

Effectiveness and Limitations of Economic Policy

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Multiple Choice Answers

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

Short Answer Questions

Question 1

- a) Expansionary.
- b) An implementation time lag refers to the amount of time involved between making decisions to vary or implement the policy. For example, monetary policy generally has a one month implementation time lag (with one board meeting per month). More generally, a time lag refers to the impact of a policy, which involves the time taken between the implementation of the policy and its full effect on the economy. Whilst fiscal policy can have a short impact lag (for example, tax cuts can come in almost instantly), microeconomic policy has the longest, at up to 20 years.
- c) Fiscal policy has an implementation time lag of up to a year, as the government budget is delivered annually in May. Also, the political process can sometimes delay the implementation of budgetary measures further. However, the government can sometimes implement emergency fiscal measures (for example, the *Nation Building and Jobs Plan* which was implemented midway through the fiscal year in response to the global financial crisis of 2008-09). The impact time lag can vary depending on the nature of the expenditure measure. Whilst welfare payments and tax cuts may be able to be implemented instantly, increasing aggregate demand; other measures, such as infrastructure spending, may take longer to have an impact upon aggregate demand.

- d)** Political constraints can operate in multiple ways to affect economic policy. First, political constraints can delay major policy initiatives due to the existence of a three year election cycle, which encourages governments to postpone unpopular policies until after an election. Also, the slow nature of the political process can sometimes lead to delays in implementing policies long after awareness of the need has passed: such as the policies to limit the effects of climate change worldwide. Secondly, the existence of close election cycles can prevent the government from implementing policies which are electorally unpopular. In particular, many microeconomic policies have short term adjustment costs such as structural unemployment or an increase in imports which may discourage a government from implementing them. Also, because the benefits are long term and unlikely to be realised during an election cycle, there is less political incentive to pursue microeconomic policies and their structural adjustment costs. Thirdly, governments often come under pressure from powerful interest groups who can use their lobbying power to alter government policies, or delay reforms. For example, lobby groups can increase negative public perceptions to microeconomic reforms such as reductions in protection in the agricultural industry. Fourthly, the Australian political system contains numerous limitations that can affect the ability of the government to implement policy. The senate can force the government to amend major policies (such as the GST exemption on fresh food) or reject them entirely (such as the privatisation of Telstra, which was rejected twice by the senate). Also, the federal structure of Australia's political system can sometimes lead to difficulties where the federal government lacks the constitutional power to implement national schemes: such as the attempted buyback of water licences in the Murray-Darling basin.

Question 2

- a)** 6-18 months.
- b)** Changes in monetary policy do not immediately impact upon the level of aggregate demand, but rather influence the decisions of firms and individuals within the economy and overseas. A change in the cash rate must first flow through to a change in interest rates generally. It may then take a significant amount of time for individuals to modify their spending decisions in response to a changed price of borrowing. Similarly, firms may take time to change their investment decisions. Finally, changes in interest rates can cause changes in the exchange rate which often do not immediately influence net exports because of the fact that the quantity of net exports is often fixed by contracts in the short term.
- c)** The political independence of the Reserve Bank of Australia allows it to make decisions on the implementation of macroeconomic policy free from the time distortions of the Australian electoral cycle: it is less likely that macroeconomic policy will become expansionary during election periods. Also, the Reserve Bank will be less concerned by the political ramifications of an economic decision to raise or lower interest rates.
- d)** As the world has become more globalised, international influences have become more of a constraint on macroeconomic policy. First, changes to macroeconomic policy can have unintended consequences for net exports as international investors react to the changes. For example, an increase in interest rates increases the interest differential between Australia and the rest of the world, which may cause an increase in financial inflows to Australia, causing an appreciation of the Australian dollar, and worsening net exports whilst decreasing the domestic price of imports, thus worsening the balance on goods and services. However, more importantly, macroeconomic policy has less room to move independently of global trends otherwise it risks losing investor confidence in the economy and a withdrawal of capital. For example, if the Australian economy were to use monetary financing (printing money) to fund its budget deficits, this would most likely cause global investors to lose confidence in the long term stability of their investments (eg, due to high inflation rates) and withdraw their capital. This would reduce investment levels as firms find it more difficult to access overseas financing for investment. This is more important now because of the large size of global financial flows, and the reliance of the Australian economy on overseas financing to make up for the low level of domestic savings. The government may also be constrained by international organisations, particularly the WTO which can impose constraints on government policy by imposing trade sanctions on protectionist policies which violate the World Trade Organisation treaty. Finally, changes in global macroeconomic policy can cause changes in the domestic economy without any change in domestic policy. For example, if global interest rates were to fall, that would widen the interest differential between Australia and the rest of the world, increasing capital inflows into Australia and causing an appreciation of the Australian dollar. This would have a contractionary impact on the Australian economy as exports become less internationally competitive, reducing exports and lower aggregate demand. Thus, without any changes to domestic policy, the stance of policy would shift towards being contractionary. Hence, there is more pressure on domestic policymakers to follow international policy stance trends in order to avoid unforeseen consequences to domestic policy.

Question 3

- a)** Deregulation is the removal of government controls over an industry which is intended to increase the role of market forces in an industry and increase efficiency, productivity and international competitiveness.
- b)** A reduction in the level of protection may be intended to improve Australia's external stability in the long run. However, in the short run, that economic objective may come into conflict with unemployment as import-competing firms exposed to greater levels of global competition are forced to restructure or close.
- c)** Microeconomic reforms aim to increase the level of aggregate supply by raising efficiency, productivity and international competitiveness. It involves a permanent restructuring of the patterns of production in the economy. The implementation of microeconomic policy will usually involve some structural adjustment costs as inefficient industries close. For example, when protection levels are reduced, inefficient import-competing industries are forced to close in the face of stronger competition. This can result in greater levels of imports and higher levels of structural unemployment in the short term. However, in the long term, the resources free up from the closure of inefficient firms will flow to efficient areas of the economy in which Australia has a comparative advantage, increasing exports and improving external stability. Another common short term consequence is a worsening of the distribution of income due to the increase in unemployment due to a decreased number of income earners in the economy.
- d)** Microeconomic reform aims to increase productivity in an economy. It can do so by changing the methods of production to increase the level of output without varying inputs. Labour market policy can increase productivity by changing the methods by which wages are set. If wage setting is decentralised, this means that firms and groups of individuals will be able to negotiate wage increases based upon the value that workers have added to the firm: in other words their increase in output. This means that there is a greater incentive for workers to increase their output in order to gain a wage increase. This means that productivity is likely to increase. Microeconomic reforms can also improve the efficiency of capital. Infrastructure policy aims to improve the technical efficiency of Australia's infrastructure. Improved transport infrastructure enables businesses (particularly in the mining sector) to increase output to the consumers by increasing export volumes, whilst the improved efficiency allows this to be done for a relatively lower price, improving productivity. More generally, policies which encourage an improvement in allocative efficiency, such as reductions to protection and public sector reform, aim to move resources away from inefficient sectors of the economy. This frees up resources for use in more efficient industries, which can achieve higher levels of output. This results in an increase in multi-factor productivity: the overall productivity level for the economy across all inputs to production.