NSW INDEPENDENT TRIAL EXAMS – 2009
ECONOMICS HSC TRIAL EXAMINATION
MARKING GUIDELINES

Section I

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Section II

Question 21(a) *Outcomes assessed: H1, H8*

Criteria	Marks
States the correct definition of both terms i.e. full employment and price stability.	2
States the correct definition of EITHER full employment OR price stability but not both.	1

Answers could include: Full employment is a situation where the economy's resources including labour are fully utilised. It can also be defined as where the economy is operating at its natural rate of unemployment. Price stability is defined as where inflation is not accelerating in the economy or when the inflation target set by the central bank is being achieved. In Australia's case this would be when the rate of CPI inflation is within the 2% to 3% target band set by the Reserve Bank of Australia over the economic cycle.

Question 21(b) *Outcomes assessed: H1, H6, H8*

Criteria	Marks
Correctly explains how governments are restricted in the simultaneous achievement of full employment and price stability.	2
Describes rather than explains how there is a trade-off between a government achieving full employment and price stability at the same time.	1

Answers could include: A trade-off may exist between the government's achievement of economic objectives in the short run. If the government is seeking to achieve full employment of resources it may use expansionary macro policies to stimulate economic growth and the demand for resources. If full employment is reached this may lead to rising inflationary pressures and a lack of price stability. On the other hand if a government wanted to achieve greater price stability it may use contractionary macro policies to reduce inflation, but this may be at the cost of lower economic growth and rising unemployment.

Question 21(c) *Outcomes assessed: H1, H2, H6, H8*

Criteria	Marks
Explains two separate effects of an easing in monetary and fiscal policies on the level of economic activity in Australia.	3
Explains only one effect of an easing of macro policies on the Australian economy	2
Outlines rather than explains one effect of an easing in macro policies on the Australian economy	1

Answers could include: A number of effects could be explained as a result of an easing in monetary and fiscal policies on the level of economic activity in Australia:

- An increase in the level of private spending (C + I) which could help to increase the level of aggregate demand in the economy
- An increase in household incomes as a result of higher cash flows through lower interest rates and increased government spending on transfer payments or cuts in taxes
- An increased demand for labour and lower rate of unemployment as employment growth is stimulated
- An increase in consumer, business and investor confidence through lower interest rates and higher net government spending

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Question 21(d) *Outcomes assessed: H1, H2, H6, H8*

Criteria	Marks
Explains correctly how global and domestic influences can limit the effectiveness of government economic policy in Australia.	3
Describes rather than explains how global and domestic influences can limit the effectiveness of government economic policy in Australia.	2
Outlines briefly one global or domestic influence on government economic policy	1

Answers could include:

- The various lags associated with the implementation of government economic policy including the recognition lag, policy formation lag and induced expenditure lag
- Global influences include changes in the global business cycle, world economic policy, the process of globalisation and the spread of financial integration and contagion
- Domestic influences could include political constraints in getting government legislation passed by both houses of parliament, continuing electoral support and favourable or unfavourable media coverage.

Question 22(a) *Outcomes assessed: H1, H8*

Criteria	Marks
Correctly states the meaning or definition of inflation.	1

Answers could include: An increase in the general level of prices over a year or a sustained increase in the general price level. Inflation usually leads to a fall in the purchasing power of money incomes.

Question 22(b) *Outcomes assessed: H1, H11*

Criteria	Marks
Correctly calculates the inflation rate from Year 2 to Year 3.	1

Answers could include:

$$\text{Inflation rate} = \frac{\text{Current CPI} - \text{Previous Year's CPI}}{\text{Previous Year's CPI}} \times \frac{100}{1}$$

$$\frac{150.4 - 144.8}{144.8} \times \frac{100}{1} = 3.86\%$$

Question 22(c) *Outcomes assessed: H1, H8*

Criteria	Marks
Sketches in general terms two possible causes of inflation.	2
Sketches in general terms one possible cause of inflation or identifies rather than outlines two causes of inflation	1

Answers could include:

- Demand pull inflation resulting from an increase in aggregate demand (C + I + G + X – M)
- Cost push inflation resulting from rising costs of production such as wage or raw material costs
- Imported inflation resulting from an increase in the price of imported goods
- Rising inflationary expectations – the general view held by the public about the future behaviour of prices based on past and present inflation (i.e. adaptive expectations)

Question 22(d) *Outcomes assessed: H1, H7*

Criteria	Marks
Provides characteristics and features of two adverse or negative effects of inflation	2
Provides characteristics and features of one adverse or negative effect of inflation or identifies rather than describes two adverse or negative effects of inflation	1

Answers could include:

- The loss of purchasing power and real income by consumers
- A decline in international competitiveness and confidence in an economy
- The impact of inflation on people with fixed incomes and the redistribution effect to high income earners
- A decline in real savings and investment
- A deterioration in the government's budget balance

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Question 22 (e) *Outcomes assessed: H1, H5*

Criteria	Marks
Shows the cause and effect of one government macroeconomic policy to address inflation in the short run and one government microeconomic policy to address inflation in the long run.	3-4
Shows the cause and effect of either one government macroeconomic or one microeconomic policy to address inflation in the short run or long run or identifies and provides only an outline of two policies.	1-2

Answers could include:

Short run macroeconomic policies to reduce inflation:

- Policies more suitable to the short run would be a contractionary stance of fiscal policy (e.g. an increase in taxation or a reduction in government expenditure or a combination of both). This would be directed at reducing demand pull inflation.
- In the short run the Reserve Bank of Australia could implement a tightening of monetary policy and increase the official cash rate. This would reduce consumption expenditure and investment and would lead to a decline in aggregate demand and reduce demand pull inflation pressures.

Long run microeconomic policies to reduce inflation:

- In the long run micro economic reform (MER) is more successfully used to address the supply side of the economy and cost push inflation. Examples of tariff reform, labour market reform and competition policy reform may be used to highlight the principles behind MER including increasing efficiency, productivity and competition in markets to reduce price inflation.

Question 23 (a) *Outcomes assessed: H1, H11*

Criteria	Marks
States correctly the formula for calculating the size of the labour force and the size of the labour force in June 2009 is 11,440,900 persons.	2
States the formula for the labour force only or calculates the correct size of the labour force in June 2009 is 11,440,900 persons.	1

Answers could include:

Labour force in June 2009 = Employed + Unemployed = 10,772,500 + 668,400 = 11,440,900 persons

Question 23 (b) *Outcomes assessed: H1, H4, H9, H10*

Criteria	Marks
Explains and states the participation rate for June 2009 as 65.4%, which is the labour force (employed plus unemployed) expressed as a percentage of the working age population.	2
Either explains the labour force participation rate or correctly states the participation rate for June 2009 but not both	1

Answers could include:

- The labour force participation rate is the percentage of the working age population in the labour force (sum of the employed and unemployed)
- The participation rate in June 2009 was 65.4%

Question 23 (c) *Outcomes assessed: H1, H5, H7, H10*

Criteria	Marks
Sketches in general terms two reasons for the increase in the level and rate of unemployment in Australia between June 2008 and June 2009.	2
Sketches in general terms only one reason for the increase in the level and rate of unemployment in Australia between June 2008 and June 2009.	1

Answers could include any two of the following:

- Declining consumer spending; the global financial crisis; declining business confidence and investment; declining commodity exports; and structural change in industry and the labour market.

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Question 23 (d) *Outcomes assessed: H1, H8, H11*

Criteria	Marks
Explains one short term policy and one long term policy in detail to prevent an increasing level and rate of unemployment.	3-4
States one policy in detail to prevent increasing unemployment or briefly states one short term and one long term policy.	1-2

Answers could include:

- Short term policies – The use of expansionary monetary policy by reducing the cash rate to encourage more borrowing and spending on goods and services to increase the demand for labour. Also expansionary fiscal policy through lower taxes and/or an increase transfer payments/stimulus payments could be used to boost aggregate demand and the demand for labour in the economy.
- Long term policies – These include the use of fiscal policy through infrastructure spending in the economy on projects in ports, roads, railways, telecommunications, electricity, gas, education and health to increase labour demand and long term productive capacity. Labour market policy can also be used through employment schemes and training programmes such as the Jobs and Training Compact in the 2009-10 budget.

Question 24(a) *Outcomes assessed: H1, H8*

Criteria	Marks
States the correct meaning of market failure.	1

Answers could include:

- Market failure can be defined as when the market fails to allocate resources efficiently. A more detailed definition would state how market failure occurs when the market fails to ensure that resources are put to optimal use.
- Market failure is commonly linked to the allocation of resources that do not lead to a state of "Pareto optimality" being attained i.e. a state where no one can be made better off without at least one other person being made worse off.

Question 24(b) *Outcomes assessed: H1, H7, H8*

Criteria	Marks
Sketches in general terms TWO causes of market failure with regard to the use of environmental resources.	2
Sketches in general terms ONE cause of market failure with regard to the use of environmental resources OR identifies rather than outlines TWO causes.	1

Answers could include:

Some of the main causes of market failure include:

- The existence of externalities also called external effects or spillover effects.
- Common property – where property rights cannot be assigned to individuals
- Public goods – these are goods and services which are non-rival and non-excludable in consumption
- Free riders – individuals obtain the benefit from the good or service whether they choose to pay or not

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Question 24(c) *Outcomes assessed: H1, H7, H8*

Criteria	Marks
Clearly and concisely demonstrates an understanding of the difference between the private cost and social cost of pollution.	3
Demonstrates a general understanding of the difference between the private cost and social cost of pollution.	2
Provides a limited response on the difference between the private cost and social cost of pollution.	1

Answers could include:
Private cost reflects the cost of resources to the individual consumer or business, while social cost involves the cost to the whole of society of the resources that an individual consumer or business uses.

Private cost is usually based on the market value of the productive factors used by the firm (i.e. labour, raw materials, capital equipment, etc) to produce some form of output. If a firm is able to dispose of pollutants by dumping them into the atmosphere or a river system then the private cost to the firm of pollution could effectively be zero. If however, the government forces firms to adopt pollution control measures and dispose of their waste products in a more environmentally responsible manner, the private cost of pollution will increase while the social cost will be reduced.

The social cost of pollution involves the cost to all parties that suffer from the negative external effects of exposure to pollutants e.g. health costs due to respiratory problems and illness, destruction of property or loss of amenity from the use of environmental resources. The social costs of pollution would also include the destruction of common property resources such as the killing of marine resources in oceans or the loss of air quality due to air pollutants released into the atmosphere.

Question 24(d) *Outcomes assessed: H1, H5, H8*

Criteria	Marks
Explain two economic instruments that a government may use to improve the management of environmental resources.	3-4
Sketches in general terms two economic instruments that a government may use to improve the management of environmental resources OR Explains ONE economic instrument that a government may use to improve the management of environmental resources.	1-2

Answers could include: Any two of the following economic instruments could be explained as methods that the government can apply to improve the management of environmental resources:

- Legislation and regulations enforced by government authorities or agencies. In the most extreme cases, punitive measures such as fines and even gaol sentences may be applied to the offending parties.
- Environmental taxes and charges:
  - Pigouvian taxes applied to the case of negative externalities and usually suggested as an approach for correcting the problem of pollution. The guiding principle is to tax the polluter according to the marginal social cost (MSC) they impose on others.
  - Pollution taxes and charges: such as a tax on petrol or a resource tax or charge where firms are taxed according to their use of a particular resource such as water or native timber.
- Tradeable permits/emissions trading schemes: These entail creating a market for the environmental issue of concern. Once a standard for behaviour has been set, for example a maximum level of a particular pollutant being allowed to be released into the atmosphere, it is possible to issue permits to polluters allowing them to discharge only a certain level of the pollutant. A market can then be established for the permits enabling them to be bought or sold. This is commonly referred to as a market for tradeable permits or transferable emission permits. An example is the proposed introduction of a Carbon Pollution Reduction Scheme (CPRS) by the Australian Government involving a cap and trade emissions trading mechanism to limit greenhouse gas emissions, helping to reduce the rate of climate change.

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Section III

Question 25 *Outcomes assessed: H1, H2, H5, H6, H8, H10*

Criteria	Marks
• Provides clear and comprehensive arguments identifying points for and/or against the use of macroeconomic policies in achieving the government's objectives of economic growth and full employment • Integrates appropriate economic terms, relevant concepts, relationships and theory • Synthesises own knowledge with the information provided to develop a sustained, logical and well-structured response	**17-20**
• Provides sound arguments, identifying points for and/or against the use of macroeconomic policies in achieving the government's objectives of economic growth and full employment • Consistently applies appropriate economic terms, relevant concepts, relationships and theory • Uses own knowledge and the information provided to develop a logical and well-structured response	**13-16**
• Sketches in general terms arguments identifying points for and/or against the use of macroeconomic policies in achieving the government's objectives of economic growth and full employment • Applies appropriate economic terms, concepts and relationships and theory • Uses own knowledge and the information provided to develop a coherent response	**9-12**
• Sketches in general terms points on the use of macroeconomic policies in achieving the government's objectives of economic growth and/or full employment • Uses some appropriate economic terms, concepts and relationships • Uses information to develop a generalised response	**5-8**
• Lists aspects of macroeconomic policies (i.e. monetary and fiscal policies) • Uses some economic terms and/or concepts • Presents a limited response	**1-4**

Question 25: Essay Plan:

The macroeconomic policies which have been used over the past 12 months in Australia to address the economic objectives of economic growth and full employment are monetary policy and fiscal policy. Monetary policy is undertaken by the Reserve Bank of Australia and involves the Reserve Bank changing the official cash rate in order to influence the cost of money (interest rates) in the Australian economy. Fiscal policy is the government's use of taxation and government expenditure (or both) in the budget to influence economic activity. Whilst both policies have played an important role in the current economic downturn, fiscal policy has become the main policy instrument to address the global financial crisis (GFC).

Approximately twelve months ago Australia's economic landscape was very different. The major issues confronting the government were inflationary pressures, a tight labour market which included a shortage of skilled labour, and rising global oil prices. However in September 2008 the state of global financial markets deteriorated significantly. This change in global financial markets had its foundation in the US property market. US banks were lending to people who were classified as sub-prime borrowers. This questionable practice collapsed as property prices fell and borrowers couldn't repay their mortgages. The US banks had created popular investment instruments, one in particular called credit default swaps (CDS) which were linked to the sub-prime market. These CDS were sold worldwide. In brief terms, when the property market linked to the sub-prime market collapsed, there were huge losses worldwide, and banks significantly reduced their lending within countries and across borders. Consequently the global financial crisis affected all countries including Australia.

In September 2008 the Reserve Bank implemented the first of its cash rate changes, with a decrease of 0.25%, making the cash rate 7%. This was followed in October 2008 by a reduction in the cash rate by 1% to 6% (refer to the stimulus material). This was a significant change in the stance of monetary policy with the Reserve Bank adopting an expansionary stance for monetary policy. This stance involved the Reserve Bank buying back government securities, which increased the supply of funds and decreased the cash rate in Australia.

Question 25continues on the next page

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Question 25 continued

(Note: Better students may include a diagram to show how changes in the cash rate impact on the supply of money.)

The Reserve Bank continued to implement an expansionary stance of monetary policy in 2008-09. Since October 2008 the cash rate has been reduced on four occasions. The current cash rate stands at 3%. The easing of monetary policy was necessary due to weakening economic conditions in the major economies of the world, falling commodity prices, with global inflation no longer being an issue and the emerging economic concerns in Australia, including higher unemployment. However given the extent of the GFC and the limitations of monetary policy to stimulate economic growth in a downturn, the government also turned to fiscal policy to stimulate economic growth and prevent rising unemployment.

The use of fiscal policy by the Rudd Government has been very significant in attempting to stimulate the level of aggregate demand and the 'flow on' to the level of economic activity in Australia, including economic growth and employment.

(Note: Students may discuss the return to Keynesian economics. John Maynard Keynes wrote in his book *The General Theory of Employment, Interest and Money* (1936) a rationale for government policy being used to restore the general level of activity in an economy. Students could include an explanation and a diagram of the role of the fiscal policy in closing a deflationary gap in order to lift the level of economic activity (i.e. income, output and employment). Some reference could also be made to the multiplier effect of a change in government spending on national income.)

The fiscal stimulus used by the Rudd Government has been delivered in three phases. In October 2008 the government announced a $10.4b package which included cash payments to pensioners and carers, and an increase in the first home buyers' grant. An even bigger stimulus package was delivered in February 2009 of $42b. This package included cash bonuses to many Australian taxpayers as well as a wide range of "shovel ready" capital works programmes. The third round of spending was delivered through the May Budget. The focus of the budget was on major infrastructure projects and increased pensions. The budget deficit was forecast at $53.1b in 2009-10 (see stimulus) and the budget would not return to surplus until 2015.

The government deemed it necessary to "pump" significant amounts of money into the Australian economy because of the depth of the economic downturn and the prediction that it will last longer than the 1990s recession. The forecasts included a contraction in real GDP of -0.5% in 2009-10, an increase in unemployment to 8.5% by 2011, and a significant decline in Australia's terms of trade and business investment. The Rudd government is committed to its "medium-term fiscal strategy". Part of this strategy is to achieve a budget surplus, on average, over the economic cycle. So the government forecasts include deficit budgets up to 2014-15 and a return to an underlying cash surplus by 2015-16. Net government debt is forecast to reach a peak of $293b in 2013-14.

There has been much debate about the government's forecast of the future budget outcomes and the impact of the current stances of monetary policy and fiscal policy. However there are signs that the Australian economy is performing better than other countries, including Japan, Germany, Canada and the United States. During the March quarter 2009 Australia's economy expanded by 0.4%. Also during the March quarter retail trade expanded by 0.8%. It is argued that this expansion was a result of the $42b stimulus package. Despite some positive economic figures there were also some negative figures: manufacturing output decreased by 3.3%; exports in agriculture shrank by 2.4%; and mining exports decreased by 1.5%. Economists will be viewing the June quarter 2009 growth figure with anticipation.

Since 1996 up until more recent times, the dominant macroeconomic tool has been monetary policy rather than fiscal policy. The use of monetary policy was viewed as being more effective in reducing or stimulating aggregate demand in the Australia economy when it was deemed appropriate by the Reserve Bank. Monetary policy was also viewed as the more favourable policy because it has a shorter implementation lag than fiscal policy. However given the extent of the downturn in aggregate demand and the fear of a recession, the Australian government has changed the role of fiscal policy. Fiscal policy is no longer playing a supporting role but is the dominant macroeconomic policy tool being used to stimulate economic growth and achieve full employment in Australia.
(Note: students should incorporate the stimulus material where appropriate to support their response.)

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Question 26 *Outcomes assessed: H1, H2, H3, H4, H5, H6, H7, H8, H9, H10*

Criteria	Marks
• Demonstrates a clear and concise understanding of the impact of changes in the global economy on Australia's economic performance. • Integrates appropriate economic terms, relevant concepts, relationships and theory in the extended response answer. • Synthesises own information with the information provided to develop a sustained, logical and well-structured response to the question.	**17 – 20**
• Demonstrates an understanding of the impact of changes in the global economy on Australia's economic performance. • Consistently uses appropriate economic terms, relevant concepts, relationships and theory. • Uses own information and the information provided to develop a logical and well-structured response.	**13 – 16**
• Describes the impact of changes in the global economy on Australia's economic performance. • Uses appropriate economic terms, concepts and relationships. • Uses own information and the information provided to develop a coherent response.	**9 – 12**
• Outlines some of the impact of changes in the global economy on Australia's economic performance. • Uses some appropriate economic terms, concepts and relationships. • Uses own information to develop a generalised response.	**5 – 8**
• Lists some impacts of changes in the global economy on Australia's economic performance. • Uses some economic terms and/or concepts. • Presents a limited response.	**1 – 4**

Question 26: Essay plan:

The global or world economy refers to the sum of countries that produce goods and services and contribute to global GDP. In addition the global economy involves the international trade of goods and services, the international movement of capital (through direct and portfolio investment), as well as trade in financial assets such as foreign exchange and financial derivatives. Changes in the global economy, especially changes in world output, trade and the global business cycle, can affect the economic performance of domestic economies in three main ways:

- Changes in global output will affect the demand for a country's exports and influence its balance of payments and exchange rate;
- Changes in global trade flows such as exports and imports of goods and services will affect a country's balance of payments, exchange rate and rate of domestic economic growth; and
- Changes in global capital flows can impact on a country's rate of economic growth, its balance of payments and exchange rate.

The current global economic environment is one of international recession caused by the global financial crisis (GFC) that accelerated and deepened in the December quarter 2008. This led to a sharp and synchronised annual contraction in global output of around -6.25% (refer to the stimulus material), with most major advanced economies experiencing recession in 2009. This includes the USA (-3%), the countries in the Euro area (-4%), Japan (-6%) and ASEAN (-1.25%). Slowdowns have also been experienced in large emerging economies such as China (6.25%), India (4%), Brazil and Russia. The IMF forecasts that the global economy will experience a -1.5% contraction in GDP in 2009 before a recovery in growth to 2.25% in 2010. International trade flows are forecast to fall by as much as -20% in 2009 and international capital flows have also experienced a sharp decline from advanced to emerging or developing countries.

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Question 26 continued

In response to the global financial crisis, major advanced and emerging economies have implemented expansionary monetary and fiscal policies to support aggregate demand and employment growth. These measures include substantial reductions in official interest rates and large fiscal stimulus packages to increase domestic spending, as export earnings and capital flows diminish, causing contractions in domestic output and employment. The other major reforms taken include the guarantee of bank deposits and a tightening of lending standards, as well as injections of liquidity into financial markets to support confidence and reduce volatility in asset prices such as interest rates, shares and real estate.

With substantial trade and financial linkages to the global economy, Australia has experienced a deterioration in its economic performance in 2008-09. Economic performance has three major dimensions:

- The extent to which a country achieves its potential in terms of sustainable economic growth;
- The extent to which a country achieves internal balance by minimising inflation and operating at the full employment level of national income; and
- The extent to which a country achieves external balance, with equilibrium in it balance of payments, a stable exchange rate, and the ability to service the cost of net foreign liabilities, including net foreign debt.

The economic forecasts provided in Budget Paper No 1 indicate that the slowdown in economic activity in Australia caused by the global financial crisis and global recession is less than in other countries. This is probably due to a few reasons including the relative flexibility of Australia's economy in adapting to external shocks because of the extensive microeconomic reforms carried out in the past 20 or so years. In addition the Australian financial system, including the major banks and NBFIs remain profitable and solvent, and well regulated by the Australian Prudential Regulation Authority, the Reserve Bank and ASIC. Finally the Australian government was in a sound fiscal position (because of accumulated budget surpluses and no public debt) before the onset of the crisis, giving it more scope to use discretionary fiscal policy to stimulate the economy through direct cash payments to households and increased spending on infrastructure.

Expansionary fiscal policy settings have helped to support spending, growth and employment through the targeting of new spending at households and the business sector. The stance of monetary policy has also been eased significantly since the scope for an easing in official interest rates was larger than in other countries. The cash rate was eased from 7.25% in August 2008 to 3% in April 2009, still allowing the Reserve Bank 'room to manoeuvre' in the future if it wishes to provide further stimulus to the economy.

Real GDP is forecast to record zero growth in 2008-09 as household consumption expenditure, business investment and exports contract, reducing aggregate demand and GDP. In 2009-10 the rate of growth is forecast to contract by -0.5%, a smaller average contraction than in other major advanced economies.

Inflation has fallen in the world economy because of lower commodity prices (including oil and food prices). This has helped to ease inflationary pressures from around 5% in Australia in 2007 to a forecast 1.75% in both 2008-09 and 2009-10. This will help to support the competitiveness of businesses in the export and import competing sectors of the Australian economy.

However with the fall in aggregate demand, employment growth is forecast to be negative in both 2008-09 (-0.25%) and 2009-10 (-1.5%). This means that insufficient full time and part time jobs will be created to meet the supply of labour looking for work. As a result, the unemployment rate is likely to rise from 6% in 2008-09 to peak at 8.25% of the labour force in 2009-10. Whilst jobs have been lost in manufacturing, the financial services sector, information technology and small business, the labour market has adjusted to lower employment opportunities, with employers switching people from full time to part time jobs, and changing hours and shift times to avoid widespread retrenchments of labour.

In terms of external balance the current account deficit is forecast to rise from -3% of GDP in 2008-09 to -5.25% of GDP in 2009-10. This reflects a decline in export earnings and an increase in the size of the merchandise trade deficit. Lower rates of domestic growth however will reduce import spending, helping to contain the deficit, whilst the lower exchange rate of US$0.80 from its high of US$0.98 in August 2008 is supporting the competitiveness of the export and import replacement sectors of the economy.

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Section IV

Question 27 Outcomes assessed: H1, H2, H3, H4, H5, H6, H7, H8, H9, H10

Criteria	Marks
▪ Integrates appropriate economic terms, relevant concepts, relationships and theory ▪ Synthesises economic data and other information to develop a sustained, logical and well-structured response ▪ Demonstrates a clear and comprehensive understanding of a range of causes of Australia's current account deficit ▪ Demonstrates a clear and comprehensive understanding of the positive and negative economic implications on the Australian economy of continuing current account deficits	**17 – 20**
▪ Consistently applies appropriate economic terms, relevant concepts, relationships and theory ▪ Uses economic data and other information to develop a sustained, logical and well-structured response ▪ Demonstrates a clear understanding of a range of causes of Australia's current account deficit ▪ Demonstrates a clear understanding of the positive and negative economic implications on the Australian economy of continuing current account deficits	**13 – 16**
▪ Applies appropriate economic terms, relevant concepts, relationships and theory ▪ Uses some economic data and other information to develop a coherent response ▪ Provides a general understanding of a range of causes of Australia's current account deficit ▪ Provides a general understanding of the positive and negative economic implications on the Australian economy of continuing current account deficits	**9 – 12**
▪ Uses some economic terms, concepts and relationships ▪ Uses some economic data to develop a generalised response ▪ Sketches in general terms the causes of Australia's current account deficit ▪ Sketches in general terms the economic implications of Australia's continuing current account deficits	**5 – 8**
▪ Uses some economic terms and or concepts ▪ Presents a limited response ▪ Lists some aspects of Australia's continuing current account deficits	**1 – 4**

Question 27: Essay plan

A range of factors has contributed to the continued widening of Australia's current account deficit (CAD) over recent years. The main influences either relate to Australia's controversial high inflation/high budget deficit deteriorating CAD period of the mid 1980s to early 1990s, or the more recent commodity cycle/ aggregate demand driven CAD expansion period.

The main structural influence on Australia's CAD remains the size of the net income deficit and the associated cost of servicing both debt and equity borrowings overseas (known as total external liabilities). The magnitude of Australia's external liabilities means that the payment of interest, dividends and royalties to overseas lenders and investors exceeds the inflow of income from Australian investment and lending abroad. In 2006-07 the net income deficit was 78.9% of the current account deficit. During the period 1997-2007 the net income deficit accounted for 50% or more of the CAD. Between 2002 and 2007 the cyclical deficit in goods and services also led to much higher current account deficits than in other years.

Australia's stock of net foreign liabilities has continued to grow, passing $500b during 2004-05 and passing $600b in 2006-07. The continued growth of net external liabilities has been required to finance persistent current account deficits. Australia's net foreign liabilities (consisting of net foreign debt and net foreign equity) grew from $170b (46% of GDP) in 1989-90 to $517b (60% of GDP) during 2004–05 and to $709b by 2007-08. Australia's net foreign debt alone, had reached an astonishing $430b (50.6% of GDP) by the end of 2004-05 and $658b (60.7% of GDP) by 2007-08.

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Question 27 continued

The interest cost of servicing net foreign debt has fallen over the last decade (to just over 6% of net foreign liabilities) reflecting lower interest rates in global markets. However the recent international commodities boom has led to resource companies making higher dividend payments to overseas shareholders. As a consequence, the net income deficit for the Australian economy jumped from around $23.7b in 2003-04 to $31.2b in 2004-05. By 2007-08 the net income deficit had reached a high of $50.2b.

Another important component of Australia's CAD experience has been the disappointing export performance over the last decade. Over 1995-2005, the real volume of our exports grew at an annual rate of only 4.8% and over the period 2003-05, exporters only managed a growth rate of 1.8% per year. In short Australia's share of world trade has been declining. The recent global commodities boom gave Australian exports a boost over the past three years, with higher commodity prices contributing to a fall in the goods deficit and subsequently the CAD during 2005-06. However the improvement was short lived as by 2007-08 the CAD had risen to $68.25b (6.3% of GDP) due to a higher net income deficit.

Unfortunately the same cannot be said for imports, as annual import volumes have grown at a rate of around 8.1% over 1995-2005. Some of this rise reflects the recent boom in export prices, with a large component of export income flowing back out of the economy in the form of payments for imported goods. Part of this spending was for capital goods, required for investment purposes by the export sector.

It also appears that Australia has become more involved in securitised lending, allowing the average Australian greater access to foreign borrowing which in turn boosted local housing and consumer spending on imports. This reflects the increased sophistication and integration of global financial markets and the linkages between Australia and the global economy.

In short there are three main factors that have been responsible for Australia's persistent current account deficits over the past couple of decades:

- The growth rate of the Australian economy. More specifically the tendency (particularly during 2001-03) for the Australian economy to grow faster than the world economy or the economies of Australia's trading partners. This means that import demand tends to outstrip export demand causing the goods balance of the current account to deteriorate. Australia's goods balance has tended to be in deficit since 1996-97.

- The growth in foreign borrowings (both private and public) since the 1980s. Foreign debt replaced equity investment as the main source of foreign capital and the net income deficit started to grow dramatically. The size of the increasing net income deficit - which reflects the cost of servicing Australia's debt and equity borrowings (total foreign liabilities) has been the major source of the growth in Australia's CAD over recent years. In 2006-07 the net income deficit was 78.9% of Australia's CAD.

- The saving-investment gap or spending-output gap. The CAD is associated with both negative domestic net savings {(T-G) + (S-I)} and positive net capital inflow (Capital Account Surplus). The capital account surplus is required to finance the current account deficit, which in turn reflects the tendency for domestic expenditure to exceed the level of domestic output. These are the main structural factors responsible for Australia's persistent and growing CAD.

Regarding the economic implications of Australia's persistent current account deficit, there is a general tendency in the media and the public to interpret a current account deficit as a sign of weakness and as harmful to the nation's welfare. Another interpretation is that the deficit enables more investment than would be possible otherwise, and since higher investment is correlated with higher living standards, the current account deficit might be interpreted as beneficial. In addition, the capital inflows that are associated with current account deficits are an implicit vote of confidence by foreigners investing in Australia.

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Question 27 continued

On the positive side, countries with good investment opportunities and high expected future rates of economic growth appear to be able to run current account deficits over considerable periods of time. As long as there are no distortions to savings or investment decisions (for example, because tax rules encourage investment or discourage savings), and as long as the government's budget deficit is small, the current account deficit will reflect utility maximising decisions by consumers and profit maximising decisions by firms making investment decisions. Under these circumstances, a current account deficit that arises may in fact be optimal. The implication of this is that governments should not try to alter the size of the deficit, as doing so will only make consumers or firms, or both, worse off.

On the negative side the most serious implications of persistent current account deficits are:

(i) Exposure to financial crisis: current account deficits may be the source of instability within financial markets and the economy in general. The capital inflows that occur with a current account deficit increase the stock of foreign owned assets inside the home country, raising the possibility that a change in investor expectations about the economy's future can lead to a sudden surge in capital outflows. In the worst case scenario, 'capital flight' is followed by a depletion of international reserves and a financial crisis. However the experiences of countries in the 1980s and 1990s has taught economists that financial crises are determined by more than the size of current account deficit and that there are no absolute thresholds between safe and dangerous levels for a deficit. While deficits of 3% to 4% of GDP begin to raise 'red flags', and deficits of 7% to 9% are considered extremely risky, there are too many other factors that must be taken into account before the probability of a crisis can be determined.

(ii) Higher levels of foreign debt: current account deficits must be financed through inflows of financial capital. Capital inflows take different forms, from direct investment to purchases of stocks, bonds and currency, to loans. Loans from abroad add to a country's stock of external debt and generate debt service obligations requiring interest payments and repayment of the principal amount borrowed. Theoretically foreign loans are no more harmful than any other type of debt. That is, as long as the borrowed funds are used to increase investment and exports, the borrower will be able to service the debt without difficulty. In practice however it is not uncommon for borrowed funds to be used in a manner that does not contribute to the expansion of the country's production capacity. Subsequently there is a risk that debt servicing will become an unsustainable burden that holds back economic development.

(iii) If a country incurs successive current account deficits, it may be more susceptible to exchange rate fluctuations and periods of currency depreciation. These depreciations may in turn lead to higher domestic inflation as import prices rise (imported inflation). Currency depreciation can also cause problems with foreign debt repayments, as the part of the foreign debt that is denominated in foreign currencies requires more domestic currency for repayment. This is known as the valuation effect on the stock of foreign debt, which serves to push up the debt servicing burden of domestic agents who have borrowed overseas.

(iii) The need for tighter monetary policy: persistent current account deficits may be interpreted by a country's monetary authorities as signalling the need for a tightening of monetary policy and higher interest rates. The interest rate increase is designed to slow down economic growth and reduce the demand for imports, to help rectify the economy's trade imbalance and reduce the current account deficit. However, higher interest rates are likely to have an adverse effect on the level of output and private sector investment. In this way the current account deficit is viewed as the economy's 'speed limit' to growth and represents an external constraint on the prospects for domestic growth.

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Question 28 Outcomes assessed: H1, H2, H3, H4, H5, H6, H7, H8, H9, H10, H11

Marking Criteria	Marks
• Integrates economic terms, concepts, issues, relationships and theory in an appropriate context. • Discusses Australia's policies regarding free trade and protection. • Outlines the reasons for protection. • Uses specific examples and relevant data of countries that are protecting domestic markets and industries to support a contemporary and comprehensive analysis of the implications of global protection for the Australian economy.	17-20
• Provides concise definitions of economic terms and applies concepts and relationships in an appropriate context. • Discusses Australia's policies regarding free trade and protection. • Outlines the reasons for protection. • Uses examples of countries that are protecting domestic markets and industries to support a contemporary analysis of the implications of global protection for the Australian economy.	13-16
• Provides clear definitions of economic terms, concepts and relationships. • Attempts to discuss Australia's policies regarding free trade and protection. • Defines protection and attempts to outline the reasons for protection. • Attempts to explain the implications of global protection for the Australian economy.	9-12
• Provides basic definitions of some economic terms, concepts and relationships. • Uses generalised knowledge to discuss Australia's policies regarding free trade and protection • Attempts to outline the reasons for protection. • Uses generalised knowledge to develop an irrelevant or inappropriate response to the implications of global protection for the Australian economy.	5-8
• Utilises some appropriate terminology to communicate economic ideas. • Develops no logical sequence in answer. • Demonstrates a lack of knowledge about free trade and protection. • Does not discuss the implications of global protection for the Australian economy.	1-4

Essay plan:

Free trade occurs where there is free movement of goods and services between countries because of the absence of government protection of local industries. Protection on the other hand is where governments provide assistance to increase the competitiveness of their local industries against imports through the imposition of tariffs, subsidies, quotas, embargoes and voluntary export restraints.

Australia is an outspoken advocate of free trade, and since 1973 (the 25% across the board cut in protection) has abolished almost all tariffs except for small tariffs assisting the motor vehicle and textiles, clothing and footwear (TCF) industries. The major cuts in protection were implemented in the 1988 and 1991 Industry Statements that announced cuts in protection for manufacturing from 16% in 1989 to 5% by 2000-01.

In 1986 Australia helped to form the Cairns Group of free trading agricultural nations that sought reductions in agricultural protection in the Uruguay Round of GATT. Australia also helped to form APEC in 1989 and this led to reduced protection in the region and increased trade with ASEAN, China, Japan and other Asia Pacific rim countries. Since 2003 Australia has also signed bilateral free trade agreements with the USA, Singapore and Thailand and is negotiating agreements with a number of other countries.

Australia does not subsidise agriculture and has dismantled price floors, marketing boards and deregulated many agricultural markets in recent years. Australia's strong unilateral stance on lowering protection has seen many firms go offshore such as Pacific Brands in 2008. However for the manufacturing sector as a whole, the dismantling of protection has led to an increase in manufactured exports as firms have increased their level of efficiency and international competitiveness.

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Question 28 continued

Australia has benefited from the move to free trade, despite losing many labour intensive TCF factories and the motor vehicle industry has continued to restructure due to increasing competition from Asia and the global slowdown, which has reduced the demand for vehicles worldwide. Free trade has led to a number of benefits for Australian industry and the economy in general:

- Restructuring of industry and employment has led to greater efficiency and improved international competitiveness of manufacturing.
- A focus on comparative advantage and efficient resource allocation through the generation of economies of scale in production.
- Lower domestic prices and less inflationary pressure from high import prices, as well as increased consumer choice of goods and services and rising real incomes.
- The benefits of APEC membership and bilateral trade agreements such as the Australia-United States Free Trade Agreement (AUSFTA) have increased trade flows between Australia and the Asia Pacific region.

Australia has embraced free trade, especially in the Asia-Pacific Region and has been able to take advantage of the rapid growth in economies such as India and China. Australia would benefit from reduced protection in agriculture in Europe and the USA but since the WTO's Doha Round started in 2001, subsequent WTO meetings have failed to overcome the opposition of the European Union and the United States on this issue. The extent of global protection is widespread:

- In the USA the federal government provides protection of farming communities in the Mid West; protection of domestic employment in the manufacturing sector (e.g. the automotive industry); prevention of dumping of agricultural surpluses from low cost overseas producers; and protection from cheap manufactured exports from China due to China's large trade surplus with the USA.

- In the European Union (EU), the Common Agricultural Policy (CAP) leads to extensive subsidies for dairy, wheat, fruit, vegetable and meat products of EU farmers. The EU operates as a preferential trading bloc, causing many world food prices to be lower than they would be in the absence of subsidies. This reduces market access for many countries' exports of farm products to the EU market.

- In Japan and South Korea, subsidies are paid to farmers to achieve national self sufficiency in rice and beef production, thereby limiting rice and beef exports from the rest of the world including Australia.

The reasons that countries such as those in the EU as well the USA, Japan and Korea protect their agricultural and manufacturing sectors are that their domestic goals may outweigh international goals for free trade and development. Governments use protection based on the following mainly economic arguments:

- To support infant industries
- To promote domestic employment
- To protect their economies from dumping
- To promote self sufficiency

Despite the WTO focus on free trade under the Doha Round many member countries are being affected by the impact of higher world oil prices and the slowing world economy, and therefore domestic issues have moved to the forefront of most national governments' agendas. There are examples of countries that are increasing protection such as France moving industries back from Eastern European countries to boost domestic employment and GDP. The main implications of an increase in world protection on Australia include the following:

- It can cause a decline in Australia's exports and export income as Australian exporters are denied market access in highly protected economies such as the EU and USA. Since Australia does not retaliate with higher levels of protection against imports, this makes it difficult to increase exports and reduce the current account deficit.

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- Global protection reduces the rate of world economic growth and the demand for Australia's exports. This in turn could lead to slower economic growth in Australia as the income returns from exports are lower than they otherwise would be, reducing the growth of aggregate demand.

- Higher levels of global protection may lead to increasing unemployment in industries that cannot compete with subsidised overseas producers. This can cause structural adjustment in industry and increase structural unemployment.

The role of the World Trade Organisation (WTO) is crucial in promoting free trade, as it is the main global body in overseeing the rules based trading system. Australia has been a member of GATT since 1944 and the WTO since its formation in 1991. The WTO performs a number of important functions in world trade:

- Implementing and expanding global trade agreements;
- Resolving trade disputes between countries;
- Enforcing trade agreements across the world;
- Promoting the benefits of free trade between nations and regions; and
- Setting targets for improved free trade at global member meetings (e.g. the Doha Round).

Promotion of globalisation and free trade has led to improved equity between countries with many developing countries decreasing their levels of poverty and debt. The current Doha Round seeks to increase levels of development through free trade, mainly by cutting tariffs and subsidies in the EU and US markets. A successful outcome of the Round would benefit the Cairns Group of countries (including Australia) as well as large developing or emerging countries such as China, India, Brazil, Russia and poorer nations in South Asia and Africa which need greater market access for their exports.

Many large developing economies such as China, India and Brazil have experienced fast growth and are becoming world leaders in international trade. The recent impact of the global financial crisis and world recession have moved the protection of domestic industries and employment as priorities for national governments. This is most evident in the push to protect domestic markets and employment during a period of slower world growth.

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NSW INDEPENDENT TRIAL EXAMS – 2009
ECONOMICS HSC TRIAL EXAMINATION
MAPPING GRID

Question	Outcome(s) assessed	Question	Outcome(s) assessed
1	H1, H8	**21(a)**	H1, H8
2	H1, H8	**21(b)**	H1, H6, H8
3	H1, H8	**21(c)**	H1, H2, H6, H8,
4	H1, H2, H8	**21(d)**	H1, H2, H4, H6, H8
5	H1, H11	**22 (a)**	H1, H8
6	H1, H8	**22(b)**	H1, H11
7	H1, H8	**22(c)**	H1, H8
8	H1, H6, H8	**22(d)**	H1, H7
9	H1, H8, H11	**22 (e)**	H1, H5
10	H1, H11	**23(a)**	H1, H11
11	H1, H8	**23(b)**	H1, H4, H9, H10
12	H1, H2, H8	**23 (c)**	H1, H5, H7, H10
13	H1, H4, H9, H11	**23 (d)**	H1, H8, H11
14	H1, H8	**24(a)**	H1, H8
15	H1, H4, H7	**24(b)**	H1, H7, H8
16	H1, H2, H7, H8	**24(c)**	H1, H7, H8
17	H1, H8, H11	**24 (d)**	H1, H5, H8
18	H1, H8	**25**	H1, H2, H5, H6, H8, H10
19	H1, H8, H11	**26**	H1, H2, H3, H4, H5, H6, H7, H8, H9, H10
20	H1, H8, H11	**27**	H1, H2, H3, H4, H5, H6, H7, H8, H9, H10
		28	H1, H2, H3, H4, H5, H6, H7, H8, H9, H10, H11

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