

THE CPAP STUDY GUIDE TO VCE ECONOMICS



PART 2 (Unit 4)

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The Unit 4 Outline: Economic Management

The focus of this unit is the study of the management of the Australian economy, which concentrates on budgetary, monetary and aggregate supply policies.

AREA OF STUDY 1: Aggregate demand policies and domestic economic stability

In this area of study students examine how the RBA and the Australian Government can utilise monetary and budgetary policy respectively to affect the level of aggregate demand in the economy. Students discuss the operation of aggregate demand policies, and analyse how current aggregate demand policy settings are intended to effect the achievement of the domestic macroeconomic goals and influence living standards. Students analyse the relative strengths and weaknesses of the policies in influencing the domestic macroeconomic goals and living standards.

Outcome 1

On completion of this unit the student should be able to discuss the operation of aggregate demand policies and analyse their intended effects on the achievement of the domestic macroeconomic goals and living standards.

Key knowledge

- the need for aggregate demand policies, including monetary policy and budgetary policy in terms of stabilising the business cycle.

Budgetary policy

- sources of government revenue, including direct and indirect taxation; progressive, regressive and proportional taxes; and revenue from government businesses and the sale of government assets
- types of government expenses, including government current and capital expenditure and transfer payments
- the budget outcome: balanced, deficit or surplus
- the underlying cash balance (budget outcome), including as a proportion of Gross Domestic Product (GDP)
- methods of financing a deficit or utilising a surplus
- the relationship between the budget outcome and the level of government (public) debt
- the role of automatic stabilisers (cyclical component of the budget) in influencing aggregate demand and stabilising the business cycle
- the role of discretionary stabilisers (structural component of the budget) in influencing aggregate demand and stabilising the business cycle
- the effect of automatic and discretionary changes in the budget on the budget outcome and government (public) debt
- the stance of budgetary policy: expansionary or contractionary
- the effect of the budgetary policy stance and budgetary initiatives over the past two years and their likely effect on the achievement of the domestic macroeconomic goals and living standards
- the strengths and weaknesses of using budgetary policy to affect aggregate demand and influence the achievement of the domestic macroeconomic goals and living standards

Monetary policy

- the role of the RBA with respect to monetary policy as outlined in its charter
- conventional monetary policy (cash rate target) and how it affects interest rates
- one example of the operation of an unconventional monetary policy tool from the past two years
- transmission mechanism of monetary policy and its effect on the level of aggregate demand, including the four channels of savings and investment, cash-flow, exchange rate, and asset prices and wealth
- the stance of monetary policy: expansionary (accommodative), contractionary (restrictive) or neutral
- the stance of monetary policy over the past two years and its likely effect on the achievement of the domestic macroeconomic goals and living standards
- the strengths and weaknesses of using monetary policy to affect aggregate demand and influence the achievement of the domestic macroeconomic goals and living standards

Key skills

- define key economic concepts and terms and use them appropriately
- gather, synthesise and use economic data and information from a wide range of sources to analyse economic issues and form conclusions
 - discuss the operation of aggregate demand policies
 - analyse the effect of current factors on the setting of aggregate demand policies and living standards
 - predict the impact of changes in aggregate demand policies on the achievement of the domestic macroeconomic goals and living standards
- analyse the strengths and weaknesses of aggregate demand policies in achieving the domestic macroeconomic goals and living standards

CHAPTER 1: BUDGETARY/FISCAL POLICY

For the purposes of VCE Economics, budgetary policy refers to the federal government's use of its **budget** to achieve specified outcomes in the country, where the **budget** contains details of all income (or revenue) and expenditure (outlays) of the federal government for the next financial year plus the following three or more years. Budgetary policy is, therefore, the manipulation of federal government receipts and outlays in order to assist in the achievement of its economic and social objectives for Australia. As with all policies, the overriding objective is to improve the welfare or living standards of all Australians, and/or to achieve the most efficient allocation of the nation's resources.

The budget is the government's major fiscal document and is typically updated and released annually in May. However, the government can (and does) attempt to change the level (or composition) of income or expenditure at any time, with 2020 and 2022 providing perfect illustrations of how governments can deliver budgets or introduce measures at any time. In early 2020, in response to the economic effects of COVID-19, the Government announced a number of immediate stimulus measures and postponed the delivery of the 2020-21 Budget from early May 2020 to early October 2020. Similarly, the former Liberal Government brought forward the 2022-23 Budget to late March 2022 so as not to conflict with the May federal election and the current Labor Government delivered a second 2022-23 Budget in early October. The 2024-25 Budget is being handed down on Tuesday the 14th of May 2024.

Exam Tip: It is worth remembering that there are two general types of budget figures or statistics: Budget figures that look ahead (i.e. estimates or forecasts of income and expenditure) and budget figures that look backward (i.e. actual income and expenditure that has taken place).

Objectives of Budgetary Policy

Budgetary policy is used to assist in the achievement of the following economic goals:

- Internal Stability (Economic Growth, Low inflation and Full Employment)
- Greater equity in the distribution and wealth
- External Stability
- Improvement in overall living standards.

Exam Tip: The budget plays a major role promoting a more equitable distribution of income, primarily via the implementation of a progressive tax system combined with welfare spending designed to minimise poverty and promote a more dignified standard of living for Australians. However, in the current VCE Economics study design, students are no longer required to demonstrate an understanding how the budget can, or has, been used to achieve a more equitable distribution of income (or external stability). Despite this, any budgetary policy initiative that is designed to achieve greater equity can easily be linked to living standards. Accordingly, in the event that a question asks for how the budget can be used to lift living standards, it is feasible to refer to initiatives that are designed with 'equity' in mind (e.g. tax breaks for lower and middle income earners announced in recent budgets). But it is important to link the initiative to material and/or non-material living standards rather than remain focused on measures of equality (e.g. the gini-coefficient) that you may have learned in Unit 2.

The achievement of these economic goals will help to boost **living standards** and welfare for all Australians – which of course is the overriding objective of governments. In addition to these economic goals, the federal government also details its **medium-term fiscal objectives** in the budget each May. We will review this shortly, but first we need to focus on the structure and nature of the budget itself.

The budget outcome: balanced, deficit or surplus

With every budget there can be three possible outcomes. To simplify, assume that the government raised exactly \$300B in taxes in order to fund the provision of the services which cost \$300B. This would result in a 'balanced budget'.

budget balance

Receipts (revenue) = outlays (expenses)



However, if the government raised \$290B from taxes, but still wanted to spend \$300B on government services, then it would result in a 'budget deficit'.

budget deficit

Receipts (revenue) < outlays (expenses)



Alternatively, if the government raised \$310B from taxes, and only spent \$300B on government services, then it would result in a 'budget surplus'.

budget surplus

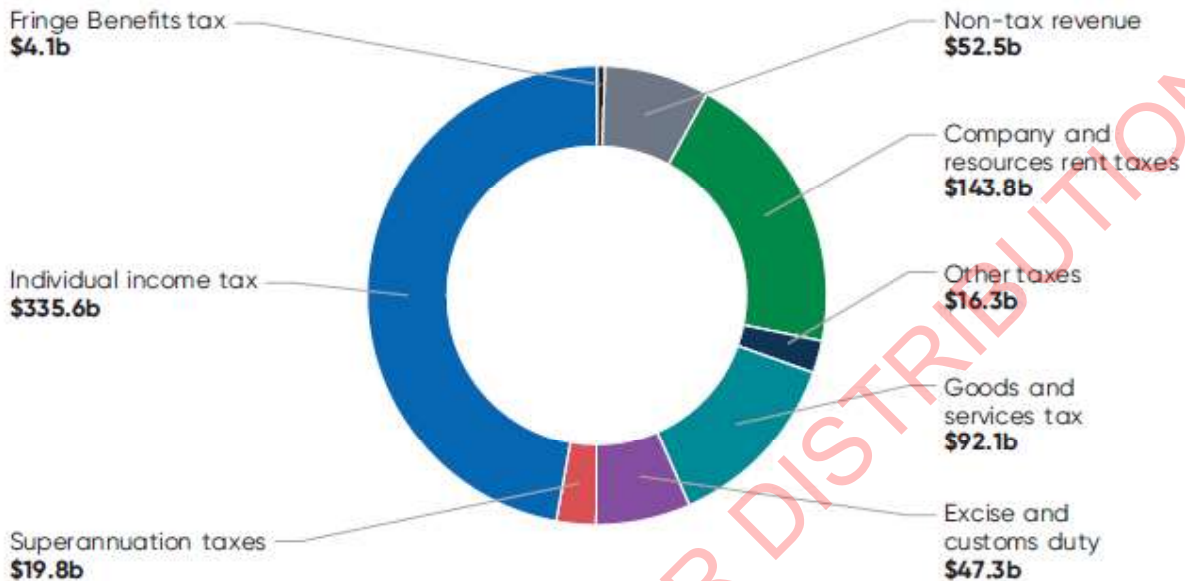
Receipts (revenue) > outlays (expenses)



Sources of Government receipts (revenue) and expenditure (expenses)

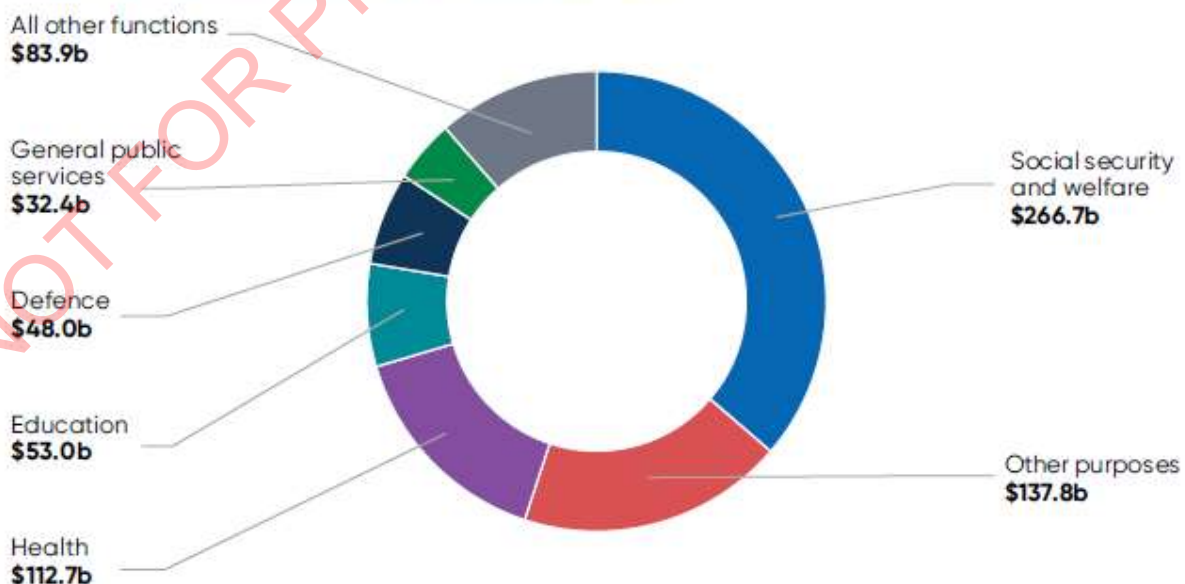
The most recent budget documents from the May 2024 Budget reveal that for the fiscal year 2024-25, the federal government expects to collect the vast majority its revenue/receipts in the form of taxation. The three major sources of taxation revenue are individuals income tax (\$336B), company tax (\$144B) and GST \$92B. In addition, total excise (on goods like fuel, tobacco and alcohol amount to approximately \$47B. Non-taxation revenue of \$52B includes dividends from the RBA, earnings from the Future Fund as well as the sale of goods and services.

Where revenue comes from (2024–25)



In relation to the estimated payments or expenditure for 2024-25, the chart below highlights that the major 'identifiable' expenses category is the \$267B to be spent on Social Security/Welfare. This spending is designed to provide support for the aged, families with children, those with disabilities, veterans, carers and unemployed persons. Approximately, \$113B is expected to be spent on health, including Medicare Benefits Schedule (MBS) and Pharmaceutical Benefits Scheme (PBS) payments. The next major identifiable expenses item is the \$53B spent on education, which includes funding support for government and non-government schools, as well as higher education and vocational education and training. The transfer of revenue to the States and Territories, which also includes further spending on education and health, is included in the 'Other purposes' category. This latter category (\$138B) also includes the payment of interest on government debt, as well as spending for natural disaster relief.

Where government spending is directed (2024–25)



Direct and indirect taxation

As the revenue pie chart above shows, most of Australia's taxes are levied against the income earned by companies and individuals – i.e. income taxes. These taxes make up the majority of total tax revenue and they are examples of **direct taxes** in the sense that the income earner pays the tax directly to the government once the income is earned. In contrast, **indirect taxes** are those levied on the production or sale of goods and services and not directly against the income earned by taxpayers. The goods and services tax (GST) is the most obvious example of an indirect tax and requires businesses to collect 10% of the sale price of most goods and services, which is then remitted (sent) to the Australian Taxation Office (ATO). Other common examples of indirect taxes in Australia include the excise taxes that apply to fuel, alcohol and tobacco.

Exam Tip: In the examination, you may be asked to distinguish between direct and indirect taxes. Best practice would be to demonstrate an understanding of each type of tax before going on to establish a clear point of difference between the two types of taxes. For example, direct taxes cannot be shifted onto another party, unlike indirect taxes which are passed on to consumers via higher prices.

Progressive, regressive and proportional taxes

The taxes highlighted in pie chart will either be progressive, proportional or regressive in nature. A **progressive tax** is one where higher income earners pay a higher percentage rate of tax compared to lower income earners. This means that a higher proportion of their income is taxed compared to lower income earners. It is designed so that higher income earners are taxed more heavily (or proportionally more) than low income earners, so that the overwhelming tax burden falls upon those with a greater capacity to pay.

In Australia's case, the lowest income earners (e.g. those earning less than \$18,200) will pay no tax at all – or a marginal rate of zero - while high income earners (e.g. those earning more than \$190,000) will pay a marginal rate of 45%. This type of tax system works effectively to redistribute incomes from high to low income earners and ensures that the burden of paying for the government's spending programs falls primarily on higher income earners.

Taxable income	Tax on this income
0 - \$18,200	Nil
\$18,201 - \$45,000	16 cents for each \$1 over \$18,200
\$45,001 - \$135,000	\$4,288 plus 30.0 cents for each \$1 over \$45,000
\$135,001 - \$190,000	\$31,288 plus 37 cents for each \$1 over \$135,000
\$190,001 and over	\$51,667 plus 45 cents for each \$1 over \$190,000

The above rates do not include the Medicare levy of 2% Source: www.ato.gov.au



The progressive nature of Australia's personal income tax system is shown in the table above, where the marginal rate of tax increases as incomes rise. For example, a low income earner on \$20,000 per year pays a marginal rate of 16 cents in the dollar (or 16%) for every dollar of income earned above \$18,200 (excluding the Medicare levy) which results in a tax bill of \$288. In contrast, a person earning \$250,000 per year will pay a much higher total of \$77,838 in tax. This is determined as follows:

- \$4,288 on the first \$45,000 earned ($\$26,800 \times 16\%$)
- \$27,000 on the next \$90,000 earned ($\$90,000 \times 30\%$)
- \$24,050 on the next \$65,000 earned ($\$65,000 \times 37\%$)
- \$22,500 on the final \$50,000 earned ($\$50,000 \times 45\%$).

Overall, the progressive nature of the system ensures that the lower income earner receiving \$20,000 per year faces a very low tax burden, paying an average tax rate of only 1.4%, in comparison to the higher income earner receiving \$250,000 per year whose average tax rate is 31%

Proportional taxes on income are those where the 'rate of tax' stays the same regardless of how much income is earned, resulting in income earners paying the same proportion of their income in tax. For example, if all Australian individual income earners paid a flat rate of 25% tax (or 25 cents for every dollar earned) then all individual taxpayers would be paying the same 'proportion' of their income in tax. In the example used above, it would mean that the lower income earner would pay \$5,000 in tax ($\$20,000 \times .25$) and the higher income earner would pay \$50,000 ($\$200,000 \times .25$). While the higher income earner pays much more tax (\$50,000 compared to \$5,000), the proportion of one's income paid in tax is identical. The company tax rate (for large companies at least) is an example of a proportional tax given that all large companies (those earning more than \$50m per year) are required to pay a flat rate of 30% of their income (profit) in tax. In contrast, smaller corporations are required to pay a proportional tax of 25%.

Regressive taxes are those that result in the proportion of income paid in tax rising as income falls (or the proportion paid in tax falling as income rises). Most indirect taxes are regressive in nature given that the taxed portion of a good or service will represent a higher proportion of a lower income earner's income, compared to higher income earners. Indirect taxes (excise) on alcohol, tobacco and fuel are regressive because they impose a greater burden on lower income earners (i.e. the taxes have a proportionally greater negative impact on lower income earners). For example, the excise on fuel is 44 cents per litre, which equates to \$50 in tax when spending \$114 on a tank of fuel. A welfare recipient earning \$250 per week will be paying 20% of their weekly income in tax, while someone earning \$2,500 per week is only required to pay 2% in tax. This tax is regressive because it imposes a relatively larger tax burden on lower income earners compared to higher income earners. The most common example of an indirect tax is the GST, and the exemption of most basic goods from GST (e.g. bread, milk, education, and health) is designed to reduce its regressive effects.

Exam Tip: The VCE Economics Study Design no longer requires students to have knowledge of ‘the ways BP can be used to influence equity in the distribution of income’. However, Australia’s progressive personal income tax system is an important means by which the government’s budget is used to transfer income from higher to lower income earners. Students traditionally struggle defining a progressive tax system, particularly in relation to fiscal drag/bracket creep and the changes to the tax system in 2024 (i.e. the Stage 3 tax cut cuts). Always remember that a progressive tax system refers to a system where the rate (or proportion) of tax payable on a person’s income (i.e. their marginal tax rate) rises as their income rises. It is not defined as ‘the more one earns the more tax they pay (note that this could also describe a proportional tax system (where the same rate of tax applies to all income earners)).

The sale of government assets

Sale of federal government assets refers to the government disposing of, or selling to the private sector, Government Business Enterprises (GBEs) such as Australia Post, Snowy Hydro Limited and the National Broadband Company (NBC). The sale of a GBE involves the government listing the enterprise on the sharemarket and then selling off the shares to the general public. The most recent high-profile sale of a GBE was the full sale of Medibank (which was completed in 2014). This form of non-tax revenue is distinct from the revenue the government earns from the sale of goods and services, e.g. merchandise sales from the ABC or the Australian Mint. Importantly, the revenue gained from the sale of government assets is a key source of revenue that is excluded from budget revenue when calculating the underlying cash outcome. This is explained in the next section.

The underlying cash balance (budget outcome),

The latest budget figures appear in Table 2 below:

Table 2: Estimated Budget Figures

	2023–24	2024–25	2025–26	2026–27	2027–28	Total ^(a)
	\$b	\$b	\$b	\$b	\$b	\$b
Cash estimates						
Underlying cash balance	9.3	-28.3	-42.8	-26.7	-24.3	-112.8
Per cent of GDP	0.3	-1.0	-1.5	-0.9	-0.8	
Receipts	692.3	698.4	719.4	760.0	801.8	3,671.9
Per cent of GDP	25.8	25.3	25.1	25.1	25.2	
Payments	683.0	726.7	762.2	786.7	826.2	3,784.8
Per cent of GDP	25.4	26.4	26.6	26.0	26.0	
Memorandum:						
Headline cash balance	6.5	-47.2	-63.8	-46.8	-42.0	-193.4

The table shows the receipts and payments in underlying cash terms, with receipts for 2024-25 expected to be \$698.4B, compared to payments of \$726.7B. Once the underlying payments are subtracted from the underlying receipts, we arrive at an underlying cash deficit of \$28.3B or -1% of GDP.

The underlying cash balance is the most common budget outcome referred to by the government and the press. It is derived from the original cash receipts and payments of the government, but adjusted to remove the effects of ‘net cash flows from investments in financial assets for policy purposes’. This is a rather technical way of saying that the underlying outcome removes the effects of transactions that are either one-off or do not affect the budget balance in net terms over time. For example, the provision of student loans that will be repaid in the future will have a net zero impact (excluding interest) on the budget position over time. Accordingly, the provision of \$2.7B of student loans in 2024-25 leads to the original or headline budget deficit to increase because it is an example of government payment. But given that these loans will eventually be repaid in the future, reversing this impact and reducing future deficits, both the payments and receipts related to the loans are excluded from underlying figures. This ensures that the underlying budget outcome provides more meaningful information about the state of the government’s finances. The same logic applies to the sale or purchase (Investment) of Government assets such as the NBN Company or Telstra. For example, investment in the NBN Co would increase the headline deficit relative to underlying deficit in any given year because the payment/investment would add to government payments for that year. However, this would be reversed in the event that the NBN Co is sold in the future – i.e. the future headline deficit would be lower than the underlying deficit. This is because the future proceeds from the sale of the NBN would add to government receipts, reducing the headline deficit, but not influence the underlying deficit. Over time, the underlying balance will therefore be relatively stable compared to the headline balance and it better captures the core or underlying changes in the budget position over time.



In total, net cash flows from investment in financial assets for policy purposes for 2024-25 amounted to -\$18.9B. This effectively means that the government expects to make net asset purchases of \$18.9B over 2024-25. Once these are subtracted from the headline deficit of \$47.2B, we arrive at a figure for the underlying cash deficit of \$28.3B (-1% of GDP). This is summarised below:

Reconciliation of underlying and headline cash deficits estimates 2024-25	\$M
Headline Cash outcome	-47,202
less Net cash flows from investment in financial assets for policy purposes	-18,916
Underlying cash outcome	-28,286

Exam Tip: The current 2023-2027 Study Design only makes specific reference to the underlying cash balance, which might imply that students are not required to demonstrate an understanding of the headline outcome. However, given that the underlying outcome is derived from the headline outcome, it is wise to spend some time knowing the difference between the two terms.

Exam Tip: The method of calculating the underlying cash balance has now changed. From 2020-21 Future Fund earnings are **no longer** taken away from the headline cash balance to arrive at the underlying cash balance (as in previous years). It will therefore be simpler for students to determine the underlying outcome in the event that a question surfaces on the exam, such as the poorly handled MC question from the 2020 exam (see Exam Tip below).

Exam Tip: Question 13 of the MC section of the 2020 examination relating to the difference between the headline and underlying outcomes was the most poorly handled question on the paper, with only 14% of students choosing the correct response. It required students to calculate the underlying cash surplus from the following hypothetical figures: total receipts \$200B; total outlays \$175B; net cash flows from investments in financial assets (IFAPP) \$10B; and Future Fund earnings \$5B. Students needed to recognise that the headline outcome was \$200B - \$175B = \$25B surplus and that \$15B of the total \$200B of receipts needed to be excluded from the headline balance to arrive at an underlying figure. That is, \$25B surplus less \$15B (IFAPP and FFE) = \$10B underlying surplus. Many students (39%) selected option B (\$25B) which is simply the headline surplus and some (13%) chose D (\$40B), making the mistake of adding \$15B to the headline surplus rather than subtracting.

Extension: Other budget balances

The **net operating balance** is an accrual measure (as distinct from the **cash** headline and **cash** underlying measures) which focuses on revenue (e.g. tax income) that has been earned over the relevant period minus the expenses that have been incurred over the period (i.e. expenses). It is different to the headline and underlying cash outcomes in that these outcomes record receipts and payments when the money is actually received or paid rather than when the money was earned or incurred. Importantly, the net operating balance **excludes** the actual spending on the purchase of capital assets (e.g. new stock of public housing or defence assets) and instead **includes** the depreciation (i.e. the using up or consumption of capital). It is regarded as the best measure of the sustainability of the government's financial position over time and therefore provides an indication of the ability of the government to sustain the existing level of government services into the future. The net operating balance helps the government to get a better handle on whether any given deficit truly reflects a situation where the government is 'spending beyond its means'. For if the government experiences an underlying cash deficit in tandem with a net operating surplus it suggests that the deficit for that year is unproblematic given that it has essentially been caused by spending on capital rather than recurrent items.

The **fiscal balance** is essentially the same as the net operating balance (i.e. revenue earned less expenses incurred) but it **includes** the actual spending on the purchase of capital assets (e.g. new stock of public housing or defence assets) and **excludes** the depreciation of those assets (i.e. the using up or consumption of this capital). The fiscal deficit for any year will, therefore, be higher than the operating deficit when there has been net new capital investment by the government (ignoring any changes in depreciation). Both the operating balance and the fiscal balance are like 'profit and loss statements' for the federal government and are the most accurate outcomes in terms of measuring the financial performance of the federal government or the longer term consequences of budget decisions for sustainable spending and balance of payments considerations.

Types of government expenses, including government current and capital expenditure and transfer payments

The pie chart provided earlier 'Where government spending is directed 2023-4' detailed the major expenditure (or expense) categories for the federal government. However, of the estimated \$682B in expenditure, there is no detail provided on the nature of expenditure taking place within each category. For example, of the \$250B to be spent on social security and welfare over the course of 2023-24, there is no indication of how much (or what proportion) of this money will be spent on physical assets (such as computer and equipment) compared to the proportion spent on consumables (such as the day to day running expenses of the relevant government department, such as wages and energy costs, etc.), or the proportion spent on **transfer payments** (e.g. income support payments pensioners or the unemployed). The money spent on physical assets that provide benefits for Australia well into the future is referred to as **capital spending**, whereas the money spent on consumables is referred to as **current expenditure** or recurrent expenditure.

While the Budget papers have always included information on the split between current expenditure and capital expenditure, the situation changed somewhat in the 2017-18 Budget. The government decided to focus on its budget outcome in a way that more clearly distinguished the relationship between budget deficits and what has become known as '**good debt**' versus '**bad debt**'. In simple terms, the government also focuses on a type of budget outcome (referred to as the 'operating budget outcome') that excludes capital expenditure from its calculations. This means that the 'operating' budget deficit for any given year will be lower than the headline/underlying deficit by the amount of net capital expenditure made during that year. It therefore means that the government is freer to invest in capital (such as buildings, roads, rail, or infrastructure more generally - all of which have the potential to contribute to social and economic benefits well into the future) without being criticised for increasing the (operating) deficit and generating an increase in 'bad debt'.

The role of the RBA with respect to monetary policy as outlined in its Charter.

Monetary policy is a policy operated by the RBA, on behalf of the government, that is designed to manipulate key financial variables in the economy (primarily interest rates) in order to achieve specific objectives. These objectives are outlined in the *RBA Charter*, which requires the Bank to implement monetary policy in a way that best contributes to:

- the stability of the currency of Australia [price stability];
- the maintenance of full employment in Australia; and
- the economic prosperity and welfare of the people of Australia.

Exam Tip: In the exam, students should not say that the RBA's goal is to maintain stability in the value of the Australian dollar (or the Australian currency). Even though the RBA's charter refers to 'stability of the currency of Australia', the RBA has made it clear that it is interpreting 'currency' to mean 'prices' and that its principal medium-term objective is to control inflation. However, any monetary policy action will take into account its effect on value of the Australian dollar.

The Charter is supported by the updated *Statements on the Conduct of Monetary Policy*, which is an attempt to provide greater transparency and to ensure that RBA decision making evolves with the times. The new *Statement on the Conduct of Monetary Policy*, released in December 2023, revealed a slight departure from the previous Statement (2016), which focused on achieving price stability *first* before targeting full employment. The new Statement now highlights the dual focus being given to the achievement of price stability and full employment. So while the RBA's overriding objective remains to increase the economic prosperity and welfare for all Australians, it believes that this is best achieved via the joint focus on:

Price stability: targeting growth in *consumer price inflation to between 2 and 3 per cent, on average, over time*);

Full employment: ensuring that everyone who wants a job can find one without searching for too long and maximising the level of employment that is consistent with low and stable inflation.

While a specific reference to the rate of economic growth is neither made in the *RBA Charter* nor the (new) *Statement on the Conduct of Monetary Policy*, the need for the RBA to pay attention to the rate of economic growth – i.e. promoting strong and sustainable growth over time - remains implicit and is an important consideration when deliberating on monetary policy. In this way, it can be argued that monetary policy is designed to achieve stability in the level of domestic economic activity (i.e. the achievement of price stability, full employment and strong/sustainable growth), where it will generally be used in a counter-cyclical way to boost activity when inflation and growth are low and restrain activity when inflation and growth are high.



Despite the reported change in RBA focus, the importance of achieving price stability as a means achieving longer term benefits for the economy remains paramount. This is highlighted by the use of monetary policy over the past year. Many economists fear(ed) that the RBA's determination to reduce inflation via higher interest rates would push the economy into recession, compromising the achievement of both a strong rate of economic growth and full employment. Despite mounting criticism of the RBA's approach, the RBA Governor remained unapologetic, highlighting that the short-term pain induced by higher interest rates is necessary in order to enjoy the longer term benefits to the economy in the form of a stronger and sustainable (i.e. low inflationary) rate of economic growth and strong employment growth (the maintenance of a low rate of unemployment). The risks associated with not focussing aggressively on the achievement of price stability were articulated in the following way:

The longer inflation remains above target, the greater the risk that inflation expectations rise and price- and wage-setting behaviour might adjust accordingly. If this were to eventuate, the end result would be even higher interest rates and a larger rise in unemployment would be required to bring inflation back to target.

Source: RBA May 2023 Statement on Monetary Policy

Conventional monetary policy (cash rate target) and how it affects interest rates

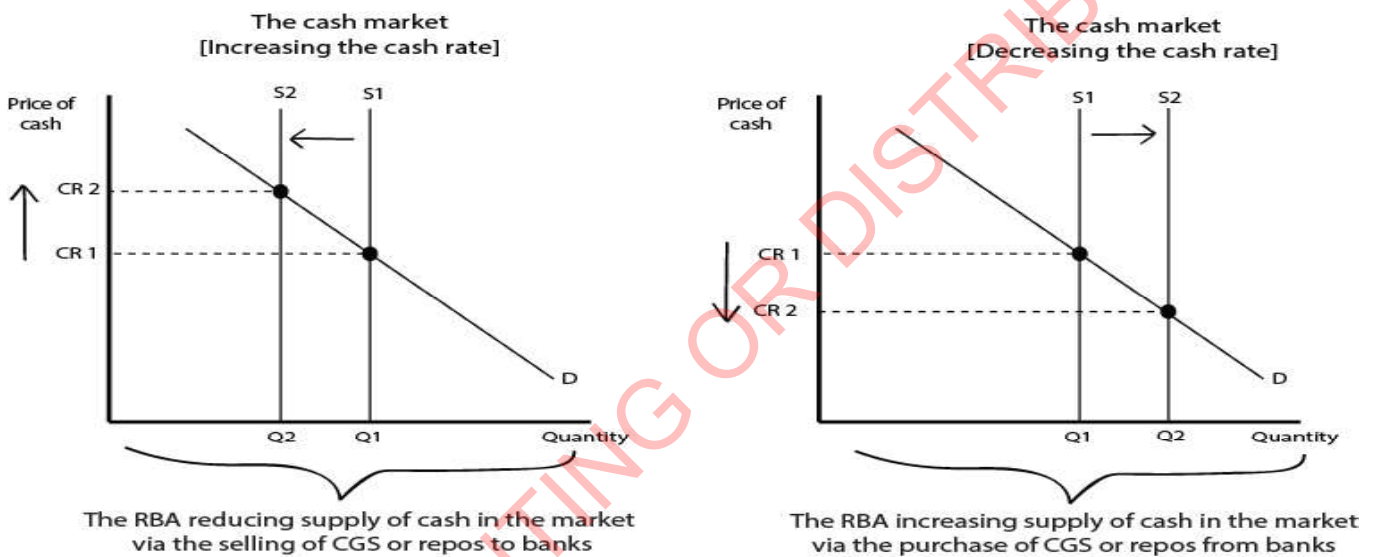
The conventional way that the RBA implements monetary policy is primarily via the manipulation of interest rates. Whilst the RBA has no *direct* control over all interest rates in the economy, its ability to directly manipulate the 'cash rate' enables it to indirectly affect all other interest rates. The **cash rate** is the interest rate that applies to borrowing and lending by banks in the overnight money market (also called 'cash market').

The RBA can directly manipulate the supply of cash in the cash market by buying and selling financial instruments such as Commonwealth Government Securities (CGS), or repurchase agreements (repos), to participating financial institutions (e.g. banks). RBA purchases of these financial instruments injects cash into the market (increases supply) and reduces the cash rate while RBA sales of these instruments withdraws cash from the market (reduces supply) and increases the cash rate. This manipulation of the cash market is commonly referred to as **open market operations (OMOs)** or domestic market operations.

Exam Tip: In the exam, you are unlikely to be expected to know the difference between government securities and repurchase agreements. Simply remember that the government uses these instruments (as well as foreign exchange swaps) to manipulate the supply of cash and therefore the cash rate. In reality, the RBA primarily uses repos when manipulating the market, but this is not required knowledge for the purposes of VCE Economics.

Each Australian bank is legally required to have an exchange settlement account (ESA) with the RBA in order to settle interbank transactions at the end of each day. This is because there are millions of transactions involving banks and their customers and there needs to be a systematic and organised way of settling the amounts that are owed from one to the other at end of the day. At the conclusion of each day, some banks will have surplus balances in their ESAs (because they have received more than they paid) and others will have a deficit. Those with surplus balances in their ESAs will be seeking to lend this money to those banks with deficits in their ESAs, which of course means that those banks with ESA deficits will be seeking to borrow from those banks with ESA surpluses. Accordingly, there is a market for 'overnight' cash, with demand by those banks willing to borrow and supply by those banks willing to lend. Like any market, equilibrium will occur where the price of cash (i.e. the cash rate) is such that demand = supply.

The RBA can manipulate the cash rate via its control of ESA balances (i.e. its control of supply of cash in the overnight cash market). It can drive the cash rate down by increasing supply of cash in the market via the purchase of CGS or repos. The supply of cash increases because banks will be holding more cash and less CGS. Alternatively, the RBA can drive the cash rate up by reducing supply of cash in the market via the selling of CGS or repos. In this case, the supply of cash decreases because banks will be holding more CGS and less cash. Diagrammatically, this can be shown as follows:



The role of the target cash rate

To ensure that it has complete control of supply in the market (which results in a vertical supply curve), the RBA creates maximum financial incentive for borrowing and lending to take place in the market. The RBA achieves this by setting a 'target cash rate' and then imposing financial disincentives upon banks for holding surpluses or deficits in ESAs. These financial disincentives are in the form of below 'market rates of interest' on both deposits with the RBA (i.e. surplus balances) and loans from the RBA (deficit balances). Specifically:

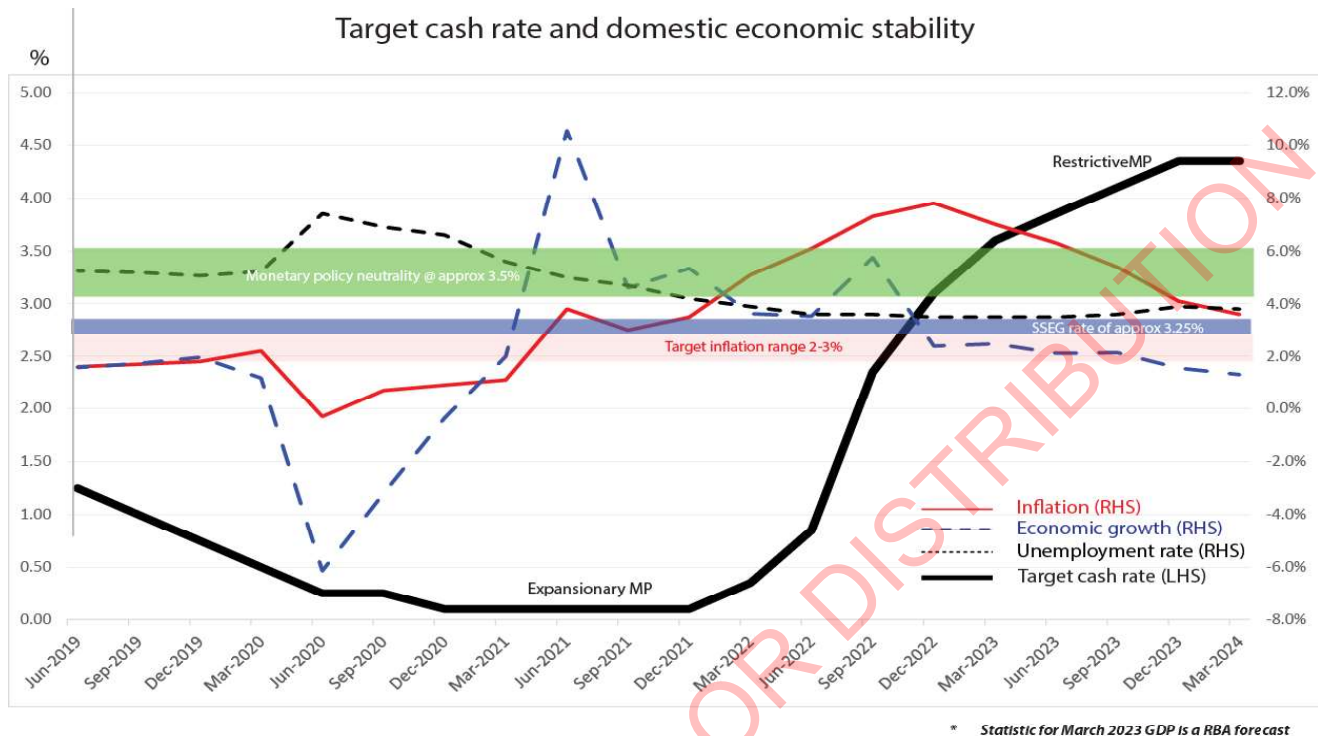
- Banks with surplus balances (i.e. depositing cash with the RBA) will be paid a rate of interest equivalent to 0.25% points (i.e. 25 basis points) below the target cash rate; and
- Banks with deficit balances (i.e. borrowing cash from the RBA) will be required to pay the RBA a rate of interest equivalent to 0.25% points above the target cash rate.

This arrangement incentivises the banks to lend any surpluses to other banks at the prevailing cash rate and borrow deficits from other banks at the prevailing cash rate, and therefore helps to ensure that they avoid borrowing from or lending to the RBA. To do otherwise would be irrational given the effective penalties imposed by the RBA for maintaining surplus or deficit balances. This means that there is a range or band within which the cash rate will stay within, which is referred to as the '**policy interest rate corridor**'. There is no incentive for the banks to either borrow or lend outside of this interest rate corridor. Diagrammatically, this can be shown as follows:



The stance of monetary policy over the past two years and its likely effect on the achievement of the domestic macroeconomic goals and living standards

The chart below describes how monetary policy has been implemented since the middle of 2019 and comparing this to the changes in the key variables underpinning the achievement of each of the government's macroeconomic goals.



The year 2020 commenced with the economic damage imposed by bushfires, which was then closely followed by the arrival of the Covid-19 and its well documented economic effects, both on the demand and supply sides of the economy. This resulted in the recession of 2020, with a large fall in economic growth (-5.8%), deflation (0.3%) and an unemployment rate climbing to 7.4% (or an the 'effective' rate of unemployment climbing to approximately 14%). In this environment, the RBA was impelled to assist budgetary policy stimulus efforts. It reduced the TCR to 0.1% in November 2020 – the lowest in history – as well as introducing unconventional expansionary measures (e.g 'quantitative easing').

For much of 2021, despite signs of ongoing recovery, the RBA continued to communicate that the Bank remained focused on full employment while [underlying] inflation remained below the target and that the expansionary policy setting would remain in place until at least 2024. This was articulated by the RBA Governor in October 2021 in the following way:

The Board remained committed to maintaining highly supportive monetary conditions to achieve a return to full employment in Australia and inflation consistent with the target. It will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. The central scenario for the economy is that this condition will not be met before 2024. Meeting this condition will require the labour market to be tight enough to generate materially higher wages growth than at the time of the meeting.

Since then, the economic recovery gained momentum faster than anticipated, evidenced by much stronger (annual) rates of economic growth by the end of 2021 (5.4% to the year ended December 2021), combined with a re-emergence of inflationary pressure (headline inflation of 3.5%) and an unemployment rate falling to 4.2%. The strength of the economic recovery during the latter part of 2021 and the early parts of 2022 were evidenced by the following types of indicators:

- Strong growth in commodity prices/terms of trade
- Continuing strong growth in net export demand
- Large growth in job vacancies and job advertisements
- Strong employment growth
- Falls in the unemployment (and underemployment) rates
- Acceleration in wages growth
- Sizeable rebounds in both consumer and business confidence
- High levels of construction activity
- Growth in the housing and share markets
- Strong growth in lending to businesses and households
- Relatively high rates of capacity utilisation

Over the course of 2022, the growth in demand inflationary pressures combined with the cost inflationary effects of the war in Ukraine, the ongoing global supply constraints (related to Covid-19) and the effects of damaging weather events in many parts of Australia. These demand and supply side effects resulted in inflation climbing to well above the RBA's target range (reaching as high as 7.8% for the year to end December 2022), causing the RBA to switch its attention from the need for economic expansion to a concern about the corrosive effects of high inflation. Accordingly, the RBA started tightening monetary policy, gradually at first in early 2022, before much more aggressively from the middle of 2022, increasing the target cash rate to 3.1% by the end of 2022 and making the monetary policy stance much less expansionary.

During 2023, the signs of ongoing inflationary pressures persisted in the economy and the RBA further tightened policy, increasing the cash rate to as high as 3.85% in May and again to 4.35% by November. This resulted in monetary policy moving from an expansionary to a restrictive stance by the middle of 2023. Despite growing community anxiety about the aggressive monetary policy tightening (much earlier than ‘promised’ by the former RBA Governor) and the negative impacts on certain groups (e.g. those with mortgages forced to endure ever increasing servicing costs), the RBA was unapologetic about its stance, highlighting that some short-term pain (from higher interest rates) was necessary to avoid the more pervasive longer term damage that high inflation brings. In his address to the National Press Club in April 2022, the RBA Governor at the time justified the RBA’s position in the following way:

‘... persistently high inflation is corrosive and damages our economy. It erodes the value of savings, puts pressure on household budgets and hurts people on low incomes the most. High inflation makes it harder for businesses to plan and it distorts investment. And if inflation becomes ingrained in expectations, it requires even higher interest rates and a larger increase in unemployment to get it back down again.’

While inflation remains relatively high, at 3.6% for the year to end March 2024, it has consistently fallen from its peak of 7.8% for the year to end December 2022. The current restrictive stance of monetary policy is helping to return inflation back into the target range over 2024-25, aided by the easing of global supply constraints and the related disinflationary effects. The RBA expects inflation to be 3.0% by June 2025. While the reduction in inflation that stems from the current restrictive monetary policy stance does come at the expense of growth in AD and economic growth, it is expected to reduce pressure in labour markets and achieve a better balance between the demand and supply of labour. In this respect, the rise in unemployment that is expected to occur is acceptable given that the rate of unemployment is currently believed to be below the full employment level. Accordingly, the unemployment rate is forecast to increase from its low level of 3.8% (March 2024) to approximately 4.4% by June 2025.

Exam Tip: Q2a of the 2018 exam required students to describe how low wages might have influenced the stance and focus of monetary policy. Many students misinterpreted the question and focused on how the RBA can directly address low wages growth. Instead, they needed to focus the macroeconomic implications of low wages growth (e.g. it contributes to low inflation and may be symptomatic of low economic growth) and then determine how the RBA is likely to respond (i.e. the RBA will focus on the disinflationary implications and then decided to maintain its expansionary stance.)

Exam Tip: Q2d of the 2019 exam required students to explain how the setting of AD policies (both monetary and budgetary) might be influenced by the combination of ‘a fall in the rate of unemployment but a weaker than expected growth in wages’. Many students were unable to reconcile how the combination of lower unemployment rates and slow wages growth might still imply slow(er) rates of economic growth and a need for a more expansionary monetary (and budgetary) policy setting. If a similar question surfaced, it is important to recognise that lower unemployment rates can be consistent with lower economic growth (and/or the existence of spare capacity in labour markets) when underemployment/casualisation of the labour force is rising).

The strengths and weaknesses of using budgetary policy to affect aggregate demand and influence the achievement of the domestic macroeconomic goals and living standards

Strengths of Monetary Policy

Some factors that make monetary policy a particularly powerful tool are the following:

- **RBA Independence** – this is an important strength that makes monetary policy superior to budgetary and microeconomic policies in terms of its ability to make policy decisions that are apolitical – that is, free from political bias. The relationship between the RBA and the government was clarified in a recent ‘Statement on the Conduct of Monetary Policy’ where it was highlighted that:

‘The government recognises the independence of the Bank and its responsibility for monetary policy matters and respects the Bank’s independence as provided by statute’

- Despite this, it is possible for the government of the day to override the RBA in the event that there is a material policy difference between the RBA and the government. In reality, this is a politically demanding process and is a course of action that is unlikely to be taken by any government.
- **Short implementation lag** – Compared to budgetary and supply side policies, it takes very little time to implement a monetary policy decision once the Board decides to change policy settings. For example, once the decision was made to tighten monetary policy in November 2023, the RBA announced the decision and the markets adjusted automatically with the cash rate climbing towards the new 4.35% target.
- **Influence on expectations** – monetary policy is particularly powerful in influencing the expectations of economic agents. In some instances, concerns expressed by the RBA Governor (without actual changes to policy settings) can have a powerful influence on the behaviour of consumers, investors, borrowers or lenders.
- **Flexibility to some extent** – the use unconventional measures over 2020-21 highlights that monetary policy is somewhat flexible enough to implement other expansionary measures (apart from a reduction in the TCR) in order to stimulate the economy.

MINI EXAM NO. 1: AREA OF STUDY 1

UNIT 4 (Total marks = 65)

Section A

Multiple choice (total marks = 15)

Section B

Short answer questions (total marks = 50)

Section A: multiple choice

Answer the following fifteen multiple choice questions. You must **shade** correct box below:

1	A	B	C	D
2	A	B	C	D
3	A	B	C	D
4	A	B	C	D
5	A	B	C	D
6	A	B	C	D
7	A	B	C	D
8	A	B	C	D
9	A	B	C	D
10	A	B	C	D
11	A	B	C	D
12	A	B	C	D
13	A	B	C	D
14	A	B	C	D
15	A	B	C	D

- Which of the following events is most likely to make the RBA consider a tightening of monetary policy?
 - A rise in the value of the Australian dollar
 - Stronger growth in the world economy
 - Rising levels of unemployment
 - An increase in the size of the budget surplus
- Which of the following is likely to change the cyclical component of the budget?
 - Investing more money in the National Broadband Company during a period of sustained growth in the economy
 - The reduction in the company tax rate to 25% for those companies with turnover less than \$50m
 - Increased funding for the super co-contribution
 - Increased personal income tax received due to stronger growth in economic activity
- The **ultimate** goal of monetary policy is to
 - Achieve price stability
 - Achieve stability in the value of the dollar
 - Promote economic growth
 - To maximise the economic prosperity and welfare of Australians
- Which of the following is likely to cause the budget deficit to fall in the short term?
 - An increase in the tax-free threshold
 - Increased spending on national defence and security
 - The repeal of the carbon tax
 - Increasing the accelerated depreciation allowance for small businesses
- Which of the following policy options are likely to be implemented in an effort to decrease demand inflationary pressure in the economy?
 - A reduction in personal tax rates and a higher cash rate
 - A rise in the budget surplus and a tightening of monetary policy
 - A reduction in both company and income tax rates
 - A higher budget deficit and a more accommodative monetary policy stance
- Which of the following statements relating to the 2023-24 Budget is correct
 - The estimated underlying cash deficit rose from the previous period
 - Fuel excise was increased in order to reduce carbon emissions
 - The estimated structural budget deficit increased despite a return to budget surplus
 - The government delivered a budget deficit to reduce cost of living pressures

7. Which of the following is most likely to result in the budget outcome moving from a surplus to a deficit?
- The unemployment rate falls
 - There is a loosening of monetary policy
 - There is a fall in economic activity
 - Growth in China increases to very high levels
8. Which of the following policy actions below is least likely to be implemented to address the future problems associated with an ageing population?
- Increased funding to address global warming
 - More favourable taxation treatment of superannuation
 - Increased funding for child care
 - Increased funding for training and education
9. Which combination of policy actions is most likely to assist in the achievement of economic growth
- A reduction of the target cash rate, greater Investment spending by the government and higher company tax rates
 - A rise in the target cash rate, greater Investment spending by the government and lower marginal tax rates
 - A rise the target cash rate, greater Investment spending by the government and lower company tax rates
 - A reduction of the target cash rate, greater Investment spending by the government and lower marginal tax rates
10. Which of the following is least likely to be a target of monetary policy?
- Increasing rates of economic growth to between 3% and 4%
 - Lowering rates of unemployment to approximately 4.25%
 - Price stability or low growth in the consumer price index
 - A low rate of inflation equal to 0% on average over time
11. Which of the following is the largest component of federal government expenditure?
- Defence
 - Social security and welfare
 - Health
 - Education
12. Which of the following occurrences is least likely to contribute to a loosening of monetary policy?
- An increase in the terms of trade
 - Low levels of consumer confidence
 - Relatively high rate of labour force underutilisation
 - Slow growth in wages
13. If the actual budget outcome for 2023-24 was a deficit (when a surplus was estimated), which of the following is likely to be a contributing factor?
- Nominal GDP growth being higher than expected
 - The terms of trade being lower than expected
 - Wages growth being higher than expected
 - The rate of unemployment being lower than expected
14. Which of the following is not a generally accepted transmission channel associated with a loosening of monetary policy?
- A fall in the value of the Australian dollar, boosting net exports
 - A fall in savings and an increase in Consumption and Investment
 - A fall in interest rates and resulting rise in the exchange rate which reduces net exports
 - A rise in discretionary income of households which helps to increase Consumption
15. Which of the following best describes macroeconomic policy settings as at May 2024?
- Restrictive monetary policy evidenced by a relatively high cash rate and expansionary budgetary policy evidenced by a larger structural budget deficit
 - Expansionary monetary policy evidenced by a low exchange rate and contractionary budgetary policy evidenced by a smaller underlying budget deficit
 - Restrictive monetary policy evidenced by a low cash rate and a contractionary budgetary policy evidenced by growing levels of government debt
 - Expansionary monetary policy evidenced by higher interest rates and a contractionary budgetary policy evidenced by a larger structural budget deficit

YOU BE THE ASSESSOR: UNIT 4 AOS 2

In this section, you are required to assess the two responses presented for each of the questions. You should assess each response and determine which one is likely to receive full marks. You should then justify your decision by annotating the responses, making it clear what was done well in the better response and what was deficient in the relatively poor response. Once complete, compare your evaluation to that of the authors [provided at the rear of the Study Guide].

1. Explain how a subsidy that is used to improve environmental outcomes might influence aggregate supply.

4 marks

Sample 1

A subsidy given to producers who commit to protecting the environment in some way will help to influence the nation's aggregate supply levels. As the environment improves, evidenced by cleaner air, less polluted rivers and oceans, more pristine roads and highways and/or less litter more generally, it will help to attract more tourists to Australia. As a consequence, net exports will increase (X minus M), which acts as a net injection into the circular flow model of the economy, resulting in more aggregate demand for goods and services ($AD = C + X + I + X - M$) and a corresponding increase in real GDP. As production increases in the economy, this effectively means that the supply of goods and services in total (i.e. aggregate supply) will also increase. This highlights that a subsidy that is designed to improve environmental outcomes can influence aggregate supply in a positive way.

Justification _____

Sample 2

A subsidy is the provision of money or some other form of assistance to economic agents (e.g. a business) to encourage a particular form of economic activity to take place. For example, the current government's 'Direct Action' policy involves the provision of subsidies to businesses which undertake activities that help to reduce carbon emissions. Providing a subsidy to businesses which invest in cleaner technologies (e.g. away from coal fired electricity and towards more renewable energies) or which invest in programs that are designed to clean up the environment (e.g. the planting of trees as part of carbon farming initiatives) will help to reallocate resources towards production methods that are less damaging to the environment. To the extent that this successfully mitigates the effects of climate change in the future, including the intensity and severity of natural disasters such as floods and cyclones, it will help to protect aggregate supply levels in the future. The willingness and ability of producers to supply goods and services in the future will be enhanced compared to the situation that would have evolved without government intervention because the negative supply shocks to the economy will be less intense. In this respect, the overall net effect on aggregate supply should be positive given that the long-term benefits are expected to outweigh any short-term costs in the form of higher taxes (to pay for the subsidy) and the higher costs of energy more generally.

Justification _____

2. Describe how investment in government infrastructure might influence aggregate supply and the achievement of price stability

4 marks

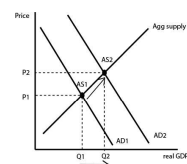
Sample 1

Investment in government infrastructure (such as improved telecommunications networks) is likely to increase aggregate supply and assist with the achievement of price stability. The government's continuing investment in the rollout of the broadband network will increase aggregate supply and expand the nation's productive capacity over time because the cost and speed of telecommunications for businesses and households will improve. Faster broadband speeds will enable businesses to cut production costs as communications with clients, staff, suppliers, etc will be more efficient and/or the speed of downloads should fall significantly. This leads to greater productivity levels over time and an increase in technical efficiency, resulting in businesses being able to produce more goods and services over any given time period (i.e. increase in aggregate supply/productive capacity) and/or reduce prices without suffering a drop in profit margins. This exerts downward pressure on the rate of inflation in the economy and therefore makes it easier for the government (RBA) to achieve its goal of 2-3% growth in the CPI on average over time.

Justification _____

Sample 2

An increase in the government's willingness to invest in infrastructure will lead to an increase in the G2 component of aggregate demand (AD), which will increase the overall level of AD. This could be shown by an increase to the right of the AD curve as shown in the diagram to the right. With more AD for goods and services, producers will respond by increasing their supply of goods and services to the marketplace. As shown in the diagram, the movement from equilibrium 1 (AS1) to equilibrium 2 (AS2) highlights this increase in supply and it shows that the nation's aggregate supply has increased. As the diagram clearly shows, this increase in investment demand will lead to an increase in inflation, with prices increasing from P_1 to P_2 which means that price stability is less likely to be achieved in the economy.



Justification _____

3. Discuss how skilled immigration policy could put both upward and downward pressure on inflation.

4 marks

Sample 1

Skilled migration in Australia involves the government issuing skilled migration visas to migrants who are qualified in an area of skill shortage. Migrants bring to Australia new skills, knowledge and innovations which can help to improve labour market productivity in Australia, this improvement in productivity will reduce unit labour costs for Australian businesses. Additionally, skilled migrants help to alleviate labour market constraints that might be evidenced by skills shortages and excessive wage pressures. Both these factors help to reduce the cost of production for Australian businesses which (to the extent that these costs savings are passed on to consumers in the form of lower prices) will reduce the rate of inflation in the longer term.

However skilled immigration can also put pressure on inflation. Migrants to Australia will increase the population and add to aggregate demand pressures via consumption spending. In the short-term an increase in consumption spending will, ceteris paribus, increase AD. To the extent that AS cannot keep up with this increase in AD, inflationary pressures will arise in the Australian economy increasing the rate of inflation.

Justification _____

Sample 2

Increased immigration can have positive and negative effects on inflation. Immigration helps to reduce inflationary pressure as wages are likely to decrease as a result of improvements in productivity. This means that firms are more willing and able to supply, reducing inflationary pressure and allowing the economy to grow in a sustainable fashion. Increased immigration can also put upward pressure on inflation as more migration increases Australia's population and therefore increases spending, leading to more inflation. The demand side effects of immigration might also contribute to other economic problems, such as the housing price boom and the associated housing affordability crisis. This is because immigration immediately adds to housing demand (as migrants need shelter and some will seek to buy rather than rent properties) which further exacerbates the core of the problem – that is, demand for houses is growing faster than supply leading to higher inflation.

Justification _____

4. Using one example, outline how the government can use the budget to encourage private sector research and development (R&D) in an effort to boost aggregate supply.

3 marks

Sample 1

The government can use both the revenue and expenses side of its budget by increasing spending on R&D grants to businesses and/or offering generous tax incentives for R&D into innovative ideas/projects that can result in new inventions or technology that accelerates productivity growth. For example, the current tax 150% R&D tax concession available to businesses results in a greater level of business expenditure going into R&D than would otherwise be the case as the effective (after tax) cost of the investment is reduced. To the extent that this works to increase rates of productivity, enabling businesses to produce more from any given level of inputs, it will help to boost the nation's aggregate supply as businesses will be more able (and willing) to increase supply of goods to markets.

Justification _____

Sample 2

The government can decide to increase its funding allocation to the Commonwealth Science and Industrial Research Organisation (CSIRO) in order to invest more in research and development that leads to advances in technologies which ultimately leads to an increase in technical efficiency across the economy. New developments might include advanced robotics that could have widespread applications across Australian industries which will help to reduce average production costs for businesses and increase their international competitiveness. As a consequence more goods and services will be produced over time.

Justification _____

5. Describe how the tax and welfare system could be reformed to encourage greater workforce participation and explain how this can increase aggregate supply and economic growth. 5 marks

The government could decide to introduce across-the-board cuts to rates of personal income tax. This will provide greater incentives for those who are unemployed to seek employment which will help to increase workforce participation and boost the size of the nation's labour supply. With more workers employed this will mean that the total volume of goods and services produced in the economy will be higher and the nation's aggregate supply increases. With more goods and services produced over time, this will be reflected by an increase in nominal GDP and an increase in the nation's economic growth.

Sample 1

Justification _____

Sample 2

The government could reform the tax and welfare system by ensuring that stay at home parents are not faced by very high effective marginal rates of tax when they re-enter the workforce and put their children into childcare. This could involve increasing the amounts that parents can earn before family welfare payments are cut, or increasing the subsidies/rebates for childcare expenses. These types of reforms will help to increase the financial returns from working and encourage an increase in the labour force participation rate (the percentage of the working age population who are members of the labour force). This will effectively increase the labour supply in the economy, providing industries with a greater pool of labour resources to use in production (and/or alleviating any labour/skills shortages and making them more able and willing to lift output, boosting aggregate supply or productive capacity in the economy. In addition, the bigger labour supply can exert downward pressure on real wages and/or upward pressure on productivity. This is because the greater competition for jobs results in some job seekers being prepared to work for lower wages and some workers feeling under greater pressure to lift work intensity and effort for fear of losing their job to competing workers. These factors help to reduce real unit labour costs and allow many businesses to increase output and reduce prices, encouraging growth in AD and real GDP, boosting the rate of economic growth.

Justification _____

Outline how increased government investment in education and training can increase the nation's productive capacity.

3 marks

Sample 1

An increase in government investment in education and training means that the government is spending more on educational institutions and training providers, including the construction of new educational infrastructure such as buildings and classrooms. The building of these facilities will necessarily require productive resources in their construction, including builders, electricians, engineers, architects, etc. which necessarily leads to an increase in production, real GDP and productive capacity. In addition, the investment in education and training might also include further professional development for teachers or training staff as well as the introduction of new teacher training software which enhances the ability of teachers to teach students. This further helps to increase the nation's productive capacity.

Justification _____

Sample 2

Government investment in education and/or training might take the form of greater funding for Australian universities, which could be used to purchase new capital (e.g. more advanced technological equipment or improved physical infrastructure), invest in better training for educators (e.g. more funding for professional development) or simply facilitate the purchase of more (non-capital) educational resources. These types of investments should result in better quality physical and human capital and improve educational outcomes such that graduating students will have better knowledge and skills. This helps to further improve the quality of human capital and boost labour productivity in the economy, as more output is likely to be attained from labour hours employed. This increases the willingness and ability of Australian businesses to supply goods and services and consequently boosts the nation's productive capacity.

Justification _____

EXAMINATION PREPARATION STRATEGY

THE EXAM STRUCTURE

Description

Examination time – 2 hours

Contribution to study score – 50%

Approved materials and equipment – Pencil to use on multiple-choice answer sheet and pen for written responses.

All of the key knowledge and skills from Units 3 and 4 are examinable.

The examination paper will consist of two sections:

Section A (15 marks)

Section A will consist of 15 multiple-choice questions which require students to apply their understanding of economics to identify the correct response. The questions will assess the student's knowledge of key concepts as well as the ability to analyse and synthesise material covered in all areas of study and outcomes in Units 3 and 4.

Section B (65 marks)

Section B will consist of short-answer and extended-answer questions, including questions with multiple parts. The number of questions may vary from year to year and Section B is worth a total of 65 marks.

A scientific calculator is now permitted to be used in the VCE Economics examination.

THE STRATEGY

Your overall strategy for exam preparation to **KAP** off a good year should be to:

1. **Know** the course and **Know** how to interpret examination questions.....
2. **Anticipate** examination questions....
3. **Practice**, practice and practice writing responses to questions.....

Knowing the course shouldn't be too difficult if you have followed this Study Guide closely and supplemented it with teachers' notes, your textbook and other resources. General things to do to help you *know the course* are:

- Prepare a summary of the course;
- Condense your notes;
- Prepare a glossary of terms;
- Prepare concept maps to highlight relationships and links;
- Teach parts of the course to friends and family;
- Complete interactive multiple choice and short answer questions at www.economicstutor.com.au;
- Complete questions and carefully read explanations on the economicstutor app;
- Attend student programs held by various bodies over September and October. For example visit the CPAP website (www.commpap.com) for details about the Exam Preparation programs in October/November. However, the timing of these programs will ultimately depend on the easing of government restrictions relating to public gatherings.

Knowing how to interpret questions will come with practice and after you have done your job of 'anticipating' questions. The interpretation of questions should be done in the 15 minutes you are given for reading time. During this time you should:

- Read over the structured questions relatively quickly and develop a general feel for what the questions are asking you.
- Read over the structured questions a second time; this time much more carefully. During this time you should:
 - Mentally re-phrase the questions and/or break the question up into parts to make them more familiar to you. Often, questions can be worded in ways that are unfamiliar and this can unsettle students. By re-wording or 'unpacking' a question you might realise that it is much more straightforward than first appearances suggest.
 - Prioritise the questions according to the ease with which you can answer them. Then be prepared to attempt these questions first.

Anticipating questions is a little more difficult. In the past, the exam setting panel relied on the use of the key knowledge and skills in the study design, as well as the *examination criteria* published in the VCAA Assessment Handbook. Examination criteria are no longer produced and the panel will therefore rely on the use of the key knowledge and skills (re-produced in the introductory pages of this Guide). The skills, summarised below, provide a basis for how questions might be asked in relation to the key knowledge.

- define key economic concepts and terms and use them appropriately
- construct and interpret demand and supply diagrams and a PPF model
- interpret and analyse statistical and graphical data
- analyse how the forces of demand and supply effect equilibrium price and quantity traded

- analyse the responsiveness of the quantity demanded and the quantity supplied to changes in price
- evaluate the role of free and competitive markets in achieving an efficient allocation of resources
- calculate relevant economic indicators using real or hypothetical data
- construct, interpret and apply economic models including the five-sector circular flow model of income and the business cycle
- explain and interpret trends and patterns in economic data and other information
- gather, synthesise and use economic data and information from a wide range of sources to analyse economics issues (and form conclusions)
- apply economic concepts to analyse economic relationships and make predictions
- evaluate the extent to which the economy has achieved the domestic macroeconomic goals over the past two years and discuss the effect of this on living standards
- explain key international economic relationships
- calculate relevant international economic indicators using real or hypothetical data
- discuss the operation of aggregate demand policies
- analyse the effect of current factors on the setting of aggregate demand policies and living standards
- predict the impact of changes in aggregate demand policies on the achievement of the domestic macroeconomic goals and living standards
- analyse the strengths and weaknesses of aggregate demand policies in achieving the domestic macroeconomic goals and living standards
- discuss the operation of aggregate supply policies
- analyse the effect of budgetary, immigration and trade liberalisation policies on aggregate supply, international competitiveness, the achievement of the domestic macroeconomic goals and living standards
- analyse the effect of an environmental policy on aggregate supply and living standards over time

To illustrate, a key knowledge point (Unit 3, AOS1) is *'the role of relative prices in the allocation of resources'* and a key skill is the ability to *'evaluate the role of free and competitive markets in achieving an efficient allocation of resources'*. A question which asks students to *evaluate the role of markets in the allocation of resources* involves significantly more skill and effort than a question such as *Explain how markets allocate resources, making reference to relative prices*.

Similarly, in relation to the government's domestic macroeconomic goals, the key knowledge (Unit 3, AOS2) requires students to demonstrate an understanding of *'the goal of full employment'* and *'the goal of price stability'*. Whereas a key skill requires students to demonstrate the ability to *'apply economic concepts to analyse economic relationships and make predictions...'*. A question requiring the *definition* of each goal is significantly less challenging than a question requiring students to *analyse* how the performance of the goals might be *related* (or how inflation might be *related* to the rate of unemployment).

It is likely that the panel will construct a table or matrix containing each of the key knowledge points/key skills and then ensure that these are adequately represented in the examination questions. It is expected that the panel will seek to incorporate a fair spread of the course in the examination, achieving a balance between Unit 3 and 4 questions, as well as a balance between the five areas of study. Accordingly, it should be designed with a view to providing students with limited opportunity to 'specialise.'

Possible questions relating specifically to the current study design

Given that 2023 was the first year of the current study design, students will not have access to a wide range of VCAA examinations focusing specifically on the current course. The VCAA's 2023 examination and sample examination (published in 2023) should therefore be downloaded (www.vcaa.vic.edu.au). In addition, the practice examinations published by various organisations in 2023 and 2024 (e.g. CPAP exams X 6 in total over 2023 and 2024) In addition, students should ensure that they tackle all of the questions in each 'Mini Exam', as well as the Bonus Exam and review questions in this Study Guide.

Below are 40 additional examples of the types of questions that could be asked in relation to the course, including both new **key knowledge points** and new **key skills**.

1. Explain how an economy's resources might be used in a way where intertemporal efficiency is not achieved. Construct a Production possibility frontier model to illustrate your response.
2. Describe how the basic economic questions of what, how, and for whom to produce are related to the problem of relative scarcity.
3. Explain why a demand curve is downward sloping, referring to the income and substitution effect.
4. Distinguish between the income and substitution effect in terms of how an increase in supply influences the demand for a product.
5. Outline how the profit motive influences the shape of a supply curve.
6. Explain how an increase in the number of suppliers within a given market is likely to influence equilibrium price and quantity.
7. Describe an example of a recent government intervention that has reduced one type of economic efficiency.
8. Evaluate the role of free and competitive markets in achieving an efficient allocation of resources.
9. Explain why the removal of government regulations, as an example of an aggregate supply factor, might contribute to the achievement of price stability and full employment.
10. Describe two separate consequences of not achieving the goals of strong and sustainable economic growth and full employment.
11. Explain what is meant by the non-accelerating inflation rate of unemployment (NAIRU) and examine the implications it has for the achievement of full employment.
12. Distinguish disinflation from deflation.
13. Describe two separate consequences of not achieving a low and stable rate of inflation.
14. Explain one negative consequence associated with a rate of inflation that is too low.
15. Evaluate the extent to which the economy has achieved price stability, full employment and strong and sustainable economic growth over the past two years.

YOU BE THE ASSESSOR: CORRECTIONS AND ANALYSIS (U4 AOS 1)

1. Explain how an increase in the terms of trade typically impacts on the government's goal to achieve fiscal consolidation. 4 marks

Demonstrating an understanding of the terms of trade

Demonstrating an understanding of fiscal consolidation

Demonstrating an understanding of the causes of the improved TOT

Sample 1

The increase in the terms of trade (prices received for exports relative to the prices paid for imports) helps the government in its attempts to achieve fiscal consolidation (i.e. to return the budget to surplus and/or reduce budget deficits). In particular, the higher prices received for commodities like iron ore and coal typically help to raise mining company revenue (and profits) as miners receive more for any given quantity of mineral exports. This should help to boost wages and national income, which ultimately lead to an increase in government tax revenue as well as a possible reduction in government expenditure as income/welfare support is likely to fall as the economy improves. This leads to a cyclical improvement in the budget outcome, with the underlying cash deficit falling over time which helps to return the budget to surplus, assisting with the achievement of fiscal consolidation.

Linking higher revenue/wages to tax revenue.

Highlighting why revenue increases.

Adding value by linking to government expenditure.

Referring back to the impact on the budget outcome and the medium term strategy.

Sample 2

Failure to demonstrate an understanding of the key terms in the question (TOT and medium term fiscal strategy).

Reference to exporters making more money is vague as assessors will be looking for students to demonstrate an understanding that exporters make more money because of higher prices received for exports (rather than higher volumes sold).

While this is okay, the failure to make reference to personal income tax as well as the possible automatic decrease in expenditure is not ideal.

The increase in the terms of trade is likely to reduce the budget deficit and/or increase the surplus. This occurs because commodity exporters will be making more money and therefore paying more company tax to the government. As the government receives more taxation revenue it is likely that existing government expenditure would be more easily covered by government revenue. As the deficit decreases over time this means that the government will be more likely to achieve fiscal consolidation. In addition, the government will be in a better position to introduce discretionary stabilisers that further help to reduce the size of the budget deficit. This might include higher tax rates or the introduction of new levies and/or decreases in government expenditure.

This sentence adds little value and potentially robs the student the opportunity to add more meaningful value to other parts of the response or the examination paper.

Again, little value add. It merely asserts that the lower deficit will assist with fiscal consolidation without demonstrating an understanding of what is meant by fiscal consolidation

While not untrue, it is not directly related to the question as the student should be focusing on the cyclical, rather than discretionary, impact. Reference to an initiative from the current budget is a nice touch but not entirely relevant in the context of the question.

Analysis (Sample 1 full marks)

Sample 1 has an excellent structure in that the student demonstrates an understanding of the key terms in the question nice and early in the piece. The assessor is left in no doubt that the student understands what is meant by the terms of trade and fiscal consolidation. In addition, the student provides an outline of how the higher terms of trade impacts on the ability to achieve fiscal consolidation. All of this is done in the 1st line. In contrast, Sample 2 neither demonstrates an understanding of the terms of trade or fiscal consolidation - this is costly. While the student does get the direction of the relationship to the budget outcome correct (i.e. higher terms of trade reducing the deficit), the assessor is likely to be left wondering whether the student understands why this occurs. Reference to 'exporters making more money' is rather vague and in no way clarifies that the additional money made has occurred because of higher prices (rather than higher volumes). Sample 1 on the other hand makes it clear why the deficit falls, making accurate reference to the income side of the budget as well as adding value by referring to the possible expenditure side impact.

Sample 2 does not finish well. The student merely asserts that the lower deficit will assist with fiscal consolidation (without highlighting what fiscal consolidation is) before going on to add information about discretionary stabilisers that is not that relevant to the question [as the question is really about the operation of automatic rather than discretionary stabilisers]. In contrast, Sample 1 does an excellent job of closing out the response in the last line by making it clear that the improvement in the budget outcome is due to the operation of automatic stabilisers (i.e. by referring to the cyclical improvement in the budget outcome) before linking it back to the greater likelihood of achieving fiscal consolidation.

2. Explain how monetary policy settings up until 2022 may have contributed to the housing price boom. In your answer refer to one transmission channel of monetary policy . 4 marks

Sample 1:

Repeating the question in 1st sentence is not necessary and adds no value.

The 3rd sentence is not entirely accurate and suggests that the student believes that a loosening of monetary policy means the same as an expansionary monetary policy setting. In addition, the students failed to acknowledge that the setting was already expansionary (the loosening therefore made it more expansionary).

Reference to open market operations is going beyond the scope of the question and is therefore not relevant. In addition, the student should have drawn a distinction between the target cash rate and interest rates more generally.

Monetary policy settings up until 2022 contributed to the housing price boom. The RBA lowered interest rates in the economy on numerous occasions. These monetary policy easings resulted in the monetary policy stance becoming accommodative of expansionary. The RBA achieved this reduction in interest rates by increasing the supply of cash in money markets, by purchasing government securities from the major banks, which eventually drove down interest rates 0.1%. These lower interest rates caused capital outflow and a reduction in the value of the Australian dollar as investors sought to take advantage of the relatively higher rates of interest in overseas financial markets. The lower exchange rate (exchange rate channel) improved the international competitiveness of our exporters, causing net export demand to increase. This in turn led to an increase in AD, economic growth and employment, reducing the unemployment rate and moving more people from welfare income and towards higher wage income. Higher incomes earned then created an increased demand for many goods and services, including housing, causing an increase in the price of houses. In addition, the lower interest rates stimulated demand for housing as a result of the cheaper cost of borrowing (i.e. the cost of credit channel/savings and investment channel). Householders had financial incentive to reduce their savings (given the lower interest return) and increase their borrowing, making it more affordable to purchase a house with a mortgage loan. This added to the demand for housing and raised housing prices further.

While the exchange rate channel is a reasonably well explained in terms of the way it reduces AD, it is not the best channel to use for this question because of the link to 'demand for houses' is relatively remote compared to the cost of credit or availability of credit channels.

Reference to a 2nd transmission channel is unlikely to be rewarded given that an explanation of only one transmission channel is required in the question. This is despite the fact that the explanation is accurate.

There is no attempt to demonstrate an understanding of a housing 'price boom' and how it might differ from an increase in the price of houses.

The student demonstrates an understanding of expansionary monetary policy, and in so doing, accurately draws a distinction between a loosening of policy and an expansionary monetary policy setting. Distinguishing the target cash rate from interest rates more generally, as well as accurate use of statistics, would be rewarded.

Accurate reference to and explanation of the cost of credit channel (savings and investment channel) and how it added to the demand for and price of housing.

Sample 2: Monetary policy was expansionary until the end of 2022, with several policy easings, as the RBA reduced the target cash rate to as low as 0.1% in 2020. This target cash rate remained at a very low level (until late 2022) and resulted in the general structure of interest rates falling to very low levels, which stimulated demand for goods and services, including housing, via a number of transmission channels. In particular, the looser monetary policy helped to fuel growth in the demand for housing, as lower mortgage rates worked to reduce the cost of credit, encouraging more demand for housing loans. This is because lower interest rates discourage saving and encourage borrowing (e.g. for investment in housing). The lower interest rates resulted in large increases in housing prices, particularly in Sydney and Melbourne, where these markets were generally considered to be in boom territory. This was a major factor behind the housing affordability crisis that is affecting younger Australians in particular.

The student makes a good attempt at demonstrating an understanding of another key concept in the question (i.e. housing price boom).

This last sentence is not required in the context of the question. It should be avoided if it means that the student struggles to complete the remainder of the paper in the allocated time.

Analysis (Sample 2 full marks)

Sample 2 would achieve full marks because it addresses all of the key components of the question and leaves the assessor in no doubt that the student understands why an expansionary monetary policy setting (or a low interest rate structure) was one of the factors contributing to the housing price boom in Australia. The student successfully distinguished an expansionary monetary policy setting from a loosening of monetary policy and made accurate use of statistics when establishing the link to an increased demand for housing. The student also used an appropriate transmission channel (i.e. the availability of credit) and referred to a 2nd appropriate transmission channel that could have been explored (i.e. cost of credit channel). [However, this bit of added value could have been removed without loss of marks.] While Sample 2 did have evidence of further 'added value' that was technically not required (e.g. the last sentence) it was not costly and did not detract from the quality of the response. In contrast, Sample 1, appeared not to know the difference between a loosening of policy and an expansionary policy setting and there was no attempt to distinguish a 'higher price of houses' from a 'housing price boom'. Sample 1's choice of transmission channel (i.e. the exchange rate channel) should have been better. However, more crucial was the student's inclusion of a discussion of open market operations and a 2nd transmission channel, both of which were irrelevant in the context of the question.