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Q: Macroeconomic policies and impact on objectives

Note: Often fiscal and monetary policy are separate, but they might combine them into a macro question to explore the impact of the **'mix'** of these 2 policies. (given the recent ineffectiveness of monetary policy)

Note: For a macro policy mix + economic objectives question, split the body paragraphs into economic objectives. After intro, have 1 paragraph explaining fiscal policy. One paragraph explaining monetary.

Note: If assess/evaluate, make sure to include limitations (external factors, contradiction between fiscal and monetary)

Mixed introduction

- Monetary and fiscal policies are the main instruments used by the government for macromanagement and to achieve the economic objectives of sustainable economic growth, price stability, full employment and external balance.

Fiscal Policy

Introduction

- Fiscal policy is a countercyclical macroeconomic policy tool that involves the use of taxation and government expenditure to achieve economic objectives, allocate resources, and redistribute income.
- By altering the level of aggregate demand in the economy, the government can strive for price stability, full employment and a sustainable rate of growth. An expansionary fiscal stance (decreasing budget surplus or increasing budget deficit) should increase the level of AD in the economy whereas a contractionary fiscal stance (increasing budget surplus or decreasing deficit) should dampen the level of AD.
- However recently the effectiveness of fiscal policy has been hindered by external influences relating to economic conditions in the global economy.
- The recent budget deficit for 2019-20 is 0.5% of GDP and is forecasted to return to surplus by 2019-20 as the government embarks upon a process of fiscal consolidation to lower government debt. This indicates a mildly contractionary stance in the medium run.

Economic Growth

- The two major components of fiscal policy that affect the level of economic growth are automatic stabilisers and discretionary policies.

Automatic stabilisers

- **Automatic stabilisers** refer to the **progressive income tax system and transfer payments,** which are influenced solely by the level of economic activity and act countercyclically to moderate the level of growth.
- In a recession, income tax receipts decrease while spending on transfer payments (e.g. unemployment benefits) increase. This increases net government spending and AD.
- E.g. after the GFC in the 2008-09, income tax revenues decreased by 12% while unemployment transfer payments increased by 40%. This caused the budget to move from a **1.7% surplus to a 2.7%** deficit, reflecting an **expansionary stance**. The effects of this are represented below:
- **AD diagram and explanation**
- During the GFC, the **countercyclical** effects of automatic stabilisers helped Australia to avoid a **technical recession**, maintaining **1.8% growth** in 2009 despite the world economy contracting by 1.3%.
- Conversely, during a boom in the business cycle, individuals will move into higher income brackets while unemployment benefits will decrease, having a **contractionary** effect on economic activity.

Discretionary fiscal policy

- Discretionary fiscal policy refers to deliberate changes to the government's taxation and expenditure policies.
- Discretionary changes can contribute significantly to the economic performance of an economy, as seen in the GFC, when a sharply expansionary fiscal stance, including a $60b stimulus package, including cash payments to people on low incomes, infrastructure spending on highways and schools and subsidies for insulation and solar panels.
- This was responsible for the successive deficits of -2.7% of GDP in 2008-09 (budget) and -2.0% in the 2009-10 (budget)

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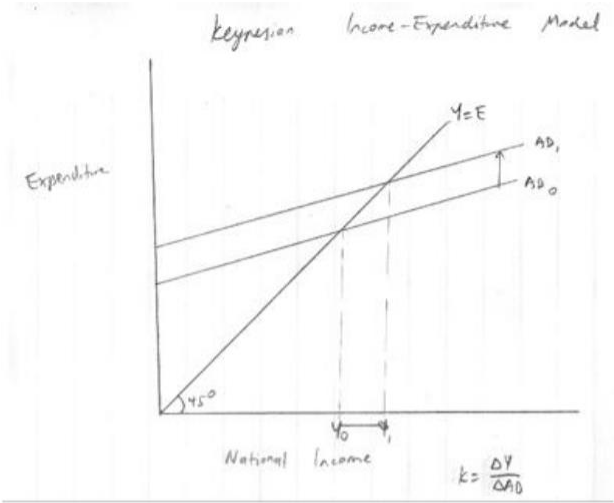
- The Productivity Commission estimates that the fiscal stimulus added 2% to GDP. The success of this policy may be explained by the multiplier effect, which is shown below:



- The increase in government expenditure leads to an initial increase in aggregate demand (AD0 to AD1).
- However, there is a larger increase to the final equilibrium level of national income (Y0 to Y1).
- The multiplier is given by k=dY/dAD. It is affected by the marginal propensity to consume: k=1/(1-MPC).
- **Explanation of multiplier effect:** This comes about because government expenditure can be spent again in the economy. (e.g. initial government spending on building materials for a road project is re-spent in the local economy by the building firm) resulting in a multiplied increase in consumption and investment.
- Thus, Australia returned to strong economic growth of 3% in 2010 while many major economies (USA, European Union) were in recession.
- **However** Strong growth in China underpinned Australia's ToT, exports and growth: reflective of how fiscal policy is strongly dependent on external factors during Australia's recovery.
- Therefore, discretionary fiscal policy was highly effective at increasing the level of economic activity due to the multiplier effect.

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Evaluation of current fiscal policy's effect on slowing down economic growth

- Since 2014, fiscal policy has had a mildly contractionary stance (lower deficits).
- This has come about largely due to discretionary changes:
    - A deficit levy of 2% for the $180,000+ income tax bracket (in effect from 2014-2016)
    - Indexation of the fuel excise to inflation (leading to an annual $1b increase in revenues)
    - Stricter requirements to get unemployment benefits (youth must be unemployed for 6 months before receiving them).
    - This contractionary stance decreases the level of aggregate demand, slowing down economic growth.
    - This is reflected in the slowdown in economic growth from 4.2% in 2012 to 3.3% in 2016.
- A lower level of economic growth decreases real incomes and material standards of living, and has caused unemployment to increase to 5.2% (2019)
- However, external factors have also contributed to slowdown: China's growth slowed to 6% from 10% due to lower ToT and exports.
- On the other hand, tax cuts for small businesses (2017-18 Budget 10 Year Enterprise Tax Plan to cut company taxes from 30% to 27.5% then to 25% by 2026-27) could increase investment (in non-mining sectors) + growth in medium run.
    - Scott Morrison in 2016 budget speech: "Australia's economic future depends on the transition from mining investment boom to a stronger, more diverse, new economy"
    - NEW SOURCES OF GROWTH IN THE FUTURE- ETM, services (70% of GDP but only 20% of exports)
- Fiscal consolidation can increase confidence + reduce servicing costs, thus increasing growth in the medium run
    - Morrison: The government aims to "balance the budget and reduce the burden of long-term debt"
- Contractionary fiscal policy is working against expansionary monetary policy (1.5% cash rate)
- Therefore, the current contractionary fiscal stance is ineffective at achieving the objective of economic growth.

Unemployment

- **Cyclical unemployment**
  - Cyclical unemployment is caused by changes in the level of aggregate demand in the economy. If AD falls, economic activity decreases and since the demand for labour is derived from the demand for goods and services, the demand for labour falls causing unemployment to increase.
  - Government can use counter-cyclical policies to prevent sharp spikes in the level of unemployment. E.g. Expansionary fiscal policy (increased discretionary spending + automatic stabilisers) can stimulate economic activity by increasing consumption and investment, having a multiplied impact across the economy.
  - **Monetary** policy can also be used. Lowering the cash rate can affect the term structure of interest rates across the economy, reducing the cost of credit. This is affect the spending and investment decisions of households and firms.
  - Expansionary fiscal and monetary policy will bring down unemployment in the short term e.g. During the GFC (fiscal stimulus of $60 bn spent on infrastructure, education, solar panels subsidies, insulation for housing, cash payments for low income earners). At the same time the cash rate was cut from 7.25% to 3.25%, stimulating economic activity.
  - The impact reflected as Australia achieved 1.8% growth domestically whereas world growth contracted by 1.3%
  - Moreover, Australia's unemployment only increased from 4% to 5.9% whereas it was forecasted to increase to 10%. Unemployment fell back to 4.9%
  - Recently in 2019: Gov has spent $10.2bn in unemployment benefits which has contributed to increasing AD.
- **Structural unemployment**
  - **However expansionary and fiscal policy can only decrease unemployment to a certain level before inflationary pressures start to increase**
  - This rate of unemployment is known as the NAIRU (non accelerating inflation rate of unemployment). Attempts to reduce unemployment before this rate will

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lead to sharp spikes in inflation levels as firms compete for existing workers bidding up prices.

- NAIRU or Full employment (which comprises of structural, frictional, youth and long term) can be targeted by microeconomic policies
- **Structural: Educational and vocational training programs to improve** labour mobility e.g. 155 million dollar growth fund to retrain automotive workers after the closure of the automotive industry by 2017 which will cause over 50 000 job losses.
- **Frictional: Making it easier to match unemployed with job vacancies through government services such as job search.** Job Services Australia- federally funded network of employment agencies that provides assistance to job seekers.
- **Long term: Tightening eligibility requirements for welfare payments. E.g. Work for the Dole Scheme.** Unemployed have to demonstrate that they are contributing at least 23 hours a week to searching for a job or developing employable skills before they can receive unemployment benefits.
    - **Wage subsidies:** Encourage employers by providing them a financial incentive to hire job seekers e.g. old people.
- **Youth unemployment: Education/Training or even the Prepare Trial hire (Path) program.** Provides unemployed youth (17% unemployment rate) with experience and skills. Prevents long-term and structural unemployment among youth.
- **Labour market policies:**
    - **Define:** Decentralisation of the labour market as it moves away from a centralised wage determination system to flexible individual agreements at a firm or enterprise level.
    - **Effect:** This has resulted in a flexible labour market which can easily cope with external economic shocks and structural changes
    - Enabled employers to cut hours and reduce wage growth instead of retrenching workers.
    - **Philip Lowe quote "flexibility of price of labour".**

Inflation

- Inflation refers to the general increase in the price level over time.
- **Fiscal:** 1. Increase leakages to reduce AD and lower demand pull inflationary pressures. Limited as short term.
- **Inflation is an issue requiring a policy mix due to the limited ability of fiscal policy to directly target inflation**
    - **Mainly done through the conduct of monetary policy** which involves the RBA conducting domestic market operations to influence the cash rate (the interest rate on the overnight money market)
    - The establishment of a 2-3% inflation target acts as an 'anchor point' for inflationary expectations. This affects inflation itself because inflationary expectations are a major cause of inflation.
    - Altering the cash rate will lead to changes in the term structure of commercial interest rates across the economy through the **Transmission mechanism. This will impact upon the consumption and investment decisions of consumers and households, influencing thus AD.**
    - AD diagram and explanation with reference to price level.
    - E.g. During 2010-12 mining boom. The economy experienced strong levels of economic growth 4.2% but subsequent cash rate increases 3.25% to 4.75% helped contain inflationary pressures below 3%.
    - Currently, the expansionary monetary policy (1.5% cash rate) is aimed at increasing inflation (1.3% to back to the target band), but appears to be ineffective in the short run, given the long impact time lag of 6-18 months.
    - **External factors:** Low global inflation (thus, lower imported inflation in intermediate goods)+ low oil prices (oil is used as a FoP in transport, manufacturing, plastics) have contributed to the lower headline (1.6%) inflation thus limiting the effectiveness of macroeconomic policies in boosting inflation back to 2-3%. In August RBA statement: "Extremely low cost pressures worldwide have contributed to the decision to cut" --referring low imported inflation.

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Distribution of income

- Fiscal policy plays a significant impact on influencing the distribution of income in the economy
- **Progressive income taxation system + Transfer payments** redistribute incomes from higher income earners (who pay more tax to create a revenue base) to lower income earners (e.g. unemployment benefits, disability benefits, pensions, family childcare subsidies which are means tested)
- **Discretionary Changes in taxation**
    - To improve income inequality, the government can reduce the amount of tax paid by low income earners. E.g. in 2012-13 (tax free threshold)
    - Reduction in marginal tax rates for high income earners will result in increased income inequality. (e.g. 2015-16, 37% marginal income tax bracket shifted from $80k to $87k benefitting the top 25% of income earners.)
    - Federal Budget 19-20: An increase in the low- and middle-income tax offset from $530 to $1080.
- **Effectiveness is hindered by**
    - **Regressive consumption/excise tax** e.g. the 10% GST and the tobacco excise tax which is expected to increase by 50% over the next 4 years. These taxes primarily impact low income earners, taxing a higher proportion of their income.
    - **Tax concessions** for high income earners and company tax cuts which increase the taxation burden on low income earners. E.g. negative gearing, capital gains tax discount, superannuation concessions.
- **Provision of civic amenities** such as healthcare, education, transport provide a greater proportional benefit for low income earners.
- **Superannuation policies**
    - Superannuation policies are intended to improve the distribution of wealth in the economy.
    - The government's policy of compulsory superannuation of 9.5% paid by employees has improved the distribution of wealth in the economy as superannuation comprises a significant proportion of the financial assets owned by low income earners.

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- Policy to increase superannuation to 12% by 2025 will seek to further improve wealth inequality.
- The recent 2019-20 budget also proposed measures to improve wealth inequality by reducing the level of superannuation tax concessions given to higher income earners. Including a cap of 25K a year from 30K a year for contributions to superannuation (which are taxed at 15%) and a lifetime cap of 0.5 million. This will work in tandem with the Low Income Superannuation tax offset (providing a 500$ rebate for low income earners) to make in the distribution of income "less unfair")

- **Labour Market Policies/ Reform**
  - The Fair Work Act 2009 helped facilitate the movement away from a centralised wage system to enterprise bargaining, however it included measures to improve income inequality.
  - Minimum wage $17.70 /hr, establishment of NES (sick leave, right to have flexible hours) and a system of modern awards
  - Limitations: Decentralisation has resulted in increased wage dispersion between and within industries as higher skilled workers can bargain for increased wages.

<u>External Stability</u>

- **Crowding Out Effect**
  - The crowding out effect occurs when government deficits are financed through borrowing from the private sector, placing upwards pressure on interest rates and crowds out private sector investors who cannot borrow at the higher interest rates. This forces private investors to go overseas to borrow.
  - The budget has been in deficit since 2008-09, contributing to the crowding out effect and increases in the CAD.
  - Therefore, government debt = 45% of GDP (tripled since 2008) however still low compared to OECD average (80%)
- **Twin deficits theorem**
  - The twin deficits theorem states that the CAD is a result of government deficits and the level of Public Sector Underlying Debt (PSUD)
  - S+T+M=I+G+X -> (M-X)=(I-S) + (G-T)
  - (Current account deficit) = (Private Savings-investment gap) + (Budget deficit)

- Therefore the current government's medium term fiscal strategy towards fiscal consolidation is consistent with reducing the size of future CADs.
- Fiscal consolidation is the aim of the government to reduce the structural deficit by cutting expenditure and raising taxes.
- **Extra Info:**
  - Historically, CAD has fluctuated between 3-6% of GDP in the last 10 years, currently at 0.2% surplus.
  - Effects of CAD: confidence (capital flight ->sudden depreciation/slowdown in foreign investment inflows), debt trap (need to borrow just to pay back servicing costs on 60% GDP net foreign debt), credit ratings (AAA jeopardised -> higher interest rates)

- **Effectiveness: Pitchford thesis** (75% of net foreign debt is the private sector and is a result of rational decisions made by consenting adults and therefore the government should not be concerned)
- Changes in the Australian Dollar / Trade Weighted Index – (RBA dirtying the float, Indirect monetary policy e.g. during the GFC, RBA bought $3.3bn AUD to curb the sharp depreciation. Afterwards interest rates were increased to stop inflationary pressures during Australia's recovery period. This contributed to the appreciation of the AUD).
- Terms of Trade, changes in commodity prices –
- **International competitiveness** – (Government refusing to extend protection for inefficient domestic industries like the automotive industry. This has resulted in Ford, Holden and Toyota closing down operations in Australia by 2017.)
- **Composition of Australia's Trade** - (**Free trade agreements** improve allocative, technical and dynamic efficiency. E.g. China (96% tariffs remove on all goods and services. This will enable Australia to tap into China's expanding middle class consumer market which is estimated to be worth around $600 billion. This represents a shift away from the importance of mining exports to other export industries such as agriculture (milk, beef), services (tourism, finance, education) and ETMs). Could improve trade balance in long run, diversified export base provides insulation from external shocks. Diversification
- Also, global interest rates are low (servicing costs remain low) hence CAD and external stability is not a large focus

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Policies

- Company tax cuts aim to increase IC of domestic firms
    - 10 Year Enterprise Tax Plan: Company tax cut from 30% to 27.5% for small businesses, will be gradually cut to 25% for all businesses across the board by 2026.
    - Reduce costs for Aust. firms
    - 2019-20 Budget: $25k instant asset write off increase to $30k
    - Allow exporting firms to expand + invest
- Thus improving net exports.

External factors:

- CAD growth has been suppressed by lower global interest rates which has reduced the size of interest repayments
- However, trade deficit has increased due to falling commodities prices and lower terms of trade (81 index pts) from 118 (2011)

Monetary Policy

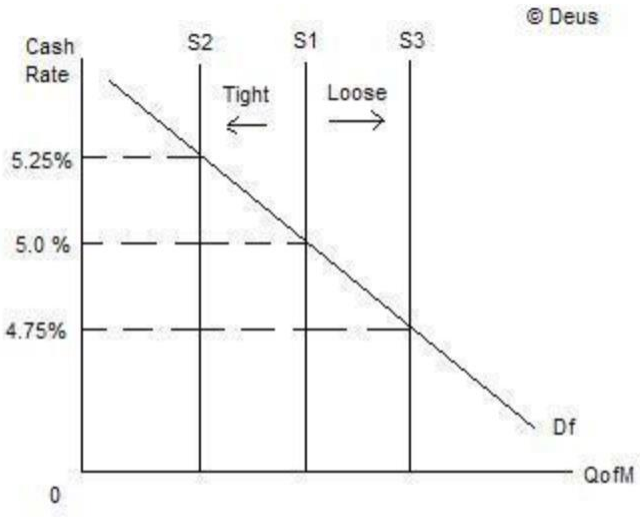
Introduction

- Monetary policy influences the cost and availability of money and credit in the economy, which in turn affects inflation, employment and economic growth.
- It is conducted by the RBA through its manipulation of the cash rate in Domestic Market Operations.
- The primary aim of monetary policy is to maintain price stability: The RBA has a 2-3% CPI inflation target over the business cycle (inflation targeting since 1993). Other objectives include maintaining full employment and achieving sustainable economic growth.

Implementation

- **Firstly, the establishment of a credible inflation target (2-3%) acts as an anchor for inflationary expectations.**
    - This prevents the wage price spiral: If low inflation is expected by workers, they will not need to demand significant wage increases. Firms also expect steady prices for inputs (including labour) so they keep the price of goods and services constant.

- To change interest rates, the RBA first changes the cash rate in the Overnight Money market, by conducting Domestic Market Operations.
- If the RBA wishes to loosen monetary policy (expansionary), they will lower cash rate by purchasing second-hand Commonwealth Government Securities from banks, depositing funds in the bank's Exchange Settlement accounts in return.
- This increases the supply of funds in the OMM (S3), decreasing the cost of borrowing (cash rate)



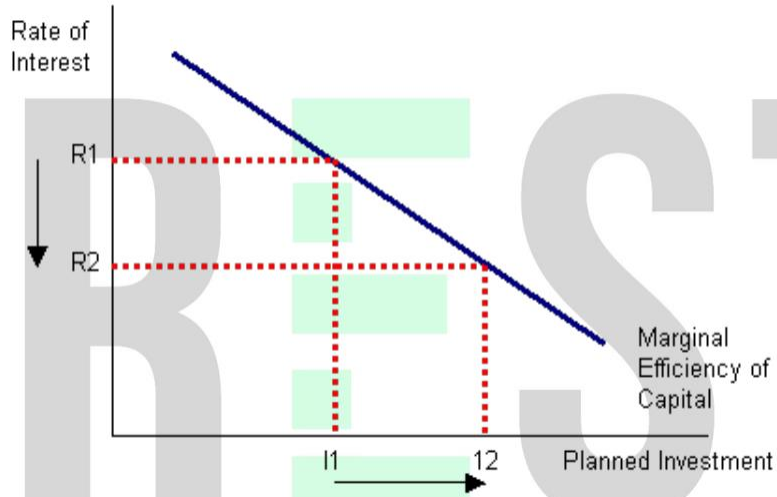
- To tighten monetary policy (contractionary), the RBA sells CGS to banks, decreasing the supply of funds in the OMM (S2), increasing the cash rate.
- If the cash rate was lowered, banks and financial institutions incur a cost saving when they borrow from the OMM, and competition between banks forces them to pass this on through lower **commercial** interest rates on home loans, credit cards, personal loans, commercial loans.
- Tightening monetary policy (contractionary): the RBA sells CGS, decreasing the supply of money in ESAs, increasing the cash rate, increasing interest rates.

Theory/Impacts

- Inter-temporal substitution effect
  - The rate of interest is the cost of spending now rather than later
  - By changing the cash rate and term structure of interest rates across the economy, the RBA can affect the spending decisions done by households and businesses. E.g.

lower interest rates **bring forward spending** (e.g. on **consumer durables**) whilst higher interest rates defer spending. Affecting spending can influence an economy's AD (consumption).

- Marginal Efficiency of Capital extension
    - **Businesses are encouraged to borrow for investing in capital and expanding, adding to the investment component of AD**. (Marginal Efficiency of Capital extends)
    - E.g. An investment project yielding 3% returns would not be profitable at 3.5% interest rates, but would be undertaken at 2.5% interest.
    -



- Cash flow effect
    - A lower cash rate will increase the cash flow and disposable incomes of households and firms.
    - Average household debt is 150% of total assets. Hence altering the cash rate can **decrease the size of interest repayments, freeing up more money for consumption and investmen**t by households and firms
- Exchange rate
    - Decrease the cash rate will decrease interest rates relative to the world which could cause capital flight
    - This increases supply of AUD, putting downwards pressure on the exchange rate.
    - An **depreciation will make our export sectors more competitive and imports dearer,** thus increasing the growth of both import and export competing industries.

- The result is a higher growth in AD
- **Unintended effect of monetary policy**

- The effect of changes in interest rates on the macroeconomy occur through the transmission mechanism
  - Thus, AD increases, economic growth increases, inflation increases (diagram)
    - Increase in GDP from Y0 to Y1 also represents an increase in employment as the demand for labour is derived from the demand for G and S.

Effectiveness of monetary policy:

- Successes:
- The use of a credible inflation target by the RBA since 1993 has been highly successful in containing inflationary expectations and maintaining price stability.
- The goal of maintaining inflation within the target band of 2-3% over the business cycle has been achieved, as the **average inflation rate since 1993 was 2.6%.**
  - Before the use of inflation targeting, Australia was a high-inflation country, **experiencing consistent 6-10% annual inflation in the 1980s**. The successful inflation targeting **ensures foreign investor confidence will remain high.** (external stability)
- Monetary policy has shorter implementation lag than fiscal policy. The RBA is independent and no legislation is required.
- Limitations
  - Due to the long and variable time lag (6-18 months) before the **full impact of** interest rate changes are felt in the economy, the RBA needs to consider the projected economic conditions in the future to set monetary policy. (pre-emptive)
    - The lag exists because consumers and businesses do not change their spending and borrowing behaviour immediately. This is seen currently, when a historic low 0.5% cash rate has not yet increased inflation significantly (currently 1.6%)
  - Economic conditions could also change during the lag period, making monetary policy inappropriate. (e.g. RBA might be still stimulating the economy when dampening is required)

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- **Monetary policy is a "blunt instrument", unable to target individual parts of the economy.** E.g. Discretionary fiscal policy was targeted at low income families in the 2008-09 stimulus packages to have the highest multiplier effect on GDP growth. This couldn't be done with monetary policy.
    - Also during the recovery period 2010-2012, the RBA increased IR from 3.25% to 4.75% however this had a negative impact on non-mining sectors due to the 2 speed nature of the Australian economy.
- There must be some **coordination** between monetary and fiscal policy for either to be effective. This may not be possible due to political constraints in fiscal policy formulation and different economic priorities between the **RBA (inflation) and government (fiscal consolidation)**. E.g. 2019-20 budget is mildly contractionary while monetary policy is expansionary. Accordingly, Australia's inflation (1.6%) and unemployment (5.6%) are too low and too high respectively.
- **Monetary policy is more effective at decreasing economic activity than increasing it.** This is because there is no upper bound for the cash rate, but there is a zero lower bound. (real interest rates will not fall below 0 as banks would be paying people to lend money)
- **Not all changes in the cash rate are passed on to interest rates in financial markets**. For example, the cash rate can decrease by 0.25% but banks will only drop market interest rates due to 0.1% to account for risk and increase profit margins.
- The **liquidity trap is a problem at low interest rates, where further decreases in interest rates fail to encourage more consumption**. This may occur in a recession where people save as a precaution, regardless of the interest rate.

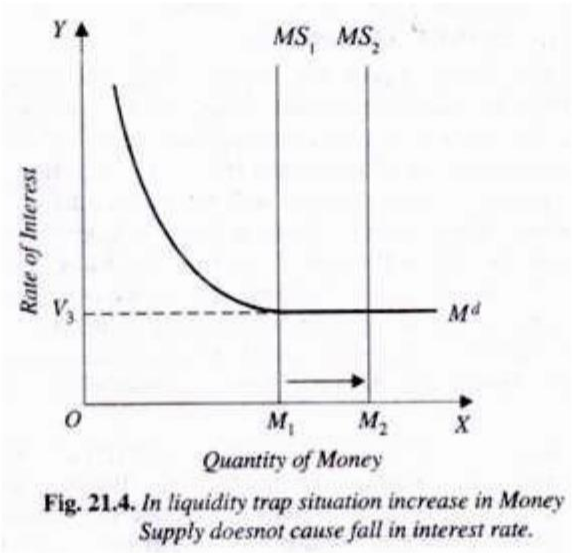

Fig. 21.4. *In liquidity trap situation increase in Money Supply doesnot cause fall in interest rate.*

- At low interest rates, banks gain so little marginal benefit from lending money out that they would rather keep it, causing perfect elasticity of interest rates with respect to changes in the quantity of money.
- This is advanced: Only use this diagram if it's a monetary-only essay

- <u>History of Monetary Policy (with evaluations)</u>
- 2002-Mid 2008: Contractionary to deal with the inflationary consequences of strong growth (mining boom Mark 1)
  - **Inflation was over 3% for half of this period and reached 5% in 2008 --not successful at containing inflation in the medium ru**n
  - However, goal of 2-3% over long-term business cycle successful.
- 2008-09: Expansionary (7.25% to 3%) due to GFC
  - Successful: unemployment remained below 6% despite projections of 10%, recession avoided (1.3% growth in 2009), inflation within 2-3% range.
  - Fiscal stimulus also contributed greatly
  - External factors (China) also contributed to Australia's recovery (growth in trade)
- 2009-2011: Contractionary due to mining-led growth (up to 4.75% in 2011)
  - Successfully contained inflation below 3% despite above trend growth of 4.2%
- 2011-2016: Expansionary due to slowdown in China (1.5% in 2016)
  - Appears ineffective in medium run, given contradiction to fiscal stance.
  - Unemployment remains high (5.7%), inflation remains low (1.3%)

- 2016- Present : Expansionary at 0.5% to further support economic growth and investment at the end of the mining boom. Stimulate falling levels of consumption.
    - Fuelled the housing boom and increased investment in construction sector but has led to unprecedented levels of debt and leverage in the economy.
- Evaluation/conclusion: However, monetary policy has been effective in the long term, because its goal of maintaining an inflation rate of 2-3% over the business cycle has been achieved since the establishment of the inflation target in 1993. The average inflation rate has been 2.6% from 1993-2016.

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