

Effectiveness and Limitations of Economic Policy

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Multiple Choice

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

Short Answers

Question 1

- (a)** An implementation time lag refers to the time taken to implement a change in economic policy after a decision has been made. An impact time lag refers to the time between implementation and seeing the policy's full effect on the economy.
- (b)** Monetary policy has an impact time lag of around 6 to 18 months, as it takes time for cash rate changes to flow through and affect the rest of the economy. Changes in the cash rate will only affect aggregate demand after households change their consumption decisions and firms change their investment plans.
- (c)** The Reserve Bank uses a pre-emptive approach to address the medium-term impact lag from increasing or decreasing the cash rate. The RBA forecasts the inflation trend for the year ahead and decides on a monetary policy stance to target the predicted inflation rate in 6 to 18 months time, rather than the current inflation rate. The monetary policy objective in Australia aims to keep inflation within 2 to 3 per cent in the medium run, which also acts as an anchor for inflationary expectations.
- (d)** In a globalised world, changes in the conduct of monetary policy can have unintended consequences on the exchange rate. An increase in the cash rate for instance, will increase financial inflows, causing an appreciation of the Australian dollar. This will make exports less internationally competitive and also decrease the domestic price of imports, worsening the balance on goods and services. The interest rate differential with foreign economies may also have an impact on the conduct of monetary policy. Australia's position as a net capital importer means that the RBA must be mindful of setting a cash rate that provides an interest rate differential with the rest of the world in order to attract foreign capital inflow. Overall, Australia is more likely to move interest rates in cycles similar to those overseas, strengthening the international business cycle.

Question 2

- (a)** Fiscal policy can have an implementation time lag of up to one year, as the Federal Budget is delivered annually in May. Political processes can also further delay the implementation of government decisions, whether for the annual budget or throughout the year for proposed taxation or spending changes.
- (b)** Fiscal policy is generally considered less effective at targeting price stability compared with monetary policy because monetary policy affects the supply of money in the economy, which is a key influence on price pressures. Fiscal policy, through the budget's spending and revenue, affects aggregate demand, but it can be difficult to raise taxes or cut back spending before price pressures have emerged because of public resistance. Additionally, fiscal policy's effectiveness in targeting inflation may be limited by conflict with other objectives such as attempting to reduce unemployment.
- (c)** Political constraints can often delay major government initiatives due to the existence of a three year election cycle, which encourages governments to postpone unpopular policies until after an election. The slow nature of the political process can also lead to long delays in implementation. Together with pressure from powerful interest groups who use their lobbying power to alter government policies or delay reforms, governments often face slow progress in dealing with controversial issues such as climate change. The role of the Senate can also limit the government's ability to implement policies. Often the Senate will force the government to amend major policies (an example being the GST exemption on fresh food) or reject them entirely.

Question 3

- (a)** Microeconomic policies often involve short-term costs, such as structural unemployment arising from a reduction in protection levels as inefficient firms are forced to shut down. Since the benefits of microeconomic reform are often not realised until 10 or 20 years after implementation, governments are constrained by political pressures to make decisions benefiting households and firms in the immediate future.
- (b)** Labour market reform is a major area of microeconomic policy by recent governments. For example, the introduction of a new workplace relations system under the Fair Work Act in 2009. A second microeconomic policy is further reduction in tariff levels for the automotive and clothing industries from 1 January 2010.
- (c)** Microeconomic reforms aim to increase the efficiency of firms and industries by encouraging structural change across the economy. The reallocation of resources away from inefficient firms towards the most efficient areas of the economy will boost productivity growth in Australia. One reason for lower productivity growth in recent years, as shown in the graph, has been the implementation of fewer microeconomic reform policies.
- (d)** Microeconomic reforms are implemented to target structural issues in the economy. For example, labour market programs and trade liberalisation are both aimed at increasing productivity and efficiency in the long-run. In contrast, fiscal policy's primary role is in smoothing out the business cycle over the short to medium-run. Microeconomic reforms often involve short-term costs to the economy, such as structural unemployment from cuts to trade protection as inefficient firms are forced to shut down. While fiscal policy is primarily aimed at improving short-term economic conditions, microeconomic reform may actually worsen economic conditions in the short-term. Both fiscal policy and microeconomic reform face political pressures to deliver immediate benefits, rather than delivering short-term costs and benefits that will only be realised in the long-term.