



EXAMINERS' REPORT ON 2002 TERTIARY ENTRANCE EXAMINATION

SUBJECT: ECONOMICS

STATISTICS

Year	Number Who Sat	Non-Examination Candidates	Did Not Sit
2002	2960	30	173
2001	2833	57	115
2000	2980	54	170

The Examiners' Report is written by the Chief Examiner to comment on matters relating to the Tertiary Entrance Examination in their subject. The opinions and recommendations expressed in this report are those of the Chief Examiner and not necessarily representative of or endorsed by the Curriculum Council.

The Marking Guide provided at the end of this report was prepared for markers and may have been substantially amplified by discussions held in the pre-marking meeting. It is not intended as a set of model answers, and is not exhaustive as regards alternative answers. Some of the answers are less than perfect, but represent a standard of response that the examiners deemed sufficient to earn full marks. Teachers who use this guide should do so with its original purpose in mind.

SUMMARY

The 2002 Tertiary Entrance Examinations paper in Economics performed very well in terms of achieving an almost perfect mean (57.5) with a large number of highly discriminating questions across all sections of the examination paper. The Examining Panel wanted to produce a paper of similar difficulty to the previous year and wanted to set a paper that included relevant and challenging questions. I believe that the paper provided for an even balance of questions across the three syllabus topics. The questions in section B were intended to test candidates' ability to interpret economic data and stimulus material. Section C tested candidates' understanding of economic theory and the application of that theory to current economic events. Both written sections included a good mix of topical questions. The overall mean mark for the paper was 57.5, lower than in the previous year, while the standard deviation for the paper was 15.02. The range of marks achieved by candidates was 0 to 97 out of 100. The reliability (measure of internal consistency) of the written part of the paper was 0.64, with the reliability for the overall paper being 0.74.

Section A this year was more difficult than previous years, reflected in a lower mean (14.24 compared with 15.77) although the standard deviation was higher, indicating a large number of highly discriminating questions. Ideally the mean for section A should fall between 14 and

15 – the result this year is excellent. The mean for Section B (Data Interpretation) was 18.64 out of 30, about 1 mark higher than the previous year. In Section C (Extended answers), the mean for all candidates was 24.38 out of 45, virtually identical with 2001. The standard of candidate responses to the written sections of the paper was consistent with previous years.

GENERAL COMMENTS

In 2002, the examination consisted of:

Section A (25 multiple-choice questions, each worth one mark);

Section B (3 sectionalised data interpretation questions, each worth 10 marks); and

Section C (5 extended writing questions, of which candidates were required to do three, each worth 15 marks).

The paper was relatively easy to mark, and both its overall structure and individual questions attracted few adverse comments. The percentage of papers requiring reconciliation was 27 per cent – lower than the previous year, an excellent result. Many markers commented that Section C, in particular, was relatively straightforward to mark.

Candidates used optical marks sheets to record their section A choices. Each of the data interpretation questions in section B was based on economic data. The three questions were set on the three broad syllabus topics: Macroeconomics, International Economics and Economic Policy. In 2002, question 26 used a graph based on macroeconomic data from the ABS, question 27 used an extract from *The Australian* newspaper concerning the value of the Australian dollar, while question 28 used a table of data sourced from the Productivity Commission. Section C consisted of three sectionalised questions and two essay style questions; two questions covered the Macroeconomics topic; two questions were set on the International Economics topic and one question was set on Economic Policy.

As always, the best answers were those which were clear, concise and logically structured, incorporated appropriate models, and referred to specific events if possible. It is important for candidates to be able to define and explain the key concepts referred to in the questions and to provide relevant examples where possible. Knowledge of the current state of the economy and important events occurring during the year is important. Students should be aware of current indicators such as the growth rate of the economy, inflation and unemployment, the current level of interest rates and the value of the Australian dollar.

I would like to thank Anne Garnett and Theresa Gibson (as co-examiners), Andrew Tibbett (as independent reviewer) and Kim Bolto (as final checker) for their time and commitment to ensuring that the Economics examination paper was a quality product.

Question	Syllabus	Section
Section A		
1-8	Macroeconomics	
9-17	International Economics	
18-25	Government Economic Policy	
Section B		
26	Macroeconomics	[1.1; 1.4]
27	International Economics	[2.5; 2.6]
28	Economic Policy	[1.4; 3.2.3]

Section C		
29	International Economics	[2.2]
30	Macroeconomics	[1.4; 3.1.2]
31	Macroeconomics	[1.3]
32	Economic Policy	[3.2.2; 3.3]
33	International Economics	[2.4; 2.3]

COMMENTS ON SPECIFIC QUESTIONS

Section A (Multiple Choice)

The correct alternatives, and the proportion of candidates selecting them, are set out below.

Question number	Answer	Proportion selecting	Question number	Answer	Proportion selecting
1	D	0.78	14	B	0.76
2	C	0.42	15	A	0.66
3	B	0.76	16	C	0.66
4	C	0.58	17	D	0.61
5	B	0.42	18	B	0.39
6	D	0.66	19	D	0.16
7	A	0.45	20	D	0.76
8	C	0.09	21	A	0.87
9	B	0.57	22	B	0.60
10	C	0.65	23	C	0.63
11	D	0.88	24	D	0.45
12	A	0.23	25	B	0.71
13	A	0.46			

Mean 14.24 Standard deviation 3.92

Section A this year was more difficult than in previous years, reflected in a lower mean (14.24 compared with 15.77) although the standard deviation was higher, indicating a large number of highly discriminating questions. Ideally the mean for Section A should fall between 14 and 15 – the result this year is excellent.

The Examining Panel again used new multiple-choice questions rather than rely on previously used questions. The aim was to reduce the number of relatively ‘easy’ questions to just a few. The number of questions where the proportion of correct candidates exceeded 0.80 was just two: questions 11 and 21 (in 2001 there were seven questions).

Several questions proved rather difficult: questions 8, 12, and 19. Question 8 was similar to question 19 in the 2001 paper. The question related to the multiplier and the MPC. If the MPC equals 0.75, then the multiplier has a value of 4. If income taxes are reduced by \$100 billion, then consumption will increase by \$75 billion and real GDP will rise by \$300 billion (4 x \$75 billion). Most students selected alternative (d). It is recommended that teachers devote more time to teaching the multiplier section and the difference between a change in taxes and a change in government spending or investment spending on the level of income. Question 12 concerned comparative advantage. Students failed to read the data carefully. The data referred to units of labour per unit of output, rather than units of output. The home

country has an absolute advantage in producing both food and steel, but a comparative advantage in producing food – alternative (a) is the correct answer. Question 19 concerned the official objectives of the Reserve Bank as set out in the Reserve Bank Act – alternative (d) is the correct answer – it is not one of the Reserve Bank’s objectives.

Section B (Data Interpretation – stimulus material, 10 marks each)

Question 26 used a graph of key economic indicators for the Australian economy for the past twenty years to test candidates’ understanding of the business cycle. Question 27 used an article about factors affecting the value of the Australian dollar, while question 28 focussed on Australia’s relative income and productivity growth.

Question 26 *The mean was 6.73, the highest for section B. The standard deviation for this question was 2.20.*

This is an excellent section B question. Each of the three questions required students to study the data in the graph. It is recommended that more section B questions be similar in style. Parts (a) and (b) were well answered – many students were able to gain maximum marks. Part (c) as expected was more difficult. The key was to recognise that the period 1990-91-1995-96 represented a ‘recovery’ year after the recession in 1990-91. Economic growth is rising, inflation is rising and unemployment after a lag of several years begins to fall. The question did ask students to include an appropriate model in their answer. Many students used a Phillips Curve diagram, while others employed a Keynesian expenditure model. The general standard of responses to this question was very good.

Question 27. *The mean was 6.17. The standard deviation for this question was 2.22.*

In part (a) most candidates could explain why a rising Australian dollar ‘hurt’ exporters. Part (b) however was poorly answered. Many students could not define or explain the terms of trade nor could they relate it to a country’s standard of living. A rise in the terms of trade enables Australia to buy more imports for a given quantity of exports – this means Australia’s real income has increased. The terms of trade has traditionally been one area of the syllabus that students do not understand. It is recommended that teachers devote time to correctly teaching this area. In part (c), candidates were required to explain the factors that were likely to increase the value of the Australian dollar over the long term. While many students were able to refer to the key factors mentioned in the article, few were able to explain the link to the exchange rate.

Question 28. *The mean was 5.76, the lowest for Section B. The standard deviation for this question was 1.94.*

Part (a) was well answered. Part (b) proved to be rather difficult. Candidates’ understanding of the concept of productivity was very poor. Productivity growth is the most important source of economic growth. Very few candidates could adequately explain the link between productivity and income growth. The key to part (c) was to recognise that microeconomic reform was the main driving force behind Australia’s excellent productivity performance over the last decade. Many candidates still do not understand a percentage change figure and therefore could not correctly interpret the data in the table.

Section C (Extended Answers, each worth 15 marks)

Question 29. *(Selected by 1526 candidates (52%) - mean 9.08; standard deviation 2.62)*

This question recorded the highest mean for section C. The question was from the International Economics part of the syllabus and was very topical and relevant given the importance of trade liberalisation and globalisation in the world economy. Australia has been pursuing a policy of trade liberalisation for some time. Part (a) required candidates to discuss the meaning of trade liberalisation. Candidates were very good at correctly defining this term and providing examples of trade liberalisation, such as the lowering and removal of trade barriers. Good answers were able to link trade liberalisation to the theory of comparative advantage. In part (b), candidates were required to explain the benefits and costs associated with trade liberalisation. Better answers included a tariff diagram to explain the effects of reducing trade barriers on domestic consumers and producers. It is important to realise that the long-term benefits of trade liberalisation outweigh the short-term adjustment costs.

Question 30. *(Selected by 1824 candidates (62%) - mean 8.19; standard deviation 2.83)*

This was a relatively new style of question for section C and was relatively popular. This question examined an area of the syllabus that had not been previously been examined. The question covered an important area within the Macroeconomics section of the syllabus. Students were required to select two economic indicators from inflation, economic growth and unemployment and explain their measurement and importance to policymakers. Most candidates were able to define and explain how each indicator was measured. Discussing the problems of measurement was a little more difficult. However, many students were able to provide good answers to the measurement problems concerning unemployment and economic growth rather than inflation. This was not a sectionalised question and candidates needed to plan their answer carefully to include all aspects of the question. It was not uncommon for candidates to generally write all they knew about inflation, economic growth and unemployment rather than directly answer the question. Some students devoted too much time to just one indicator and this affected their total mark.

Question 31. *(Selected by 1638 candidates (55%) - mean 8.25; standard deviation 2.78)*

This question was from an important section of the Macroeconomics syllabus and should be well understood by all candidates. Part (a) required candidates to explain the role of aggregate expenditure in determining the level of economic activity. Students needed to define aggregate expenditure and discuss the components of the AE equation. Good answers needed to use a model to explain how the level of AE determines the level of income and how a change in AE affects that level. The multiplier process was a key part to the answer but few candidates adequately incorporated this into their explanation. Part (b) required a relatively sophisticated answer in which candidates had to provide an explanation for the business cycle. Most could define the business cycle and include a diagram detailing the various phases of the business cycle, but the causes of the business cycle were not well explained. Basically candidates needed to demonstrate why the economy might contract into a recession or expand into a boom, linking their answer to part (a) - autonomous changes in aggregate expenditure working through the multiplier process.

Question 32. (*Selected by 2307 candidates (78%) - mean 8.39; standard deviation 2.85*)

This was the most popular question in section C and it was relatively well answered. This question is based on the Economic Policy section of the syllabus, specifically to monetary policy. There were three parts to the question: (i) explain the role of monetary policy and its objectives; (ii) outline why the Reserve Bank would want to increase interest rates and (iii) explain the effects of a rise in interest rates on the economy. Most candidates could define monetary policy adequately, but few knew its specific objectives. These are to achieve price stability, full employment and promote economic prosperity and welfare for the people of Australia. Part (ii) was not well answered. Given the information in the question, candidates needed to explain the reasons for the Reserve Bank raising interest rates during 2002. This required knowledge of the performance of the Australian economy during this period. If students can demonstrate topical knowledge of the economy and incorporate this into their answers then they will be rewarded. Part (iii) was more of a textbook style answer and was generally well done.

Question 33. (*Selected by 1455 candidates (49%) - mean 7.21; standard deviation 3.05*)

This question proved to be the most difficult question in section C. The question is from the International Economics section of the syllabus. This was also the least popular question in section C, probably because students find this area of the syllabus quite difficult. Part (a) required candidates to define the term foreign debt and explain its link with the balance of payments. Most students could adequately define foreign debt but many found it difficult to relate it to the balance of payments. There are two links between foreign debt and the balance of payments. Australia runs a current account deficit and this has to be financed by a capital account surplus. A CAD can be financed by either an increase in borrowing or an increase in foreign ownership. Foreign borrowing adds to the stock of foreign debt and is recorded in the capital and financial account. The servicing costs of foreign debt (interest payments) are recorded in the current account of the balance of payments.

Part (b) was more straightforward and required candidates to discuss the economic costs and benefits of an increase in the level of foreign debt. Many candidates could list and discuss the costs associated with foreign debt, but few could adequately explain the benefits accruing to the Australian economy. Foreign debt supplements Australia's domestic saving to allow for a greater level of investment in the economy and a potentially higher rate of economic growth. There are still some students who confuse foreign debt with government debt and confuse the current account deficit with the government's budget deficit. It is important for students to realise that most of Australia's foreign debt is private and therefore self-regulating.

POINTS FOR CONSIDERATION BY THE SYLLABUS COMMITTEE

The current structure of the paper in three separate sections appears appropriate and a good test of candidates' understanding of both economic theory and economic policy. Questions should continue to be set that encourage candidates to be aware of current developments in the economy and candidates should be able to apply economic concepts and theory to real world events. The Economics examination paper should be topical, interesting and relevant. The 2003 paper should continue to reflect a similar style and level of difficulty to the 2002 and 2001 examination papers.

Steven Kemp
December 2002

2002 Examining Panel

Chief Examiner: Mr Steven Kemp

Deputy: Ms Anne Garnett

Third member: Ms Theresa Gibson

Chief Marker: Mr Steven Kemp

SECTION B

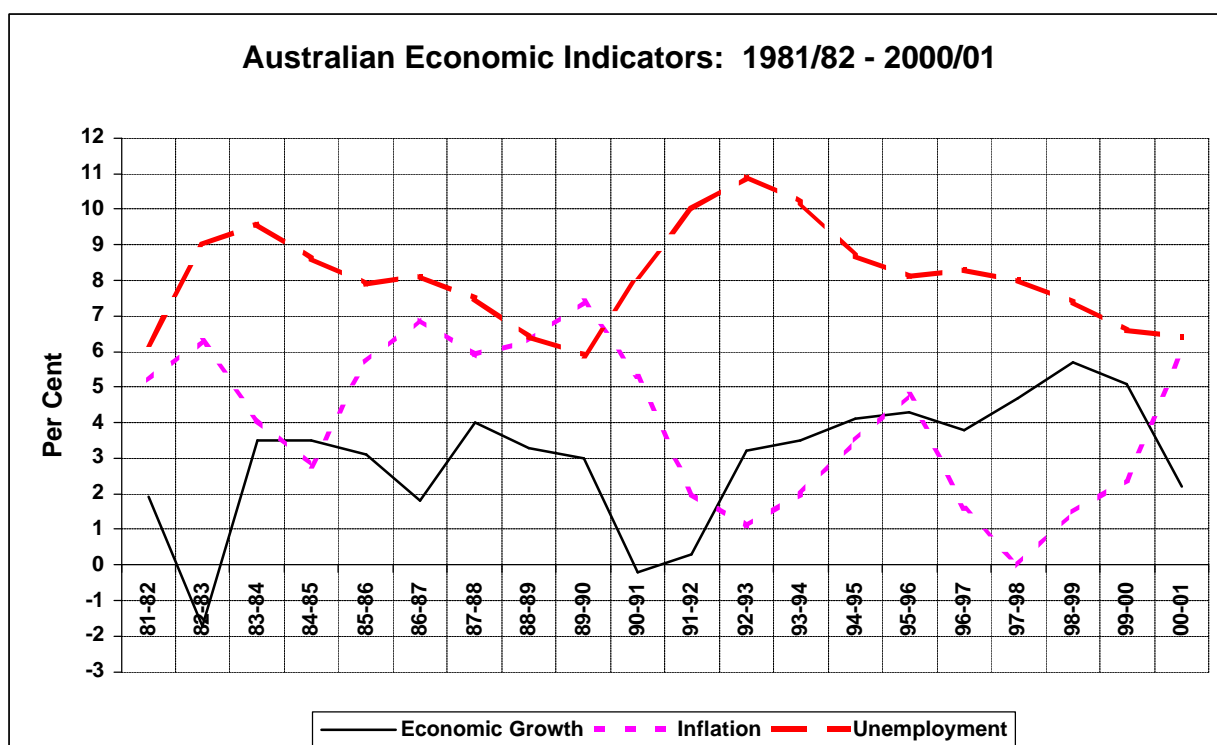
Data Interpretation (30 marks)

Suggested time: 60 minutes

Answer ALL THREE (3) questions. Each question is worth 10 marks.

Write your answers in the spaces provided under each part question.

26. This question refers to the data below.



Source: ABS Cat 135.0

Unemployment: proportion of the labour force unemployed – annual data

Inflation: annual percentage change in the CPI

Economic Growth: annual percentage change in real GDP

- (a) For the period shown, Australia's
- (i) highest rate of economic growth was 6% (nearest %) in the year 1998-99.
 - (ii) highest rate of unemployment was 11% (nearest %) in the year 1992-93 (2 marks)

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- (b) In which years did Australia experience an economic recession? Use the data available to explain your choice. (3 marks)

1 mark - 1982-83 & 1990-91

2 marks - Economic growth negative in both years.

Unemployment rising rapidly and peaking with lag after recession year.

- (c) Discuss the relationship between the three economic indicators from 1990-91 to 1995-96, using an appropriate model. (5 marks)

1990-91 to 95-96: economy in expansion phase - typical pattern of business cycle expansion due to - in aggregate demand.

Economy recovering from recession to 4% growth by 95-96.

- **Inflation rising from 1% in 92-93 to 5% in 95-96.**
- **Unemployment rising at first to peak at 11% in 92-93 due to recession and then falling to 8% in 95-96.**

Appropriate model: either use a Phillips Curve or AD/AS showing increase in AD or Keynesian expenditure model showing - in AE.

Relate to - in economic growth, inflation and fall in unemployment.

27. This question refers to the extract below:

The Australian dollar creeps above US\$4 and we start throwing our hats in the air. Miners, farmers and other exporters are by no means so keen on a rising Aussie. But the popular view is that a strong currency is the badge of a strong, prosperous country. Conversely a weak currency is generally seen as a judgment by the rest of the world of national inadequacy.

Since 1970, the dollar has fallen from \$US1.10 to about half that now. It has also almost halved on a broader measure, the trade weighted index. A lot of people associate this fall with a fall in living standards. For much of the postwar years the trend decline in the dollar was associated with a decline in Australia's terms of trade. If our terms of trade are declining, so is our standard of living. We are suffering a loss of real purchasing power.

Since the mid 1980s an almost century long decline in our terms of trade stopped. The trend for the past 15 years has been up. How has this come about? The view for most of the past century has been that the decline was an inevitable result of Australia's dependence on commodity exports, prices of which have been declining relative to the price of the manufactured goods we import. This view has turned out to be wrong. One reason is that Australia has been recently lifting the share of manufactures and services in its exports. Another reason has been the change in the nature of our manufactured imports. The rising share of new technology goods in our imports (goods with prices falling much faster than the commodities we export) has meant a favourable swing in our terms of trade.

There are other factors at work helping to reverse the fall in the exchange rate. One is that Australia has considerably improved its inflation performance in the '90s. From 1970 to 1990, Australia's consumer prices rose 40 per cent faster than our leading trading partners. But in the '90s Australia's inflation performance was as good as or better than our trading partners. Australia is also putting in a world beating productivity performance. Australia has started to improve its current account position with the average size of the deficit dropping from 4.5 per cent of GDP to around 3.5 per cent. All this adds up to a persuasive case for optimism about the trend in the dollar over the next 20 years.

[Source: Alan Wood "The Australian" April 23 2002, p.11]

- (a) Why do miners and farmers lose from a rising Australian dollar? (2 marks)

An appreciation of the \$A increases the price of Australian exports in overseas currency making them less competitive.

- (b) Explain the link between a country's terms of trade and its standard of living. (3 marks)

Define the terms of trade and explain how this affects a country's ability to consume goods and services (its standard of living)

Terms of trade – index which measures movements in prices of exports and imports.

It reflects the capacity of any given amount of exports to pay for a quantity of imports.

A rise in Terms of Trade enables Australia to buy more imports for a given quantity of exports [®] - domestic real income.

- (c) Explain why the author is optimistic about the future trend for the Australian dollar. (5 marks)

Need to refer to 3 factors and link to a rise in the value of the \$A (- D for \$A)

- **Improvement in the terms of trade – long term decline arrested; trend is now up due to - share of manufactured and services exports relative to primary exports; falling prices of technology imports**
 - **Improved inflation performance [®] - competitiveness**
 - **Improved productivity performance [®] - competitiveness**
 - **Improved CAD performance**
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-
-
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28. This question refers to the data below.

Growth in average income and labour productivity in OECD countries						
Annual average rates of growth (per cent)						
	GDP per capita			GDP per hour worked		
	1950-73	1973-90	1990-2001	1950-73	1973-90	1990-2001
USA	2.42	1.94	2.04	2.98	1.27	1.60
Japan	7.75	2.92	1.05	7.01	2.84	1.80
Canada	2.70	1.84	1.16	2.82	1.07	1.08
Australia	2.31	1.70	2.53	2.54	1.50	2.30
Germany	4.59	1.57	1.19	5.43	2.29	2.22
France	3.97	1.89	1.33	4.98	3.06	1.19
UK	2.41	1.83	1.87	2.81	2.20	2.06
Sweden	3.02	1.59	1.35	4.06	1.35	1.72
Switzerland	3.03	1.01	0.33	3.21	1.23	0.98
Europe total	3.83	1.74	1.12	4.61	2.39	1.74
OECD total	3.57	2.02	1.51	4.04	2.04	1.76

Source: Productivity Commission, 'Productivity Growth in Australia', 2002.

(a) For the time periods shown identify the country with the highest rate of productivity growth:

1950-73 **JAPAN** **1 mark**

1990-2001 **AUSTRALIA** **1 mark**

(b) Explain the link between GDP per capita and GDP per hour worked. (3 marks)

GDP per hour worked is a measure of labour productivity. GDP per capita is a measure of standard of living. Productivity growth is a crucial source of growth in living standards. For living standards to rise (more income/person) output per worker must increase. Simply adding more inputs will not increase income earned per unit of input.

Note the strong correlation in the table – a rise in productivity growth results in improved income growth.

- (c) Describe Australia's relative performance in income and productivity growth during 1990-2001 and provide reasons for its improved performance over this decade. (5 marks)

Australia 'outperformed' each of the economies listed and outperformed the OECD in both income and productivity growth.

Average annual income growth: 2.53%

Average annual productivity growth: 2.30%

1st period since 1950 that Aust has exceeded the OECD average for both measures!

Reasons – main focus will be on policy reforms

- **microeconomic reform – increasing competition (both domestic and international) through lower trade and investment barriers; deregulation and pro-competition regulation**
 - **greater openness to trade has encouraged greater specialisation and easier access to new technology**
 - **labour market reform**
 - **education and skills - - in human capital**
 - **increased investment in ICTs and application of ICTs.**
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END OF SECTION B

SECTION C

Extended Writing (45 marks)

Answer any **THREE (3)** questions. Each question is worth **15 marks**.

29. Usually the first question is popular - however the term 'trade liberalisation' may scare students away

Australia has benefited from trade liberalisation, despite the significant short term adjustment costs. Even conservative estimates suggest that in the past decade, the average Australian family had gained around \$1,000 per year from tariff reductions. [Department of Foreign Affairs, 'Trade Liberalisation Opportunities for Australia' 1999]

- (a) Discuss what is meant by 'trade liberalisation'. (5 marks)

Basically a definition, explanation & some discussion for 5 marks
Provide examples: reducing and/or removing trade barriers such as tariffs, subsidies, quotas, negotiating free trade agreements
Say something about importance - link between increasing trade intensity and economic growth
Trade liberalisation based on theory of comparative advantage & competitive markets
Some may use tariff diagram to illustrate ok here or in part (b)

- (b) Explain how the Australian economy has benefited from trade liberalisation and outline the nature of the short term adjustment costs. (10 marks)

7 marks – outline the benefits of liberalising trade - arguments for liberalising trade based on comparative advantage - specialisation & trade increases real income & living standards
e.g. use tariff diagram to show effects of lowering trade barriers - consumers gain from lower prices, greater consumption; domestic producers gain from lower costs; economies of scale; exporters gain; resource allocation improves; higher real incomes & living standards; overall economy benefits
3 marks – short term adjustment costs - protected industries will lose (output & employment will fall) but costs < benefits

30. Nice question, quite different in style, should be popular – many students will simply write everything they know about inflation, unemployment & growth

Much of macroeconomics is concerned with the measurement and analysis of aggregate economic data, including prices, output and employment. Choose **two** of the following macroeconomic indicators: inflation; economic growth; unemployment. Explain how these indicators are measured, the problems with their measurement and their importance for economic policy makers. (15 marks)

Best approach would be to split the 15 marks between the discussion of two indicators: perhaps allocate 3 marks for definition & measurement; 2 marks for problems with measurement and 2-3 marks for importance of indicator
Most students will probably be weak on problems of measurement

Inflation: define & explain measurement – CPI (representative basket, regimen, weights etc);

problems - how accurately does CPI reflect ‘real’ inflation e.g. does typical basket = actual basket?, CPI not likely to reflect changes in quality, will it reflect changes in consumption patterns

importance – price stability is key policy objective especially for Reserve Bank which has now adopted inflation targeting; why? - costs of inflation damaging to economy e.g. redistributes income, increases uncertainty, encourages speculative investment, retards growth, reduces international competitiveness

Economic growth: define & explain measurement - GDP, distinguish between nominal and real GDP, perhaps distinguish between increases in real GDP over time and increases in real GDP/capita over time

problems – excludes non-market transactions, quantitative rather than a qualitative measure, does not measure distribution of income, excludes underground economy, includes production of economic ‘bads’

importance – the father of all policy objectives, ultimate objective is to increase economic welfare - key to raising living standards over time

Unemployment: define & explain measurement - % of the labour force who don’t have a job but are seeking one, monthly survey by ABS

problems – does not include hidden unemployed, discouraged workers, changes in participation rate may affect U rate, no distinction between part-time & full time employment

importance – policy goal of full employment, U imposes considerable costs on the economy

31. This is the standard boring, text-bookish style of question required each year, again should be very popular, easy to gain a pass mark, but very good answers may be sparse

- (a) Using either the Keynesian expenditure model or the aggregate demand/aggregate supply model, explain the role of aggregate expenditure in determining the level of economic activity. (9 marks)

3 marks: Need to define aggregate expenditure and discuss components

$$AE = C + I + G + X - M$$

6 marks: role of AE in determining level of economic activity

Need to use model (most will use Keynesian expenditure model) to illustrate the equilibrium level of income - aggregate spending determines output & employment - show and explain why changes in AE schedule change the level of economic activity; probably should include discussion of multiplier concept with example but this may overlap into part (b)

(b) Use either model to provide an explanation for the business cycle. (6 marks)

2-3 marks - need to define the business cycle – perhaps include diagram describing phases of cycle

3-4 marks - explanation of business cycle – relate to changes in AE & multiplier if using Keynesian model; or changes in AD and/or AS if using AD/AS model. Need to explain why economy may contract into recession or expand into boom phase using either model.

32. Quite topical (when it was set in May) but should be popular & well prepared

In May 2002 the Reserve Bank of Australia raised the cash rate for the first time since August 2000.

Explain the role of monetary policy and its broad objectives. Outline why the Reserve Bank would want to increase interest rates and the effects this would have on the economy. (15 marks)

6 marks - define monetary policy, outline its role & its objectives
Generally considered to be the main economic policy tool because of its flexibility
Key objectives:

- price stability
- full employment
- economic prosperity & welfare

Role is to influence economic activity through interest rates (changing cash rate) - main focus tends to be on price stability (inflation targeting)

4 - 5 marks - reasons why RBA would want to increase interest rates
Feeling that expansionary policy setting no longer required

- set monetary policy to more 'neutral' stance
- domestic economy growing more solidly
- international outlook may have improved e.g. US economy
- inflation pressures beginning to rise - push against the 3% target
- credit growth may be excessive
- overheating in the housing market

4 – 5 marks - effects on the economy
Raising i/rs will affect private spending (consumption & investment) Why?
Perhaps use AE model to show effect of fall in investment (and C) on the level of economic activity - purpose to slow economy, slow growth in credit & borrowing, ease inflationary pressures, slow asset inflation in housing market, may impact on \$A e.g. currency appreciation

33. More difficult - will attract either the good or the weak

- (a) Define the term foreign debt and explain the link between Australia's foreign debt and the balance of payments. (7 marks)

2-3 marks: define foreign debt, perhaps distinguish between net & gross; between private & public sector noting that most of Australia's foreign debt is private

4-5 marks: this will sort them out - explain the link between foreign debt & balance of payments; need to understand that foreign debt is a stock variable & CAD is a flow (a CAD will add to the stock of foreign debt) but you probably won't get this; CAD needs to be financed by a capital account surplus (KAS) - an increase in external liabilities - either as foreign equity or as foreign debt; foreign debt accounts for around $\frac{3}{4}$ of Aust's foreign liabilities; should also mention that interest payments on foreign debt will feed into the CAD adding to the income deficit

- (b) Discuss the economic costs and benefits of an increase in the level of foreign debt. (8 marks)

Split the 8 marks between costs & benefits

Simple fact is that Australia will always run a CAD and a KAS - therefore external liabilities (debt and/or equity) inevitable

Costs - tend to be associated with a 'bad' CAD

- debt must be serviced - interest payments which will feed into the income deficit
- credit rating may be downgraded
- may put downward pressure on \$A
- economy may be exposed to negative external shocks e.g. fall in terms of trade, world growth declines

Benefits - associated with capital inflow, foreign investment, increase in KAS

- supplements domestic saving to allow for increased investment
- facilitates foreign investment, higher rate of economic growth, import of new technology
- Aust's wealth has actually risen because total assets have increased faster than foreign liabilities
- Aust's foreign debt is mainly private - self regulating