

EFFECTIVENESS & LIMITATIONS OF ECONOMIC POLICY

18

MULTIPLE CHOICE

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

SHORT ANSWER QUESTIONS

Question 1

- (a) The government would implement an expansionary fiscal policy stance.
- (b) A significant implementation lag exists because Budget is handed down only once per year. A short impact time lag exists because changes to government revenue and expenditure in the Budget have an immediate impact on the economy.
- (c) Fiscal policy is a macroeconomic tool used to influence aggregate demand. When aggregate demand is low, the government may increase expenditure as a direct injection into the economy. It may also lower taxes, which stimulates consumption through increasing households' disposable income. Through the multiplier effect, these changes have a significant impact on aggregate demand which promotes economic growth.
- (d) Full employment occurs where cyclical unemployment is eliminated, also known as the natural rate of unemployment. As a macroeconomic policy, fiscal policy can stimulate aggregate demand through an expansionary stance. As labour is a derived demand, an increase in aggregate demand will reduce cyclical unemployment, moving the economy towards full employment. Accordingly, fiscal policy is an effective tool for achieving full employment.

Question 2

- (a) An implementation time lag refers to the time taken to execute a change in government policy, whereas an impact lag refers to the time taken for the policy to influence economy activity or achieve its objectives.
- (b) An answer to this question may include any one of the following :
- Monetary policy has an impact time lag of 6-18 months, meaning that the RBA must anticipate future economic conditions in determining current interest rates.
 - Monetary policy is a blunt instrument as it impacts on aggregate demand throughout the economy. It is ineffective in addressing economic activity within a particular firm or industry.
 - Monetary policy is effective in addressing short-term, cyclical economic issues through influencing aggregate demand, but it is ineffective in addressing long-term, structural issues.

- (c) High interest rates slows investment because it is more expensive for firms to borrow money. Consumption also slows because debt-servicing payments consume a greater proportion of households' disposable income. As a result of a decrease in these components of aggregate demand, economic growth will slow where interest rates are high.
- (d) Monetary policy is ineffective in achieving external stability. The RBA may increase the cash rate to slow a depreciation of the Australian dollar by attracting financial inflow. This policy may also be attractive because it slows aggregate demand, reducing demand for imports. However, while financial inflows slow a depreciation, they add to Australia's foreign liabilities and create servicing payments which worsen the net incomes component of the current account deficit.

Question 3

- (a) Deregulation is the removal of government controls over an industry and the exposure of firms to greater influence from domestic and global market forces.
- (b) An answer to this question may include one of the following:
- Microeconomic reform tends to incur short-term costs, such as an increase in structural unemployment due to structural change, whereas its benefits have a time lag of up to 20 years. Given the short length of an Australian political term, the government may face pressure to abandon its policy.
 - Due to the complexity and detail of microeconomic reform, it may take many years to complete the steps necessary to implement the policy. These steps may include a major government study, and negotiations with both state and federal governments.
- (c) Microeconomic reform may impose short-term costs on firms in order to increase their efficiency and maintain market share. This may involve investment in new technology or changes to the products they produce. Some firms will collapse due to inefficiency. Certain individuals suffer from structural unemployment in the short term, as changes to production render some skills irrelevant, decreasing their income and living standards. The government may suffer political unpopularity as the costs of microeconomic reform emerge.
- (d) Microeconomic reform aims to improve the productivity of resources so as to maximise output. An increase in productivity may be achieved through microeconomic reform policies that increase competition, such as the removal of tariffs to introduce foreign competition, creating a need for more efficient domestic production. Alternatively, microeconomic reform may create incentives to higher productivity, such as the use of productivity-based wage increases under labour market reform as an incentive to increase productivity. Microeconomic reform is therefore an important means to achieve productivity growth.