

# CONTENTS

<b>Economics – End of Year Examination</b>	<b>1</b>
<b>VCE Economics Study Design 2017-2021</b>	<b>3</b>
Unit 3 – Area of Study 1 – An Introduction to Microeconomics	4
Key Knowledge	4
Key Skills	5
Unit 3 – Area of Study 2 – Domestic Macroeconomic Goals	6
Key Knowledge	6
Key Skills	7
Unit 3 – Area of Study 3 – Australia and the World Economy	8
Key Knowledge	8
Key Skills	9
Assessment for Unit 3	9
<b>Unit 3 – Area of Study 1 – Microeconomics</b>	<b>10</b>
Macroeconomics and Microeconomics	10
Introductory Concepts	11
Relative Scarcity	11
Resources	12
An Efficient Allocation of Resources	13
Opportunity Cost	13
Production Possibility Curve (Frontier)	15
Australia’s Economic System	17
Sectors of the Economy	17
Microeconomics Analysis	18
The Market or Price Mechanism	18
Competitive Markets	19
Market Structures	20
Demand and Supply Analysis	21
Demand	21
Changes in Demand Conditions Causing a Shift in the Demand Curve	22
Demand Factors	23
Supply	28
Changes in Supply Conditions Causing a Shift in the Demand Curve	30
Supply Factors	31
Equilibrium	34
Movement to Equilibrium	35

The Structure of Relative Prices	38
Elasticity	40
Price Elasticity of Demand	40
Price Elasticity of Supply	42
The Price Mechanism and Resource Allocation	45
Market Structure and its Impact on Prices, Efficiency of Resource Allocation and Living Standards	46
Competitive Markets	48
Market Failure	51
Government Failure	57
<b>Unit 3 – Area of Study 2 – Domestic Macroeconomic Goals</b>	<b>58</b>
Macroeconomic Analysis	60
Economic Activity in Australia	60
The Concept of Living Standards	60
The Nature and Purpose of Macroeconomic Activity	61
Definition of Economic Activity	61
Indicators of the Level of Economic Activity	63
The Five Sector Model of Economic Activity	64
Changes in the Level of Economic Activity	65
Non-Market Activity	66
Aggregate Demand	66
The Aggregate Demand Equation	67
Demand Factors	70
Private Consumption Expenditure	70
Private Investment Expenditure	71
Government Expenditure	72
Net Exports	72
Aggregate Supply	74
Factors Affecting Aggregate Supply	74
Quantity, Quality and Availability of Resources	75
Costs of Production and Profitability	76
Efficiency and Productivity	77
Using Aggregate Demand-Supply Diagram to Illustrate Changes in Economic Activity	78

The Goal of Low Inflation	80
Definition	80
The Significance of Low Inflation	81
Measurement of Inflation	81
Limitations of the CPI as a Measure of Inflation	82
Headline vs Underlying Rate of Inflation	82
The Effects of Inflation on the Goal of Living Standards	83
Types of Inflation	85
Consequences of a High Inflation Rate	85
Demand Factors Affecting the Goal of Low Inflation	85
Supply Factors Affecting the Goal of Low Inflation	87
Australia's Performance in Achieving the Goal of Low Inflation	90
Strong and Sustainable Economic Growth	91
Measurement of Economic Growth	92
The Goal of Strong and Sustainable Economic Growth and Living Standards	92
The Impact on Living Standards of Failing to Meet the Goal of Strong and Sustainable Economic Growth	94
Demand Factors Affecting Economic Growth	95
Supply Factors Affecting Economic Growth	97
Australia's Performance in Achieving the Goal of Strong and Sustainable Economic Growth	99
Factors that May Influence Australia's Future Rates of Economic Growth	101
Full Employment	103
Limitations of the ABS Unemployment Statistics	104
The Costs and Benefits of Achieving Full Employment Including the Impact on Living Standards	106
Benefits of Full Employment	106
Costs of Full Employment	107
Types of Unemployment	108
Consequences of Unemployment	108
Demand Factors Affecting Cyclical Unemployment	109
Supply Factors Affecting Cyclical Unemployment	110
Australia's Performance in Achieving the Goal of Full Employment	111

<b>Unit 3 – Area of Study 3 – Australia and the World Economy</b>	<b>114</b>
Definition and Measurement	116
The Significant of Factors that Influence Australia’s International Transactions	116
Important Concepts	117
Trade and Living Standards	117
Balance of Payments	118
Net Foreign Liabilities	120
The Impact on Living Standards of Changes in International Transactions	120
The Concepts of Free Trade and Protectionism	122
Arguments for Protectionism	123
Methods of Protectionism	124
Factors Influencing Australia’s International Competitiveness	125
Demand Factors	125
Supply Factors	126
Australia and the World Economy – Performance Over the Last Two Years	132
<b>Solutions</b>	<b>138</b>

## MOVEMENT TO EQUILIBRIUM

***How does the market reach the equilibrium price, to bring the market into balance, if a shortage or surplus exists?***

If the price is initially set above equilibrium, then quantity supplied will be greater than quantity demanded creating a **surplus** in the market. For example, if the price was set at \$20, quantity demanded would be 500 but the quantity supplied would be 1500 creating a surplus of 1000 CDs.

Suppliers will notice that they are not selling all of the CDs they have supplied at existing prices. They may offer the CDs at a discounted price which encourages new buyers to enter the market (demand will expand). At the same time the suppliers will no longer find the production and supply of CDs to be as profitable, so they may supply less CDs and/or leave the CD market (a contraction in supply). Therefore, this will continue until the market converges and meets at the equilibrium price.

If the price is initially set below the equilibrium, the quantity demanded will be greater than quantity supplied creating a **shortage** in the market. For example, if the price was set at \$10 the quantity demanded would be 1500 with a quantity supplied of 500. This creates a shortage of 1000 CDs.

Some consumers in a competitive market will be willing to pay more for the CDs than the going price and will therefore try to 'outbid' competing consumers to obtain the product, causing the price to increase. As the price increases suppliers will find it more profitable to supply CDs and therefore **supply will expand**. The higher prices will reduce the number of consumers who are willing and able to purchase the product resulting in a **contraction in demand**. Prices will continue to increase until demand and supply converge and meet at the equilibrium price.

### QUESTION 4 (VCAA 2015)

The effect on the market for product A of a rise in the price of a substitute product B will be:

- A Shift the demand curve left and decrease the equilibrium price of product A.
- B Shift the demand curve right and increase the equilibrium price of product A.
- C Shift the supply curve left and increase the equilibrium price of product A.
- D Shift the supply curve right and decrease the equilibrium price of product A.

### QUESTION 5 (VCAA 2015)

An expansion in the quantity supplied would be shown graphically as a:

- A Movement up the supply curve.
- B Shift to the left of the supply curve.
- C Shift to the right of the supply curve.
- D Movement down the supply curve.

**QUESTION 6 (VCAA 2014)**

A major determinant of demand in one particular market could be the:

- A Cost of raw materials.
- B Method of production.
- C Number of sellers in the market.
- D Disposable incomes of buyers in the market.

**QUESTION 7 (VCAA 2014)**

The effect on the market for product A from a rise in the price of a complementary product B will:

- A Shift the demand curve right and increase the equilibrium price.
- B Shift the demand curve left and decrease the equilibrium price.
- C Shift the supply curve left and increase the equilibrium price.
- D Shift the supply curve right and decrease the equilibrium price.

**QUESTION 8 (VCAA 2013)**

The effect of an introduction of a carbon tax of \$23 per tonne of CO<sub>2</sub> emissions on the market for electricity that is generated from burning coal would be to:

- A Shift the supply curve to the left and cause a contraction in supply.
- B Shift the supply curve to the left and cause a contraction in demand.
- C Shift the demand curve to the left and cause a contraction in supply.
- D Shift the demand curve to the left and cause a contraction in demand.

**QUESTION 9 (VCAA 2012)**

Which one of the following will cause the supply curve for a good or service to increase (shift to the right)?

- A An increase in government taxes.
- B An increase in the level of income.
- C An increase in worker productivity.
- D A decrease in the price of a substitute good or service.

**QUESTION 10 (VCAA 2016)**

When resources are used to produce the goods and services that best satisfy society's needs and wants, this is known as:

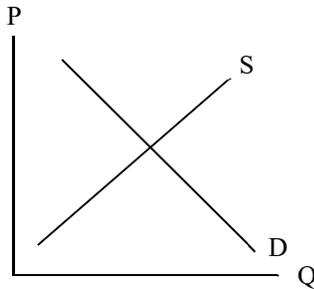
- A Dynamic efficiency
- B Allocative Efficiency
- C Intertemporal efficiency
- D Productive or technical efficiency

**QUESTION 11**

On the curves shown below, indicate:

- A The shift of the curve.
- B The effect on the equilibrium price and quantity.

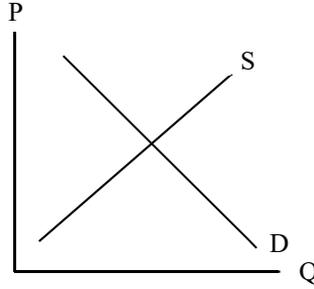
**Train tickets**



Petrol prices increase

Effect on: P Q

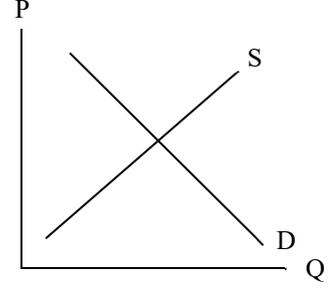
**Tomato Sauce**



Pies increase in price

P Q

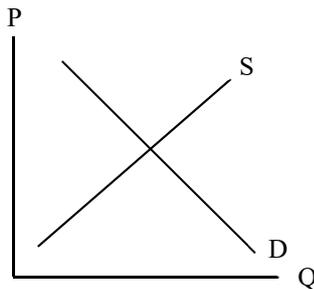
**iPods**



The tax free threshold is increased to \$8,000

P Q

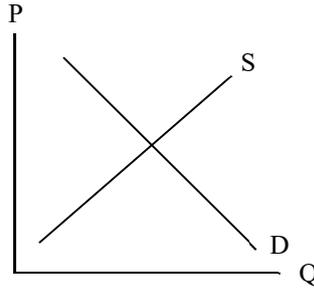
**Apples**



A shortage of bananas

Effect on: P Q

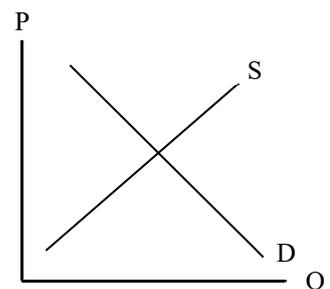
**Haircuts**



Increase wages for hairdressers

P Q

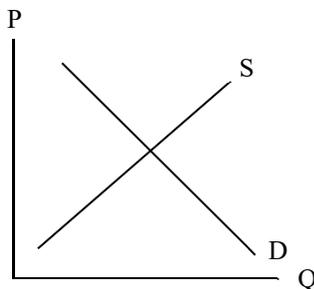
**Motorscooters**



An increase in petrol prices

P Q

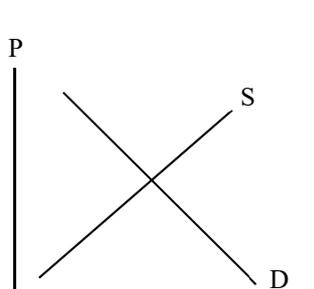
**Leather**



The increased popularity of steak

Effect on: P Q

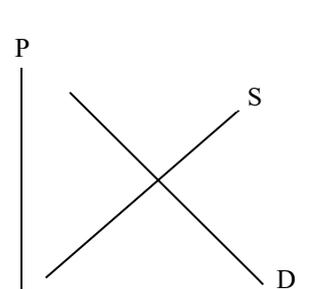
**Private health cover**



An increase in average weekly earnings

P Q

**Electricity**



Water shortages

P Q

## THE STRUCTURE OF RELATIVE PRICES

The price for a product in a competitive market is determined by the interaction of supply and demand. Markets for different goods and services are inter-related and price movements in one market may affect several others (which may not initially appear as an obvious consequence).

For example, a product may be used as a raw material in the production of another product. This will increase the cost of production for the supplier who may increase the price of his/her product (depending on price elasticity).

### Exam Tip

The concept of price changes or relative prices has appeared on exam papers in recent years.

A change in 'relative prices' means that the price of a good increases or decreases relative to another good.

There are obviously many markets each with a set of prices. Relative prices of goods and services exist and act as signals to both consumers and producers. When the price of a good or service increases this may be the result of increased demand and/or decreased supply. If the change in price is a result of increased demand, then this will indicate to suppliers that there is greater profitability in the product.

New producers may be enticed to enter the market and in doing so they may direct resources away from less profitable industries. The increase in supply may also mean that they require more factors of production so labour resources may be enticed from other areas. In order to entice the extra labour higher wages may need to be offered.

The structure of relative prices therefore affects Resource Allocation.

### QUESTION 12

In a competitive market economy, explain how the market (price) mechanism allocates resources.

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**QUESTION 13 (VCAA 2014)**

Explain how a change in relative prices might result in a reallocation of resources.

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**QUESTION 14 (VCAA 2013)**

Explain what is meant by an efficient allocation of resources.

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**QUESTION 15 (VCAA 2011)**

With reference to the price mechanism, describe how resources are allocated in a competitive market.

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# ELASTICITY

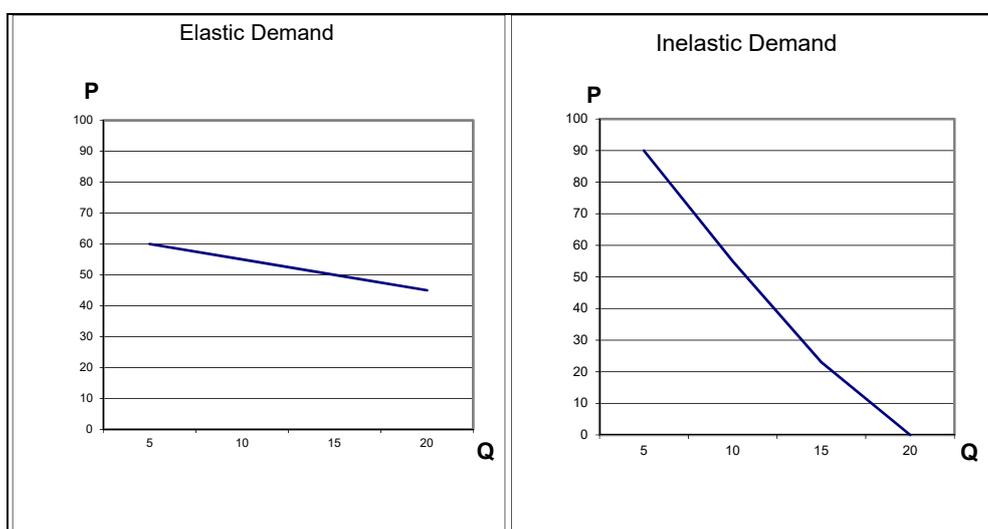
**Elasticity** is a measure of the responsiveness of changes in one variable (quantity) to changes in another variable. An important part of consumer and producer behaviour relates to price elasticity of demand and price elasticity of supply. That is, the percentage change in demand or supply in response to a certain percentage change in price.

## PRICE ELASTICITY OF DEMAND

Measures the responsiveness of quantity demanded (as a percentage) to changes in price (as a percentage).

i.e. When price increases, to what extent do consumers reduce their demand?

- If demand is **relatively elastic**, the demand for a product changes more than proportionally with a change in price, e.g. A 10% fall in price results in a 20% rise in quantity demanded. Products with elastic demand have a 'flat' demand curve.
- If demand is **relatively inelastic**, the quantity demanded changes less than proportionally with a change in price, e.g. A 10% fall in price results in a 5% rise in quantity demanded. Products with inelastic demand have a 'steep' demand curve.
- If demand is of **unit elasticity**, the quantity demanded changes by the same proportion as the change in price, e.g. A 10% fall in price leads to a 10% rise in quantity demanded.



## Factors affecting price elasticity of demand:

- **Availability of substitutes.**

If a good or service has a number of viable alternatives (substitutes) and it is traded in a competitive market then price elasticity of demand will tend to be higher (more elastic). Fully informed rational consumers will want to change quickly from the more expensive good to the readily available substitute.

- **Proportion of income.**

Demand will decrease by a relatively small percentage if the price of the good or service represents a small proportion of consumers' incomes. i.e. Demand is relatively inelastic. If the product represents a high proportion of consumer's incomes, demand is relatively elastic.

- **Degree of necessity.**

Those goods and services which are essential will tend to be less responsive to price changes. i.e. Demand is relatively inelastic. On the other hand, demand for luxury products is more likely to be elastic.

- **Time period.**

Demand is more elastic in the long term as time gives buyers the opportunity to find alternatives.

