

**ECONOMICS Unit 3 Examination Semester 1 2018**

**Marking Guide**

**Section 1 (24 marks)**

1 C

2 B

3 A

4 B

5 D

6 C

7 B

8 D

9 A

10 A

11 A

12 D

13 B

14 B

15 C

16 B

17 D

18 A

19 C

20 D

21 A

22 B

23 A

24 B

**Section 2 (36 marks)**

**Question 25 (12 marks)**

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| 1. The purpose of a tariff is to restrict imports by increasing their price & increase domestic output & employment in the import competing industry. | 1-2 marks |
| 1. This argument, also called the national defence argument suggests that it is necessary to protect certain industries, such as steel, to ensure continued domestic production in the event of a war. Steel & aluminium would be considered essential inputs in the production of defence equipment. | 1- 2 marks |
| 1. *2 marks* for correctly labelled model of US steel market – showing world price, tariff, domestic production & consumption, imports.   *2 marks for explanation* – the tariff increases domestic production & employment in the steel industry, decreases domestic consumption & reduces imports. | 1- 2 marks  1- 2 marks |
| d)  The tariff harms US consumers of steel/aluminium products by increasing prices and reducing the quantity of imports – consumer surplus decreases.  The tariff harms other US industries that use steel & aluminium as inputs in production – their costs increase, reducing employment, output & competitiveness.  Other countries are likely to retaliate & impose tariffs on US exports, harming US export industries. | 1-2 marks  1-2 marks  1-2 marks |

**Question 26 (12 marks)**

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| 1. 2016-17 2. 2016-17 | 1 mark  1 mark |
| 1. Over the period in the table the services deficit has fallen from a deficit of around $13bill in 2011-12 to less than $3bill in 2016-17.   During this period there was a significant depreciation of the $AUD causing a large increase in education & tourism exports. | 1 mark  1-2 marks |
| 1. There is a direct/positive link between the export price index (XPI) and the value of total exports.   In the years when the XPI fell (2012-13, 2014-15 & 2015-16), the value of exports fell and when the XPI rose (2013-14 & 2016-17) the value of exports increased.  Reason - A rise in the XPI automatically increases the value of a given quantity of exports – e.g. if price of iron ore increases from $50/tonne to $70/tonne then 1 million tonnes of iron ore will now be worth $70 mill instead of $50 mill. | 1 mark  1 mark  1 mark |
| 1. This would decrease the trade balance – an increase in investment would increase capital goods imports (e.g. machinery, computers) 2. This would increase the trade balance – a depreciation in the TWI would increase the competitiveness of Australia’s exports by lowering the price to overseas buyers, increasing export sales. | 1-2 marks  1-2 marks |

**Question 27 (12 marks)**

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| 1. Approx. $104,000mill or $104bill – must be between $100bill - $108bill for the mark 2. No years – the stock of FDI would have increased each year 3. Mining (or Resources or Commodities) | 1 mark  1 mark  1 mark |
| 1. **Foreign** **Direct Investment** (FDI) is when a foreign firm establishes a new business or acquires 10 per cent or more of an Australian enterprise.   **Foreign** **Portfolio Investment** (FPI) refers to the purchase of Australian securities (such as shares or bonds) which do not offer the investor any control over the operation of the enterprise (<10%). | 1 mark  1 mark |
| 1. *For both Direct & Portfolio: 1 mark for the change; 1 mark for a reason*   Between 2014-15 and 2016-17, portfolio investment more than halved from around $95bill to around $35bill. This was caused by fall in market performance – lower company profits, lower relative interest rates.  Direct investment fell from $60bill in 2014-15 to around $45bill in 2015-16, but then increased to $70bill in 2016-17 – these changes were due to the changes in commodity prices (most FDI is in the mining sector) | 1-2 marks  1-2 marks |
| 1. *Any 2 Benefits – 2 marks; One Cost – 1 mark*   **Benefits:** FDI helped develop Australia’s mining sector; FDI adds to real investment spending which increases output & employment; FDI can bring new technology & managerial expertise; FDI can increase labour productivity through capital deepening & thereby increasing wages.  **Costs:** FDI will lead to increased income payments to o/s investors (profits & dividends) which increases the income deficit in the current account; OR FDI can lead to increased o/s ownership of Australian businesses | 1-2 marks  1 mark |

**Section 3 (40 marks)**

**Answer TWO questions**

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

a. Discuss the significance of trade for the Australian economy and describe the composition of Australia’s trade. (10 marks)

b. Discuss the importance of the concept of international competitiveness and explain three key determinants. (10 marks)

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| 1. **Significance** of trade – *5 marks (need to discuss 4-5 points)*  * Trade (exports + imports) accounts for around 40% of GDP * 1 in 5 jobs in the Australian economy involve trade-related activities * Trade increases production, employment, incomes & the overall living standard of the Australian population * Trade results in lower prices for consumers & greater variety * Trade stimulates competition & innovation which enhances productivity   **Composition** of trade – *5 marks.*  *Discussion of both exports & imports.*  Exports - 3 marks   * main category is resources – fuels & minerals – which accounts for around (40%). Examples are iron ore, coal, natural gas, gold, bauxite. * Next largest category is services (22%) – education, personal travel (tourists), business services * Other categories – agriculture (13%) & manufactures (14%)   Imports - *2 marks*   * largest category is producer type goods including capital goods & intermediate goods. These account for around half of all imports & include computers, goods vehicles, machinery, fuels * Consumer goods comprise 28% of total imports & include motor vehicles, mobile phones while services account for 22% (freight & personal travel). | 1-5 marks  1-3 marks  1-2 marks |
| 1. Discuss **importance** of international competitiveness *– 4 marks*   *Define & provide at least two valid reasons*  **Competitiveness is** a measure of a country's advantage in selling its products in international markets – the ability of a business or country to compete effectively in international markets.  Increases in competitiveness reflect   * higher productivity/lower unit labour costs. * higher per capita income * higher living standards. * In a globalised world, a rise in competitiveness is seen as an important determinant of a country’s economic welfare.   **Determinants** – *any three for 6 marks (3 x 2 marks)*   1. Productivity – is a measure of output per worker. An increase in productivity reduces costs which improves competitiveness 2. Exchange rate – A fall (depreciation) in ER will lower export prices which boosts competitiveness of exporters. At the same time it increases import prices which boosts competitiveness of import competing firms 3. Relative inflation - if the inflation rate is relatively lower than other countries, then prices will be increasing at a slower rate boosting price/cost competitiveness 4. High rates of investment in both physical & human capital – ultimately this leads to an increase in productivity 5. Relatively higher unit labour costs will decrease competitiveness – reasons why firms may re-locate production to lower wage countries | 1-4 marks  1-2 marks  1-2 marks  1-2 marks  1-2 marks  1-2 marks |

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

a. Explain the effects of an exchange rate appreciation on consumers, businesses and foreign investment into Australia. (8 marks)

b. Using the demand and supply model, demonstrate the impact of the following factors on Australia’s exchange rate:

i. An increase in Australia’s interest rate differential

ii. A decrease in commodity prices

iii. An improvement in Australia’s economic performance (12 marks)

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| 1. **Effect of ER appreciation on consumers, businesses and FI**   Consumers will benefit since imports prices will fall – *2 marks*  Businesses that export will lose since export prices will increase for overseas buyers – *2 marks*  Businesses that import intermediate & capital goods will benefit since import prices will fall – *2 marks*  FI - Australian assets will now be more expensive for overseas buyers so an appreciation is likely to decrease capital inflow – *2 marks* | 2 marks  2 marks  2 marks  2 marks |
| 1. *4 marks for each factor – 1 mark for the model, 3 marks for the explanation. Each should have a separate D/S model.* 2. An increase in Australia’s i/r differential means that i/r’s in Australia have increased relative to o/s – this will increase foreign investment (capital inflow) into Australia, increasing the D($A) and appreciating the exchange rate. 3. A decrease in commodity prices will decrease the value of Australia’s commodity exports (iron ore, coal etc) which will decrease the D($A) and depreciate the exchange rate 4. An improvement in Australia’s economic performance will lead to an inflow of capital (esp portfolio investment) chasing higher returns from the sharemarket which will increase D($A) but at the same time higher national income will lead to increased spending on imports which will increase the S($A) so effect on the exchange rate is ambiguous. | 1-4 marks  1-4 marks  1-4 marks  Need both effects for 4 marks |

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

a. What is the terms of trade index? Explain the meaning and effects of an unfavourable movement in the terms of trade. (10 marks)

b. Discuss the changes in Australia’s terms of trade since 2012 and describe three factors that affect Australia’s terms of trade. (10 marks)

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| 1. **Meaning/explanation** – *4 marks*   The terms of trade index shows the relativity between Australia’s export prices and its import prices. It is calculated as an index:  Export price index/Import price index x 100  If the index decreases, then this is referred to as an unfavourable movement since a given quantity of exports can purchase a smaller quantity of imports & so this reflects a fall in economic welfare – a decrease in the purchasing power of national income.  A decrease in the ToT can occur if either the export price index falls and/or the import price index increases.  **Effects** of an unfavourable movement – *6 marks*  *Any THREE effects (3 x 2 marks)*   1. A decrease in the trade balance (increase the CAD) – value of exports will fall relative to imports 2. A decrease in national income – less imports can be purchased reducing living standard 3. A depreciation in the exchange rate – a fall in the ToT will decrease the D($A) 4. Aggregate D decreases – since the value of net exports falls which reduces GDP and the price level 5. Investment and employment falls in the resource sector due to decreased revenue | 1-4 marks    1-2 marks for each effect |
| 1. **Changes** in the terms of trade – *4 marks*   Australia’s terms of trade fell dramatically after 2012 mainly due to the collapse of commodity prices which reduced the XPI – this sparked the end of the mining boom. From Q26, the ToT fell from 142.6 in 2011-12 to 100 in 2015-16 – a 30% fall. But then in 2016-17, the ToT increased again by 15% due to a surge in commodity prices.  Any **Three factors** affecting terms of trade – *6 marks (3 x 2 marks)*  Need to discuss factors that affect both the XPI & the MPI   * For Australia the main driver of the ToT is the XPI which is dominated by commodity prices – items such as iron ore, coal, natural gas, aluminium ores, beef and wheat. An increase in commodity prices will increase the ToT * World economic growth (esp China) drives the commodity price cycle – an increase in world economic growth will increase Australia’s ToT * The MPI is dominated by manufactured goods (producer & consumer goods) – these tend to fall over time due to technology effects which will increase Australia’s ToT * Oil prices – Australia is a net importer of oil so an increase in world oil prices will decrease Australia’s ToT | 1-4 marks  1-2 marks  1-2 marks  1-2 marks |

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

a. Explain the concept of net foreign liabilities and distinguish between Australia’s two main foreign liabilities. (10 marks)

b. Explain why Australia has a high level of foreign debt and the effect this has on the current account in the balance of payments. (10 marks)

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| **Discussion of foreign liabilities & foreign assets** – *4 marks*  Net foreign liabilities is the difference between total foreign liabilities and total foreign assets. Foreign liabilities is the stock of foreign investment into Australia, while foreign assets is the stock of Australia’s investment abroad. So net foreign liabilities = foreign investment into Australia – Australian investment abroad. FI and FIA have both been increasing but FI > AIA. Therefore, Net foreign liabilities increase each year because each year there is a net inflow of capital – which is the financial account surplus (or the CAD).  **Discussion of foreign debt & foreign equity** – *6 marks*  Foreign debt is the amount borrowed from non-residents by residents of Australia – both private (business) sector (75%) and the government sector (25%). Australia’s net foreign debt is approx. $1,000bn.  Foreign equity is the extent to which foreign residents own Australian assets. Australia's net foreign equity is -$25bn – which means that Australian has a positive net equity asset position (we own more overseas assets than the world owns of our assets!).   1. High level of **foreign debt** – *6 marks*   Australia has a high level of foreign debt because of Australia’s investment/savings (I – S) gap. Australia records current account deficits/financial account surpluses because its investment is greater than its savings. The accumulation of CADs represents the stock of net foreign liabilities. Most of Australia’s net foreign liabilities are in the form of foreign debt – in fact foreign debt currently accounts for all of net foreign liabilities (because Australia’s net foreign ­equity position is positive).  Each year there is a financial account surplus, this increases the stock of foreign liabilities (either as foreign debt or foreign equity).  The Aust. Govt. partly funds it budget deficits by borrowing offshore which adds to foreign debt. The Private sector prefers to borrow from overseas rather than sell assets to obtain funds which increases foreign debt.  **Effect** on the current account – *4 marks*  The servicing costs associated with foreign liabilities are recorded in the income account of the current account. Australia pays interest on foreign debt and dividends on foreign equity – these payments increase the income deficit and therefore the current account deficit. Because Aust has a high level of foreign debt, net income is always in deficit – the structural component of the CAD. | 1-4 marks    1-3 marks  1-3 marks  1- 6 marks  1-4 marks |