
LIMITATIONS AND EFFECTIVENESS OF ECONOMIC POLICY



Short answer questions

Question 1

- (a) i) **Achieve inflation of 2-3 per cent, on average, over the course of the economic cycle.**
ii) **Achieve sustainable economic growth of 3.5 to 4 per cent, on average, over the course of the economic cycle.**
- (b) i) **Monetary policy is the primary tool used to combat inflationary pressures. Monetary policy manipulates the level of interest rates in the economy to influence the level of aggregate demand and control inflationary pressures. Microeconomic policy has also been used in recent years to increase the efficiency and competition within the economy to maintain a low-inflationary environment.**
ii) **In the short to medium term, both monetary policy and fiscal policy have been used to stabilise the level of economic growth. Fiscal policy in particular, since 2000, has played a significant role in stimulating growth when required. Micro economic policy is also used to affect structural changes which will allow this sustainable growth target to continue and even lift by 2010.**
- (c) **Monetary policy have been used by great success over the last decade to control inflation..Inflation targeting, which began informally in 1002,and was formalised in 1996 has been one of the stalwarts of our recent economic success.Throughout the late 1990s the RBA managed to maintain an average level of inflation within in 2-3 per cent target band, which set the scene for continued growth.Monetary was unable to stop the 6 per cent inflation blip following the GST in 2000-01,however inflation quickly returned to normal level, although many speculated that the RBA overreacted in raising interest rates at the time. Although inflation is still slightly above the target range at 3.4 per cent,this is not a concern because of weak global factors and consistent economic performances elsewhere.Thus, monetary policy has been extremely effective in achieving inflation within the RBA and Government's target level.**

Question 2

- (a) **Fiscal consolidation involves stabilising the Government's Budget balance in surplus. IN Australia for example, fiscal consolidation in the late 1990s meant shifting a Budget deficit over \$10bn to a surplus of \$13bn in the space of three years.**

(b) **Fiscal policy has played a mixed role in Australia in recent years. In the late 1990s, fiscal policy concentrated only on increasing national savings and thus, after returning to surplus, was not forecast to alter greatly. However, the downturn of the domestic and global economies in 2000 prompted the government to return fiscal policy to the forefront of demand management for the following two years. This year, the Government has solidified the role of fiscal policy as a kind of loose weapon that will no longer run large surpluses but could be used to provide timely stimulus to the domestic economy when growth requires it.**

(c) **Outline the use of macroeconomic policy in recent years in a country other than Australia. 5**
In 2000-2001, the US economy experienced a significant downturn, largely attributed to the technology sector crash, as well as a fall in consumer and investor confidence following the terrorist attacks in late 2001. In response to this downturn, the US government has adopted a strongly expansionary macroeconomic stance.

Monetary policy in the US is directed toward maintaining low stable inflation as well as maintaining sustainable economic growth. Since the downturn in the US economy, monetary policy has adopted an expansionary stance with the aim of increasing sagging economic growth. Since the beginning of 2001, the federal funds rate has been cut 13 times to 1.0% by America's central bank, the Federal Reserve. The adoption of expansionary monetary policy has been directed not only toward promoting economic growth, but also increasing economic activity so as to prevent deflation in the US economy.

Fiscal policy in the US is also currently very expansionary, with a recent mid year revision by the Office of Management and Budget suggesting that in 2003 the budget deficit will blow out to \$455 billion, or 4.2% of GDP. One of the major sources of this increase are the large tax cuts announced by the Bush Administration. These tax cuts, worth \$2.2 trillion over the next 10 years, will have a large positive impact on the US economy by bolstering consumer spending.

Question 3

(a) **The success of micro policy is difficult to judge for two main reasons:**

1. There is a significant time lag associated with the impact of micro reforms. It can take 10 to 15 years for the full effect of some policies to take hold.

2. Micro reforms can have such broad reaching implications that it is difficult to identify what economic outcomes are specifically related to micro reforms. For example, Australia's strong growth over the last ten years is definitely in debt to micro reforms, but isolating what success are directly attributable to micro reforms as opposed to other policies can at times be virtually impossible.

(b) **Cost – Increase unemployment in the short run. As inefficient firms are forced out of the market, unemployment will increase.**

Benefit – Improved allocation of resources as competition increases and resources are moved to areas that will best meet the demands of consumers.

- (c) **Microeconomic reform creates the stage upon which the demand management game is played out. By improving the productivity, efficiency and resource allocation of the economy, micro reform creates a low inflationary environment in which growth can be sustained over the longer term. For the Australian Government, micro reform has been instrumental in increasing our sustainable growth target from 3-4 per cent, to 3.5-4 per cent in recent years, and will be a crucial influence on allowing this to increase further by 2010.**
- (d) **Microeconomic reform, whilst providing a range of benefits to the economy, tends to result in a worsening of income inequality in an economy:**
- **Labour market policies designed to increase the number of individual agreements can worsen inequality by removing the notion of comparative wage justice, particularly when coupled with the demise of union power in workplace negotiations.**
 - **Industry and trade policies which has promoted deregulation and the removal of protection levels have resulted in increased cost cutting and business closures which increase the level of unemployment and worsen income inequality.**
 - **The introduction of the GST in 2000 worsened income inequality by introducing a regressive tax which impacts most heavily on lower income earners.**

MULTIPLE CHOICE ANSWERS

- 1. B 2. B 3. D 4. C 5. A 6. A 7. B 8. C 9. A 10. D
11. A 12. B 13. C 14. D 15. A 16. A 17. D 18. D 19. B 20. C**