

**Economic Fundamentals in Australia**  
**MacGregor and Salla**  
**Sample responses to questions contained in**  
**Activity Centre: Unit 4 Outcome 1**

**Question 1**

- a. *Since 2014-15 the budget outcome has improved (i.e. decreased), from a deficit of \$37.9B in 2014-15 to an estimated deficit of \$26.1B in 2017-18. The target cash rate has also fallen over the same time period from (approx) 2.5% in 2014-15 to 1.5% in 2016-17.*
- b. *Monetary policy has become more expansionary (or accommodative). This is evidenced by the target cash rate being reduced on three occasions since then by combined 100 basis points, with the TCR falling from an expansionary 2.5% in January 2015 to very expansionary 1.5% by late 2016.*
- c. *The government's medium-term fiscal strategy is to achieve budget surplus on average over the course of the economic cycle. This requires the government to reduce the deficit as the economy recovers, and eventually return the budget to surplus when economic growth is at or above trend. The government's budget deficit is estimated to fall from \$39.9 billion in 2015-16 to \$26.1 billion by 2017-18 and then projected to fall to \$5.9 billion by 2019-20. This steady fall in the budget deficit is indeed consistent with the government's medium-term fiscal strategy and if the trend continues should see the budget returned to surplus shortly thereafter.[The government expects the budget to reach a surplus position by 2020-21].*
- d. *The easing of monetary policy that took place in May and August of 2016 resulted in lower interest rates. This encouraged capital outflow and/or discourage capital inflow as Australian interest rates were relatively lower (ceteris paribus) than those rates being offered overseas. As fewer funds enter the country [i.e. Australians borrow less from overseas] and more funds exit the country [i.e. foreigners borrow more from Australia], the net demand for Australian dollars on the foreign exchange market will fall, which reduces the price or value of the dollar. This increases the international competitiveness of Australian goods and services in the global marketplace which increases net export demand (i.e. X minus M) and therefore stimulates aggregate demand in the economy.*
- e. *The federal government has continued to pursue fiscal consolidation, evidenced by the smaller budget deficit for 2016-17 in line with its medium term fiscal strategy to achieve budget surpluses on average over the course of the economic cycle. By attempting to limit growth in government spending and increasing government revenue, the budget is attempting to ensure that the government's budget position is sustainable into the future. While this can have a (mildly) contractionary impact on economic growth in the short term, it does help to ensure that economic and employment growth rates are more sustainable into the future.[However, the pace of 'budget repair' slowed somewhat in recent budgets following further signs of deterioration in the economy (e.g. the effects of plummeting commodity prices). This has involved specific tax and revenue measures (such as the 'jobs and small business package' and the 'enterprise tax plan') that were designed to support RBA efforts at expanding the economy.]Specific measures introduced in the most recent two budgets have also been designed to promote employment and further reduce the unemployment rate. For example, the youth employment package announced in the 2016-17 budget involves the provision of skills training, internships, and employer wage subsidies. The government claims that this will help to secure jobs for up to 120,000 young persons and help to reduce (youth) unemployment over time.*

## Question 2

- a) *Budgetary policy refers to the government's use of its Budget to achieve specified outcomes in the country, where the Budget is the major fiscal document released each May, outlining information for the next financial year plus the following three years. It contains details of all income (or revenue) and expenditure (outlays) of the federal government. Budgetary policy is, therefore, the manipulation of federal government receipts and outlays in order to assist in the achievement of its economic and social objectives for Australia, such as full employment or greater equity in the distribution of income. As with all policies, the overriding goal is to improve the welfare or living standards of all Australians, or to achieve the most efficient allocation of the nation's resources.*
- b) *Monetary policy is a policy operated by the RBA on behalf of the government designed to manipulate key financial variables in the economy (primarily interest rates) in order to increase welfare and prosperity (living standards) for all Australians. However, monetary policy has a clearly defined medium term objective to achieve low inflation (growth in the CPI of between 2 and 3 per cent, on average, over the course of the economic cycle) because it is recognised as the key to achieving strong and sustainable economic growth and full employment in the longer term. Once low inflation is achieved, the RBA will often directly focus on economic growth and full employment. Accordingly, low inflation helps to promote material living standards in the long term.*
- c) *The structural component of the budget refers to the change in the Budget outcome that reflects a deliberate attempt (i.e. an actual policy decision) to use the Budget to change the allocation of resources or assist with the achievement of its economic or social goals. In this respect, the actual 'structure' of the Budget is deliberately altered by the government. This is sometimes referred to as discretionary stabilisers. The cyclical component of the Budget, on the other hand, refers to that part of the Budget (outcome) that changes in line with the economic cycle, with the surplus falling during downturns and increasing during upturns. This occurs without any discretionary action by the government and is sometimes referred to as automatic stabilisers.*

*During an economic downturn or recession (two quarters of negative growth), the government will tend to change the composition of the budget (i.e. discretionary stabilisers) to ensure the budget provides a net stimulus to the economy. It will, for example, tend to offer tax cuts or tax concessions (such as the recent increase in the Low Income Tax offset) and increase government expenditure (such as expenditure within the \$42B fiscal stimulus package released in early 2009). These factors will work to push the budget towards a (bigger) deficit and budgetary policy becomes more 'expansionary.'*

*In addition, an economic downturn should automatically increase the budget deficit as receipts from taxation (primarily individual and company taxes) fall and the payments for government services or transfer payments (such as unemployment benefits) increase. This helps to act as a 'cushion' for the economy, as lower average taxes paid for those workers on variable incomes (e.g. self-employed persons, casual workers, etc) prevents a larger fall in disposable incomes, and those who would otherwise receive no income (such as the newly unemployed) are given some income support to sustain spending.*

*As a consequence, the cyclical and structural expansion within the budget helps to support levels of Consumption, Investment and Government expenditure, which raises levels of AD and real GDP above the levels that would otherwise have occurred.*

- d) *An increase in the budget deficit (decreasing revenue relative to expenditure) will typically represent a more expansionary budget because the government is injecting more (net) funds into the economy, which lifts the overall level of AD and real GDP. However, it does not necessarily mean that the government is delivering a more expansionary budgetary policy stance. This ultimately depends upon the reasons for the higher deficit. If it occurred purely for cyclical reasons (i.e. as a result of automatic stabilisers), then a bigger deficit can actually be contractionary if the government increased tax rates and reduced government spending over the same period. For example, it is possible for weaker economic growth to result in automatic decrease in tax revenue and an automatic increase in welfare expenditure, such that the deficit increases by \$20B. However, the government could theoretically reduce some government expenditure (or increase some tax rates), resulting in the overall increase in*

*the deficit being less than \$20B. Overall, the deficit increased, but the structural component of the deficit actually decreased, resulting in a more contractionary stance of budgetary policy.*

- e) *A weakening global economy is likely to impact negatively on the Australian economy as it causes the budget outcome to deteriorate for both cyclical and structural reasons and leads to a more expansionary budgetary policy. As growth overseas declines, it results in fewer export sales for Australia, reduces global financial flows and damages consumer and business confidence. As AD and real GDP decline, the budget moves automatically towards a deficit as tax revenue falls and welfare payments increase. To protect the Australian economy from the negative effects of slower growth, the government is likely to implement discretionary stabilisers, such as tax breaks and higher levels of G2. The combined impact of these automatic and discretionary stabilisers will make budgetary policy more expansionary via a larger budget deficit.*

### Question 3

- a. *Public debt refers to the total stock of debt (money owed to another party as a result of borrowing in the past) held by Australian governments whereas private debt relates to the debt held by non-government entities, such as households and businesses.*
- b. *A budget deficit occurs when government expenditure exceeds government receipts. It means that the government will typically need to borrow money in order to fund the shortfall (or deficit), which it does via the issue of government securities, such as Treasury bonds. This will increase the value of government securities held in the market place (by Australians and/or foreigners) which means that the stock/value of government or public debt will necessarily be higher than before.*
- c. *Macroeconomic settings refer to how the government has decided to position or set both monetary and budgetary policy, with the general settings being characterised as either expansionary or contractionary/restrictive. Better economic conditions are likely to result in policy makers deciding to make the policies more contractionary and/or less expansionary. In the case of budgetary policy, the signs of a stronger economy embolden the government to continue with its pursuit of fiscal consolidation/budget repair, which is consistent with its medium term strategy to achieve budget surplus on average over time. In other words, the stronger economy means that the government does not need to further delay deficit reduction which otherwise might have been required to support growth. In this respect, budgetary policy is likely to become contractionary. Similarly, despite the RBA further easing of monetary policy in May 2016, it is possible that the RBA Board may consider an additional loosening (or a bigger than 25 basis point reduction in the target cash rate) were it not for the signs of a stronger economy. In other words, the RBA may feel that the economy does not require further support of growth and jobs. In this respect, the stronger economy may result in monetary policy becoming less expansionary than otherwise would be the case.*

- d. *Fiscal (budgetary) policy is eased by the (federal) government deciding to increase government expenditure relative to government receipts, thereby raising the budget deficit (or reducing any surplus) in an effort to stimulate (or expand) aggregate demand (AD) and economic growth. Monetary policy is eased by the RBA deciding to reduce the target cash rate, which then flows through to lower the general structure of interest rates, and is intended to stimulate AD and economic growth over time.*
- e. *The monetary policy easing in May 2016, evidenced by a reduction in the target cash rate from 2.00% to 1.75%, is likely to be less effective because the rising indebtedness of households increases their willingness to de-leverage (i.e. pay off debts quicker) rather than spend on goods and services. This means that households are generally less sensitive to interest rate reductions and are choosing to use any increase in their cash flow to repay debts rather than increase spending. In addition, they are choosing not to further increase their indebtedness despite record low interest rates. Accordingly, the RBA needs to reduce interest rates by much more today, compared to the past, if it wishes to stimulate AD.*
- f. *The RBA would most likely tighten monetary policy if the rate of economic growth and inflation increased significantly over 2016-17, with inflation moving beyond the target range of 2-3%. This would represent an attempt by the RBA to reduce demand inflationary pressures and bring the rate of headline inflation down below 3%. A restrictive monetary policy stance is one where the general level of interest rates in the economy is high enough to be restraining growth (or reducing growth in AD). [Currently, a restrictive setting occurs when the target cash rate (TCR) is higher than approximately 3.5% (monetary policy neutrality)]. A tightening of monetary policy will therefore not necessarily mean that monetary policy becomes restrictive unless the TCR increases to a high enough level such that interest rates will be restraining the economy. For example, if the RBA increased the TCR from 1.75% to 2.00%, it results in less expansionary stance, but not a restrictive one.*
- g. *A cyclical deterioration in the budget outcome means that the budget deficit automatically gets bigger [or the surplus smaller] as a result of a downturn in the economy. [This is the same as saying that automatic stabilisers will cause the budget outcome to deteriorate.] As economic growth falls to low levels, or even becomes negative, this results in less government revenue because national incomes fall (e.g. profits are lower and less income is earned by workers), which negatively impacts on the tax revenue/receipts of the government. In addition, government expenditure automatically increases because employment falls (unemployment increases) and more income/welfare support is paid to those in need. These automatic increases in expenditure and decreases in revenue result in the budget deficit growing [or the budget surplus falling] which is evidence of a deteriorating budget outcome for the government.*

**Question 4**

- a. *A reduction in the rates of personal income tax is likely to increase the participation rate and reduce the unemployment rate over time.*
- *Once taxes are cut, it tends to encourage people to (re)enter the labour market seeking employment because the net returns from working are now relatively higher. This causes the number of people looking for work to increase, swelling the number of unemployed in the short term and boosting the participation rate.*
  - *Over time, the higher unemployment level and participation rate tends to place downward pressure on the real wage (or costs of labour) because there is more competition for jobs. The more competitive real wage should increase the demand for labour by businesses, increase employment and reduce unemployment. This is supported by the demand side effect of tax cuts, where higher disposable income will tend to boost consumption, AD, real GDP, demand for labour and employment.*
- b. *If the RBA decides to increase the target cash rate (e.g. from 2.5% to 2.75%) it will immediately increase the rate paid (or charged) on surplus (or deficit) ESA balances by the same magnitude (e.g. the rate paid on ESA surplus balances increases from 2.25% to 2.5%). It will then intervene in the cash market via OMOs to ensure that at the start of each day, the actual cash rate is as close as possible to the new higher target cash rate. Theoretically, this will involve the RBA acting swiftly to reduce liquidity in the cash market (via the selling of CGS or repos) in order to increase the cash rate towards the new target level. In reality, the market will automatically adjust without this RBA intervention because the mere expectation that the RBA will act to move the cash rate to its new target is enough for this to happen immediately. Accordingly, following a tightening of monetary policy, the RBA will simply need to focus once more on narrowing or eliminating the gap between the actual cash and the new target cash rate.*
- c. *The further increase on excise is designed primarily to improve Australian (non-material) living standards. However, it will tend to result in a less equal distribution of (final) income. With respect to living standards, the increased excise will raise the price of cigarettes and cause the consumption of cigarettes to fall. Over time, this should help to improve health outcomes and quality of life for Australians as fewer people will be exposed to illnesses that are related to cigarette consumption (e.g. lung cancer/emphysema) leading to improvements in non-material living standards. [One could also mount the argument that less cigarette smoking will improve national productivity as people on average are healthier and better able to contribute to production.]*

**Question 5**

- a) *An expansionary monetary policy setting is one where the current level of the target cash rate (or interest rates more generally) is at a low enough level to be stimulating economic activity. An expansionary budgetary policy setting is one where the recent budget delivered by the government has involved discretionary (or structural) changes to outlays or receipts that have a net stimulating impact on the economy.*
- b) *During a downturn, the budget outcome is likely to move from surplus to deficit for a combination of cyclical and structural reasons. First, the government is likely to implement structural (discretionary) measures designed to prevent Australia from entering a recession. This can involve tax rates being reduced and the introduction of new or increased government spending programs, both working to erode the surplus and create a deficit. Second, a large downturn in economic activity results in the cyclical (or automatic) component of the Budget moving into deficit as revenues fell (e.g. income and company taxes) in line with lower economic activity and expenditure increases (e.g. welfare/income support payments), again helping to erode the surplus and create a deficit.*
- c) *Large budget deficits are generally combined with a more expansionary monetary policy in order to stimulate growth during times of economic contraction (e.g. 2008-9). The large budget deficit will add to AD and stimulate growth. However, the deficit needs to be financed and this is typically done via the sale of government bonds to the private*

sector, which effectively means that the government borrows from the public. When the bonds are issued it places upward pressure on domestic interest rates as the demand for funds on financial markets increases. This makes it much more difficult for any monetary policy loosening to do its job of stimulating the economy. Any reduction in the target cash rate is likely to be less than fully passed on to all rates in the economy as normal market pressures will be working in the opposite direction. This may even cause the RBA to purchase some of the government bonds to increase liquidity in financial markets, which only adds to inflationary pressure and once more limits the effectiveness of monetary policy to achieve 'non-inflationary growth'.

d) *i. The significant deterioration in the prices received for exports relative to the prices paid for imports contributes to a fall in national income as Australia's commodity exporters receive less revenue from any given volume of exports. This reduction in export values causes a reduction in AD and reduces the rate of economic growth. The slower economic and employment growth, combined with a reduction in demand inflationary pressure and fewer capacity constraints, allows the RBA to switch its focus away from inflation towards growth and jobs. Accordingly, the RBA is more likely to reduce the target cash rate (i.e. loosen MP).*

*ii. Large declines in consumer confidence have a negative impact on Consumption, AD and economic growth and can be a significant factor contributing to lower rates of economic and employment growth. In this environment, demand inflationary pressures subside and the RBA becomes more concerned about restoring confidence, lifting growth and saving jobs. Accordingly, this provides another reason for the RBA to lower the target cash rate.*

*iii. A sharemarket collapse can have a significant 'negative wealth effect' on Australian households and businesses, helping to drive down levels of consumer and business confidence, and reduce the rate of economic and employment growth. With many households/businesses losing a substantial portion of the value in their equity investments, it can lead to a reduction in spending (consumption and investment), which causes the rate of economic growth to fall. Once again, this provides another reason for the RBA to lower the target cash rate in order to stimulate spending and help to achieve non-inflationary growth.*

## Answers to crossword puzzle:

