the strong performance of students on the multiple-choice section and the fact that most students attempted all questions in Section B. There were also many excellent written responses in Section B.

Students who applied appropriate knowledge about current and recent performance and management of the Australian economy were likely to score higher marks. It is important for students to use examples of recent economic events and think about how these events are likely to impact on the performance of the Australian economy in terms of economic objectives and the management of Australian economic policies. In 2007 appropriate issues included increasing interest rates, lower income tax rates, capacity constraints, labour force participation and commodity prices – all of which could be used and applied in responses to questions on the paper. If students do have current knowledge of the performance of the economy, they can use this knowledge to check their economic logic and perhaps challenge some of the material in their textbooks. For example, some questions that need to be raised are:

- if the Australian economy currently has an unemployment rate around 4.0%, why do students write about the government's target being 6–7%?
- does running successive budget surpluses mean that we achieve lower interest rates?
- are budget surpluses always contractionary?
- are income tax cuts only a positive for the economy?
- is an appreciating dollar only a positive for the economy?

While it is tremendous to see that students had heeded the advice provided in previous assessment reports, it is important to remind students that they do need to develop clear understandings of key economics concepts so that they can accurately give a definition when required. Many students were not able to maximise their marks in the 2007 examination because they could not give a clear definition when required; for example, in Section B, Question 3a.

It is also important for students to read the questions carefully to make sure they directly answer the question asked. For example, if only one factor or impact is required, such as in Question 1d., students should use the time to explain **one** factor or impact in detail, rather than wasting time on superficially discussing a number of factors or impacts. In the 2007 examination there were too many instances where students failed to answer the required question. This was especially so in Section B, Question 3c. (see specific comments on Question 3c. below).

In order to secure the maximum marks in Section B, students are advised to discuss economic relationships in some detail, stepping out the economic links rather than simply making an assertion about a relationship. An example related to this is discussed in Question 2d. below.

SPECIFIC INFORMATION

Note: Student responses reproduced herein have not been corrected for grammar, spelling or factual information.

For each question, an outline answer (or answers) is provided. In some cases the answer given is not the only answer that could have been awarded marks.

Section A – Multiple-choice questions

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

Question	% A	% B	% C	% D
1	2	3	1	93
2	80	4	3	12
3	7	88	2	3
4	9	9	3	79
5	1	1	86	12
6	6	82	4	8
7	1	5	6	88
8	8	65	18	9
9	71	8	14	7
10	77	11	8	4

Question	% A	% B	% C	% D
11	8	17	67	7
12	2	90	4	4
13	6	13	75	6
14	1	7	4	87
15	69	12	9	9

Section B – Written responses

Question 1a.

Marks	0	1	2	Average
%	10	33	58	**1.5**

This two mark question tested students' current knowledge of the performance of the Australian economy. Students were required to describe the trend in the Australian inflation rate and the Reserve Bank of Australia's target for the cash rate during 2007.

A number of students struggled with this question, particularly in describing the trend in inflation across 2007. Some students appeared to be uncertain about how to describe a trend, with many stating what they thought the inflation rate was without referring to the trend over the course of 2007. However, the majority of students were able to describe the trend in the cash rate and stated that the trend for interest rates was up, with two increases occurring in 2007.

Students need to be reminded that it is important to directly answer the question. There is no need to provide additional information that is not required by the question.

Question 1b.

Marks	0	1	2	3	4	5	6	Average
%	12	7	12	16	16	18	18	**3.4**

The sort of influences likely to put pressure on inflation include:

- the increase in domestic demand and economic activity through income tax cuts and/or increased income from mining and commodities and/or strong performance of stocks and shares and/or real estate (this tending to add to inflationary pressures because the economy is operating close to full capacity)
- high capacity utilisation
- a decline in unemployment and news of skills shortages persisting (which may impact on wages in the future)
- the continued strength of business and consumer confidence
- the inflationary impact of increasing oil prices and, notwithstanding US economy issues, world economic growth remains relatively strong.

The Reserve Bank of Australia raised the cash interest rate so that inflation was less likely to go above the goal of 2–3% on average.

The majority of students identified two influences that had impacted on the behaviour of Australia's inflation rate during 2007 and discussed how the Reserve Bank of Australia had responded to these influences in setting its target for the cash rate. This was a clear indication that students were aware of changing conditions in the Australian economy.

There was evidence in some cases that students did not realise that an increase in demand does not always mean that inflation will become worse. Inflationary pressures will only be ignited when the economy is operating close to capacity; that is, there are few unused resources available to increase supply to match the increased demand.

A small number of sophisticated answers talked about some moderating influences on inflation; that is, that inflation may have been higher if not for the continuing moderating wage increases and/or the moderating influence of a higher Australian dollar. These moderating influences meant that the cash rate was only increased twice during 2007.

Question 1c.

Marks	0	1	2	3	4	5	6	Average
%	19	9	13	17	13	14	14	**3.0**

Most students explained that a tighter monetary policy meant that the cash rate was raised and that interest rates were increased. Students were then required to explain how higher interest rates will affect price stability. It is important for students to acknowledge that tighter monetary policy is focused on lowering inflationary pressures in order to achieve the target for price stability/low inflation; that is, to keep increases in prices on average between 2–3% as measured by CPI.

A number of students appeared to be confused by the impact that higher interest rates are likely to have on the exchange rate, inflation and price stability. Too many students incorrectly thought that an appreciation of the Australian dollar, which is likely to occur when interest rates are raised, will tend to have an inflationary impact. Rather, when there is an appreciation of the Australian dollar imports become relatively cheaper which therefore lowers the cost of imports, including imported component cost prices. This may lower inflationary pressures, which has a positive effect on the achievement of price stability.

Too many students still used the term disposable income in an incorrect manner. Disposable income is the amount of income available once income tax has been paid. It is not the amount of income available for households to spend following changes in interest rates.

The best answers explained how there are a number of channels through which higher interest rates may work to lower inflationary pressures, and chose two examples to illustrate this. These channels involve influences on savings and investment, cash flows, money and credit, asset prices and exchange rates. Below are some examples of high-scoring explanations related to these channels.

The impact on savings. Higher interest rates increase the incentive to save or to delay spending. This is likely to reduce demand pressures, thus lowering inflationary pressures.

The impact on investment. For households, the biggest single investment decision is likely to be the decision to buy a house. Although interest rates are not the only factor in this decision, a rise in mortgage rates will tend to have the effect of encouraging some households to delay the purchase of a home, or to reduce the amount that they can spend on a home, again reducing demand pressures. Or for the business sector, when the cost of finance is high due to higher interest rates, fewer investment projects such as investment in new plant and equipment might be expected to generate sufficiently high rates of return to justify going ahead, so again demand pressures may be reduced.

Question 1d.

Marks	0	1	2	3	4	Average
%	22	19	21	19	19	**2.0**

Many students found this question difficult to answer. Often the quality of the answer depended to a large extent on the economic objective chosen. For example, students who chose to discuss how the achievement of price stability may affect the achievement of economic growth generally gained higher scores than students who discussed the achievement of price stability and its affect on efficiency. A large number of students failed to directly answer the question, with many discussing how the policies used to pursue the objective of price stability may affect another objective. The question required students to focus on why price stability is such an important objective and how its achievement may then affect the achievement of other objectives.

Following are examples of good student responses.

Price stability has a positive impact on the achievement of external stability. The avoidance of inflation lifts the price competitiveness of local firms. Thus our exports are likely to remain more internationally competitive and therefore in demand. This is likely to have a positive impact on the balance on merchandise trade (reducing the deficit or increasing the surplus) which may therefore reduce the size of the current account deficit thus assisting the achievement of external stability.

Price stability has a positive impact on economic growth. Price stability lowers inflationary expectations and helps to create a climate of where business and consumer confidence is strong. This encourages non-speculative, productive investment in new plant and equipment that can increase economic capacity and thus economic growth.

Question 2a.

Marks	0	1	2	3	4	Average
%	21	14	25	19	21	**2.1**

Most students were able to select a demand factor, such as that the booming economies and large economic growth in China and India have meant huge demand for minerals and resources to fuel this growth; however, the majority of students found it difficult to select a supply factor. The best answers in relation to supply chose either:

- base metals and minerals are generally non renewable resources
- supply disruptions of some resources have occurred due to war and/or natural disasters.

The demand part of this question was well answered but the answers on a supply factor were generally weak. Most students did not appear to understand that the prices of commodities are generally determined in world markets and that their answers should therefore discuss world demand and supply factors.

Question 2b.

Marks	0	1	2	3	4	Average
%	16	11	19	25	29	**2.4**

Students generally recognised from the chart that, since 2004, there has been an increasing trend in commodity prices, particularly for base metals and other resources, and explained that Australia is a big exporter of commodities.

This question was generally well answered, which was an improvement compared to responses in 2006 on a similar question.

Good answers used approaches as seen in the student examples below.

Effect on the current account of the balance of payments

Higher commodity prices mean Australia is receiving more for commodities exported. This may lead to a surplus (or bigger surplus) on balance on merchandise trade and lower the size of the balance of payments on current account deficit.

Effect on the unemployment rate

Higher commodity prices means Australia would be encouraged to increase supply of commodities because of the higher returns. This has required large increases in the demand for labour especially in the mining sector in order to do this. This has been the case for example in Western Australia. Thus there has been a lowering in the unemployment rate.

Effect on equity in personal income distribution

Higher commodity prices has meant an increase in income to those selling commodities that is to exporters and miners. Thus the phrase 'two speed' economy has been applied to the mining sector compared to other sectors. The mining and exporting sector are becoming wealthier with higher levels of growth in personal income in these sectors thus less equity may be achieved as this sector increases its income compared to other sectors.

The increased employment opportunities generated have led to lower unemployment. Lower unemployment means less citizens dependant on welfare and thus an improvement in equity related to personal income distribution is likely.

Question 2c.

Marks	0	1	2	Average
%	15	33	53	**1.4**

Most students were able to gain at least one mark for this question, with a large number of students showing that they understood the concept of international competitiveness by giving a detailed definition; for example, 'international competitiveness involves Australian producers cutting production costs and/or improving quality and/or raising efficiency in production and marketing so that their goods and services can compete at a competitive price on international markets'. However, a number of weaker answers defined competition rather than competitiveness and/or applied the concept at an individual firm level rather than at the economy level.

Question 2d.

Marks	0	1	2	3	4	Average
%	22	15	19	22	22	**2.1**

This was a generally well-answered question. The best answers explained what is meant by the objective of external stability and then explained one way that improved international competitiveness may affect this objective. A number of students seemed to have a general understanding of how improved international competitiveness may affect the objective of external stability, but often students did not work through the steps in enough detail to show that they truly understood the economic links and relationships. For example, students often wrote that improved international competitiveness is likely to increase exports and thus improve the current account deficit (CAD), but few students stepped out the relationship through increased exports leading to improved balance on merchandise trade leading to an improved CAD and thus leading to better external stability.

Students did not need to go on to comment on all the possible effects on external stability. Often when students attempted to do this their answers often became confused.

A significant number of students stated that external stability was about a country 'paying its way' and then tried to explain how an increase in export revenue would help pay the way for imports. Other weaker answers incorrectly suggested that exports could be used to pay debt. Many students also believed that a higher Australian dollar (AUD) is good for servicing debt. While students got some credit for this argument, they should be aware that currently most foreign debt is written in AUD.

Question 2e.

Marks	0	1	2	3	4	5	6	7	8	Average
%	13	7	9	12	13	13	16	11	7	**4.1**

Most students made a reasonable attempt at this question, apart from a relatively small number of students who chose demand side policies, such as budgetary and monetary policies, thus revealing that they did not know what microeconomic policy (MER) is. The majority of students selected the microeconomic reform policies of labour market reforms (LMR) and tariff reforms (trade liberalisation) when answering this question. However, a number of students lacked a detailed understanding of recent occurrences in these two MERs and their likely effects on efficiency and international competitiveness, often asserting that the reform has a positive impact on efficiency without explaining how. Many students who wrote about the privatisation of Telstra failed to go the final step by explaining that Telstra services are an input for other industries that do operate internationally and therefore this might improve their competitiveness.

Question 3a.

Marks	0	1	2	3	4	Average
%	13	20	28	23	17	**2.1**

This question again emphasised that students need to develop clear understandings of key economics concepts. Few students were able to achieve full marks for this question. Many students missed part of the question and either failed to define economic growth, focusing instead on the strong and sustainable aspects of economic growth, or gave a definition of economic growth and did not discuss the meaning of strong and sustainable. To achieve full marks students needed to define economic growth and discuss the meaning and significance of strong and sustainable.

The following is an example of a sound answer.

Economic growth occurs when a nation increases the volume that is the real value of goods and services produced over a period of time. The government's objective is for the annual volume of goods and services to grow at a strong (textbooks talk of 3–4 % pa) but steady rate so that the achievement of other economic objectives such as price stability and external stability are not jeopardized. A strong but steady rate is desirable so that material welfare is improved and unemployment reduced.

Question 3b.

Marks	0	1	2	3	4	5	6	Average
%	8	10	15	18	21	17	11	**3.3**

Many students provided good definitions of the labour force participation rate (LFPR), which was a great improvement on the performance on this concept in 2006. Many students understood the importance of LFPR increases and the impact this has on firms' willingness and ability to supply.

Weaker answers discussed how participation rates would increase the demand side rather than focusing on the real problem, which is supply constraints. That is, students talked about demand increasing rather than a supply constraint being lifted. Many students assumed that an increase in the LFPR automatically means that more people are employed, which suggests that students still misunderstood the link between participation rates, the labour force and the unemployment rate.

The second part of the question was generally not as well handled, and many students misinterpreted the graph on capacity utilisation. The best answers started with a definition of capacity utilisation and then suggested that as the economy nears full capacity utilisation, economic growth is likely to be curbed. Much has been written about this problem in recent times, with this question providing a good opportunity for students to use and apply their current knowledge about the performance of the Australian economy.

Weaker answers tended to see increases in capacity utilisation as a good thing, but then did not see it as a force that constrains future growth potential. Other weaker answers confused productive capacity and productivity. Many students assumed that an increase in capacity utilisation meant there had been an increase in productivity and provided an answer on the affect of improved productivity, thus showing a lack of economic understanding of these concepts.

Question 3c.

Marks	0	1	2	3	4	5	6	7	8	9	10	Average
%	13	9	10	11	12	11	10	10	7	4	3	4.2

A number of students did not read this question carefully enough. Far too many students did not discuss any macroeconomic policies (the central requirement of the question) and wasted their answer by simply writing about the statistics in the chart and whether the economic objectives had been achieved.

The best answers to this question cited examples of budgetary and monetary policies that had been implemented during the past three years and explained the extent to which they had/had not/would be likely to contribute to the achievement of the economic objectives. Again, students who had kept abreast of current economic conditions could use this question to demonstrate and apply their knowledge and understanding of current macroeconomic policy.

While many students knew that interest rates had been increased and that monetary policy had been tightened, they demonstrated less knowledge of the last three years' budget initiatives. Students also needed to evaluate the performance of the policies they chose in terms of their impact on domestic stability. Responses demonstrated that many students need more practice at considering economic policies in terms of the positives and negatives. For example, many students thought that it was good that the government was giving income tax cuts to boost aggregate demand, without pointing out the negative consequences that the economy is running at close to capacity and that this policy is in conflict with the tightening of monetary policy.