

The Objectives of Economic Policy

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Multiple Choice Answers

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

Short Answer Questions

Question 1

- a) The government could adopt expansionary macroeconomic policy in order to boost the level of aggregate demand and reduce cyclical unemployment. The government could also use labour market programmes to assist in the process of retraining the unemployed, reducing structural unemployment.
- b) In the short term, there is a conflict between demand-pull inflation and cyclical unemployment. If there is an increase in aggregate demand, firms will experience an increase in demand for their products, causing an increase in production. Firms will in turn demand more labour as an input into production, reducing cyclical unemployment. However, at the same time, if firms are unable to match the increase in aggregate demand, prices will increase causing demand-pull inflation. While unemployment may fall, inflation will rise.
- c) High inflation will cause an increase in Australia's current account deficit. High inflation in Australia relative to the rest of the world means that Australian prices are rising faster than prices overseas. This reduces the competitiveness of Australia's exports as exporters price themselves out of the global market, resulting in a fall in exports, a worsened balance of goods and services and a worsened current account balance. Also, high domestic inflation rates increase the price of domestic products relative to imports, increasing demand for imports and worsening the balance on goods and services and the current account balance. Also, high inflation rates tend to increase nominal rates of interest, which may increase Australia's servicing costs on foreign liabilities which are controlled by domestic interest rates. This will increase the net income account deficit, worsening the current account deficit.

Question 2

- a) Fiscal policy or Monetary policy
- b) The natural rate of unemployment refers to the level of unemployment which cannot be reduced by economic growth alone. It consists of structural, frictional and seasonal unemployment.
- c) Macroeconomic policy operates on the demand side of the economy, and so is only generally effective at influencing the level of cyclical unemployment. Macroeconomic policy is therefore only effective when there is a significant amount of cyclical unemployment in the economy, such as after a recession. However, if unemployment is close to or at the natural rate of unemployment, macroeconomic policy becomes ineffective because it is unable to address the structural causes behind the natural rate of unemployment. When the economy is at the natural rate of unemployment, if the government adopts expansionary macroeconomic policy, it will only lead to an increase in inflation without an increase in unemployment, because no matter how high the rate of economic growth, firms are unable to properly utilise labour which is structurally unemployed because the workers would lack the necessary job-related skills.
- d) Macroeconomic policy operates on an economy-wide scale to influence the level of aggregate demand. It generally operates in a counter-cyclical fashion, focusing on smoothing out fluctuations in the business cycle to achieve prolonged periods of economic growth with moderate inflation and low unemployment. It operates with a short to medium term output. There are only four possible macroeconomic policies – fiscal policy, monetary policy, prices and incomes policy and exchange rate policy. Microeconomic policy, on the other hand, operates on an industry specific basis to influence the level of aggregate supply. Microeconomic policy has a long term focus, addressing structural problems in the economy with the aim of improving the long run sustainable rate of economic growth. Microeconomic policy aims to increase aggregate supply by improving productivity, efficiency and international competitiveness of firms throughout the economy. Examples of microeconomic policy include National Competition Policy, public sector reforms and reductions in protection.

Question 3

- a) Microeconomic policies are targeted at individual industries and aim to improve the productivity, efficiency and international competitiveness to achieve structural change in the economy. They are long term in focus and operate on the supply side of the economy.
- b) Australia's balance of goods and services is affected by a narrow export base and low international competitiveness. Australia tends to export low value-added products and imports high value-added products, which tends to lead to a deficit on the balance on goods and services. The reason for this narrow export base is a lack of international competitiveness in high value-added exports. The balance on goods and services has also been affected by capacity constraints in recent years, which restrict the ability of firms to increase export volumes due to poor transport infrastructure and a lack of excess capacity at a firm level. The main structural cause of the net income deficit is the savings and investment gap. Australia tends to have a high level of investment, but a low level of domestic savings. As a result, firms must look to overseas finance in order to fund investment projects, which increases foreign liabilities and creates servicing costs, resulting in a net income deficit.
- c) Excessively high levels of economic growth can result in external instability. Australia's economic growth is primarily driven by consumption, which makes up 60 per cent of aggregate demand. Australia also tends to import a high proportion of finished consumer goods. Hence when economic growth is high, incomes are rising and consumers increase their consumption, some of which spills over to imports, worsening the balance on goods and services and worsening the current account deficit. In addition, Australian investment is heavily reliant on overseas financing due to a low level of national savings. When economic growth is high, businesses are more likely to undertake investment, which increases financial inflows. This raises foreign liabilities and increases servicing costs on the net income account, worsening the current account deficit. On the other hand, external instability can affect the level of economic growth. High levels of import consumption are a direct subtraction from aggregate demand, as more money is leaving the circular flow of income for overseas economies. This reduces economic growth. Similarly, a high level of foreign liabilities can make it more difficult for firms to obtain foreign loans, especially if overseas financial institutions see Australia as a more risky investment destination. This may reduce the level of investment in the long run. External instability can also cause instability in the exchange rate, which may affect the performance of Australia's exports, reducing economic growth.