

4 Aggregate demand policies and domestic economic stability

4.1 Overview

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4.1.1 Introduction

Let us take a sneak preview of what lies ahead in VCE Economics Unit 4. Essentially, it focuses on how the federal government uses its aggregate demand policies (Outcome 1) and aggregate supply policies (Outcome 2) to help improve Australia's domestic economic stability and prosperity. It is about lifting the performance of the economy so that living standards are optimal.

Earlier in topic 2, we saw that our market economy typically experiences economic instability with booms and recessions. This undermines the simultaneous achievement of the government's three key macroeconomic goals required for domestic economic stability:

- *the goal of low inflation* (a slow average rise in general consumer prices of 2–3 per cent a year over the economic cycle)
- *the goal of a strong and sustainable rate of economic growth* (the fastest growth in national production — around 3 per cent per year (or a little higher) rise in GDP — that does not jeopardise the achievement of other economic and environmental goals)
- *the goal of full employment* (the lowest unemployment rate — around 5 per cent of the labour force, or a little less — that does not accelerate inflation).

Economic instability (represented by the business cycle) is largely attributed to changes in the general strength of aggregate demand-side factors affecting total spending ($AD = C + I + G + X - M$). However, the economist John Maynard Keynes pointed out that cyclical instability can be reduced by the government applying *aggregate demand policies* in a countercyclical way, so during a slowdown or recession they gradually switch to become more expansionary to stimulate activity, and during the recovery or boom they progressively become more contractionary to steady spending and avoid inflation.

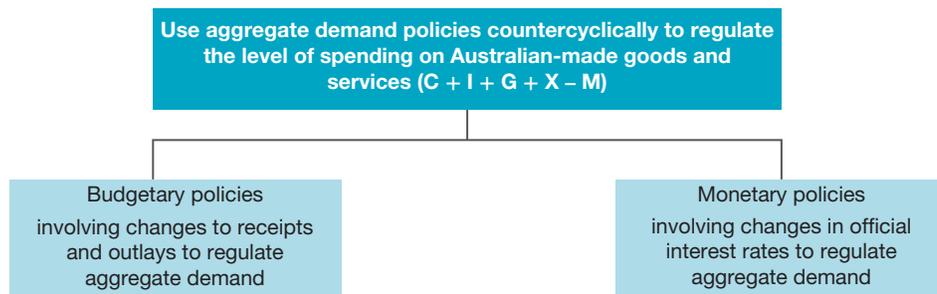
In recent years our economy has been growing more slowly, causing unemployment to be higher than usual and inflation to be low. One reason for this is that consumer spending has been rising more slowly due in part to weaker confidence that encourages saving, along with the slowdown overseas. Overall, to help stimulate economic activity and achieve our domestic macroeconomic goals, the federal government and the Reserve Bank of Australia used budgetary and monetary policies to help stimulate spending and domestic economic activity.

With this in mind, topic 4 (part A) puts the spotlight on the federal government's *budgetary policy* while topic 4 (part B) looks at the Reserve Bank's *monetary policy*.

FIGURE 4.1 Treasurer Josh Frydenberg delivers his first budget in April 2019



<https://www.theguardian.com/australia-news/live/2019/apr/02/federal-budget-2019-d-day-politics-live>

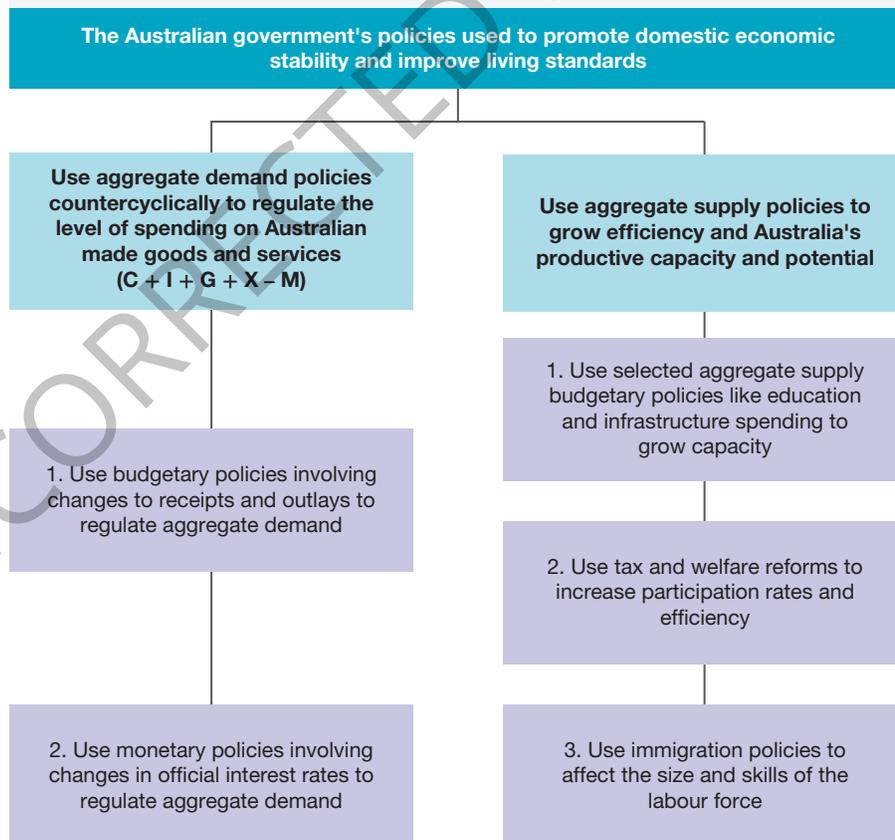


Together these two measures are used to help to stabilise the growth of AD to ensure it is economically sustainable and does not exceed the growth in the economy's productive capacity or aggregate supply.

Additionally, however, in topic 5 we study *aggregate supply policies* including tax and welfare reforms, immigration policy and aspects of budgetary policy. This is because these efficiency promoting policies have the potential to help accelerate the growth of the economy's productive capacity. This helps to ensure that rising levels of aggregate demand can be met or actually satisfied through increases in the economy's aggregate supply.

Through this *policy mix*, or combination of aggregate demand and aggregate supply policies summarised in figure 4.2, it should be possible for the government to improve Australia's prosperity and ensure the economy's performance is optimal.

FIGURE 4.2 Overview of government aggregate demand and aggregate supply policies used to help improve domestic economic goals and living standards



4.1.2 What you will learn

KEY KNOWLEDGE

Use each of the points from the VCE Economics Study Design below as a heading in your summary notes.

Budgetary policy

- sources of government revenue including direct and indirect taxation, revenue from government businesses and the sale of government assets
- types of government expenses including government current and capital expenditure and transfer payments
- the budget outcome: balanced, deficit or surplus
- the ways government may finance a deficit or utilise a surplus
- the relationship between the budget outcome and the level of government (public) debt
- the role of automatic stabilisers (cyclical component of the budget) in influencing aggregate demand and stabilising the business cycle
- the role of discretionary stabilisers (structural component of the budget) in influencing aggregate demand and stabilising the business cycle
- the effect of automatic and discretionary changes in the budget on the budget outcome and government (public) debt
- the stance of budgetary policy: expansionary or contractionary
- the effect of budget initiatives from the past two years on the Australian Government's domestic macroeconomic goals of strong and sustainable growth, full employment and low inflation.

Monetary policy

- the role of the RBA with respect to monetary policy as outlined in its charter
- the role of open market operations in altering interest rates
- transmission mechanisms of monetary policy and their influence on the level of aggregate demand including savings and investment, cash flow, availability of credit, exchange rate movements and asset prices
- the stance of monetary policy: expansionary or contractionary
- the focus of monetary policy from the past two years on the levels of aggregate demand and the Australian Government's domestic macroeconomic goals of strong and sustainable economic growth, full employment and low inflation
- the strengths and weaknesses of using monetary policy to achieve the Australian Government's domestic macroeconomic goals and how these goals may affect living standards.

Key skills

- define and use key economic concepts and terms relating to the Australian Government's aggregate demand policies
- gather relevant data and information about the nature and operation of aggregate demand policies in Australia
- discuss and analyse the effect of contemporary factors on the setting of aggregate demand policies
- evaluate the strengths and weaknesses of aggregate demand policies in achieving the Australian Government's domestic macroeconomic goals.

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 **Digital documents** Key terms glossary — Topic 4 (doc-XXXX)

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PART A Aggregate demand budgetary policies and the pursuit of domestic economic stability

4.2 Definition and aims of budgetary policy

KEY CONCEPT

- the federal government's *budgetary strategies* or policy is designed to help promote the Australian government's domestic macroeconomic goals and improve living standards

4.2.1 Definition of budgetary policy

Budgetary policy (sometimes also called fiscal policy) relates to the projected changes in the level and composition of federal government revenues (receipts or incoming money) and expenses (outlays or outgoing money) for the year ahead.

- **Budget revenues** come from *direct taxes* such as those on personal income and company profits, and from *indirect taxes* such as excise or tariffs, along with *non-tax* revenue.
- **Budget expenses** arise from various types of government outlays on public goods such as defence, health and education, involving both government *consumption* spending (G_1) and government *investment* spending (G_2), as well as transfer payments including welfare.

The *difference* in value between the government's expected revenues and expenses is called the overall **budget outcome** which, as we shall soon see, might be a *deficit* (when the value of receipts is less than outlays), *surplus* (when receipts are greater than outlays) or *balance* (when receipts are equal to outlays).

Budgetary policy is regarded as a key macroeconomic or **aggregate demand management policy** instrument, simply because changes in the levels of government revenue (receipts) and expenses (outlays) can have a powerful overall effect on total expenditure (especially the levels of C, I and G), national production, employment and the general level of prices or inflation.

However, because budget receipts and outlays are only *estimated* values based on certain *assumptions* and *forecasts*, what is announced on Budget night might not actually happen, particularly in an election year such as 2019 and when governments don't have a strong majority in both houses of the parliament. As we have seen in recent years, the actual or closing budget numbers might be quite different to those forecast, reflecting *unexpected* developments. For instance, *actual* budget deficits have often been *bigger* than anticipated due to weaker economic growth, higher unemployment, weaker wage growth, depressed TOT, a global slowdown, greater household and business pessimism, and the failure of the government to get its policies passed through the Senate or upper house.

Sometimes, if economic circumstances deteriorate significantly from those when the budget is usually announced in May each year, it might be necessary for the federal treasurer to bring down a *mini budget*, or at least revise the numbers during the Mid-Year Economic and Fiscal Outlook (MYEFO) that is updated, usually in December each year.

4.2.2 The domestic macroeconomic aims of budgetary policy

The medium-term *operational aim* of recent budgetary policy has been to gradually return to a surplus at a prudent rate (see explanation in section 4.5.3). However, within this general framework and the backdrop of a weaker economy, recent budgets have also sought to promote the Australian government's key domestic macroeconomic goals including low inflation, strong and sustainable economic growth and full employment. Through these, the hope is to create optimal economic conditions for better living standards.

More specifically, in their budget speeches, recent Treasurers have focused on particular objectives.

Budget	Focus objectives
2017–18 budget	Sought to ‘grow our economy and create more and better paid jobs’, ‘reduce cost of living pressures’ and ‘ensure the government lives within its means’
2018–19 budget	Emphasised that ‘a stronger economy will create more jobs and guarantee the essential services that Australians rely on’
2019–20 budget	Delivered earlier than usual, given the timing of the federal election. It claimed to restore our nation’s finances without increasing taxes, strengthen the economy, create more jobs, provide essential services and tackle cost of living pressures

4.2 ACTIVITIES

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Check your understanding

1. Define budgetary policy.
2. What are the aims of budgetary policy?

Applied economic exercises

1. In what ways can budgetary policy be regarded as an aggregate demand policy? **(2 marks)**
2. (a) What is the medium-term *operational goal* of budgetary policy? Why is it important to achieve this aim? **(2 marks)**
(b) Besides the general operational goal of recent budgetary policy, what are the *two* main domestic macroeconomic goals pursued by recent budgets? **(2 marks)**

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4.3 Sources of government revenue (receipts)

KEY CONCEPT

- sources of government revenue including direct and indirect taxation, revenue from government businesses and the sale of government assets

Budget revenues are the federal government’s incoming receipts of money that are used to pay for budget outlays. As such, they impact greatly on disposable incomes, AD, economic activity, inflation, the allocation of resources, external transactions, income distribution and living standards.

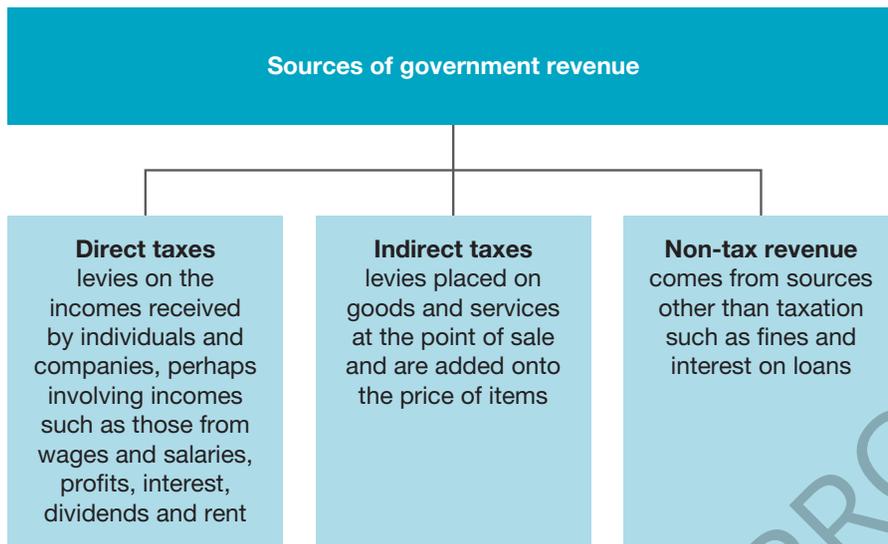
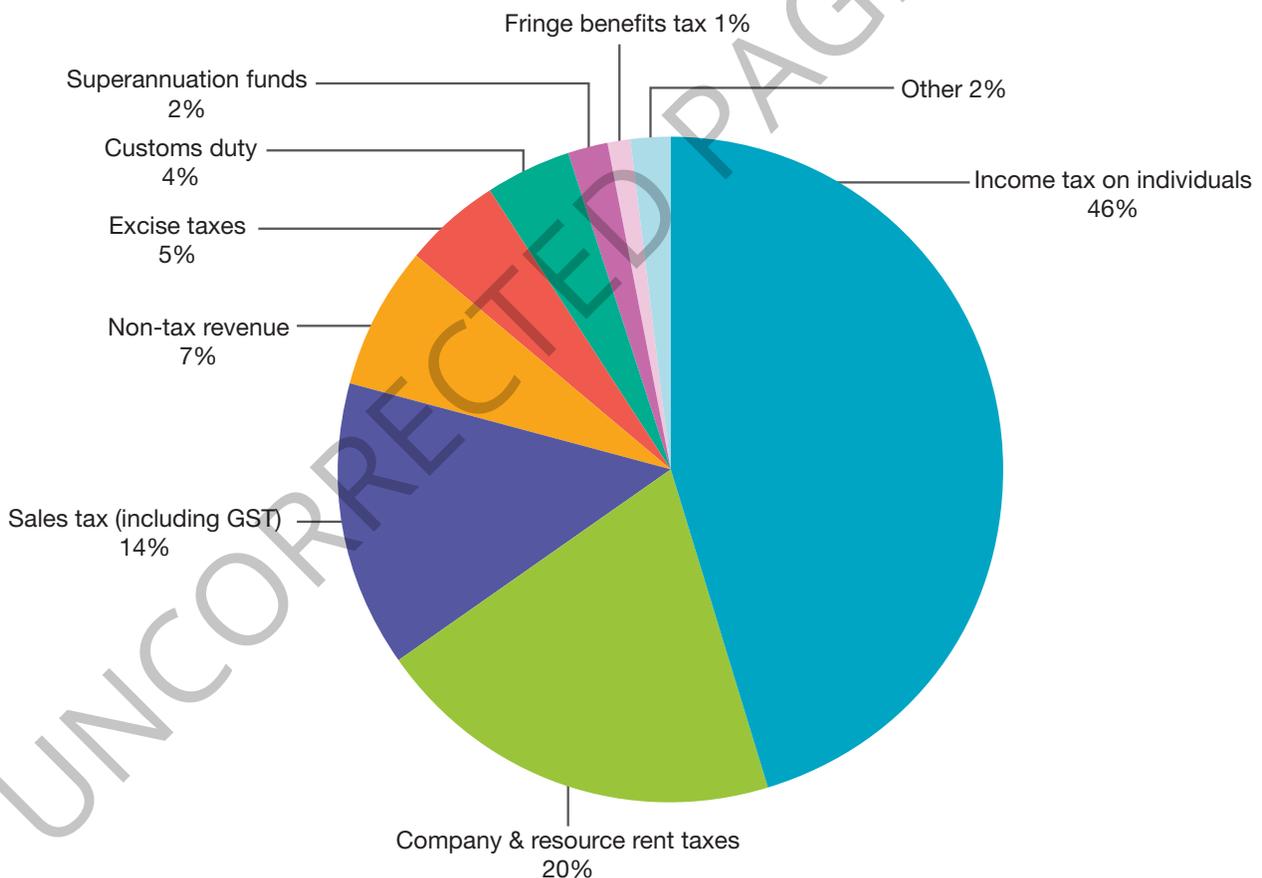


FIGURE 4.3 Sources of estimated federal budget receipts of \$513.8 billion for 2019–20, calculated as a percentage of total revenue



Source: Data derived from Budget Papers 2019, see https://www.budget.gov.au/2019-20/content/bp1/download/bp1_bs4.pdf

4.3.1 Direct taxation

Direct taxes levied on those receiving incomes, make up almost 70 per cent of all budget receipts.

They include the following:

- *Personal income tax* is a direct tax paid by individuals who earn incomes in the form of wages, salaries, rent, interest and dividends. For most people, income tax is deducted by firms from the pay packets of employees before they are paid (**pay-as-you-go** or PAYG). However, for self-employed individuals, a different system exists for estimating income and the amount of tax that must be paid. In both cases, tax is levied (charged) at progressive rates where the marginal tax rate, or percentage of income taken in tax, increases as income rises. In 2018–19, personal income tax rates ranged from 0 per cent on incomes below the tax-free threshold of \$18 200 per year, up to the top marginal tax rate of 45 per cent on annual taxable incomes in excess of \$180 000 (47 per cent after the 2 per cent Medicare levy is added). In addition, the 2018–19 budget announced a reduction in personal tax by lifting the upper limit of the 32.5 per cent tax bracket to \$90 000, as well as increasing the low-income tax offset. For 2019–20, there are further reductions in tax for low- and middle-income earners through rises in tax offsets or rebates. Overall, income tax raises around 46 per cent of all federal government receipts.
- *Capital gains tax (CGT)* is levied on the real profits made from the sale of capital assets such as land and shares purchased after 1985. During 2018–19, the CGT applied to only 50 per cent of the capital gain, so the actual rate is only half the normal appropriate marginal income tax rate (with the Medicare levy added). Currently this means that the effective top marginal income tax rate is around 23.5 per cent. However, recent discussions may result in changes to this tax rate.
- *Medicare levy* is a direct tax designed to provide medical insurance in order to help cover the basic costs of family health care and the National Disability Insurance Scheme. For most people, this was levied at a rate of 2 per cent of personal taxable incomes during 2018–19.
- *Withholding tax* is applied to individuals who fail to register their tax file number when receiving income such as dividends and interest. In 2018–19, it was levied at the top marginal tax rate (excluding the Medicare levy) of 45 per cent.
- *Company tax* is a flat or proportional tax levied directly on business profits. In recent years this tax has been progressively reduced so that for 2018–19, the rate was 27.5 per cent for small to medium-sized businesses with an annual turnover up to \$50 million. Further reductions have been scheduled so that by 2021–22, the rate will fall to 25 per cent for all but the largest companies that will remain on the 30 per cent tax rate. Company tax raises around 20 per cent of all budget revenue. In addition, there is a special additional levy on bank profits.
- *Fringe benefits tax (FBT)* represents a direct tax paid by firms on the value of ‘perks’ provided by businesses to their employees, such as a company-provided car or house. In 2018–19, it is levied at 47 per cent of the taxable benefit.
- *Petroleum resource rent tax (PRRT)* is levied at 40 per cent of the profits made from offshore petroleum operations.
- *Superannuation fund tax* is levied at 15 per cent of most premiums, as well as on the interest from fund investments. Currently, people aged over 60 can withdraw their superannuation tax-free, but this may change.



4.3.2 Indirect taxation

Indirect taxes are added onto the price of some goods at the point of sale, and make up nearly 25 per cent of all budget receipts. They include the following:

- *Excise duty* is an indirect tax imposed on selected, locally produced goods such as petrol, alcohol and tobacco. It is a flat amount of tax per physical unit (e.g. a kilogram or a litre). For example, the excise on unleaded petrol is about 30 per cent of the price of each litre sold, while that for brandy is over \$50 per litre of alcohol. The precise rates applicable are adjusted twice a year and are indexed or linked to changes in the CPI. Overall, excise tax raises about 5 per cent of government revenue. The system of excise duty on alcohol has been reviewed, with steep rises in the excise on tobacco in recent years.
- *Customs duties or tariffs* are an indirect tax levied on certain imported goods to raise revenue and protect local producers from foreign competition. Since the early 1970s, and especially between 1984 and 1996, the general tariff rate for manufactured goods was reduced dramatically from an average rate of nearly 40 per cent to 5 per cent or less.

- *Goods and services tax (GST)* was introduced in July 2000 and is a broad-based indirect tax levied at the rate of 10 per cent in 2019–20. It is collected by the federal government on behalf of the states and territories. Consumers pay the GST when they purchase goods and services. The retailer adds GST to the price of items when they are sold, making the GST a regressive tax because the tax burden or rate (expressed as a percentage



of their income level) is heavier for low-income earners than it is for high-income earners. Although the GST is levied on most things, for equity reasons there are currently some exemptions for necessities including basic unprocessed foods, residential rent, gifts to charities, secondhand goods, government charges for rates, water and car registration, export production, education and school fees, health care, health insurance, women's sanitary products, prescription medicines and public health goods, nursing home charges, childcare and financial services. In recent years, there has been periodic discussion about changing the GST tax rate and or its tax base.

4.3.3 Non-tax revenue (revenue from government businesses and the sale of government assets)

Non-tax receipts currently raise around 7 per cent of all federal government revenues. They come from three main sources:

- The profits gained from the operation of *government business enterprises* that sell goods and services (such as Australia Post).
- Receipts from asset sales when government business enterprises (GBEs) are *privatised*, such as Medibank Private in 2014 (however, these will only be included in the *headline* budget outcome and *not* the *underlying* outcome).
- Interest (e.g. earned by the Future Fund), petroleum royalties, the repayment of loans by state and local governments, HECS loan repayments by students, GST administration costs and property rentals.



4.3.4 Other features of the tax system

Other important features of the budget's tax system include the following.

Tax mix

The tax mix refers to the balance between direct and indirect taxes as sources of revenue. Around 93 per cent of all federal revenues are derived from taxation, of which around 69 per cent is from direct taxes on incomes. Of the remainder, just over 24 per cent comes from indirect taxes, with the 7 per cent balance from non-tax revenue.

Tax base

The tax base refers to how broadly the particular tax is applied. For example, currently the GST exempts most necessities. If the tax base was widened and covered all goods and services, more revenue would be raised.

Tax burden

The tax burden relates to the *rates* of direct or indirect tax applied. In the case of progressive personal income tax, the average tax burden automatically tends to increase over time, because rising levels of incomes and inflation cause people to move into higher marginal tax brackets. This is referred to as **bracket creep** (also called *fiscal drag*) and can be avoided only by regular and deliberate cuts in tax rates or changes in the tax brackets.

4.3 ACTIVITIES

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Check your understanding

1. Define budget receipts.
2. What are the main sources of budget receipts?

Applied economic exercises

1. Distinguish the following pairs of terms:
 - (a) A direct tax and an indirect tax, giving an example of each. **(2 marks)**
 - (b) Personal income tax and company tax. **(2 marks)**
2. How might each of the following changes in tax affect the level of AD (i.e. $C+I+G+X-M$)?
 - (a) A reduction in the marginal rate of personal income tax. **(2 marks)**
 - (b) An increase in the rate of capital gains tax. **(2 marks)**
3. What is *bracket creep* and how does this affect the level of *budget revenues* over a period of time? **(2 marks)**

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4.4 Types of government expenses (outlays)

KEY CONCEPT

- types of government expenses including government current and capital expenditure and transfer payments

Budget expenses relate to how the government uses the revenues it collects to directly or indirectly provide households and businesses with goods, services and incomes and hence can affect AD and economic activity mainly by changing the levels of C and I.

These expenses or payments can be classified in two ways:

1. the specific functions they serve
2. their general nature or type.

4.4.1 Classifying government budget expenses by their function

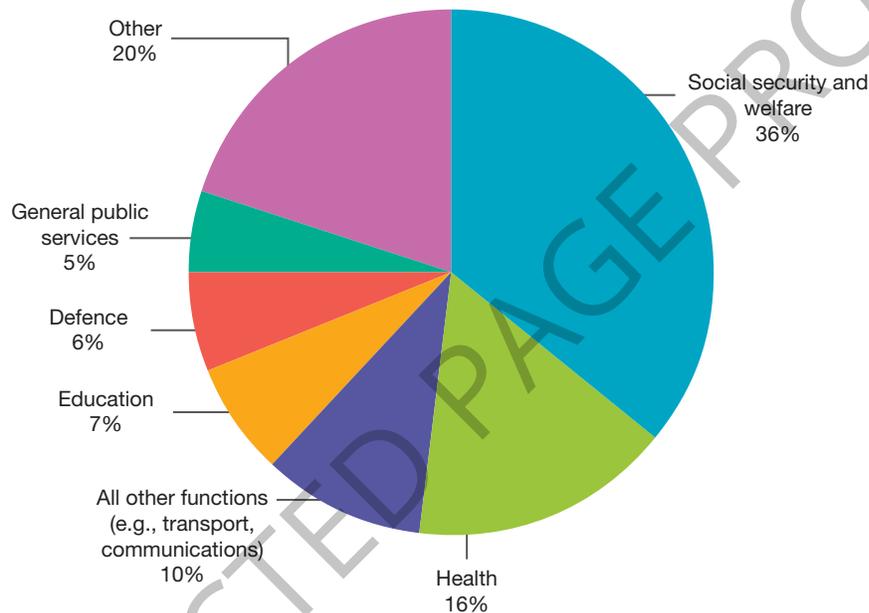
Budget expenses are directed to the provision of particular goods, services and other *functions* including the following:

- *Social security or welfare outlays* are government cash transfer payments to the neediest groups who meet the means and assets tests (i.e. those whose incomes and assets are below certain cut-off levels). These benefits represent over 36 per cent of all government outlays and include those for the aged, unemployed job seekers, supporting parents and families, carers, students, the disabled and war veterans.
- *Health spending* entails the provision of medical attention and incorporates consumption outlays on running expenses (such as drugs and staff salaries), along with the funding of capital infrastructure (such as hospital buildings) within the public health system. In addition, health outlays cover the funding of medical subsidies paid for doctors' services, the provision of free hospital services by state governments and some prescribed pharmaceuticals. This accounts for around 16 per cent of budget outlays.
- *Defence* involves budget outlays for the payment of staff and day-to-day running expenses for the armed services. Increases in finance are provided where necessary for our defence capacity, peacekeeping activities, border protection and surveillance, and for the war on terrorism. This takes around 6 per cent of budget outlays.
- *Education spending* represents more than 7 per cent of budget outlays and is designed largely to help provide public education through the payment of staff and the provision of ordinary operating expenses, along with capital spending. These outlays also include spending on universities, support of state and non-government schools, vocational education and training (VET) and building programs.
- *Transport and communications* cover current and capital spending on the provision of government infrastructure in areas like road, shipping, aviation and rail services. The roads of national importance or highways programs, and the recent nation-building infrastructure packages involving improvements to ports, railways, roads and the broadband network, are specific examples of these outlays.
- *Housing and community amenities* include outlays to provide public housing, measures to cut greenhouse gas emissions and support alternative energy sources, and water supply programs.
- *General public services* outlays take up almost 5 per cent of expenses and include those for the payment of wages and salaries for public servants, government administration and parliament, and overseas aid and foreign affairs.
- *Public debt interest* is the annual cost to the federal government of paying interest on its accumulated debts or borrowings. Debt arises when the government wants to finance a budget deficit and involves the payment of interest to holders of government bonds and securities. During and following the global financial crisis (GFC) (between 2008–09 and 2018–19, and perhaps beyond 2019–20), the federal government ran up massive budget deficits totalling over \$360 billion to stimulate economic activity. These budgets were financed by domestic and overseas borrowing and again require the annual repayment of public debt interest (around \$17 billion in 2018–19).
- *Net payments to other governments* are federal handouts to state and local governments to enable them to provide community services including public education, health, housing and transport. Traditionally these payments were necessary because the states had few other sources of revenue from which to fund their outlays and responsibilities.

- *Mining, manufacturing and construction* outlays involve government help for industry research and development, special assistance provided to the automotive and textile industries to help structural adjustments associated with reduced tariffs, and the introduction of exploration tax offsets for mining companies.

Figure 4.4 shows that the government's main priorities in 2019–20 for resource allocation by *function* include social security, health, education and defence. Clearly the government is using the budget to correct market failure and improve the allocation of resources that would otherwise occur if there was total reliance on the market or price system.

FIGURE 4.4 Direction of estimated federal budget expenses of \$500.9 billion by function for 2019–20, calculated as a percentage of total outlays



Source: Data derived from Budget Papers, April 2019 (prior to mid year update), Budget overview, see https://www.budget.gov.au/2019-20/content/bp1/download/bp1_bs5.pdf.

4.4.2 Classifying government budget expenses by their general type

Apart from looking at the different functions of budget outlays, government expenses can also be broken down according to their general nature or type:

1. **Government current spending (G_1).** Government current (or consumption) spending (abbreviated as G_1) includes the payment of wages and salaries for federal government employees (around \$30 billion) in the public sector including health, education, defence, housing, transport and welfare, along with the day-to-day operating expenses of departments. In addition, sometimes these government departments need to purchase goods and services from the private sector such as prescription drugs and medications used in hospitals, educational materials for schools, food and munitions for the defence department and the cleaning and repair of public assets. In the 2019–20 budget, this represented about 90 per cent of all government spending.
2. **Government capital spending (G_2).** Government capital (or investment) spending (abbreviated as G_2) involves budget outlays on national social and economic infrastructure including the building of schools and universities, roads and highways, airports, reservoirs and water supply, the national broadband network system (NBN), pipelines and the purchase of capital equipment for hospitals, schools, universities and railways. An important reason for government capital spending is that it helps

to grow the economy's productive capacity, make conditions more favourable for businesses to operate and improve the daily lives of households. In the 2019–20 budget, this represented about 10 per cent of all government spending.

3. **Government transfer payments.** These mainly involve budget outlays on welfare benefits, along with grants and industry assistance. Social security payments are means- and assets-tested transfer payments to the neediest individuals in society (those whose incomes and assets are below certain tapered cut-off levels). These benefits include those for the aged, unemployed job seekers, supporting parents and families, carers, students, the disabled and war veterans. Their main aim is to redistribute final incomes more equitably than that for market or private incomes so that even the poor can better access basic goods and services. This helps to reduce poverty and improve general living standards. Overall, federal welfare outlays claim around 36 per cent of total budget expenses. In the next few years, spending on this area is expected to rise, partly because of our ageing population. Note that transfer payments are not regarded as government spending (G_1 or G_2) because it is the recipient of transfer payments who actually spends the money.

Sometimes the government provides collective goods and services (such as basic education, most roads and ABC television) to the community free of direct charge. At other times, services are sold at a reduced or subsidised price to make them more affordable (e.g. public housing, higher education, health). Increasingly, however, the *user-pays principle* has been applied. This means that individuals and firms using government-provided services are charged a price sufficient for the government to cover costs or make a profit, thereby helping to increase non-tax revenues. There is also a trend towards the *corporatisation* of some government businesses. Again, this reflects the government's desire to reduce costs, slow rises in budget outlays and ultimately return the budget to surplus.

As expected, the impact of budget outlays on both domestic and external stability will vary, depending on the proportion of outlays that are actually spent overseas. For instance, the purchase of imported defence equipment, or rises in foreign aid, tend to slow domestic activity and increase our current account deficit (CAD).

Resources

 **Weblink** Keynesian economics with Jacob Clifford

4.4 ACTIVITIES

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Check your understanding

1. What are *budget expenses*?
2. How can they be classified?

Applied economic exercises

1. What are the *three* most important areas of federal government budget outlays or expenses by function? **(xxx marks)**
2. Giving examples, *distinguish* between the following pairs of terms related to budget expenses:
 - (a) G_1 and G_2 (as part of budget outlays or expenses) **(2 marks)**
 - (b) Government spending and government transfer payments. **(2 marks)**

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4.5 The budget outcome

KEY CONCEPTS

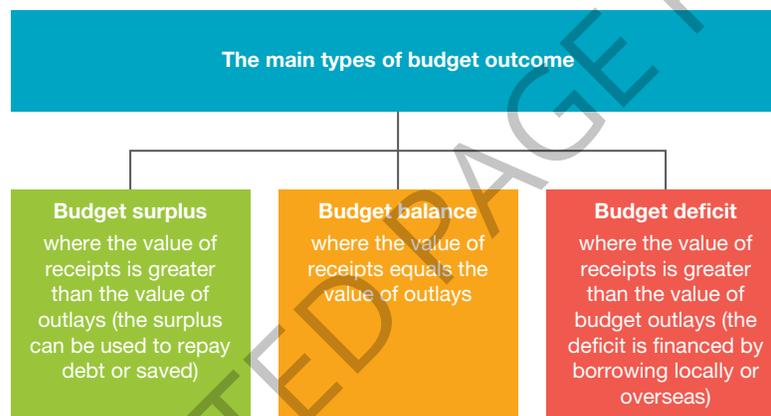
- the budget outcome: balanced, deficit or surplus
- the ways government may finance a deficit or utilise a surplus
- the relationship between the budget outcome and the level of government (public) debt

In simple terms, the *budget outcome* reflects the difference between revenues and expenses. On this basis, there are *three* possible budget outcomes:

- *budget balance* where the total value of receipts or revenue = the value of outlays or expenses
- *budget deficit* where the total value of receipts or revenue < the value of outlays or expenses
- *budget surplus* where the total value of receipts or revenue > the value of outlays or expenses.

Let us now take a closer look at these *three* budget outcomes as summarised in figure 4.5.

FIGURE 4.5 The three main types of budget outcome



4.5.1 A balanced budget

A **balanced budget** is where the total value of government receipts or revenues extracted exactly *equals* the total value of expenses or outlays pumped back into the economy. In itself, a balanced budget is neither *expansionary* nor *contractionary* in its impacts on the level of AD and economic activity. In a general sense, this outcome tends to have little effect on overall levels of production, employment and inflation. It is, therefore, said to be a relatively *neutral stance*.

4.5.2 Budget deficits and how they might be financed

When the budget outcome is negative or in *deficit*, the total value of government revenue is *less* than the total value of government expenses. This outcome occurred between 2008–09 and 2018–19, with cumulative deficits over \$360 billion.

There are *three* ways to finance a budget deficit.

1. *Borrow from overseas.* The government or Treasury can borrow from overseas by, for instance, selling Australian government bonds. This approach was used to finance large budget deficits during and



Source: *The Australian*, Wednesday 3.4.19, John Hanna.

following the GFC between 2008–09 and 2018–19 (or beyond) that in themselves added stimulus to AD and economic activity. However, such borrowing adds to our net foreign debt (NFD). Additionally, it may initially increase the demand for the Australian dollar and push up the exchange rate in the short term, thereby causing unwanted reductions in exports and economic activity. Furthermore, it increases interest repayments (primary income debits) and thus grows the size of the current account deficit (CAD).

2. *Borrow from the RBA or create money.* The government may choose to borrow from the Reserve Bank of Australia (RBA). There are two possibilities. The government could use up any savings balances it has with the RBA accumulated during periods of budget surpluses. Alternatively, the government could sell IOUs (*I owe you*, where the government will repay the debt with interest at some future date) or bonds to the RBA. This is the same as issuing instructions to print more money. This latter option is regarded as a very expansionary way of financing the deficit because it adds directly to the volume of money in circulation and the level of spending.
3. *Borrow from the Australian public or financial sector.* The government could borrow from the Australian public and financial sector by selling them government bonds or treasury notes. Indeed, this was one of the methods recently used by the federal government to finance budget deficits during and following the GFC between late 2008 and 2019. This option is a fairly sound method of financing a budget deficit since the money, withdrawn from the economy's private sector by the sale of government securities, is returned when the government actually uses the money to cover its budget outlays. However, this approach could cause upward pressure on domestic interest rates because the government is also competing against the private sector for access to limited savings. In turn, higher interest rates may **crowd out** and depress private sector borrowing, investment spending and economic activity at a time when policy needs to boost AD and economic activity.

While budget deficits are necessary when economic activity is weak, they are also associated with certain *problems*:

- *The loss of a nation's good credit rating.* Budget deficits normally add to official or public sector debt. Over time these can build up and get out of hand, as has happened in Greece, Spain and Japan. In turn, this could lead to a downgrading of our international AAA credit rating, which might later make it more expensive to borrow due to higher interest rates reflecting the increased risk for lenders.
- *Interest payments take money from providing community services.* Deficits that are financed by borrowing involve the payment of interest. This involves an opportunity cost. It diverts money and resources away from more productive uses like the provision of adequate education, welfare and health. For instance, in 2018–19, the interest payments on the Australian government's debt amounted to a massive \$17 billion.
- *Less able to deal with economic crises.* Persistent large budget deficits weaken the government's ability to deal with an economic crisis such as the GFC or serious recession. Borrowing and heavy levels of debt reduce our capacity to increase borrowing and lower the government's cash reserves available in a 'fighting fund'.
- *Increasing debt is unsustainable and a burden on future generations.* Ongoing large budget deficits are unsustainable. Eventually they will need to be covered by higher taxes and/or lower government outlays that detrimentally impact on the living standards of future generations.

4.5.3 Budget surpluses and how they might be used

A **budget surplus** is where the total value of government revenues *exceeds* the total value of its expenses (as happened in some years prior to 2007–08 and perhaps again starting in 2019–20). Typically, a surplus occurs when the pace of economic activity is too strong causing inflationary pressures.

There are *three* main things the government can do with its budget surplus.

1. *Reduce debt.* The government could use the surplus to repay or retire its local and or overseas debts. This happened between 1996–97 and 2007–08. In the case of domestic debt, this action would cause

government savings balances at the RBA to be transferred into the savings accounts of the private sector. With increased liquidity (liquidity in this sense means funds available for lending) the cost of credit (interest rates) may fall, partly offsetting the initial contractionary effects on the economy of the surplus budget.

2. *Save with the RBA.* The government's savings balances with the RBA could be built up as a 'fighting fund' for a rainy day (perhaps for use during a future recession or another financial crisis) when there is a need to finance deficit budgets. This option would tend to cause money to be transferred from private sector savings into government savings. It would tend to reduce the availability of credit and put upward pressure on domestic interest rates.
3. *Add to investment balances in special savings funds.* The budget surplus may be put into special purpose, nation-building funds to benefit current and future generations of Australians. Essentially, money set aside in this way acts as seed capital (early stage finance) that is invested (e.g. in Australian and international shares, cash and infrastructure projects) to generate returns, thereby hopefully growing the government's wealth (sovereign worth) and making funding payouts possible for important national projects. As shown in table 4.1, in December 2018 the federal government had *five* of these special savings funds managed under the umbrella of the Future Fund.

TABLE 4.1 The Australian government's special purpose savings funds

Fund	Balance (\$b, 31 December 2018)
Future Fund	147
Education Investment Fund	3.9
Building Australia Fund	3.9
Medical Research Future Fund	9.4
Disability Care Australia Fund	14.4
Total	178.6

Source: Data derived from Future Fund, Facts at a glance, www.futurefund.gov.au and Portfolio Update, file:///D:/Users/24665/Downloads/Portfolio%20update%20at%2031%20December%202018.pdf.

There are *advantages* in being able to run a *budget surplus*:

- *Can offset deficits and avoid debt.* Running budget surpluses can be used to offset budget deficits without needing to increase public sector borrowing or sovereign debt. Surpluses are sustainable and do not create a burden for future generations.
- *Create a fighting fund for bad times.* A budget surplus allows the government to build up its 'war chest' or 'fighting fund', which allows it to better deal with a severe economic crisis or slowdown in the future.
- *Protect Australia's credit rating.* A budget surplus helps to protect our international AAA credit rating. This rating allows credit to be borrowed more cheaply in the future, freeing financial and other resources for use elsewhere in areas such as infrastructure.
- *Generates confidence.* Surpluses help to support international confidence among investors, and strengthen Australia's external situation.

For these reasons, the *operational aim* of recent budgetary policy has been the *return to surplus* at a prudent rate over the medium-term as Australia's economic conditions permit.

4.5.4 The impact of unexpected events on the final budget outcome

When estimating a particular budget outcome, the federal treasurer estimates the levels of receipts and outlays based on domestic and international forecasts of upcoming economic conditions. Sometimes these

are either *over-optimistic* leading to a weaker *actual* outcome than expected budget outcome (e.g. a bigger actual budget deficit). At other times, they prove to be *over-pessimistic* and the *actual* outcome is better than that forecast on Budget night (e.g. a smaller actual deficit).

These key forecasts for the year ahead include the following:

- *The forecast rate of growth in Australia's GDP.* If the forecast growth rate is faster than what actually eventuates, the value of tax receipts collected from households and companies will be lower due to a slower rise in incomes and profits. In addition, welfare outlays for the unemployed are likely to end up higher, weakening the final budget outcome.
- *The forecast global rate of economic growth.* Global rates of economic growth, especially among our trading partners such as China, greatly impact on budget revenues because it affects the demand for our exports, the terms of trade and hence the value of Australian exports sold. This can either raise or lower the profits made by companies and the level of company tax paid.
- *The forecast wages growth.* The growth in household wages affects the amount of income tax collected. For instance, a slower than forecast growth in wages will reduce the revenue collected.
- *The forecast unemployment and participation rates.* Unemployment and participation rates affect revenue from both personal income tax, as well as outlays on welfare. For example, if the forecast unemployment rate is lower than the actual rate, tax revenues will be lower and outlays higher, perhaps generating a bigger budget deficit than that anticipated.
- *The forecast level of commodity prices and terms of trade.* What happens to the level of commodity prices and Australia's terms of trade greatly affect tax receipts as well as welfare outlays. Weaker terms of trade (perhaps lower export prices for iron ore, coal, wool and wheat, relative to import prices) than that forecast reduces company tax collections. In addition, when the world pays us lower prices for our exports relative to those we pay for imports, this reduces the value of net exports or injections of spending. In turn, this tends to cause a slower growth in GDP where firms cut their demand for resources leading to a rise in the number of people on unemployment and welfare benefits.
- *Unexpected changes in household confidence.* An unforeseen reduction in *consumer confidence* would tend to lower the level of C spending. This would reduce the actual level of receipts from sales and excise taxes, as well as tending to drive up budget outlays on welfare.
- *Unforeseen disasters.* Unexpected *natural disasters* including drought, cyclones and floods slow the growth rate in Australia's GDP. In turn, these events lessen tax receipts and increase government outlays on repairs to infrastructure and welfare support.
- *Political obstacles and numbers in the parliament.* Recent governments have sometimes experienced *political obstacles* associated with passing aspects of the budget through the Senate because they lacked the numbers. This meant that discretionary rises in receipts and/or cuts in budget outlays were delayed or rejected, weakening the budget's bottom line.



Source: AFR, David Rowe, <https://twitter.com/roweaf?lang=en>.

Some of the domestic and international assumptions behind the 2019–20 budget are shown in table 4.2.

TABLE 4.2 Forecasts and assumptions behind the federal government budget outcome, 2019–20 (percentage change on previous year)

Part A – Domestic economy forecasts*	Outcomes	Forecasts		
	2017–18	2018–19	2019–20	2020–21
Real gross domestic product	2.8	2 1/4	2 3/4	2 3/4
Household consumption	2.8	2 1/4	2 3/4	3
Dwelling investment	0.2	1/2	-7	-4
Total business investment	6.0	1	5	4 1/2
<i>By industry</i>				
Mining investment	-4.1	-10 1/2	4	4 1/2
Non-mining investment	9.7	4 1/2	5 1/2	4 1/2
Private final demand	3.0	1 1/2	2 1/4	2 3/4
Public final demand	4.5	5 1/2	3 1/4	3
Change in inventories	0.0	0	0	0
Gross national expenditure	3.4	2 1/2	2 1/2	2 3/4
Exports of goods and services	4.1	3 1/2	4	1 1/2
Imports of goods and services	7.1	1 1/2	3	2 1/2
Net exports	-0.6	1/2	1/4	-1/4
Nominal gross domestic product	4.7	5	3 1/4	3 3/4
Prices and wages				
Consumer price index	2.1	1 1/2	2 1/4	2 1/2
Wage price index	2.1	2 1/2	2 3/4	3 1/4
GDP deflator	1.8	2 1/2	1/2	1
Labour market				
Participation rate (per cent)	65.6	65 1/2	65 1/2	65 1/2
Employment (f)	2.7	2	1 3/4	1 3/4
Unemployment rate (per cent)	5.4	5	5	5
Balance of payments				
Terms of trade (h)	1.9	4	-5 1/4	-4 3/4
Current account balance (per cent of GDP)	-2.8	-1 3/4	-2 3/4	-3 3/4

(Continued)

TABLE 4.2 Forecasts and assumptions behind the federal government budget outcome, 2019–20 (percentage change on previous year) (*Continued*)

Part B– International GDP forecasts*	Outcomes		Forecasts	
	2018	2019	2020	2021
China	6.6	6	6	5 3/4
India	7.3	7 1/2	7 3/4	7 3/4
Japan	0.8	1	3/4	3/4
United States	3.0	2 1/4	2	1 3/4
Euro area	1.8	1 1/4	1 1/2	1 1/2
Other East Asia	4.3	4 1/4	4 1/4	4 1/4
Major trading partners	4.2	4	4	4
World	3.7	3 1/2	3 1/2	3 1/2

*Note: Estimates as at the time of the April 2019 budget prior to the completion of the 2018–19 financial year and before the mid-year updates in December 2019.

Source: Data copied from Budget Paper, 2019, Statement 2, Economic Outlook (tables 1 and 2), https://www.budget.gov.au/2019-20/content/bp1/download/bp1_bs2.pdf

4.5.5 The budget outcome, its operational goal and the relationship with government debt

It is vital for the federal government to manage Australia’s finances carefully and maintain a sustainable budgetary position in the long term. Having the right **fiscal balance** includes avoiding high levels of sovereign or *government debt* caused by budget outlays consistently exceeding budget receipts in the medium and long terms. The economic woes experienced in some European countries (Greece, Italy, Spain, Cyprus) are all examples of what might happen if the government continually runs bigger budget deficits than surpluses. By contrast, running budget surpluses gives the option of reducing the burdens and risks of high debt levels.

Recent federal treasurers have consistently restated that the *operational goal* of the budget is to ‘*achieve budget surpluses, on average, over the medium term*’. This requires that budget receipts are more than sufficient to meet budget outlays. A surplus over the medium term would help to avoid an overall rise in public sector debt or borrowing, thereby making the budget’s position sustainable without adding to the net debt burden for future generations. However, a return to surplus in our current situation (where economic activity is weaker and below trend) requires the treasurer to adopt a balanced and prudent pathway. It cannot happen overnight, and may take some years so that economic growth and jobs do not suffer as a result of undue budget tightening. In addition, sometimes deficits (called structural deficits) won’t go away naturally when the economy recovers. In such cases, returning to surplus might require a rebalancing of the budget with deliberate but unpopular discretionary rises in receipts and/or cuts in outlays.

4.5.6 Understanding figures showing the budget outcome

During the late 1990s, a change was made to how *budget outcomes* were calculated and reported. This involved using not just the traditional cash accounting system, but also the accrual approach (as used by many business firms). The *cash approach* reports the value of budget receipts and outlays only when the government actually receives or pays out cash, whereas the *accrual system* shows expenses as they are incurred and revenues as they are earned. One reason for this shift in reporting was the acceptance in 1996 of the Charter of Budget Honesty. This was designed to make the government more accountable and its actual fiscal position more transparent. For example, it now becomes easier to determine the extent to which

current budget expenses are being paid for by current revenue (as opposed to increases in borrowing or debt). Nowadays, the reporting system for the budget includes the *three* following measures:

1. *headline* balance
2. *underlying* balance
3. *fiscal* balance.

Recent changes in these indicators of the federal government's budgetary position are shown in table 4.3.

TABLE 4.3 Changes in the federal government's budget outcome using different measures (2 April 2019)

	Actual		Estimates		Projections		Total (a) \$b
	2017–18 \$b	2018–19 \$b	2019–20 \$b	2020–21 \$b	2021–22 \$b	2022–23 \$b	
Receipts	446.9	485.2	505.5	522.3	551.0	566.9	2,145.7
Per cent of GDP	24.2	25.0	25.2	25.1	25.4	25.0	
Payments (b)	452.7	482.7	493.3	511.3	533.2	557.7	2,095.6
Per cent of GDP	24.5	24.9	24.6	24.6	24.5	24.5	
Net Future Fund earnings (c)	4.3	6.6	5.1	na	na	na	5.1
Underlying cash balance (d)	-10.1	-4.2	7.1	11.0	17.8	9.2	45.0
Per cent of GDP	-0.5	-0.2	0.4	0.5	0.8	0.4	
Revenue	456.3	495.8	513.8	534.3	564.7	580.5	2,193.2
Per cent of GDP	24.7	25.6	25.6	25.7	26.0	25.6	
Expenses	460.3	487.3	500.9	516.1	535.9	559.9	2,112.8
Per cent of GDP	24.9	25.1	25.0	24.8	24.7	24.6	
Net operating balance	-4.0	8.5	12.9	18.2	28.8	20.6	80.4
Per cent of GDP	-0.2	0.4	0.6	0.9	1.3	0.9	
Net capital investment	1.3	6.5	4.7	7.7	9.7	10.8	33.0
Fiscal balance	-5.3	2.0	8.1	10.4	19.1	9.8	47.5
Per cent of GDP	-0.3	0.1	0.4	0.5	0.9	0.4	
<i>Memorandum items:</i>							
Net Future Fund earnings (c)	4.3	6.6	5.1	5.2	5.6	6.2	22.2
Headline cash balance	-25.9	-12.7	-4.4	-0.5	7.9	2.5	5.6

Source: Data copied directly from Budget Papers, April 2019, Statement 3, Fiscal Strategy and Outlook Budget Paper No. 1 (table 2) 2019–20, see https://www.budget.gov.au/2019-20/content/bp1/download/bp1_bs3.pdf.

What are the main *differences* between these three measures?

1. The budget's headline balance

The budget's **headline balance** (whether it is *positive* or *negative* overall) represents the difference between cash outlays and cash revenues from all sources. Often this figure makes the budget outcome look more impressive than it actually is, because it *adds* the anticipated value of one-off events such as asset sales (such as from the privatisation of Qantas, the Commonwealth Bank and Telstra) and debt repayments received from other governments. However, this figure is not very useful when trying to determine the impact of the budget on the level of government borrowing or national savings.

2. The budget's underlying balance

The budget's underlying balance uses the figures for the headline balance but then *subtracts* the value of volatile, one-off items such as those from asset sales, special loans to state governments or debt repayments by other governments. The **underlying budget outcome** more clearly reflects the government's real financial position, with less scope for political distortion. This is a very useful measure of the budget's stance because it tells us how much cash is currently being drained out of, or pumped back into, the economy. The underlying cash balance can also be used to determine whether the government overall is running down or adding to national savings and debt.

3. The fiscal outcome

Like the underlying balance, the *fiscal balance* is also quite a useful indicator of the government's financial position. However, the difference between the two measures is that the fiscal balance is arrived at through the *accrual approach*. The two indicators provide similar results but they are not identical. One reason for this is that the fiscal balance takes into account the impact of various financial transactions, even where these are deferred and there is *no immediate* transfer of cash.

When there is a *positive* fiscal balance or surplus, the existence of government savings means there are sufficient funds available to finance government activities without adding to foreign borrowing or worsening the CAD. However, a *negative* fiscal balance means there is a shortfall in savings that puts upward pressure on the CAD through increases in our overseas debt and income payments abroad.

Over the duration of a *business cycle* (i.e. the medium term), the government aims to have fiscal balance by running surpluses during booms that are more than sufficient to pay for deficits that occur in recessions. As a result, there should theoretically be zero impact on the levels of private sector savings and government debt over the long term. By adding to national savings, surplus budgets not only solve the problem of *crowding out* (where government borrowing to finance deficit budgets puts upward pressure on interest rates and discourages private sector spending), but encourages *crowding in* (where private sector investors are enticed by lower domestic interest rates).

on Resources

 **Weblinks** Ways that governments reduce federal debt
Deficits & debts

4.5 ACTIVITIES

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Check your understanding

1. What is meant by the term *budget outcome*?
2. What are the three main *types* of budget outcome?
3. How is a budget deficit financed?
4. How might a budget surplus be used?

Applied economic exercises

1. (a) Distinguish the following pairs of terms:
 - i. A budget deficit and a budget surplus (2 marks)
 - ii. A headline budget deficit and an underlying budget deficit. (2 marks)
- (b) Assume the government runs a budget deficit of \$20 billion. Identify and outline the various *options* available to the government for financing this deficit. (3 marks)
- (c) Identify *two* important economic problems associated with running budget *deficits* in the long term. (2 marks)
- (d) Identify *two* important advantages of reducing the deficit and returning to budget surplus as soon as possible. (2 marks)
- (e) What is the *medium-term operational goal* of budgetary policy? (2 marks)
2. The Australian government has attempted to reduce its budget deficit in recent years to 2018–19. Outline *two* key options available that could be used to reduce the size of the budget deficit, assuming this was the main priority.
3. Outline how any *four* of the following events would be likely to affect the *actual outcome* of the Australian government's budget. (1 + 1 + 1 + 1 = 4 marks)
 - i A rise in domestic consumer and business confidence
 - ii The slower rate of economic growth in China
 - iii A rise in the unemployment rate from 5.0 per cent to 6.4 per cent
 - iv Increased tax evasion by multinational corporations operating in Australia
 - v An acceleration of wages growth
 - vi An ageing population with a declining proportion of people of working age
 - vii A reduction in the level of government debt
 - viii Cuts in rates of PAYG tax on personal incomes to compensate individuals for the effects of 'bracket creep' (where generally rising incomes over a period of time cause most people to move into higher tax brackets)
 - ix The increased commitment of defence personnel for overseas peacekeeping and anti-terror operations
 - x A serious flu epidemic spreading
 - xi The unexpected return of favourable climatic conditions
 - xii A tightening of rules relating to welfare access

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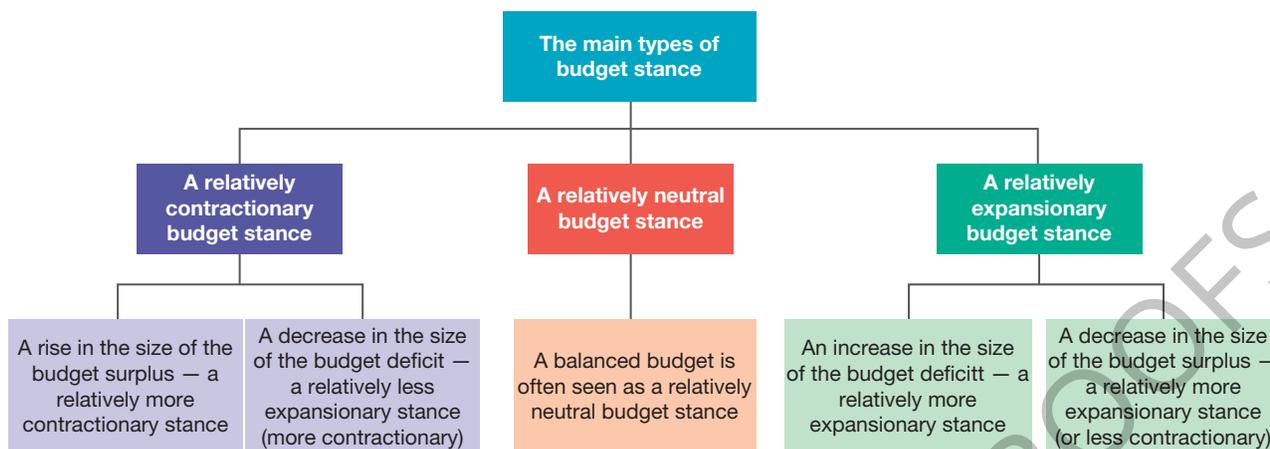
4.6 The stance of budgetary policy — is it expansionary or contractionary?

KEY CONCEPT

- the stance of budgetary policy: expansionary or contractionary

The *budget outcome* is the difference between the values of government revenue (money taken out of the economy) and expenses (money injected into the economy). This outcome can involve a budget deficit or surplus, and is often used as a *rough guide* to the *budget's stance* being adopted by the treasurer. Here the term **budget stance** relates to the intended macroeconomic impact of the budget outcome on the direction of AD ($C + I + G + X - M$) and whether an expansionary or contractionary stance has been adopted. The three main stances for budgetary policy are summarised in figure 4.6.

FIGURE 4.6 Overview of budget outcomes



4.6.1 Using the size of the deficit or surplus to help decide the budget's stance

One way to roughly decide whether the budget's stance is relatively expansionary or contractionary is to check out the absolute *size* of the budget deficit or surplus (measured in terms of the number of dollars):

- *A relatively expansionary budgetary or fiscal policy stance.* Budgets that seek to *stimulate AD* and economic activity (because there is a slowdown in the economy) are said to be relatively **expansionary budgets**. They typically include reductions in receipts and/or rises in outlays. Hence, expansionary budgets generally involve *either* one of the following:
 - an increase in the size of the budget *deficit* against the previous year (such as a rise in the deficit from \$30 billion to \$50 billion)
 - a cut in the size of the budget *surplus* against the previous year (such as a decrease in the surplus from \$20 billion to \$5 billion).
- *A relatively contractionary budgetary or fiscal policy stance.* Budgets that seek to *slow AD* and economic activity (because there is an inflationary threat), are said to be relatively **contractionary budgets**. They typically include rises in revenue relative to expenses. Therefore, *contractionary budgets* generally involve *either* one of the following:
 - a reduction in the size of the budget *deficit* against the previous year (such as a cut in the deficit from \$30 billion to \$10 billion)
 - a rise in the size of the budget *surplus* against the previous year (such as a rise in the surplus from \$10 billion to \$20 billion).

4.6.2 Some other considerations in deciding the budget's stance

While looking at variations in the absolute size of the budget deficit or surplus (in billions of dollars) is often used as a *rough guide* to the *direction* of the budgetary policy's stance, on its own, this measure can be misleading and hence to be sure, more information is needed.

Is the changed outcome the result of automatic or discretionary stabilisers?

Having additional information can help us to more accurately determine whether the change in the budget outcome between one year and the next is likely to be expansionary or contractionary. For instance, it would also be handy to know whether the change in the overall size of the budget deficit or surplus between one year and the next has occurred mostly because of *automatic changes* (that are caused by rises and falls in the level of economic activity) and/or because of *discretionary changes* (caused by deliberate changes in policy by the treasurer) in the value of receipts relative to outlays. We will look at these two types of budgetary stabilisers in more detail shortly; but for now, try to understand that the size of the *discretionary*

deficit or surplus can provide a clue to the federal treasurer's *true intentions*. It allows us to more clearly see whether the budget stance is *deliberately* seeking to have an expansionary or contractionary impact on AD and economic activity.

For instance, imagine there was a *rise* in the size of the budget deficit (measured in dollar terms) in a particular year, in response to *weaker economic activity*. We may be tempted to conclude that the budget has become *more expansionary* and is adding extra *stimulus* to AD. While this is probably true, an often better guide in this situation is to see whether there has been a rise in the size of the structural or *discretionary budget deficit* (as opposed to a rise in the deficit due to the operation of *automatic changes* or stabilisers). In this case, if there was an increase in the *discretionary budget deficit* (due to deliberate reductions in tax rates and/or higher outlays), it could confirm the treasurer's *intentions* and whether it was felt that *additional stimulus* (over and above the cyclical deficit) was needed to lift total spending and production, and lower unemployment.

Comparing the budget outcome against the changing size of the economy

The changing size of the economy is another limitation to just using the change in the absolute size of the budget deficit or surplus between one year and the next as a guide to the budget's stance.

A deficit of \$30 billion in a small economy will have a more expansionary effect than the same sized deficit in a larger economy. To help overcome this problem, the budget outcome (along with receipts and outlays) is often expressed as a ratio or *proportion* of GDP or the size of the economy. For example, the budget deficit in 2017–18 equaled 0.5 per cent of GDP while that for 2018–19 was smaller at just 0.2 per cent, suggesting a less expansionary stance.

on Resources

-  **Weblinks** Expansionary fiscal policy
How government uses fiscal policy to influence the economy

4.6 ACTIVITIES

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Check your understanding

1. What is a contractionary budget stance? When would this be used?
2. What is an expansionary budget stance? When would this be used?
3. How would you determine whether the budget stance is expansionary or contractionary?

Applied economic exercises

1. (a) Distinguish between an expansionary budget stance and contractionary stance. **(2 marks)**
(b) Examine table 4.4 showing changes in the Australian government's underlying budget outcome.

TABLE 4.4 The Australian government's underlying budget outcome

Year	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14
Federal government underlying budget outcome (\$ billions)	19.7	–27.0	–54.5	–47.5	–43.4	–18.3	–48.5
Federal government underlying budget outcome (percentage of GDP)	1.7	–2.2	–4.2	–3.4	–2.9	–1.2	–3.0

(continued) ▶

TABLE 4.4 The Australian government's underlying budget outcome (*continued*)

Year	2014–15	2015–16*	2016–17	2017–18*	*2018–19	*2019–20*	2020–21
Federal government underlying budget outcome (\$ billions)	–37.9	–39.6	–33.2	–10.1	–4.1	7.1	
Federal government underlying budget outcome (percentage of GDP)	–2.3	–2.4	–1.9	–0.5	–0.2	0.4	

*Note: Budget estimates as at April 2019. However, these may also be affected by policy and other changes following the federal election in May 2019.

Source: Data derived from Budget Papers April 2019.

Giving reasons and quoting data from the table, describe the *change* in the *budgetary policy stance* adopted between each of the following periods:

- the change in 2012–13 against 2011–12 (1 mark)
- the actual and forecast changes during 2017–18–19–20 against the outcome for 2016–17. (1 mark)

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4.7 The roles of automatic and discretionary stabilisers in affecting the budget's outcome and stance, and the impact on the level of government debt

KEY CONCEPTS

- the role of automatic stabilisers (cyclical component of the budget) in influencing aggregate demand and stabilising the business cycle
- the role of discretionary stabilisers (structural component of the budget) in influencing aggregate demand and stabilising the business cycle
- the effect of automatic and discretionary changes in the budget on the budget outcome and government (public) debt

Budgetary policy is an important macroeconomic or aggregate demand policy. During an economic *slowdown* when GDP growth is below trend, unemployment is high and inflation is low, governments often use *expansionary* aggregate demand budgetary policies designed to boost spending and activity.

One of the functions of the Australian government is to regulate or *stabilise* the level of AD and hence economic activity, thereby helping to create conditions optimal for the achievement of key domestic macroeconomic goals and living standards. As an aggregate demand strategy, budgetary policy is one way of regulating spending, so as to help reduce the severity of booms and recessions that are typical of the normal business cycle.

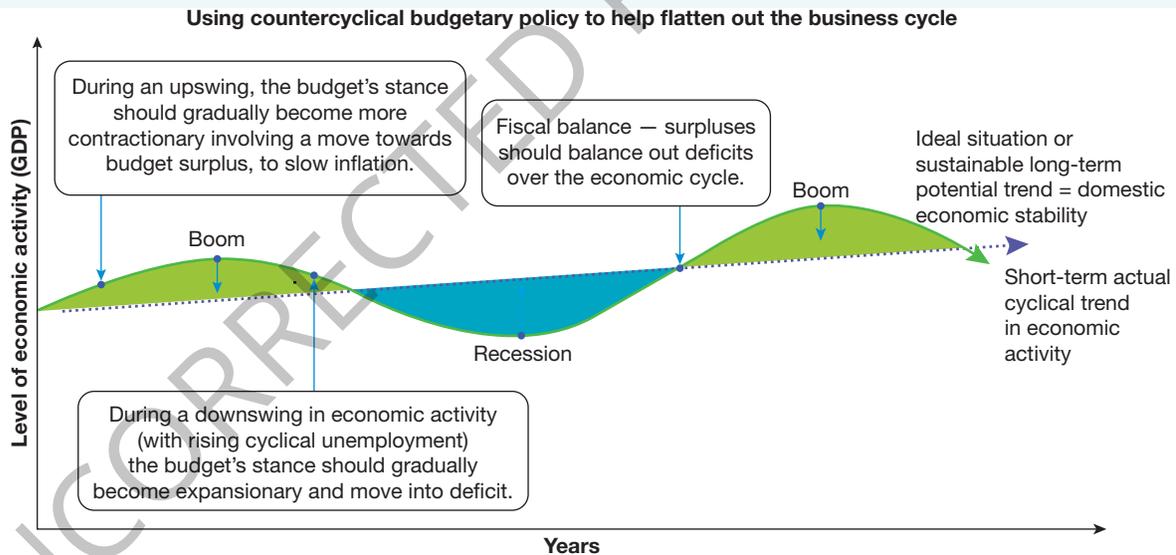
To moderate instability and the business cycle, a **countercyclical budgetary policy** application is required and is illustrated in figure 4.8. This means that:

- in a *slowdown* (where there is weaker growth and higher unemployment), the budget typically becomes progressively more *expansionary* to boost AD
- during a strong inflationary *upswing* in economic activity, the budget typically becomes more *contractionary* to slow the growth in AD to a sustainable rate.

FIGURE 4.7 As seen in Australia, this economic stimulus typically involves budget deficits. However, a downside of deficits is that the level of government debt can rise, increasing the burden on future generations.



FIGURE 4.8 How expansionary and contractionary budgetary policy works as a countercyclical stabiliser of AD and economic activity



For the budget outcome to become either *more expansionary* (with bigger deficits or smaller surpluses) or *more contractionary* (with smaller deficits or bigger surpluses) in this way, it must rely on *two* types of stabilisers:

- *automatic stabilisers* (also called cyclical stabilisers)
- *discretionary stabilisers* (also called structural stabilisers).

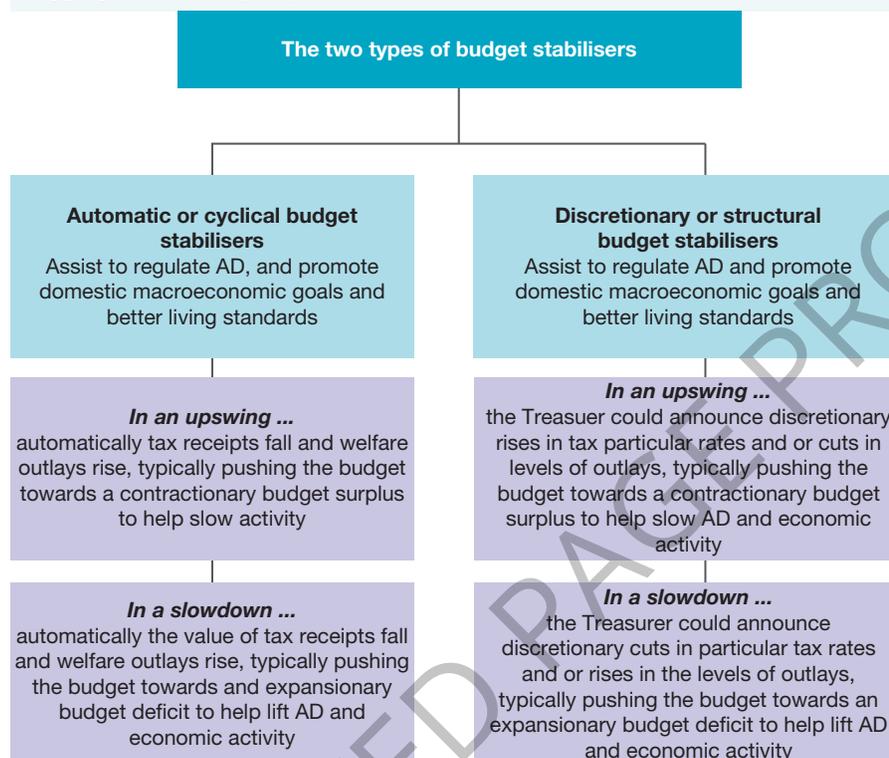
These two stabilisers in the budget are summarised in figure 4.9.

By changing the value of budget receipts relative to outlays, these two stabilisers can especially affect the levels of household consumption spending (C), business investment spending (I), government consumption spending (G_1), government capital spending (G_2), national savings (S) and hence AD. At least in theory,

fiscal or budgetary policy applied countercyclically, should be able to help *steer the economy* along the narrow but ideal pathway between boom on the one hand and recession on the other.

So how exactly do these automatic and discretionary stabilisers work?

FIGURE 4.9 The two types of stabilisers used in budgetary policy as an aggregate demand policy measure.



4.7.1 The role of automatic stabilisers in influencing aggregate demand and stabilising the business cycle

Automatic stabilisers (also called *cyclical stabilisers*) are built into budget tax receipts and some government expenses. They are called automatic stabilisers because they operate in a *countercyclical* way to boost or slow AD and economic activity, without the federal treasurer deliberately changing their level or announcing new policies. They are cleverly programmed to change as a result of the ups and downs in the level of economic activity. Operating on their own, automatic stabilisers would normally cause the budget outcome to gradually switch from a *deficit* in a slowdown, to a *surplus* in a boom and back to a deficit in the next slowdown, theoretically allowing the budget to be in *balance* over the medium to long term.

Automatic stabilisers include most types of tax receipts, such as revenues from PAYG tax, company tax, CGT, GST and excise, as well as expenses including some welfare benefits (especially those paid to the unemployed). How do these stabilisers work to help regulate private sector spending and iron out severe booms and recessions?

Using automatic stabilisers during slowing economic activity and recession

During and immediately following a *cyclical slowdown* in economic activity, or in a *recession*, the level of budget tax receipts from PAYG, company and indirect taxes, such as excise and the GST, automatically falls. This is because weaker economic activity and rising unemployment cause a drop in disposable incomes; they reduce company profits and lower sales of goods and services. In addition, higher unemployment also means that budget outlays on welfare benefits for the unemployed and other needy

groups automatically rise. This combination of lower receipts and higher outlays automatically tends to grow the *cyclical budget deficit*. In turn, this tends to have an expansionary effect on household C and business I spending, thereby helping to restore domestic stability by stimulating national production and employment.

Using automatic stabilisers during rising economic activity and an inflationary upswing

During a *cyclical upswing* or recovery in the level of economic activity, or a *boom*, the value of budget receipts automatically tends to increase and some budget expenses fall. This is because increased spending and sales causing the upturn also decrease unemployment, raise incomes and grow business profits. Hence, government revenues from personal, company, capital gains and indirect taxes are boosted, while welfare payments to the unemployed are reduced (because there are fewer unemployed people). In this case, the budget cyclical budget deficit is reduced automatically and the budget outcome tends to move towards a



cyclical surplus, gradually withdrawing the stimulus. This helps to slow the growth in private sector C and I spending, and economic activity, to more sustainable rates.

Remarkable as it seems, automatic stabilisers work fairly quickly and efficiently, without the government having to deliberately announce or implement any new measures. In addition, given the right fiscal settings, cyclical budget deficits that are run up during a slowdown should be repaid by cyclical surpluses recorded in the recovery (at least in theory). As a result, in the medium to long term the operation of automatic stabilisers should not lead to a rise in government debt.

4.7.2 The role of discretionary stabilisers in influencing aggregate demand and stabilising the business cycle

Discretionary stabilisers (sometimes called *structural stabilisers*) in the budget can also help deliberately bring about a change in the budget outcome and be used as a stabiliser of economic activity. However, unlike automatic stabilisers, *discretionary stabilisers* depend on *deliberate* changes to the levels of budget receipts and outlays by the federal treasurer. For instance, the treasurer could alter existing *tax rates* applied to personal incomes, company profits or the goods and services tax; introduce a *brand new tax*; or *abolish* an existing tax. Alternatively, the treasurer could alter the *nature and levels* of government outlays on areas like welfare payments to families, education, purchases of defence equipment, foreign aid and the building of a new hospital, or announce particular national infrastructure building projects such as the National Broadband Network (NBN), the upgrade of particular highways or the building of a rail line. Discretionary changes such as these alter the *structural budget outcome*, AD (especially C, I, G1 and G2), and hence the levels of economic growth and jobs.

Discretionary measures are sometimes introduced when automatic stabilisers are not sufficiently powerful on their own to deal with a prolonged and severe recession or a really serious boom. However, unless these are removed following the crisis, they could lead to permanent budget surpluses or, far more likely, permanent structural deficits.

Using discretionary stabilisers during slowing economic activity and recession

During a *slowdown*, the federal treasurer has the option of announcing discretionary reductions in personal or company tax rates, or *rises* in spending on border security or infrastructure. These would cause the size of the *structural budget deficit to grow* (or the structural surplus to shrink), typically making the budget *more expansionary*. In turn, this would stimulate AD (perhaps by accelerating C, I, G1 and G2 expenditure), strengthening economic growth and jobs.

The danger with discretionary rises in budget outlays or cuts in receipts, is that they are politically difficult for the government to remove after the economy recovers. This is, especially the case if the government has a small majority or do not have the numbers in the upper house or Senate. So there is a risk that a *permanent structural budget deficit* will develop, remaining even when the need for the stimulus has passed. As a result of this bias towards expansionary budget deficits, over time government finances and debt can gradually become unsustainable and lead to severe consequences, as has happened in many countries in Europe and elsewhere. Australia is not yet in this situation, but the writing is on the wall and decisive action has been required to gradually return the budget to surplus.

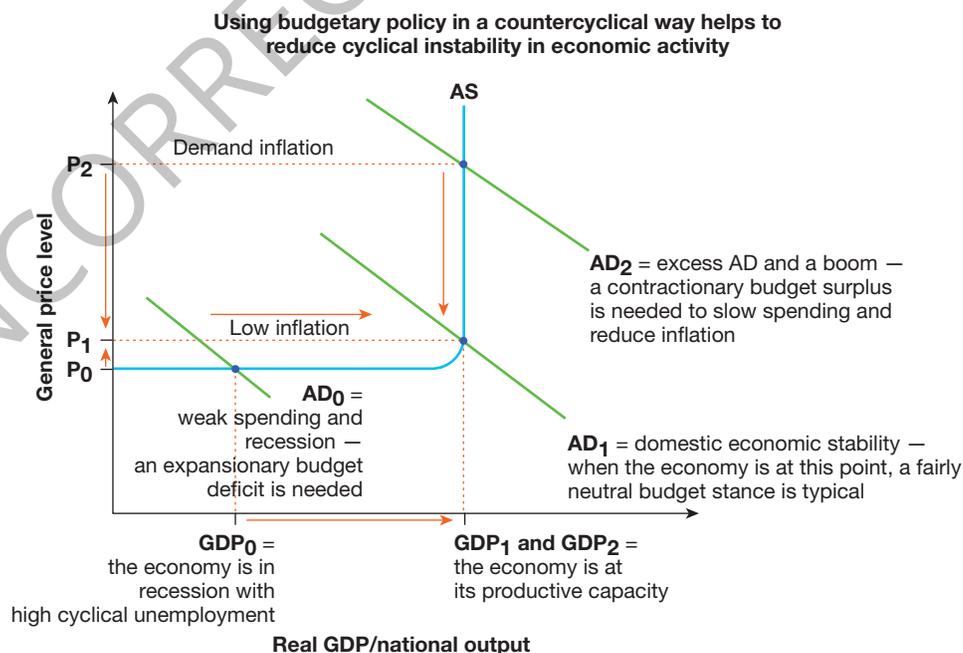
Using discretionary stabilisers during rising economic activity and an inflationary upswing

When the economy starts to recover and activity is picking up, the federal treasurer needs to gradually withdraw any remaining discretionary stimulus to avoid creating a permanent structural budget deficit. This could mean reversing the previous discretionary cuts in receipts and/or rises in outlays. However, as pointed out and seen recently in Australia, such moves are unlikely to be popular with voters or opposition parties.

4.7.3 Reviewing how automatic and discretionary stabilisers work together to affect AD

Putting automatic and discretionary budget stabilisers *together* and using the AD–AS diagram for the economy shown in figure 4.10, it is possible to see theoretically how these measures might operate in a *countercyclical* way to improve Australia's prosperity.

FIGURE 4.10 How countercyclical budgetary policy can be used to help regulate AD and promote domestic economic stability



During a prolonged *slowdown in economic activity*, when economic growth is relatively weak and cyclical unemployment is rising, the budget stance progressively becomes *more expansionary* to boost AD (shift spending from AD_0 to AD_1) and economic activity (shift production from GDP_0 to GDP_1). In this situation, any budget surplus would quickly disappear, and there would typically be a rise in the deficit. This can happen in *two* ways.

- First, there are *automatic* reductions in tax receipts and rises in welfare outlays.
- Second, if required, there could also be *discretionary* reductions in tax receipts and rises in outlays.

As a result of these two types of *expansionary stabilisers*, the budget typically moves towards a *deficit* and the economy shifts towards domestic economic stability (moves towards AD_1 , GDP_1 and P_1) where, simultaneously, there is low inflation, strong and sustainable economic growth and full employment.

By contrast, as the economy *strengthens* and there is a fear of inflationary pressures, the budget stance gradually becomes *more contractionary* as the stimulus is withdrawn and the brakes are applied to slow AD (moving AD_2 to AD_1), economic activity and inflation (P_2 to P_1). Typically, the cyclical and possibly also the structural budget deficit will switch to become a budget surplus. Again, this can happen in *two* ways.

- First, *automatically* receipts will rise and welfare outlays fall.
- Second, any *discretionary* stimulus measures from earlier periods could be gradually withdrawn through deliberate rises in budget receipts and cuts in outlays.

Again, as a result of these two contractionary budget stabilisers, the economy shifts towards domestic economic stability (moves towards AD_1 , GDP_1 and P_1) where, simultaneously, there is low inflation, strong and sustainable economic growth and full employment.

on Resources

-  **Weblinks** Fiscal & monetary policy review
Fiscal policy
Keynesian economics
A look at fiscal and monetary policy
Economic activity, unemployment & fiscal policy

4.7 ACTIVITIES

To answer questions online and to receive **immediate feedback** and **sample responses** for every question go to your learnON title at www.jacplus.com.au.

Check your understanding

1. What are *automatic stabilisers* and how do they work to help promote domestic economic stability?
2. What are *discretionary stabilisers* and how could they be used to promote domestic stability?

Applied economic exercises

1. (a) During 2017–18–19, the rate of economic growth *slowed* from 2.8 to around 2.25 per cent. Explain how *automatic stabilisers* would work in this situation to help promote domestic economic stability. **(4 marks)**
(b) During 2019–20, the budget forecast that the rate of economic growth would *strengthen* from 2.25 to 2.75 per cent. Explain how you would expect *automatic stabilisers* to work in this situation to help promote domestic economic stability. **(4 marks)**
(c) How would the recent slow growth in wages tend to affect the budget outcome and household consumption spending? **(2 marks)**
2. How should the government apply *discretionary stabilisers* during a severe *slowdown* in economic growth where unemployment has risen to 6 per cent? **(2 marks)**

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4.8 The effect of budget initiatives on the government's key domestic macroeconomic goals during the past two years

KEY CONCEPT

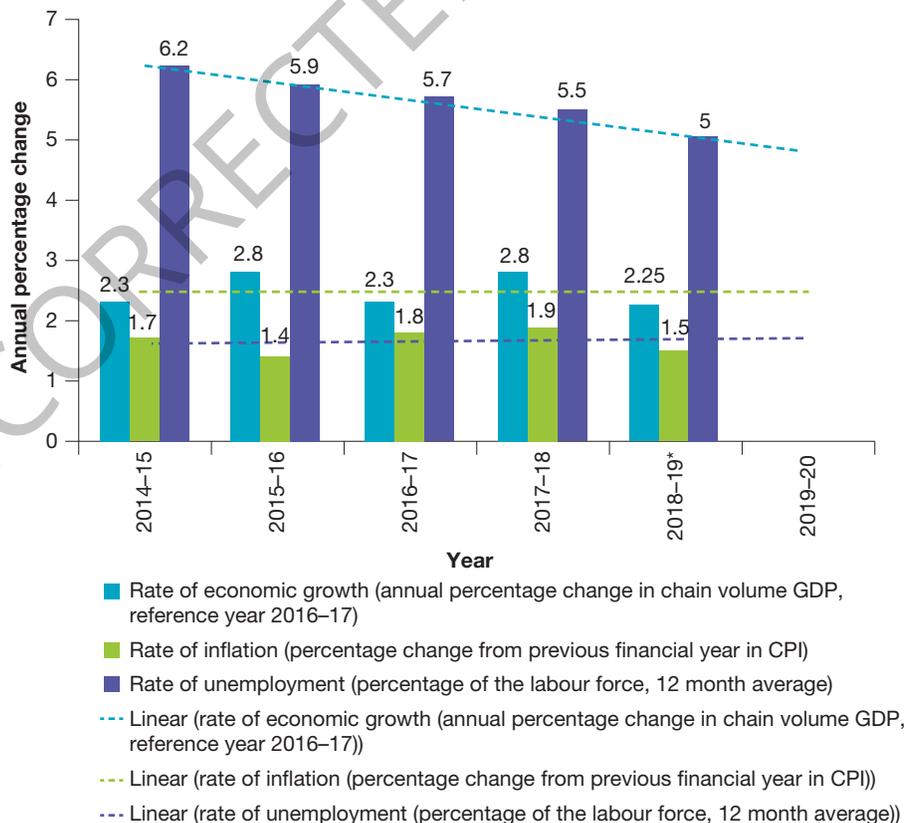
- the effect of budget initiatives from the past two years on the Australian government's domestic macroeconomic goals of strong and sustainable growth, full employment and low inflation

This section is devoted to how the Australian government's budgetary or fiscal policy has been used during the past two to three years as an aggregate demand-side policy instrument to help promote our three key domestic macroeconomic goals: low inflation, strong and sustainable economic growth, and full employment. The change in focus by the current VCE course means that this subtopic will need continual updating. However, it will provide you with a suitable framework by concentrating on the 2017–18, 2018–19 and 2019–20 budgets.

4.8.1 Recent trends in Australia's domestic macroeconomic conditions

Let us start with figure 4.11, which shows recent trends in Australia's *domestic macroeconomic conditions* involving the rates of economic growth, unemployment and inflation.

FIGURE 4.11 Recent trends in Australia's domestic macroeconomic conditions
Indicators of Australia's domestic macroeconomic conditions in recent years (annual rates of inflation, economic growth and unemployment)



Source: Data derived from ABS 5206.0, 6202.0, 6401.0.

In particular, note the following developments during the two years between 2017–18 and 2018–19:

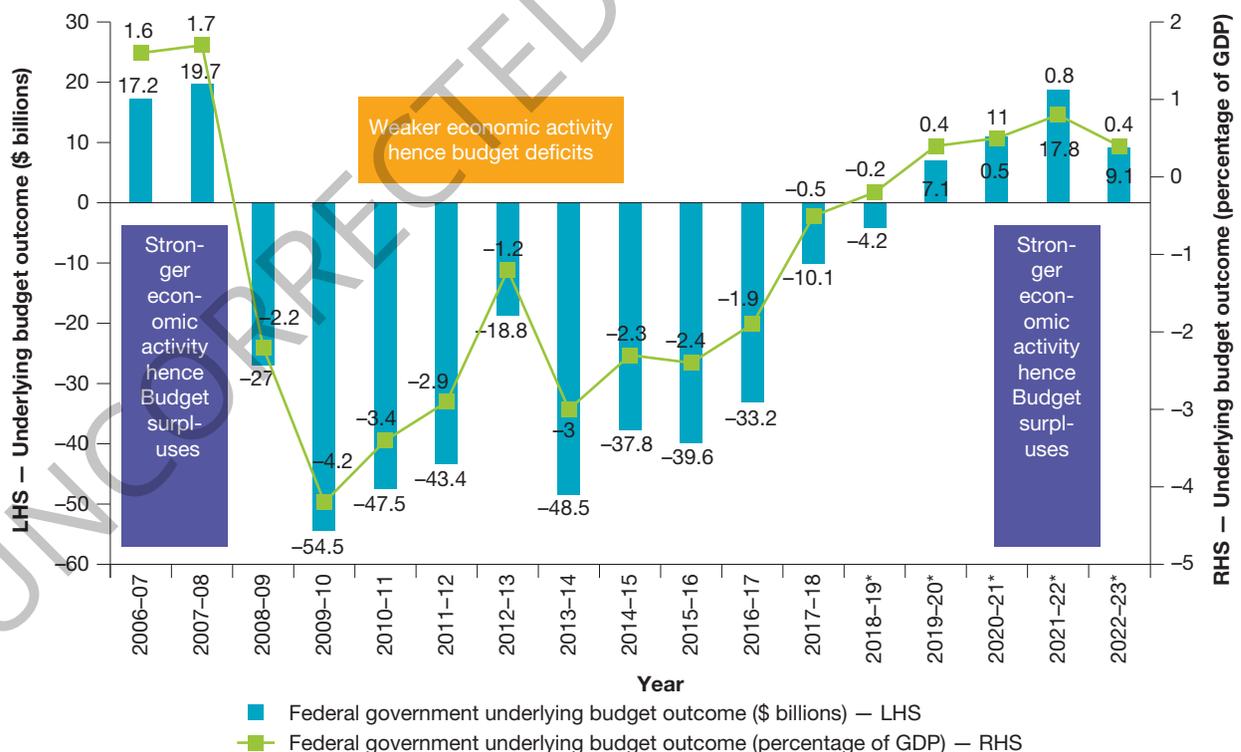
- *Economic growth slowed* to average around 2.5 per cent during the two years to 2018–19 (with 2.75 per cent forecast for the two years to 2020–21) — below the 3 per cent government target rate.
- *Unemployment remained relatively high* averaging around 5.2 per cent for the two years to 2018–19 (with 5.00 per cent forecast for each of the two years ending 2020–21) — above the 5 per cent target rate.
- The *inflation rate slowed* to an average 1.8 per cent during the past two years to 2018–19 (with 2.25 and 2.5 per cent forecast for the next two years ending 2020–21).

Overall, these trends in the last two years are indicative of ongoing weakness in an economy operating below its productive capacity. They also seem to suggest that the Australian economy could use some ongoing fiscal stimulus to help support AD and restore domestic stability. In other words, at the very least, small cyclical budget deficits might normally be expected (rather than budget surpluses) due automatically to



weaker budget tax receipts and stronger welfare outlays. Figure 4.12 shows that indeed there were ongoing deficits during 2017–18 and 2018–19, annually averaging nearly \$7 billion or about 0.35 per cent of GDP.

FIGURE 4.12 The countercyclical change in the federal government’s budget outcome to help reduce the severity of booms and recessions, 2006–07 to 2022–23



*Note: Estimates only and may vary due to changing political and economic circumstances.

Source: Data derived from Budget Papers, April 2019, see Statements 10 https://www.budget.gov.au/2019-20/content/bp1/download/bp1_bs10.pdf.

4.8.2 The key budget initiatives from the past two years

Despite these relatively weak recent domestic macroeconomic conditions, a decision was made some years ago to try and slowly reduce the size of the budget deficit at a responsible rate. This is illustrated in figure 4.12 and it meant that the last few budgets were overall *mildly contractionary (or less expansionary)*, from around -1.9 per cent of GDP in 2016–17 to an estimated -0.2 per cent in 2018–19 (and projected to return to small surplus of 0.4 per cent in 2019–20 based on the assumptions).

Recent federal treasurers frequently made mention of the need for **fiscal consolidation, budget repair and return to surplus** as part of the budget's medium-term operational goal. This was seen as necessary because there was growing concern over the unsustainable rise of public sector debt to a peak of around 20 per cent of GDP. In addition, some economists felt that there was a problem of *structural deficits* that may even prevent a return to budget surplus in the foreseeable future unless there were *discretionary rises in receipts* relative to outlays. Table 4.5 shows some of the key discretionary announcements designed to rein in the deficit (see the notes in red).

Although the recent reductions in the budget deficit were *less expansionary or mildly contractionary overall* (thereby tending to relatively slow AD, economic growth, job creation and inflation), table 4.5 also shows that there were at least some individual *discretionary* measures (see the notes in green) that in themselves would tend to have an *expansionary* effect and thus help to achieve domestic economic stability. At least some of these discretionary actions would be likely to stimulate C, I, G_1 and G_2 and hence AD. Given the existence of spare productive capacity at this time, some stimulus would not add significantly to cost or demand inflation. Here, firms would be able to collectively increase national output, thereby accelerating economic growth and lowering cyclical unemployment. In addition, some of these specific expansionary aggregate demand policy measures would tend to have beneficial aggregate supply impacts that would boost productive capacity and our potential GDP, while also slowing inflationary pressures. We will consider this aggregate supply policy channel of influence in topic 5.

TABLE 4.5 Some discretionary measures announced in the 2017–18, 2018–19 and 2019–20 budgets that may affect the structural deficit, and the levels of AD and economic activity

The 2017–18 forecast budget outcome = $-\$18.2$ billion

Announced discretionary changes in budget receipts in the 2017–18 budget

- *Medicare levy*: A proposed rise in the Medicare levy from 2.0% to 2.5% for most taxpayers to help fully fund the National Disability Insurance Scheme (NDIS) (this was later abandoned).
 - Likely to slow C, AD and economic activity
-
- *Tax incentives and assistance for home savers*: Households saving for a home loan deposit will be able to contribute up to \$15 000/year (capped at \$30 000 total) through their superannuation account at the special tax discount rate of 15%, rather than at the normal marginal tax rate. This should allow more people to reach their savings deposit target at a faster rate. In addition, tax incentives were announced for private sector investment in affordable social housing, with a discount of 60% rather than 50% on any taxable capital gains. Furthermore, foreign investor demand for housing should be eased by the limit of 50% ownership in new developments, along with a tax of \$5000/year on all future investors who fail to live in their property for six months per year. Some older Australians downsizing their home will be allowed to contribute up to \$300 000 into their superannuation fund gaining the added advantage of lower tax rates on contributions.
 - Likely to lift AD and economic activity

-
- *Company tax and assistance:* The promise to introduce the Ten-Year Enterprise Tax Plan announced in the 2016–17 budget, was again reaffirmed. If successful in the Senate, there would be phased-in reductions in company tax rates for all businesses starting in 2023–24, to arrive at the tax rate of 25% by 2026–27, along with the previously announced reduction in the tax rate to 27.5% for small to medium-sized companies starting July 2017 (this measure was later rejected and scaled back to gain Senate approval). In addition, there is to be an extension of the \$20 000 instant tax write-offs for capital items purchased by small to medium-sized firms with an annual turnover of less than \$10M.

- Likely to lift I, AD and economic activity
-

- *Bank Levy:* A big Bank Tax Levy was announced of 0.06%. This should raise \$1.6B per year.

- Likely to slow I, C, AD and economic activity
-

- *Student fees and charges:* University fees are to rise and students to pay an additional 7.5% of their course costs, along with a lower threshold for HELP loan repayments, to help raise an extra \$2.8B over three years and reduce the \$52B in outstanding student loans.

- Likely to slow C, AD and economic activity
-

- *Overseas workers:* A new levy on firms who bring in overseas workers on visas to fill Temporary Skills Shortages was announced costing up to \$1800/worker, as well as a levy of up to \$5000/worker for those on various Permanent Skills Visas. Together these should raise \$1.2B over four years.

Likely to have mixed effects on AD and economic activity

Announced discretionary changes in budget outlays in the 2017–18 budget

- *Infrastructure spending:* There is to be a large boost of \$20B to government investment spending involving the building of national infrastructure projects (up from the previous figure of \$50B to \$70B for the period, 2014–15 to 2019–20). This is to include funding arrangements for the Inland Rail Project from Melbourne to Brisbane (cost \$8.4B), a new western Sydney airport, work on the Snowy Mountains hydro-electricity scheme, a hospital in WA, urban and regional rail links in Victoria including duplicating the Geelong-Waurn Ponds line, highway upgrades in Victoria to the M80 Ring Road and Monash Freeway, and in Queensland, improvements to the Bruce Highway. In addition, there is the Regional Growth Fund boost of \$472M for regional infrastructure and Building Better Regions.

Likely to lift G2, I, AD and economic activity

- *Welfare changes:* There is to be a new Jobseeker Payment that consolidates and simplifies seven current income support payments. In addition, measures were announced that tighten the obligation of unemployed jobseekers to attend interviews. This is designed to increase the labour force participation rate and reduce welfare dependence.

Likely to slow C, AD and economic activity

- *Health:* The previous freeze on the Medicare Benefits Schedule will be removed. It will be allowed to rise at a total cost of \$1B over four years; along with new Pharmaceutical Benefits listings for subsidised medicines at a cost of \$1.2B over five years.

- Likely to lift C, AD and economic activity
-

(Continued)

TABLE 4.5 Some discretionary measures announced in the 2017–18, 2018–19 and 2019–20 budgets that may affect the structural deficit, and the levels of AD and economic activity (*Continued*)

- *Education spending:* The policy of deregulating university fees announced in the 2014 budget (and retained in the 2015 and 2016 budgets) was officially abandoned. However, universities will face some funding cuts due to the assumption of a 2.5% efficiency dividend, and are expected to be more financially accountable. Schools are to receive an increase in funding of \$18.6B over the next 10 years under a proposal called *Quality Schools – true needs-based funding for Australian Schools* where the funding model is the same for all school systems (similar in some ways to the previously proposed Gonski Model under Labor).
- **Likely to have mixed effects on AD and economic activity**

- *Outlays involving housing affordability:* Establish a \$1B National Housing Infrastructure Facility to reduce infrastructure obstacles limiting the building of new homes on various sites (e.g. new defence department land to be released). The current National Affordability Housing Agreement is to be replaced with the creation of a new National Housing and Homeless Agreement with the states. It is designed to improve housing affordability, and will gain a funding boost of \$375M.
- **Likely to lift G2, I, AD and economic activity**

The 2018–19 forecast budget outcome = –\$5.2 billion

Announced discretionary changes in budget receipts in the 2018–19 budget

- *Personal income tax cuts* for low- and middle-income earners:
 - From 1 July, there is to be an extension of the upper cut-off for the 32.5% marginal tax rate bracket from \$87 000 to \$90 000 taxable income. This also helps to reverse the effects of bracket creep.
 - The low-middle income tax offset and upper income threshold is to be lifted to \$90 000, allowing a tax cut of up to \$530 per year.
 - There was the announcement of the Seven-year Income Tax Reform Plan to lower and simplify tax rates for most taxpayers.
 - The initially proposed rise in the Medicare levy to 2.5% was abandoned, so the levy remains at 2.0%.
- **Likely to lift C, AD and economic activity**

- *Assistance to companies:*
 - Reaffirmation of the plan to lower the tax rate for small and medium-sized companies.
 - The announcement of continued help for small and medium-sized companies by extending the special instant tax write-off of up to \$25 000 per eligible capital item for small to medium-sized companies (i.e. those with annual turnovers of less than \$10M).

Likely to lift I, AD and economic activity

- *Excise tax:* The 40% excise tax on craft beer is to be removed.

Likely to lift C, AD and economic activity

- *The black economy:* Attempts are to be made to crack down on the illegal tobacco trade to help raise around \$3.6B over the next four years. Also, recommendations from the Black Economy Taskforce are to be implemented to bring in an estimated \$5.3B extra in tax revenue over four years from those under reporting their income.

Likely to lift to have mixed effects on AD and economic activity

Announced discretionary changes in budget outlays in the 2018–19 budget

- *Government spending on national infrastructure:* Increased government capital spending on infrastructure contained in the announcement of a \$75B Ten-Year Infrastructure Plan. This is an increase of around \$25B in spending for roads and rail building project to help reduce bottlenecks and business costs, especially in transport. For instance, there is \$5B for the Melbourne Airport rail link, \$1.8B for the North East road link, continued works on widening the M80 Ring Road, the Waurn Ponds rail duplication to Geelong, the Monash rail link, and works to improve the Bruce and Pacific Highways.

Likely to lift G2, I, AD and economic activity

-
- *Spending on technology, medical and scientific research:*
 - Over the next 12 years, the government announced an increase in investment of \$2.4B for scientific research and improving our technology capabilities required for growing a smart economy.
 - There will be \$1.9B set aside over 12 years for lifting government investment spending on research infrastructure.
 - \$26M is set aside to create an Australian Space agency.
 - Likely to lift G2, AD and economic activity

-
- *The government announced welfare measures, and support for the aged:*
 - The government's new \$1.2B Child Care Package to support child costs for lower income families will commence.
 - \$1.6B has been allocated to make 14 000 extra high-level home care support packages for the elderly, so they can live longer at home.
 - Announcement of a Pensioner Loan Scheme where applicants can boost their retirement income by up to \$17 800 per year, by borrowing against equity in their house as an asset.
 - There is to be an extra \$280M of funding to cover ongoing wage subsidies up to \$10 000 to employers taking on older, indigenous, rural and other disadvantaged Australians.
 - Extra funding of \$250M was announced for boosting the Skilling Australia Fund.
 - The waiting period for migrants to access some welfare benefits will be increased to four years starting in July 2018.

-
- A \$2000 wage subsidy will be made available for older people to update their training, skills and employment prospects, following ongoing rises in the pension age.
 - \$38M is to be outlaid on ABSTUDY over the next five years.
 - \$300M in government spending on disability employment services.
 - Likely to lift C, AD and economic activity

-
- *Government budget outlays on education:*
 - Previous budget commitments are proceeding, including those for the \$24.5B Quality Schools Package, with promises of further rises to \$30B in 2027.
 - Additional outlays of \$440M are directed to extending the National Partnership Agreement on Universal Access to Early Childhood Education, boosting the total for 2018 and 2019 to \$870M.
 - Likely to lift G2, I, AD and economic activity

The 2019–20 forecast budget outcome = –\$7.1 billion

*Note: Estimates only and may vary due to changing political and economic circumstances.

Announced discretionary changes in budget receipts in the 2019–20 budget

- *Personal income tax offsets* for low-middle income earners:

(Continued)

TABLE 4.5 Some discretionary measures announced in the 2017–18, 2018–19 and 2019–20 budgets that may affect the structural deficit, and the levels of AD and economic activity (*Continued*)

- From 1 July 2019, low and middle-income earners are to receive tax offsets of between \$1080 (single income earner) and up to \$2160 (dual income families).
- Further reductions in the marginal rates of income tax for some individuals were announced. These would be rolled out over 10 years where around 94% of taxpayers would pay a marginal rate of 30% or less by abolishing the 32.5% and 37% marginal tax rates by 2024–25 and lifting the upper thresholds of the 19% and 30% tax rates, making the personal income tax system less progressive.
- **Likely to lift C, AD and economic activity**

- *Assistance to companies:*
 - Restate the already scheduled reductions in the rate of company tax for small and medium-sized businesses (with an annual turnover up to \$50M) that currently pay 27.5% tax on profits. The next reduction to 26% will occur in 2020–21, ending with a further reduction to 25% for 2021–22.
 - The announcement of continued help for small and medium-sized companies by extending and increasing the special instant tax write-off of up to \$30 000 per eligible capital item for small and medium-sized companies.

Likely to lift I, AD and economic activity

- *Tax crackdown on multinationals and the wealthy:* By boosting funding for the Australian Tax Office (ATO) by around \$1B and singling out multinationals, wealthy families and trusts for closer scrutiny, an extra \$3.6B in tax revenue is anticipated.

Likely to have mixed effects on AD and economic activity

Announced discretionary changes in budget outlays in the 2019–20 budget

- *Government spending on national infrastructure:* There is to be an increase in government capital spending on infrastructure (especially road and rail programs), up from \$75B (2018–19) to \$100B as part of a rolling Ten-Year Infrastructure Plan. Projects to include a \$3B rise in the Urban Congestion Fund to ease road congestion and increase parking at railway stations, \$2B for a fast train service from Geelong to Melbourne, \$1.4B for upgrading unsealed country roads in Victoria, over \$2B for blackspot areas and to repair potholes, \$3.5B for the West Sydney North–South Rail Link, \$2.5B for important Queensland roads, and \$1.6B for extending the M1 Pacific Motorway.

Likely to lift G2, I, AD and economic activity

- *Export Market Development Grants:* There is an additional \$60M to lift Export Market Development Grants to help small and medium-sized businesses to develop markets abroad and sales opportunities.

Likely to lift net X, AD and economic activity

- *Spending on technology, medical and scientific research:* The Medical Research Fund is to get a grant of \$5B that includes \$614M in research funding for diseases and rare cancers, over \$600M for building clinics and \$220M for cardiovascular research.

Likely to lift G2, AD and economic activity

- *Health initiatives:*
 - \$7.7B spread over three years to help cover the cost of MRI scans for screening those with breast cancer.
 - \$1.4B for the period to 2022–23 to cover the costs of adding new free drugs to the Pharmaceutical Benefits Scheme.

- \$737B set aside for the treatment of mental health and drug abuse issues.
- An extra \$1.3B to be spread over seven years to improve hospitals and health care.

Likely to lift G2, AD and economic activity

- *New welfare measures and support for the aged:*
 - There will be 10 000 home care packages provided for the elderly so they can stay in their own homes longer.
 - Pensioners to receive a one-off payment of \$75 for singles or \$125 for a couple to help cover the increased costs of electricity.

Likely to lift C, AD and economic activity

- *Government budget outlays on education and training:*
 - A record \$36B to be spent on education.
 - A total of 80 000 apprenticeships will be funded to help target and overcome skills shortages.
 - Employers hiring apprentices will be eligible to receive a grant of \$8000 (double the old rate) and new apprentices to each receive \$2000.
 - Establish 10 new training hubs or centres to connect young people with industries and schools in areas with high youth unemployment.
 - Funding of 1000 scholarships to encourage young people to study in regional centres.
 - \$453M to go towards expanding opportunities for 350 000 children to gain early learning.
- Likely to lift G2, C, AD and economic activity

4.8.3 The effects of recent budget initiatives on domestic macroeconomic goals

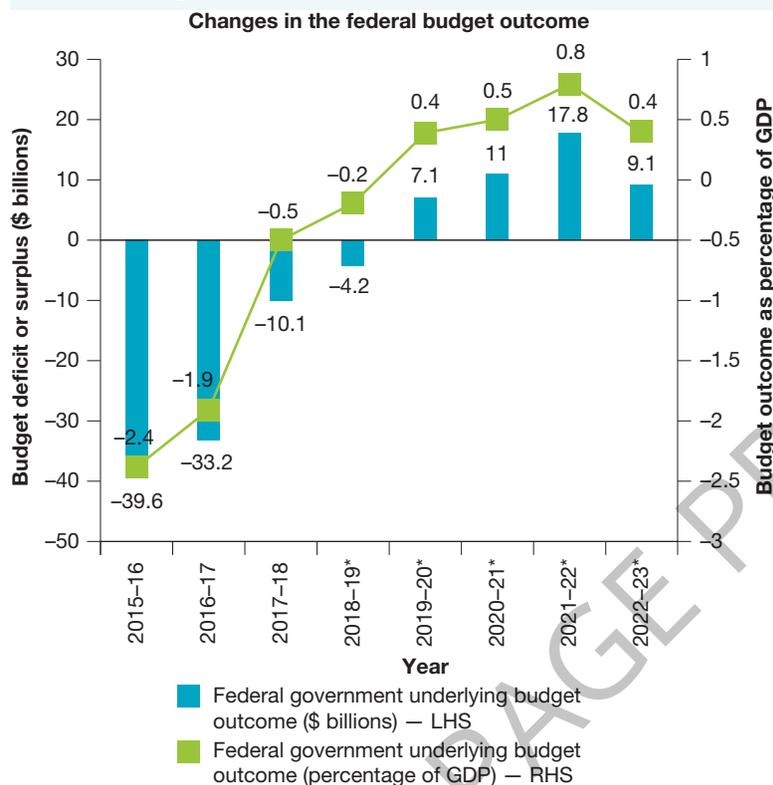
We have seen that the government typically relies on a combination of *automatic and discretionary stabilisers* in the budget to help reduce the severity of booms and recessions, and promote domestic economic stability (namely, the simultaneous achievement of strong and sustainable economic growth, full employment and low inflation) and improve living standards. To work effectively, these budget stabilisers must operate in a *countercyclical* manner with an overall looser stance in downswings to stimulate AD and a tighter stance in upswings to slow AD and economic activity to a sustainable rate.

The impact of recent budgetary policy measures on Australia's domestic macroeconomic goals

In the past two years, Australia's rate of economic growth was fairly slow and below trend, rising by just 2.5 per cent a year (against the target rate of 3 per cent). While this kept inflation low, it caused cyclical unemployment to remain higher than usual. Given this recent *softness in economic activity* and significant unused productive capacity, budget *deficits* continued to provide some *stimulus* to AD and stubbornly remained, averaging 0.35 per cent of GDP. This is because *slower* cyclical rates of economic growth *automatically* caused budget receipts to rise more slowly and welfare outlays to remain relatively high. Hence, despite a desire to avoid adding further to high levels of public sector *debt*, reducing the deficit and *returning to surplus* as the *medium-term operational goal* of recent budgets (possibly in 2019–20), has taken longer than expected. This is shown in figure 4.13.

Additionally, cutting the deficit and returning to surplus has taken *longer* because of the Treasurer's use some *expansionary discretionary policy measures* (see table 4.5 in section 4.8.2) that deliberately slowed rises in tax receipts and increased budget outlays. Many of these stimulus measures were probably justified because of the ongoing weakness of spending and economic activity. Indeed, some argued that even bigger deficits and stimulus were needed. So instead of the budgets overall being mildly contractionary as we have seen, perhaps we might have expected them to be expansionary. This, however, was not the case because of

FIGURE 4.13 Australia's actual and projected path from budget deficit to budget surplus



Source: Data derived from Budget Papers, April 2019, see https://www.budget.gov.au/2018-19/content/myefo/download/03_Part_3.pdf.

concern over rising levels of *government debt*. In addition, as we shall see, the slow withdrawal overall of budget stimulus was substantially *offset* and made *possible* by the RBA maintaining a *highly expansionary monetary policy stance* involving record low interest rates designed to help accelerate AD.

So what were the top *three discretionary budgetary tax and spending initiatives* announced by the treasurer in the last two years to 2019–20 that sought to stimulate AD, accelerate the rate of economic growth and lower unemployment (without adding to inflationary pressures)?

Reductions in company tax rates and assistance to businesses

As an *aggregate demand policy initiative*, recent budgets have announced special discretionary measures designed to assist companies, boost business confidence, stimulate private investment spending (I) and accelerate AD. With more spending and falling stocks of goods, lower company tax rates helped to lift economic growth and create more jobs and employment opportunities, without adding to inflationary pressures, given unused capacity.

- *Reductions in the rates of company tax* levied on the profits made by small and medium-sized business commenced in 2015–16. The scheduled reductions being rolled out till 2021–22, as shown in table 4.6, should help stimulate investment spending, AD and economic activity. Originally, big businesses, including multinationals, were also to benefit from the reductions, but political opposition in the Senate meant that the original Ten-Year Enterprise Tax Plan announced in the 2016–17 budget was never fully implemented.
- *Instant tax write-offs* (tax deductions) for small and medium-sized businesses purchasing new capital items or equipment, such as a truck, computer system or new machinery, were also implemented by the treasurer, and were designed to boost business investment spending, along with AD, GDP and employment growth. These commenced in 2017–18 at \$20 000, but have been subsequently increased to \$25 000 and more recently to \$30 000 in the 2019–20 budget.

TABLE 4.6 Scheduled reductions in company tax rates

Year	Turnover threshold for small and/ or medium-sized companies	Tax rate for small and medium-sized companies	Tax rate for large companies
2015–16	\$2 million	28.5%	30%
2016–17	\$10 million	27.5%	30%
2017–18	\$25 million	27.5%	30%
2018–19	\$50 million	27.5%	30%
2020–21	\$50 million	26%	30%
2021–22	\$50 million	25%	30%

Source: Data derived from ATO, <https://www.ato.gov.au/rates/changes-to-company-tax-rates/>.

Reductions in rates of personal income tax

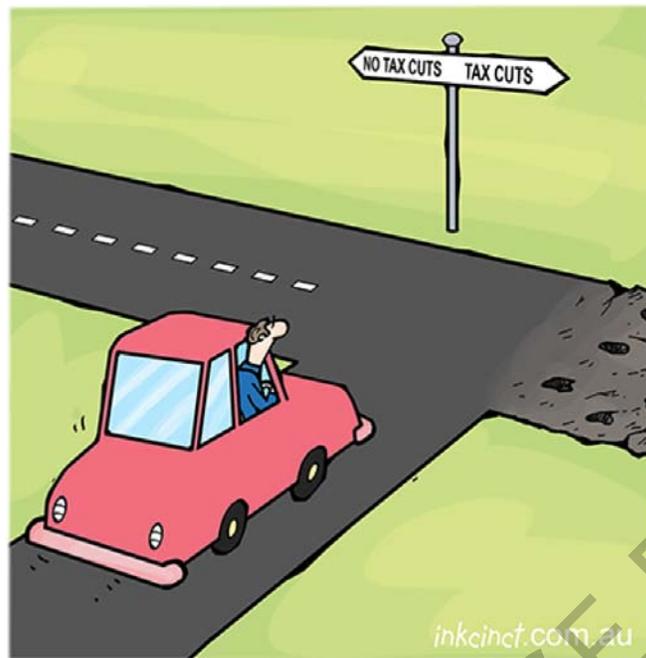
- Discretionary changes in personal income tax have been announced in recent budgets as an *aggregate demand budgetary policy initiative*. Table 4.7 shows the current changes passed by federal parliament in late 2018. These involve *reducing the tax burden and bracket creep* (i.e. caused by individuals moving into higher marginal tax brackets over time as their incomes rise) by lifting the various tax bracket upper income thresholds or cut-offs.

TABLE 4.7 Updated personal income tax rates, thresholds and offsets passed by the parliament

Rate (%)	New tax thresholds From 1 July 2018 Income range (\$)	New tax thresholds From 1 July 2022 Income range (\$)	New tax thresholds From 1 July 2024 Income range (\$)
Tax free	0–18 200	0–18 200	0–18 200
19	18 201–37 000	18 201–41 000	18 201–41 000
32.5	37 001–90 000	41 001–120 000	41 001–200 000
37	90 001–180 000	120 001–180 000	–
45	>180 000	>180 000	>200 000
New low and middle income tax offset	Up to \$530	–	–
Current Low Income Tax Offset	Up to \$445	–	–
New low income tax offset		Up to \$645	Up to \$645

Source: Table copied from ATO, see <https://www.ato.gov.au/general/new-legislation/in-detail/direct-taxes/income-tax-for-individuals/personal-income-tax-plan/>.

- Effectively, these changes lowered the marginal tax rate paid by many individuals and families. This helped to improve consumer confidence, increase household disposable income, accelerate consumption spending and lift AD. With more spending, unplanned reductions in stocks and rising orders, firms were encouraged to lift their production, thus helping to boost economic growth and lower cyclical unemployment.



TAX OPTIONS EXPRESSED AS A ROAD

<https://www.inkinct.com.au/web-pages/cartoons/past/2018/2018-306P--Tax-options-expressed-as-a-road,-cuts-potholes--SOCIAL-AUSTRALIA-2nd-July.png>

More specifically, policy changes have included the following:

- Starting in 2017–18, the temporary budget deficit repair levy on high-income earners introduced in 2014 was abolished, effectively returning the top marginal tax rate from 47 per cent to the previous level of 45 per cent (excluding the Medicare levy). These measures should add to spending, production and employment. In addition, effective for 2017–18, there was a widening of the 32.5 per cent marginal tax bracket from \$80 000 to \$87 000 so that middle–upper income earners would pay less tax.
- The 2018–19 budget further lifted this upper threshold for the 32.5 per cent tax bracket from a taxable income of \$87 000 to \$90 000, providing additional tax relief especially to middle-income earners.
- The 2019–20 budget announced that starting 1 July 2019, low and middle-income earners would get tax offsets of between \$1080 (single income earner) and up to \$2160 (dual income families). Further reductions in the marginal rates of income tax for some individuals were also publicised. These reforms would be rolled out over 10 years. Around 94 per cent of taxpayers would then pay a marginal tax rate of only 30 per cent or less, achieved by abolishing the 32.5 and 37 per cent marginal tax rates by 2024–25 and lifting the upper thresholds of the 19 and 30 per cent tax rates. This would make the personal income tax system less progressive but would increase disposable income, consumption spending, AD and domestic economic activity.
- However, these or other possible changes depend what changes are made by the new Coalition government after the May 2019 election.



Increased government spending on building national infrastructure

Each of the 2017–18, 2018–19 and 2019–20 budgets announced huge increases in government *capital spending* to help improve and build *national infrastructure* projects. As an *aggregate demand budgetary policy initiative*, increasing government investment spending (G_2) has helped to strengthen AD, and caused more orders and falling levels of unsold stocks of goods. Firms were then encouraged to lift production, boosting economic growth and the employment of resources, helping to create more job opportunities and lowering unemployment.

- The 2016–17 budget announced over \$50 billion in spending over the four years to 2019–20 for road, railways, ports, airports, water and NBN infrastructure projects that helped to boost G_2 and I.
- The 2017–18 budget allocated a further \$20 billion boost to funding including that for the Inland Rail Project from Melbourne to Brisbane (cost \$8.4B), a new western Sydney airport, work on the Snowy Mountains hydro-electricity scheme 2.0, a hospital in WA, urban and regional rail links in Victoria including duplicating the Geelong-Waurn Ponds line, highway upgrades in Victoria to the M80 Ring Road and Monash Freeway, and in Queensland, improvements to the Bruce Highway. In addition, there is the Regional Growth Fund boost of \$472M for regional infrastructure and Building Better Regions. The building of such national infrastructure adds to GDP, helps to create jobs and, as we will see later, grows the economy's productive capacity
- The 2018–19 budget promised \$75 billion in government infrastructure spending on transport over the next decade as part of the Ten-Year Infrastructure Plan. This included the Melbourne Airport and North East rail links in Victoria, along with highway upgrades across many states.
- As part of a rolling Ten-Year Infrastructure Plan across Australia, the 2019–20 budget committed an additional \$25 billion, taking the total government spend to \$100 billion. This included an extra \$3 billion for the Urban Congestion Fund to help cut urban travel times and to provide for improved parking at railway stations, \$2 billion for the Geelong-Melbourne fast train project to halve the journey and \$100 million for regional airports. In addition, there is the West Sydney, North-South rail Link, extension of the M1 Pacific Motorway and \$2.6 billion for Queensland's key roads and other projects.

Figure 4.14 shows some of the Australian government's major projects under way in Victoria and new commitments in 2019–20.

Review

Despite the gradual reduction in the overall budget deficit and its possible return to surplus, these *three* discretionary government spending and tax initiatives in recent budgets, provided some much needed stimulus to AD over the last two years. As a result, it is reasonable to claim that in themselves, they helped to *promote* Australia's *three* key *domestic macroeconomic goals* and hence help to create conditions optimal for better *living standards*.

The goal of low inflation: These three key budget initiatives (lower personal and company taxes, and higher infrastructure spending) would not have jeopardised the achievement of low inflation. This is because there was significant unused productive capacity available that could easily cater for stronger spending without generating shortages and demand inflation. Besides, inflation has been below the RBA target and overall recent budgets have been mildly contractionary by withdrawing some of the previous stimulus by further cutting the deficit.

The goal of strong and sustainable economic growth: These three budget initiatives should have helped to stimulate household consumption (C), private business investment spending (I) and government capital spending (G_2), lifting AD. More spending from these three sources, helped to lift AD and the rate of economic growth, thereby helping to offset the mildly contractionary reductions in the overall size of the budget deficit.

The goal of full employment: By helping to stimulate AD and economic growth, these three initiatives should have helped to bring down Australia's unemployment rate to around 5 per cent, as seen over the last few years.

FIGURE 4.14 Australian government infrastructure spending in Victoria as part of the Ten-Year Infrastructure Plan to improve transport, reduce congestion and create jobs

Victoria

The Government has committed \$6.2 billion to new projects to bust congestion, improve safety and better connect towns and regions



Major projects underway

- Melbourne Airport Rail Link
\$5 billion
- Key transport links in Melbourne: \$2.75 billion
 - North East Link
\$1.75 billion
 - Monash Freeway
\$500 million
 - M80 Ring Road
\$500 million
- Melbourne to Brisbane Inland Rail total funding
\$9.3 billion

New commitments

State allocation \$5.3 billion	Urban Congestion Fund \$396 million	Roads of Strategic Importance \$490 million
Goulburn Valley Highway, Shepparton Bypass (stage 1) \$208 million	Hume Freeway (Lithgow Street to M80 Ring Road) \$50 million	Sean Hill Bridge \$60 million
Western Highway (Final Stage of Duplication from Ararat to Stawell) additional \$360 million	Caldar Freeway (Gap Road to the M80 Ring Road) \$50 million	Schucco to Robinvale \$20 million
Victorian Congestion Package, including: \$162 million	Balfarto Road, Skye \$30 million	Ballarat to Croyen \$10 million
• Racecourse Road, Pakenham \$70 million	Plymouth Road improvements \$2.5 million	Melbourne to Mildura \$60 million
• Napoleon Road, Ferntree Gully \$50 million	Princes Highway Intersection Upgrades - Pakenham to Beaconsfield \$17.8 million	Troopemba to Seymour \$160 million
Princes Highway \$300 million	McGregor Road, Pakenham \$13 million	Stawell to St Albans \$60 million
Geelong to Melbourne Fast Rail \$2 billion	Fitzsimons Lane/Main Road corridor, Bream \$10 million	Southeast Victoria \$80 million
South Geelong to Warrnambool Rail Upgrade (stages 2 and 3) \$700 million	Thompson Road intersection \$70 million	Other Roads of Strategic Importance projects \$40 million
Suburban Roads Upgrades (South Eastern and Northern Roads) \$1.14 billion	Muroondah Highway, Colac \$20 million	
Wellington Road Duplication \$110 million	Connector car parks (Croydon, Ferntree Gully, Mitcham, Riddiough, Berlioz, Hampton) \$68 million	
Sealing roads in the Dandenong Ranges and surrounds \$300 million	Marrington Peninsula grade separation and duplication to Bony Road \$63 million	

Source: Diagram copied directly from The Australian Government, Budget Papers, April 2019, see <https://www.budget.gov.au/2019-20/content/community.htm>.

on Resources

Weblink The 2016-17, 2017-18 and 2018-19 budgets

4.8 ACTIVITIES

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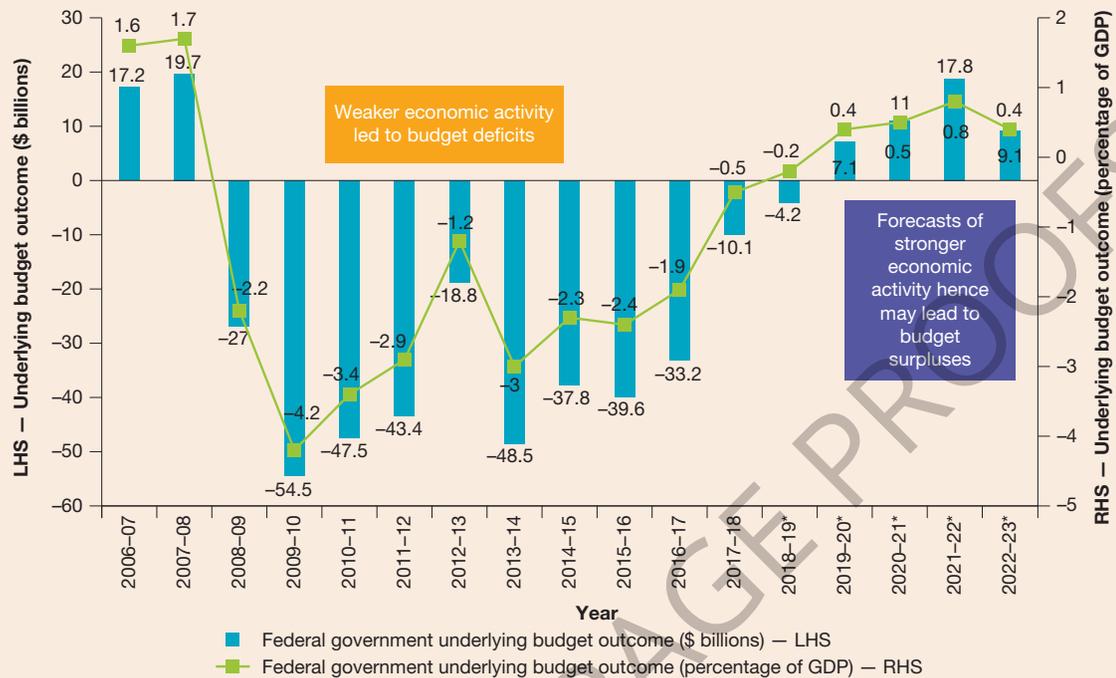
Check your understanding

1. Describe the domestic macroeconomic conditions that have recently existed in Australia.
2. Have recent budget outcomes been expansionary or contractionary? Why?
3. Identify and explain the main budget initiatives from the last two years that have been used to affect Australia's domestic macroeconomic goals.

Applied economic exercises

1. Examine figure 4.15.

FIGURE 4.15 The countercyclical change in the federal government's budget outcome to help reduce the severity of booms and recessions, 2006–07 to 2022–23



Source: Data derived from Budget Papers, 2019 see https://www.budget.gov.au/2018-19/content/myefo/download/03_Part_3.pdf.

- Identify and explain the likely *causes* of the ongoing budget deficits in recent years (as shown in figure 4.15). **(4 marks)**
- As a branch of aggregate demand policy, explain how recent budgets have helped to promote 'jobs and growth'. **(6 marks)**
- How would you expect any *two* of the following discretionary budgetary measures as part of aggregate demand policy to affect the rate of demand inflation and the rates of economic growth and unemployment? **(2 + 2 = 4 marks)**
 - Discretionary reductions in the rates of company and PAYG taxes (2017–18–19–20–23 budgets)
 - Increased defence spending on new imported equipment and overseas peacekeeping
 - The construction of a nuclear desalination plant to ease water shortages
 - Further encouragement of household superannuation and national savings
 - The introduction of the \$30 000 instant tax write-off for small and medium-sized businesses and accelerated depreciation allowances for companies (2019–20 budget)
 - Outlays of \$453 billion to extend access to pre-school education (2019–20 budget)
 - A huge increase in government investment spending on national infrastructure projects to \$100 billion over the next 10 years
 - Increased spending on defence equipment and foreign aid
 - Payment of the \$75 per single pensioner as part of the Energy Assistance payment and \$755 million in outlays on home care packages (2019–20 budget)
- Outline *two* general ways whereby a budget deficit could be returned to a budget surplus. **(2 marks)**
- Identify and explain *two* reasons why a return to a budget surplus in the medium term could be seen as desirable. **(2 marks)**
- Assume that you are the federal treasurer right now. You are about to deliver a budget in the next few weeks that seeks to promote *domestic economic stability* and improve living standards.
 - Identify and outline the *three* most important factors or events that would affect your budgetary policy stance at this time. **(3 marks)**
 - In this situation, explain the *operation* of automatic (cyclical) stabilisers and discretionary (structural) stabilisers in your budget that would help improve domestic stability at this time. Include reference to specific discretionary policies you would use. **(4 marks)**

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4.9 Strengths and weaknesses of using budgetary policy to achieve the government's domestic macroeconomic goals and the affect on living standards

KEY CONCEPT

- the strengths and weaknesses of using budgetary policy to achieve the Australian government's domestic macroeconomic goals and how these goals may affect living standards

Using budgetary policy to help promote our three domestic macroeconomic goals and provide better living standards can have a number of *strengths* and *weaknesses* that the treasurer needs to keep in mind in order to optimise success.

4.9.1 The strengths of using budgetary policy to achieve Australia's domestic macroeconomic goals

Table 4.8 summarises some of the key *strengths* of using budgetary policy to help promote domestic macroeconomic goals and livings standards.

TABLE 4.8 Some possible strengths of using budgetary policy to promote macroeconomic goals and living standards

Possible strength	Description of strength
1. Automatic stabilisers have short time lags for their recognition, implementation and impact	Many government economic policies involve <i>three</i> types of time lags and so can take years to work. There is the <i>recognition lag</i> for identifying the problem — this is due to the existence of lagging indicators like GDP; the <i>implementation lag</i> in activating the policy; and the <i>impact lag</i> in waiting for the policy to actually boost or slow AD and economic activity. A real advantage of automatic budget stabilisers is that they work very quickly in a countercyclical way to affect AD and reduce economic instability even in the short term, with almost no time lag. For instance, the moment the economy slows and incomes fall and unemployment rises, receipts will automatically decline and welfare outlays rise, causing the budget stance to quickly become more expansionary.
2. Automatic stabilisers do not normally create permanent budget deficits or a need for borrowing	Unlike discretionary stabilisers, automatic stabilisers used during a slowdown should disappear once the economy recovers, returning the budget to surplus. They will not normally lead to a permanent structural budget deficit that needs to be funded by a rise in government borrowing. The burden of repaying debt is hence avoided.

Possible strength	Description of strength
3. Discretionary policy can precisely target particular areas of weakness in the economy	Budgetary policies involving changes in receipts and expenses can <i>precisely</i> target particular economic problems in different parts or sectors of the economy. For instance, the budget can surgically alter the allocation of resources to specific industries like health, education and the environment, and help the aged or homeless. It can also discourage the consumption of particular products like alcohol, as well as operate more generally on the macro level to affect consumption, investment, government spending, net exports, AD and GDP. Potentially, this makes it a very versatile instrument for pursuing some government economic goals.
4. Works fairly directly to change AD and economic activity	The budget can work in a very <i>direct</i> way to affect AD and economic activity. For instance, in a recession, reduced budget receipts and increased outlays (perhaps leading to an expansionary rise in the budget deficit) can be used to inject extra cash or disposable income directly into people's bank accounts, where they are likely to spend at least part of it. Additionally, discretionary government consumption (G_1) and investment spending (G_2) can also directly feed extra expenditure into the economy to lift economic activity (although this is likely to add to the deficit and government debt that may take years to repay). In reverse, during inflation, automatic rises in receipts and cuts in welfare outlays directly hold down AD, slowing the economy.
5. Apart from regulating aggregate demand, some budget initiatives can also make aggregate supply conditions more favourable, growing the economy's productive capacity	While we know that budgetary policy can help regulate aggregate demand and improve domestic stability. However, an added bonus is that changes in some budget receipts (such as a lower rate of company tax) and outlays (such as an increase in spending on infrastructure projects and education) can also improve aggregate supply conditions for businesses and individuals. In turn, these can help to lower inflation, strengthen the sustainable rate of economic growth, create fuller employment and improve both material and non-material living standards.

4.9.2 The weaknesses of using budgetary policy to achieve Australia's domestic macroeconomic goals

Table 4.9 summarises some of the key *weaknesses* of using budgetary policy to help promote domestic macroeconomic goals and living standards.

TABLE 4.9 Some possible weaknesses of using budgetary policy to promote domestic macroeconomic goals and living standards

Possible weakness	Description of weakness
1. Discretionary budget stabilisers can become pro-cyclical due to their long time lags between recognition of a problem in economic activity and the impact of the corrective policy	There are often long time lags associated with the recognition, implementation and impact of many government policies, so discretionary measures run the risk of becoming pro-cyclical , increasing instability in AD. Most discretionary budget stabilisers are in this category and so are of limited use in correcting short-term or cyclical instability. Their full impact on the level of AD and economic activity can take 3–8 years or

(Continued)

TABLE 4.9 Some possible weaknesses of using budgetary policy to promote domestic macroeconomic goals and living standards (*Continued*)

Possible weakness	Description of weakness
	<p>even longer. Discretionary changes are often more suited to promoting medium- to long-term stability. Examples of discretionary measures with long time lags might include government spending projects involving large-scale public or capital infrastructure works (e.g. building the NBN, water pipelines and reservoirs, electricity grids, major highways and technical colleges). While these measures will eventually impact on AD, GDP and employment, discretionary spending measures can become <i>pro-cyclical</i> (worsening instability) rather than <i>countercyclical</i> (reducing instability). For instance, the announcement of a large discretionary budget deficit involving capital works during a recession (to help reduce unemployment) might not actually lift AD and economic activity for several years, during which time the economy may have recovered and moved into a boom phase. More spending in a boom would only add to inflationary pressures and actually undermine economic stability.</p>
2. Lack of flexibility in some parts of the budget to be able to change some outlays, receipts or AD	<p>Some budget receipts and outlays are <i>inflexible</i> and cannot suddenly be increased or decreased in response to changes in the level of domestic economic activity. For example, apart from political considerations, the rate of pensions and welfare benefits, or per capita outlays on education or health, cannot be suddenly reduced, since these areas must be maintained, irrespective of the prevailing conditions.</p>
3. Financial constraints and the creation of a structural budget deficits can limit budget options during a slowdown	<p>Like individuals, governments face <i>financial constraints</i> where there is limited money available for spending (especially given that raising taxes is unpopular). For instance, during a slowdown, the government may want to cut tax rates, increase outlays or run an expansionary budget deficit to help stimulate AD and economic activity. Given that the medium-term operating goal of budgetary policy is to run surpluses, financial constraints limit the federal treasurer's options. Recently for example, the treasurer was forced to gradually try to cut the deficit despite some ongoing weakness in the economy, instead shifting the main burden of stimulus onto monetary policy (involving record low interest rates).</p>
4. Budgetary policy can undermine monetary policy through the problems of crowding out or crowding in.	<p>Budgetary policy used as a stabiliser can sometimes undermine the effectiveness of monetary policy. For instance, when the economy is weak and the government decides to run budget deficits to stimulate AD financed by borrowing through the sale of government bonds domestically, this can increase the demand for credit in local financial markets. As an unintended result, this puts upward pressure on local interest rates at a time when it would be better to have lower interest rates to boost spending. In turn, higher interest rates can lead to the problem of <i>crowding-out</i> private sector C and I spending, unfortunately slowing the economy. In reverse, when there are budget surpluses during a boom designed to slow AD and economic activity and the government decides to repay previous debt, this can cause lower interest rates and lead to the problem of <i>crowding-in</i> by borrowers, adding to spending, inflationary pressures and instability.</p>

Possible weakness	Description of weakness
5. Constraints due to conflicts or trade-offs between government economic goals	<p>Some fiscal policies cannot be used to pursue one particular government economic goal because they can <i>conflict</i> with the pursuit of another policy objective (there is a trade-off). For example, although mildly contractionary budgets like some of those in 2016–17–18–19–20 slow inflation, they also reduce economic growth and increase unemployment. In reverse, expansionary budget deficits, which are designed to boost economic growth and create jobs, may also accelerate inflation. Additionally, while slowing welfare or government spending on services such as health, public transport and education may help return the budget to surplus, these measures are also likely to reduce equity in the distribution of income and undermine living standards. Further, using contractionary budgets (perhaps involving higher taxes and cuts in outlays on education, R&D and infrastructure to slow demand inflation) can have negative long-term effects on productive capacity and AS, slowing economic and employment growth and eroding living standards.</p>
6. Adverse political constraints can limit budget options	<p>As seen in recent years, there are <i>three</i> types of political constraints that can act as deterrents and reduce the effectiveness of budgetary policy as a stabiliser of economic activity.</p> <ul style="list-style-type: none"> • <i>The absence of a federal government majority in the Senate.</i> For some parts of the budget to become law, they first need approval in both houses of parliament. In recent years, the Liberal Coalition government has lacked a majority in the Senate, which was controlled by Labor and various minorities. This caused significant aspects of budget receipts and outlays to be rejected. Examples include the proposed tightening of welfare, cuts to education and the \$7 co-payment scheme for health services. As a consequence, the budget deficit became larger and more expansionary than otherwise, adding to the structural deficit and delaying the return to surplus. • <i>Adverse voter reaction.</i> Some changes in receipts and outlays can have significant adverse ramifications in election years. For example, while few voters oppose discretionary tax cuts, or increased outlays on health and education (that increase the structural budget deficit), most voters object to higher tax rates or cuts to government services, and may take out their anger on unpopular governments at the next election. As a result, the budget has an expansionary bias and structural deficits can easily develop, even if they are not entirely warranted. This undermines the financial sustainability of important budget outlays like welfare and health, and weakens the government’s ability to respond to future economic crises. • <i>The federal government has limited powers.</i> Under Australia’s Constitution, specific responsibilities are allocated between the states and the federal government. This restricts what budgetary policy actions the federal government can take as it seeks to stabilise the economy. For example, the Australian government lacks the power to directly lower or raise the GST (from 10 to 15 per cent was suggested by some during 2015–16) since this would require approval from the states.
7. Psychological constraints can reduce the budget’s effectiveness as a stabiliser	<p>The success and strength of any budget depends partly on the prevailing level of <i>confidence</i>. For instance, reduced consumer and business confidence (e.g. during 2014–19) would tend to weaken the expansionary effects of budget deficits. In reverse, if confidence is strong, contractionary budgets can be made less effective than expected in slowing the level of AD, adding to instability.</p>

4.9 ACTIVITIES

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Check your understanding

1. What are the main strengths of using budgetary policy?
2. What are the main weaknesses of using budgetary policy?

Applied economic exercises

1. During a *recession*, identify and outline two important weaknesses of using budgetary policy as a stabiliser of domestic economic activity. For each, try to give a specific current example illustrating the weakness. **(2 + 2 = 4 marks)**
2. How might the existence of long *time lags* reduce the effectiveness of using budgetary policy as a stabiliser of aggregate demand and economic activity? **(4 marks)**
3. A possible advantage of using budgetary measures is that they can target particular economic problems more precisely. Explain, giving possible examples. **(4 marks)**

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PART B Aggregate demand monetary policy and the pursuit of domestic economic stability

4.10 Definition and aims of monetary policy, and the role of the RBA

KEY CONCEPT

- the role of the RBA with respect to monetary policy as outlined in its charter

Monetary policy is an aggregate demand management strategy implemented by the Reserve Bank of Australia (RBA) that involves changes in **interest rates**.

Monetary policy is an important macroeconomic or aggregate demand measure that is applied countercyclically by the RBA to help stabilise spending. During an economic slowdown, when GDP growth is weak and below trend, unemployment is high and inflation is low, the RBA often uses an expansionary monetary policy stance designed to boost spending and activity. As seen recently in Australia, this economic stimulus has involved 12 reductions in official interest rates. In turn, lower interest rates work to stimulate AD through various transmission mechanisms. In reverse, when the RBA is concerned about inflationary pressures, it uses rises in the cash rate to slow spending and promote the goal of low inflation.



4.10.1 Definition of monetary policy

Monetary policy involves the RBA using changes in official interest rates to affect the cost, availability and demand for credit and the rate at which credit flows between the financial sector and the rest of the economy. In so doing, the RBA can regulate the level of AD.

Because changes in interest rates have the capacity to alter the level of spending or AD (particularly C, I and even net X) and economic activity, this is regarded as *an aggregate demand policy* that can be used to help achieve the government's key domestic macroeconomic goals including low inflation, strong and sustainable economic growth, and full employment.



4.10.2 Role of the Reserve Bank of Australia

The RBA is our country's independent central bank and is accountable to the parliament. Under its charter, it has *three* main responsibilities or roles:

- The RBA implements monetary policy involving changes in interest rates designed to influence AD and *improve domestic economic conditions*. This role was outlined in the *Reserve Bank Act of 1959*:
... to ensure that the monetary and banking policy of the [Reserve] Bank is directed towards the greatest advantage of the people of Australia and that the powers of the Bank . . . are exercised in such a manner . . . as will best contribute to the stability of the currency of Australia; the maintenance of full employment in Australia; and the economic welfare and the prosperity of the people of Australia.
- The RBA is responsible for *issuing coins and notes* and is custodian of Australia's reserves of foreign currencies.
- The RBA is *banker to the federal government*. For instance, here it might arrange the issue of government bonds to help finance budget deficits.

4.10.3 The macroeconomic aims of monetary policy

The RBA uses monetary policy involving changes in interest rates to pursue three key *domestic macroeconomic* goals, creating optimal conditions for better *living standards*.

The pursuit of the goal of low inflation

Foremost, the RBA sees the goal of low inflation as its number one priority. **Inflation targeting** (summed up as '*fighting inflation first*') means achieving an *average* inflation rate of between 2–3 per cent a year over the cycle. This is the *medium-term operational aim* of monetary policy. While the RBA uses changes in consumer prices as measured by the headline CPI to help guide policy decisions, it is also especially interested in the underlying CPI to determine the direction of core inflation since this can be a better guide to future inflationary problems or trends.

Hence, when inflationary expectations exist and there are signs that inflation will accelerate to exceed the upper end of the 2–3 per cent target range (and especially when core inflation is up), the RBA will normally *tighten* its stance (set higher interest rates) in a **countercyclical** way, to depress inflationary expectations, slow the growth of AD or spending, and curb economic activity to a sustainable rate. Additionally, by

slowing AD and economic activity, rises in interest rates help to soften the demand for labour, and hence ease wage pressures and possibly also cost inflation.

The pursuit of the goals of strong and sustainable economic growth and full employment

When inflation is *not* a threat, the RBA usually turns its attention to other aspects of domestic economic stability such as the pursuit of a strong and sustainable rate of *economic growth* and *full employment*. So when the level of economic activity is too weak (yet inflation is under control), the RBA gradually adopts a countercyclical expansionary stance to stimulate economic activity.

The main reason for the RBA giving *priority to the control of inflation* is that low inflation is seen as a precondition for achieving other government macroeconomic goals. Limiting inflation is often seen as the best way to create conditions that maximise the sustainable rate of economic growth and minimise cyclical unemployment.

The thinking behind this approach is simple. For instance, low inflation helps to maintain solid consumer and business confidence that is needed for a steady rise in spending. Low inflation also discourages speculative activity, promotes adequate saving and attracts resources into productive investment in new plant and equipment (as opposed to more speculative uses) that is so important for long-term economic growth.

The recent priorities of monetary policy

During the last couple of years, the rate of *economic growth* has been *weaker* and below trend (averaging just 2.5 per cent), *unemployment* has been *higher* than 5 per cent and *inflation* has been very *slow* and less than 2 per cent, below the RBA's target range. As a result of having much spare or *unused productive capacity* and hence no threat of demand inflation, the RBA's priority has been to adopt a *highly expansionary stance* designed to strengthen economic growth and lower cyclical unemployment by encouraging higher levels of credit-based and other types of spending.

on Resources

-  **Weblinks** Monetary policy
Monetary policy and the Federal Reserve

4.10 ACTIVITIES

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Check your understanding

1. Define what is meant by *monetary policy*.
2. What are the main *goals* of the RBA's monetary policy?

Applied economic exercises

1. (a) What is meant by *inflation targeting*? **(xxx marks)**
(b) Why is monetary policy regarded as an *aggregate demand policy*? **(2 marks)**
(c) What is the primary medium-term operating goal of the RBA? **(1 mark)**
(d) If inflation is slow, what other goals might monetary policy pursue? **(1 mark)**
(e) What were the main priorities of the RBA's monetary policy during the past two years? **(2 marks)**

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4.11 The role of open market operations in altering interest rates

KEY CONCEPT

- the role of open market operations in altering interest rates

Changes in the level of interest rates are central to monetary policy and are used by the RBA to help regulate the levels of AD and economic activity. In general terms, *interest rates represent the cost or price of credit*. As such, they are normally determined in *financial markets* by the *demand* for credit by borrowers such as households, firms and governments, relative to the *supply* of credit by lenders (households and businesses who place their savings in financial institutions). However, the RBA also has the capacity to affect the level of interest rates generally, by changing the **official cash rate**.

The *cash rate* is the interest rate that applies to a specialised market called the overnight or **short-term money market**. This rate depends on the overall supply of cash (deposits) in the overnight money market which, in turn, is controlled by the RBA through its open market operations (OMO). These activities affect the size of special balances held by each major financial institution (e.g. the banks, building societies, finance companies and superannuation funds) in its *exchange settlement account* with the RBA. But how does this complex system work to affect interest rates? First, more background information is needed.

Each major financial institution is required to keep its *exchange settlement account* with the RBA in credit (for which it receives interest). These account balances exist mainly for settling transactions between institutions during the day's trading. Such transactions are caused mainly by the movement of cheques; for example, a customer with one bank writes a cheque payable to a customer at another bank. In turn, through the *Reserve Bank information and transfer system* (RITS), cheque amounts are either credited or debited electronically against the exchange settlement account for each institution. This settlement process does not affect the total level of cash or deposits in these accounts (since rises in deposits for one institution are offset by a fall in deposits belonging to another). As a result, transactions of this type do not cause deposited funds to become either scarcer or more plentiful and so they do not affect the cash rate. What can add to, or reduce, the overall size of cash deposits in exchange settlement accounts are the activities between financial institutions and the RBA. For example, when companies and individuals use cheques or electronic funds transfers to pay taxes to the government, the overall level of balances in exchange settlement accounts falls. In reverse, when the government through the RBA pays tax refund cheques into individuals' bank accounts, overall balances in exchange settlement accounts grow. However, while these transactions may have some effect on the cash rate in the short-term money market, they do *not* allow the RBA to actually control or determine the cash rate.

The main determinant of the cash rate (along with other interest rates generally) is the daily conduct of **open market operations** that directly affect the supply of cash in the short-term money market. *Market operations involve the RBA either buying back or selling secondhand government securities or bonds to members of the RITS through the short-term money market*. Here, you should think of securities or bonds as simply government IOUs for particular amounts of money that earn a given rate of interest over a period of time. Armed with this understanding, let us take a



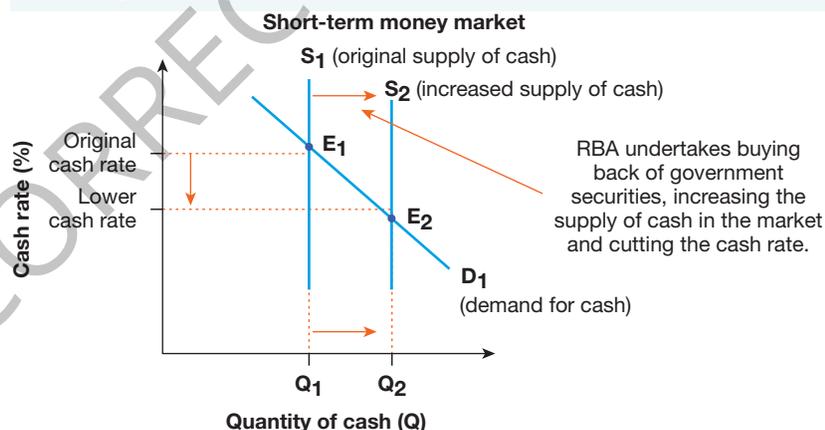
look at the three positions or types of **monetary policy stance** on interest rates that the RBA may want to adopt in its management of economic activity.

4.11.1 How the RBA can use open market operations to lower interest rates – an expansionary stance

Suppose that the RBA wanted to *reduce interest rates* to help *stimulate AD* and economic activity during an economic *slowdown*. The process would involve several steps.

Step 1	The RBA would first announce a lower cash rate target, giving the reasons for its decision (such as weak economic growth, rising unemployment, a recession in China).
Step 2	To reach this new target, the RBA would conduct open market operations that would involve <i>buying back government securities</i> or bonds from the financial institutions operating in the short-term money market. Here, RBA buying would cause the price paid for securities to increase, thereby lowering their yield so that financial institutions would be happy to get rid of them.
Step 3	In exchange for government bonds, the RBA transfers cash deposits into the accounts of financial institutions. As shown in figure 4.16, this increases the supply of cash or the level of deposits held by financial institutions in their exchange settlement accounts (the shift from S_1 to S_2), leaving the market with excess funds or liquidity. The consequence of this would be a fall in the cash rate equilibrium towards the desired RBA target.
Step 4	The drop in the cash rate in the short-term money market would spread to cause other interest rates in the financial sector to also fall, through a ‘ripple effect’.
Step 5	As we shall soon see, the general drop in the cash rate to below a rate of perhaps 2.5 per cent, usually signals a <i>looser</i> or more <i>expansionary monetary policy stance</i> that would tend to make borrowing and spending cheaper and more attractive, thereby boosting AD and economic activity.

FIGURE 4.16 How OMO involving the RBA buying back government securities in the short-term money market can decrease the cash rate (a more expansionary stance).

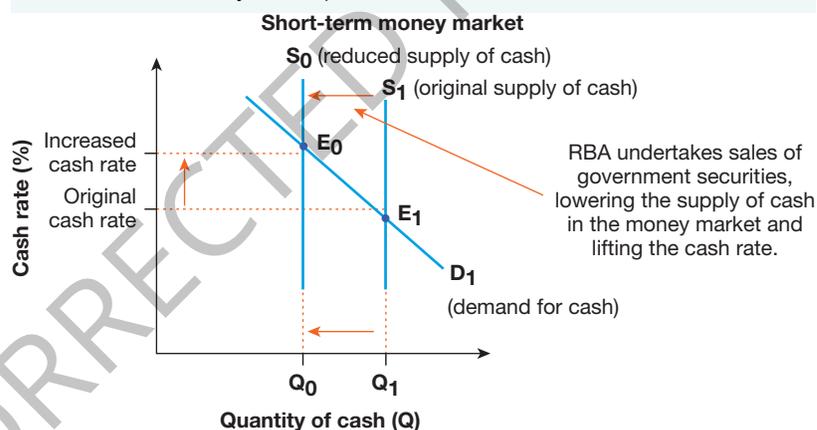


4.11.2 How the RBA can use open market operations to increase interest rates – a contractionary stance

Assume that the RBA needed to *raise interest rates* because it wanted to *slow AD* and curb inflationary pressures. How would the RBA go about raising the cash rate?

Step 1:	The RBA would announce a rise in the cash rate target and provide a detailed explanation of the reasons for its decision (e.g. the rise in the CPI was at the upper end or above the 2–3 per cent target range).
Step 2:	The RBA would then set out to achieve this target by conducting open market operations involving <i>selling government securities</i> at a discounted rate in the short-term money market. Financial institutions, keen to make a profit, would suddenly find these securities more attractive because when purchased at a lower price, their yield would rise. This gives owners a better rate of return on their investment.
Step 3:	Organisations taking up this tempting offer would transfer cash deposits to the RBA in exchange for receiving government bonds or IOUs. This directly reduces deposits or the supply of cash held by financial institutions in their exchange settlement accounts. Competition among institutions for limited funds to top up their exchange settlement accounts would cause an increase in the cash rate towards the announced target. The impact of net sales of government securities in the short-term money market is illustrated in figure 4.17. Notice the decrease in the supply of cash in this market (the shift from S_1 to S_0) causes a rise in the cash rate (the shift from the original cash rate to a higher one).
Step 4:	The rise in the cash rate in the short-term money market would spread through a ‘ripple effect’, increasing interest rates in other parts of the financial market.
Step 5:	A rise in the cash rate set by the RBA to a level perhaps above 2.5 per cent, would nowadays be indicative of a <i>tighter monetary policy stance</i> designed to slow AD and reduce inflationary pressures.

FIGURE 4.17 How OMO involving the RBA selling government securities in the short-term money market can increase the cash rate (a more contractionary stance).



4.11.3 How the RBA can keep interest rates steady

Often, however, the RBA just wants to keep interest rates *steady* since they are already at an appropriate level given current economic conditions. In this case, the RBA’s daily selling and buying back operations will seek to avoid changing the overall supply of cash in the short-term money market, keeping the current cash rate unchanged. When the cash rate is held at around 2.5 per cent (i.e. the rate currently required for low inflation and full employment), this is considered to be a fairly *neutral stance* and within the *normal* range for a healthy economy. By contrast, if the cash rate is kept above or below this neutral range, there must be inflationary or deflationary circumstances requiring attention.

By being able to control the cash rate in this way, RBA policy has the capacity, through a ripple effect, to influence other commercial interest rates (e.g. those on home mortgages, overdrafts, credit cards and savings deposits) that are generally applicable elsewhere in the financial sector. As we shall see, changing

the RBA's monetary policy stance through variations in the cash rate target is a handy instrument for stabilising the level of spending and economic activity.

on Resources

 **Weblink** Tools of monetary policy

4.11 ACTIVITIES

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Check your understanding

1. Explain how the RBA can use open market operations to change the cash rate target.

Applied economic exercises

1. (a) Define each of the following terms:
- i. the cash rate target (1 mark)
 - ii. open market operations. (1 mark)
- (b) Assume that the RBA decided to *decrease* its cash rate target. Clearly explain the steps or process used by the RBA to lower interest rates. Illustrate this approach using a labelled demand–supply diagram representing the short-term money market (showing the *before* and *after* situations). (4 marks)

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4.12 Transmission mechanisms of monetary policy and their influence on the level of aggregate demand

KEY CONCEPT

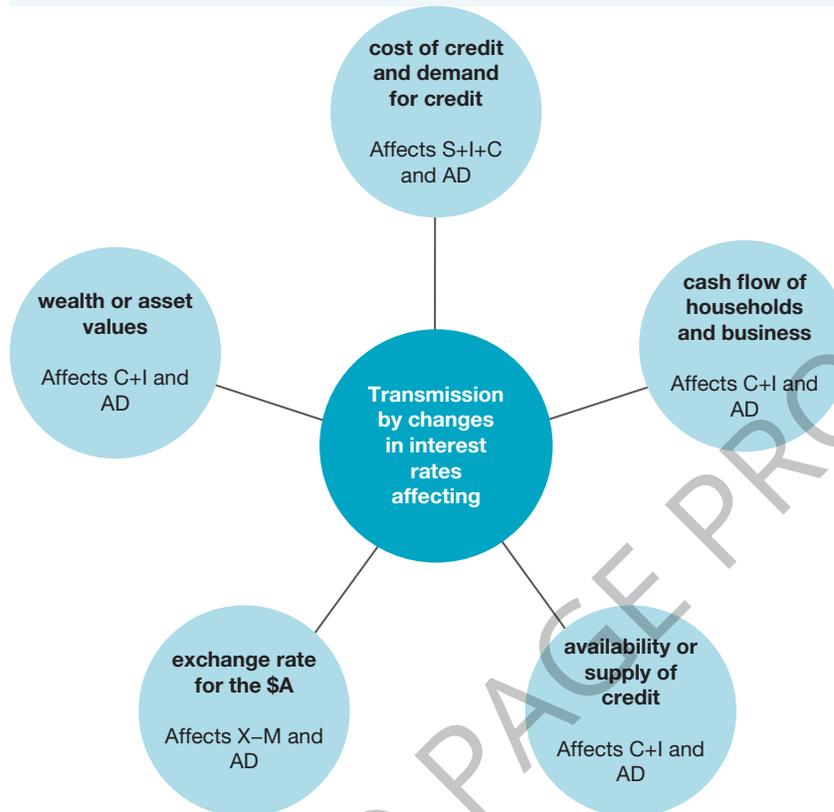
- transmission mechanisms of monetary policy and their influence on the level of aggregate demand including savings and investment, cash flow, availability of credit, exchange rate movements and asset prices

Monetary policy is an *aggregate demand policy*. In this section, we are going to look at the various **transmission mechanisms** (sometimes called *transmission channels*). They are simply the ways whereby an increase or decrease in the cash rate operates to bring about a rise or fall in AD and economic activity, designed to help improve domestic economic stability. There are at least *five* of these transmission mechanisms or channels, including:

- transmission by changing the cost of and demand for credit
- transmission by affecting the cash flow of households and firms
- transmission by affecting the availability or supply of credit
- transmission by affecting the exchange rate
- transmission through the wealth or asset values effect.

An overview of these transmission channels is provided in figure 4.18.

FIGURE 4.18 The five transmission mechanisms of RBA's monetary policy



4.12.1 Transmission by changing the cost of and demand for credit

The most obvious transmission mechanism whereby a change in interest rates affects AD and economic activity is by altering the cost of borrowing credit (called the **cost of credit effect** or channel) as opposed to saving. Lower interest rates increase the demand for credit and make it cheaper to borrow and repay debt. Furthermore, lower rates make saving (affecting leakages) less attractive. Households and businesses become more willing to take out loans to finance credit-sensitive consumption and investment spending on goods and services, thus stimulating AD and economic activity.

By contrast, higher interest rates make households and firms less willing to borrow in order to finance their purchases of goods and services. The demand for credit slows and people also have more incentive to save. With weaker consumption and investment, AD and economic activity slow.



4.12.2 Transmission by affecting the cash flow of households and firms

Changes in interest rates affect the level of discretionary spending by households and others with existing loans, such as home mortgages and overdrafts, changing the amount of income that they have left to spend on other things. This is called the **cash flow effect**.

When interest rates are cut, borrowers have more cash to spend on other goods and services after they have met their interest repayments on debt. This tends to stimulate consumption spending, AD and economic activity. However, when interest rates rise and individuals with existing loans have to make larger interest repayments, the lack of cash flow means they have to cut other purchases, slowing national spending.

4.12.3 Transmission by affecting the availability or supply of credit

Changes in interest rates work through the **availability of credit** channel and hence influence the level of spending and economic activity. Lower interest rates increase the availability of credit or money offered by banks and other financial institutions. This is because more borrowers can service this debt and can meet the criteria or tests set by financial institutions since the risk of customer default is lower. Lending approvals are therefore higher. This leads to increases in consumption and investment spending, encouraging AD and boosting activity.

However, when interest rates increase, fewer borrowers can meet the requirements. The number of bank approvals and loans is reduced, limiting spending and activity.

4.12.4 Transmission by affecting the exchange rate

Domestic interest rates affect the exchange rate for the Australian dollar (called the **exchange rate effect** or channel) and hence the level of AD and domestic economic activity.

For example, a cut in our interest rates relative to those overseas tends to weaken the Australian dollar. This is because overseas lenders of credit are discouraged by the relatively lower and less attractive returns here than in their home country, reducing the demand for the Australian dollar in the foreign exchange market. At the same time, local borrowers are less attracted to borrowing money overseas. Either way, with less money capital flowing into the country, the Australian dollar typically falls. This makes our exports cheaper and imports dearer, boosting AD and economic activity.

In reverse, when Australian interest rates rise relative to those abroad, overseas capital becomes more attractive to both foreign lenders and local borrowers. This increases the demand for and decreases the supply of the Australian dollar in the foreign exchange market, pushing up the exchange rate. As a result, net exports ($X - M$), AD and economic activity are slowed.

In its attempts to stabilise AD and economic activity, the RBA has sometimes exploited this handy connection between its changes in domestic interest rates and the exchange rate for Australian dollar.

4.12.5 Transmission through the wealth or asset values effect

Interest rates can affect how wealthier people with shares and property *see* their financial position. This influences their actual level of spending and economic activity (called the **wealth effect** or transmission channel).

Lower interest rates, for instance, tend to increase the value of property and shares. This is because cheaper credit often leads to an increase in the demand for these assets, raising their price or value. As a result of feeling wealthier, owners are more likely to increase their consumption spending, leading to an increase in AD and economic activity. Furthermore, asset speculators who use credit to buy cheap and then sell at a higher price will realise bigger capital gains and a real increase in their wealth.

In reverse, higher interest rates make credit dearer to borrow. This causes asset prices or values to fall, leading to a feeling of being less wealthy, thereby slowing AD and economic activity. Additionally, asset owners who sell in this situation will make smaller capital gains or perhaps incur a loss of wealth.

-  **Weblinks** How interest rate cuts affect consumers
- Monetary policy and the Federal Reserve
- Monetary policy (EconMovies 9: Despicable Me)

4.12 ACTIVITIES

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Check your understanding

1. What are transmission mechanisms or channels and how do they work?

Applied economic exercises

1. Explain how each of the following transmission mechanisms would operate to affect AD, following a rise in the RBA's cash rate target.

(a) The cost of credit	(2 marks)
(b) The cash flow of households and businesses	(2 marks)
(c) The availability of credit	(2 marks)
(d) The exchange rate	(2 marks)
(e) The wealth or asset values effect	(2 marks)

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4.13 The stance of monetary policy and how the RBA decides this

KEY CONCEPT

- the stance of monetary policy: expansionary or contractionary

Monetary policy is an aggregate demand management strategy used to help stabilise the economy by changing official interest rates. It is applied in a *countercyclical* way to help improve domestic economic stability and promote better living standards.

Hence, when the economy is running too *slowly* and growth and employment trends are weak, often an *expansionary stance* is adopted, whereas when activity is too *strong* causing inflationary pressures, a more *contractionary stance* is required. So what exactly do we mean by the term *monetary policy stance*?

4.13.1 Definition and nature of the RBA's monetary policy stance

In discussion, economists often talk about the RBA's *monetary policy stance*. This simply refers to whether the change in the cash rate or policy setting is designed to slow, maintain or stimulate AD and the level of economic activity. So at a very simple level, there are *three* possible stances or positions that can be adopted by the RBA — expansionary, contractionary or neutral.

- *A fairly neutral stance.* A *neutral* monetary policy stance exists when the RBA sets or keeps interest rates at a level that is required to bring about full employment and stable inflation over the

medium-term. The cash rate corresponding to this stance has fallen over the last decade by around 150 basis points and while it is hard to be precise because it can change, nowadays a *neutral* cash rate could be around 2.5 per cent. At this rate, the RBA is not deliberately trying to either accelerate or slow AD and economic activity.

- *An expansionary stance.* When the RBA's reduces its cash rate target to a level below 2.5 per cent, this is often seen as a relatively *expansionary stance* since the intention here is to lift AD and stimulate economic activity, and reduce unemployment.
- *A contractionary stance.* If the RBA were to raise the cash rate target to a level perhaps above 2.5 per cent, nowadays this would probably be regarded as a relatively *contractionary stance* designed to curb AD, economic activity and inflation.

These three positions are summarised in table 4.10.

TABLE 4.10 Describing the RBA's three main monetary policy stances

Monetary policy stance	Main indicators of the policy stance	Aim of this policy stance
<ul style="list-style-type: none"> • Expansionary or looser monetary policy stance (e.g. from late 2016 to mid 2019, the cash rate was just 1.5 per cent). • This stance may be adopted by the RBA if there is: <ul style="list-style-type: none"> • very low inflation • slow GDP growth • rising unemployment • a rise in the labour force underutilisation rate • slow growth in AD • weaker confidence • a slowdown overseas • a drop in the terms of trade • a tighter budget. 	<p>The RBA has an expansionary stance when the cash rate is relatively <i>low</i> (perhaps below the normal range of around 2.5 per cent) and it then <i>cuts</i> the rate using open market operations involving <i>net repurchases</i> of government bonds or securities in the short-term money market. An example of an expansionary stance would be a reduction in the cash rate from, say, 2.5 to 1.5 per cent.</p>	<p>The aim is to use <i>lower interest rates</i> and various transmission mechanisms or channels to help <i>stimulate</i> AD and economic growth, and reduce unemployment without adding significantly to inflationary pressures.</p>
<ul style="list-style-type: none"> • Contractionary (tighter or restrictive) monetary policy stance. • This stance may be adopted by the RBA if there is: <ul style="list-style-type: none"> • high inflation • strong spending and confidence • very fast GDP growth • low unemployment • strong global growth. 	<p>The RBA has a contractionary stance when the cash rate is relatively <i>high</i> and it then <i>raises</i> the rate (above the normal range of perhaps 2.5 per cent) using its open market operations involving <i>net sales</i> of government bonds or securities in the short-term money market. An example of a contractionary stance is a rise in the cash rate from 2.5 to 4.5 per cent.</p>	<p>The aim is to use <i>higher interest rates</i> and various transmission mechanisms or channels to <i>slow</i> AD and economic activity, thereby reducing inflation to within the 2–3 per cent target range.</p>
<ul style="list-style-type: none"> • Neutral or normal monetary policy stance. • This stance may be adopted if reasonable domestic economic stability already existed with: <ul style="list-style-type: none"> • low inflation • strong and sustainable growth • full employment. 	<p>The RBA has a neutral stance when the cash rate target is within the <i>normal range</i> for a healthy economy of around 2.5 per cent. It then holds interest rates fairly steady by appropriate and regular open market operations involving both the buying back and selling of government bonds.</p>	<p>The aim here is to neither stimulate nor slow AD and economic activity because conditions are ideal. Monetary policy is adopting a fairly neutral role.</p>

4.13.2 Checklist of indicators used by the RBA to decide its policy stance

A *checklist of indicators* is used by the RBA to decide whether the monetary policy stance should be expansionary or contractionary.

The board of the RBA meets 11 times each year, on the first Tuesday of each month (except January) to consider its monetary policy settings in relation to the current and expected future state of the economy. In making important decisions about the appropriate cash rate target and whether to adopt an expansionary (looser), contractionary (tighter) or neutral monetary policy stance, the board typically uses a *checklist of important indicators* of macroeconomic conditions. Some of these are shown in table 4.11.

TABLE 4.11 Checklist of some key indicators used by the RBA to influence its monetary policy stance

Checklist indicator	Description of indicator
1. Trends in inflation	The RBA takes a careful look at quarterly trends in the headline CPI, the underlying inflation rate, costs of materials used in manufacture and wage costs. For instance, when core inflation is below the target range, the RBA might choose to adopt a more expansionary stance to stimulate AD and economic activity. However, when inflation is near the upper end of the RBA's 2–3 per cent target rate or higher, a more contractionary stance is usually required to help control inflation by slowing AD and economic activity.
2. Levels of national spending and confidence	The RBA keeps a close watch on the growth in AD (relative to the economy's productive capacity or AS), housing approvals, household debt, private consumption and investment spending, and changes in consumer and business confidence. For instance, if national expenditure is rising faster than GDP and confidence is strong, this might suggest a need for a more contractionary stance so that inflation is avoided. In reverse, when spending is rising very slowly, perhaps due to weaker confidence, the RBA might be more tempted to adopt an expansionary stance to boost GDP and jobs.
3. Labour market conditions	Changes in labour market conditions (indicated by trends in the unemployment rate, labour force underutilisation rate, average hours worked, job vacancies and the labour force participation rate) are seen as important indicators of economic conditions. These tell the RBA whether the economy is operating near its capacity and might throw light on the risk of boom or recession. For instance, the RBA would be more likely to adopt an expansionary stance if labour market conditions are getting weaker, while a more contractionary stance is likely if conditions are very strong.
4. Budgetary policy stance	When setting its stance, the RBA takes account of the budgetary policy outcome and whether it is becoming more or less expansionary in its effect on AD. For instance, if the federal treasurer is forced to reduce the deficit when the economy is quite weak so as to slow the rise in government debt (a more contractionary stance), the RBA might help offset this change with a more expansionary stance. Alternatively, a more expansionary budget could cause the RBA to adopt a less expansionary stance if it thought there was a risk of inflationary pressures.
5. International developments	The RBA reviews overseas trends in inflation, economic activity, interest rates, the terms of trade and other events such as the debt problems of some countries like Greece, as well as changes in Australia's exchange rate and CAD. This is because these developments can affect Australia's AD and economic activity. For example, when there is a slowdown in China or elsewhere and the terms of trade weaken, the RBA is more likely to adopt an expansionary stance to stimulate AD. However, when overseas developments are strongly boosting our expenditure, the RBA might become concerned about the risk of inflation and adopt a more contractionary stance.

After weighing up the sometimes conflicting evidence, the board votes and the RBA may choose to change its monetary policy stance.

4.13 ACTIVITIES

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Check your understanding

1. What is meant by the term *monetary policy stance*?
2. Distinguish a *contractionary* (tighter) monetary policy stance from an *expansionary* (looser) stance.
3. What is the inflation checklist?

Applied economic exercises

1. (a) Recently till 2019, the RBA's cash rate target has been held at a record low level. Identify and outline *four* important factors that the RBA may have taken into account in adopting its current monetary policy stance. **(4 marks)**
(b) Under what circumstances would the RBA:
 - i. reduce its cash rate target? **(2 marks)**
 - ii. increase its cash rate target? **(2 marks)**(c) Distinguish an *expansionary* monetary policy stance from a *contractionary* stance. **(2 marks)**
(d) Select *one* of the following events and explain why this would be likely to cause the RBA to *tighten* its monetary policy stance, and *one* that would be likely to cause the RBA to *loosen* its stance. **(2 + 2 = 4 marks)**
 - i. A rise in Australia's unemployment rate from 5 to 6 per cent when inflation was low
 - ii. Large tax cuts and rises in budget outlays
 - iii. Lower inflation rates and official interest rates overseas
 - iv. A slowdown in Australia's rate of GDP growth
 - v. Rising prices for oil, fruit and vegetables
 - vi. The collapse of the property and share markets
 - vii. A very large appreciation of the Australian dollar

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4.14 The focus of monetary policy over the past two years to help regulate aggregate demand and promote key domestic macroeconomic goals

KEY CONCEPT

- the focus of monetary policy from the past two years on the levels of aggregate demand and the Australian government's domestic macroeconomic goals of strong and sustainable economic growth, full employment and low inflation

Domestic economic stability is a desirable or ideal situation for a nation because conditions are likely to maximise living standards. Domestic stability exists when low inflation (an annual average CPI rise of 2–3 per cent over time), strong and sustainable economic growth (an annual average rate of economic

growth of around 3 per cent or a little higher) and full employment (currently a low unemployment rate of around 5.0 per cent of the labour force) occur simultaneously.

4.14.1 Recent trends in Australia's domestic macroeconomic conditions

During the last two years to 2019, *domestic economic stability* was not fully achieved:

- *inflation* was very *slow*, averaging just 1.8 per cent per year — below the RBA's target rate of 2–3 per cent
- *economic growth* was too *weak* and below trend, averaging just 2.55 per cent a year
- *unemployment* was relatively *high*, averaging 5.5 per cent, even though it had reached the government's target of 5 per cent in March 2019.



4.14.2 How the RBA used monetary policy to change aggregate demand and pursue domestic macroeconomic goals during the past two years

As we know, the RBA uses its *checklist of indicators* to assess economic conditions before it decides its appropriate monetary policy stance. Recently, this list showed that economic growth was too weak, our underutilisation rate was still too high (suggesting unused capacity) and inflation was awfully slow. In addition, the RBA was concerned that global economic activity was slowing, trade tensions between China and the United States were potentially affecting Australian exporters, and our terms of trade were expected to fall. Weighing up all these considerations, the RBA continued to maintain its highly *expansionary monetary policy stance*. This involved a *record low cash rate target* of just 1.5 per cent designed to stimulate AD and economic activity

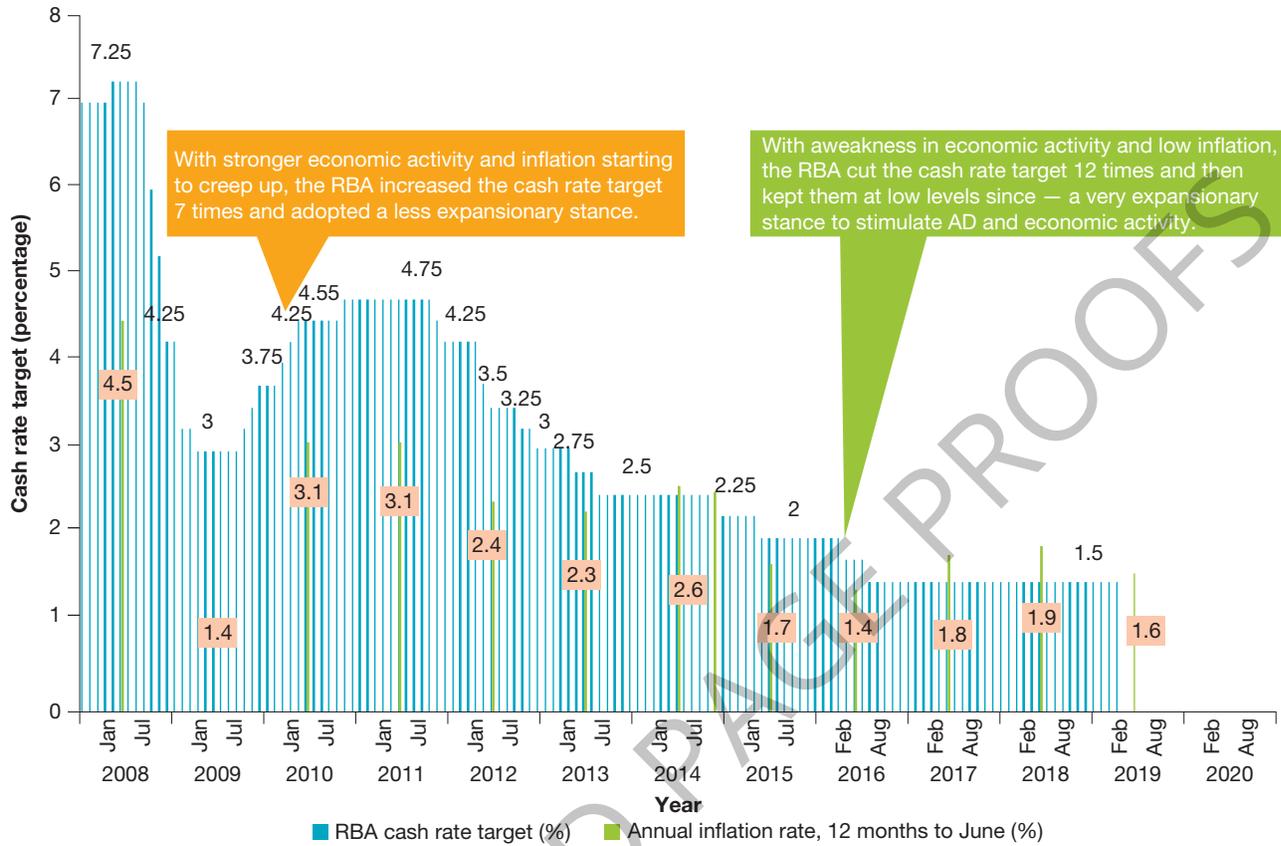
The RBA's *expansionary stance* over the last two years was also required because there was a need to gradually *cut the size of budget deficit* and *return to surplus* in the medium term so as to avoid an excessive build-up of government debt. As a result of the mildly contractionary budgetary stance, monetary policy became the main instrument used to do the heavy lifting, by providing ongoing stimulus to AD and economic activity.

Figure 4.19 clearly shows that the RBA certainly maintained a highly expansionary stance in the past two years. Indeed, there were a total of 12 consecutive cuts in the cash rate target from 4.74 per cent in late 2011 to a record low of just 1.5 per cent in 2016. Subsequently, this low cash rate was maintained during 2019.

The effects of the RBA's ongoing *expansionary stance* in the two years to 2019 can be illustrated hypothetically on the AD–AS diagram shown in figure 4.20. Starting at AD_0 and GDP_0 , spending, economic growth and employment are relatively weak. This (and the absence of inflation) prompts the RBA to adopt a more expansionary stance and cut the cash rate, which it did three times between January 2016 and December 2018. In itself, this should have helped to stimulate spending towards AD_1 and lift GDP and employment in the direction of GDP_1 (where there is domestic economic stability). There should be little risk of serious inflation (there is only a small rise from P_0 to P_1) because of the existence of considerable unused capacity in the Australian economy at this time.

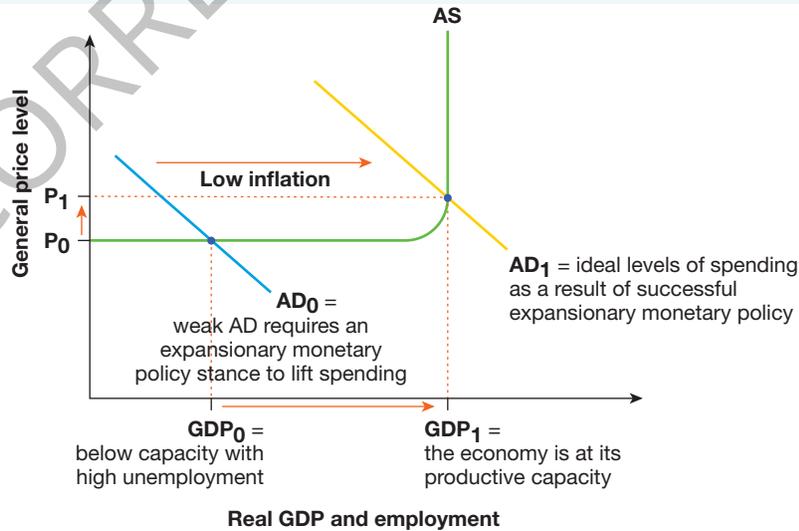
So let us now examine the effects of the reductions in the cash rate target on the Australian government's key domestic macroeconomic goals.

FIGURE 4.19 How the RBA has changed the cash rate countercyclically to regulate the level of AD and economic activity



Source: Data for the graph was derived from RBA Statistics.

FIGURE 4.20 How the RBA's expansionary monetary policy stance should help to promote domestic economic stability with higher levels of GDP and employment



The recent effect on the goals of strong and sustainable economic growth and full employment

Seeing that economic growth was weak and below trend, with much unused productive capacity available and hence little risk of serious demand inflation, the RBA was comfortable maintaining its record low cash rate target to just 1.5 per cent over the last two years to mid 2019. Low interest rates helped to stimulate AD, strengthen the rate of economic growth and promote fuller employment without adding to inflation, through various *transmission channels or mechanisms*. These included the following:

- *The cost of credit effect.* Low interest rates have recently made households and businesses more willing to take out loans than otherwise, increasing the demand for credit and stimulating C and I spending, and hence AD.
- *The availability of credit effect.* Low interest rates have recently increased the supply of bank credit made available for spending on goods and services because more people than otherwise could meet bank lending criteria and so qualify for bank loans. This helped to stimulate household C and I spending, and hence AD.
- *The cash flow effect.* For some individuals with existing mortgages and overdrafts, the maintenance of recent low interest rates helped to maintain current levels of disposable income remaining after they met their interest repayments. This would not have been possible had rates been increased because there would have been less income available for C and I spending, slowing AD.
- *The exchange rate effect.* Recent low interest rates relative to those in some countries, have contributed to a lower exchange rate for the Australian dollar by slowing capital inflow from abroad. This weakened the demand for our currency and also increased its supply. In turn, the fall in the Australian dollar has helped to stimulate X spending (more injections) while slowing M spending (fewer leakages), again boosting AD.
- *The wealth effect.* The maintenance of low interest rates usually helps to strengthen the demand for assets such as property, pushing up their price higher than otherwise. When this occurs, rising demand and asset prices normally make asset owners feel wealthier, possibly stimulating C spending and AD. However, during 2018–19, it is interesting to note that Australian property prices fell from their boom levels, even though interest rates remained at a record low. Unfortunately, through a wealth effect unrelated to interest rates, this slowed household consumption and economic activity.

Through a combination of these *transmission mechanisms*, low interest rates into 2019 helped to strengthen AD and orders and cause stocks to fall, encouraging firms to lift their rates of production and employ more staff. Without this expansionary approach, GDP growth would certainly have been weaker and unemployment higher.

The recent effect on the goal of low inflation

During 2017–18–19, there was *considerable spare capacity* in the Australian economy. This was evidenced by Australia's relatively high underutilisation rate and low inflation rate. Under these circumstances, low interest rates were most unlikely to add to either demand or cost inflation.

4.14 ACTIVITIES

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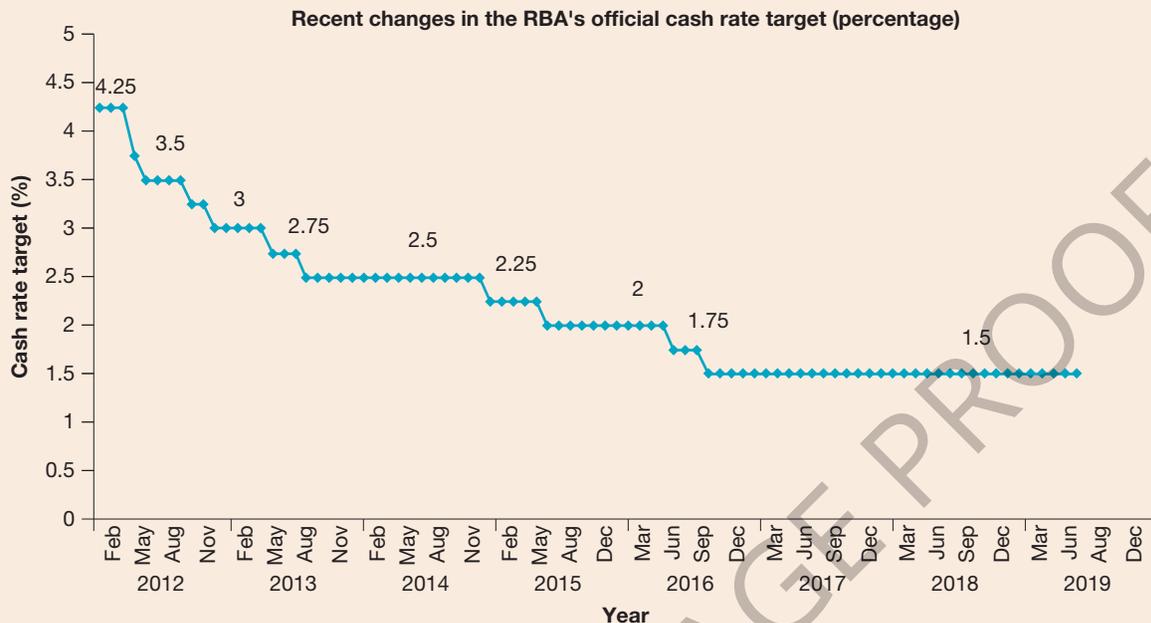
Check your understanding

1. How has monetary policy been used recently to promote Australia's domestic macroeconomic goals?

Applied economic exercises

1. Examine figure 4.21 showing recent changes in the RBA's cash rate target, and read the extract justifying the RBA's monetary policy decision to cut the cash rate to 1.5 per cent (the last reduction up until April 2019). ▶

FIGURE 4.21 Changes in the RBA's official cash rate target (percentage) and the justification for a decision to reduce the cash rate target in 2016 to 1.5 per cent



Statement by Glenn Stevens, Governor: Monetary Policy Decision

2 August 2016

At its meeting today, the Board decided to lower the cash rate by 25 basis points to 1.50 per cent, effective 3 August 2016.

The global economy is continuing to grow, at a lower than average pace. ... conditions have become more difficult for a number of ... economies. ... China's growth appears to be moderating.

... Australia's terms of trade remain much lower than they had been in recent years.

... In Australia, recent data suggest that overall growth is continuing at a moderate pace, despite a very large decline in business investment. ... Labour market indicators continue to be somewhat mixed. ...

Recent data confirm that inflation remains quite low. ...

Low interest rates have been supporting domestic demand and the lower exchange rate since 2013 is helping ... the economy to make the necessary economic adjustments, though an appreciating exchange rate could complicate this.

Supervisory measures have strengthened lending standards in the housing market. Separately, a number of lenders are also taking a more cautious attitude to lending ... All this suggests that the likelihood of lower interest rates exacerbating risks in the housing market has diminished.

Taking all these considerations into account, the Board judged that prospects for sustainable growth in the economy, with inflation returning to target over time, would be improved by easing monetary policy at this meeting.

Source: Data for the graph was derived from RBA Statistics, edited extract copied from the RBA, Media release, 2 August 2016, see <https://www.rba.gov.au/media-releases/2016/mr-16-18.html>.

a. Referring to this statement by the RBA:

- i Describe the change in the RBA's monetary policy *stance* in August 2016. **(3 marks)**
- ii From the extract, identify and explain *three* important reasons from the RBA's checklist of indicators that were used to justify the decision to cut the cash rate target in May 2016. **(3 marks)**
- iii Outline how the RBA would have used its *open market operations* at this time to cut the cash rate. **(2 marks)**
- iv Identify and explain any *three* important *transmission mechanisms* or channels whereby the RBA's decisions to lower its cash rate target 12 times (from 4.75 per cent in November 2011 to just 1.5 per cent in August 2016) might have helped to promote sustainable economic growth and full employment, consistent with achieving the low inflation target. **(3 marks)**

b. What were the main *domestic economic problems* faced by Australia's economy during the past two years? **(2 marks)**

- c. What were the main local and international *aggregate demand factors* contributing to Australia's domestic macroeconomic conditions at this time? **(2 marks)**
- With the help of a labelled AD–AS diagram, describe the *monetary policy stance* adopted by the RBA during the past two years in its attempt to strengthen domestic economic stability and improve living standards. **(4 marks)**
- Explain how a reduction in interest rates by the RBA would tend to affect any *three* of the following options. **(1 + 1 + 1 = 3 marks)**
 - The level of private business investment spending
 - Residential building approvals and new car sales
 - Cost and demand inflation
 - Imports of consumer goods and services
 - The level of cyclical unemployment

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4.15 Strengths and weaknesses of using monetary policy to achieve the government's domestic macroeconomic goals and the affect on living standards

KEY CONCEPT

- the strengths and weaknesses of using monetary policy to achieve the Australian government's domestic macroeconomic goals and how these goals may affect living standards

Monetary policy has a number of *strengths* and *weaknesses* when it is used to pursue domestic macroeconomic goals and improve living standards.

4.15.1 The strengths of using monetary policy to achieve Australia's domestic macroeconomic goals

Table 4.12 summarises the main *strengths* of using monetary policy to help promote domestic macroeconomic goals and better living standards.

TABLE 4.12 Some strengths of using RBA monetary policy to achieve domestic macroeconomic goals and living standards

Possible strength	Description of strength
1. Short implementation time lag helps make monetary policy flexible and convenient	Because of the three types of time lags associated with the use of many government policies (the lag in recognition of a problem, the lag in implementation of a corrective measure and the lag in impact), some government policies, intended to act as countercyclical stabilisers, run the risk of becoming pro-cyclical. As the RBA normally meets during most months of the year, any change in policy stance could theoretically

(Continued)

TABLE 4.12 Some strengths of using RBA monetary policy to achieve domestic macroeconomic goals and living standards (Continued)

Possible strength	Description of strength
	be <i>implemented</i> quickly if necessary. This strength makes the policy more flexible than discretionary budgetary measures, which are normally changed only once a year. It reduces the risk of the policy becoming pro-cyclical rather than countercyclical, thereby improving stability.
2. Monetary policy may work better at controlling inflation	Some commentators suggest that monetary policy is most effective in slowing inflation (rather than helping recovery from recession). This is because rises in interest rates designed to slow AD and economic activity are felt directly by borrowers who are <i>forced</i> to find extra money to meet interest repayments on existing loans. This makes it a very effective policy because spending on other things has to be reduced and new borrowing deferred.
3. Monetary policy may have fewer political considerations for the government than budgetary policy	Budgetary policy is implemented by the federal treasurer, who is an elected member of the Australian government. Monetary policy is implemented by the RBA, which is fairly independent of the government. This may potentially reduce the unpopular political or voter fallout from rises in interest rates.

4.15.2 The weaknesses of using monetary policy to achieve Australia's domestic macroeconomic goals

Monetary policy has a number of *weaknesses*. These are summarised in table 4.13.

TABLE 4.13 Some weaknesses of using RBA monetary policy to achieve domestic macroeconomic goals and living standards

Possible weakness	Description of weakness
1. Long impact time lags could make monetary policy pro-cyclical, reducing stability	As mentioned, there can be long time lags associated with the recognition, implementation and impact of many government policies, so measures run the risk of becoming pro-cyclical. While, as noted, changes in monetary policy have quite short <i>implementation lags</i> (given that the RBA board meets regularly most months), they have quite long <i>impact lags</i> . This partly limits the usefulness of monetary policy in correcting short-term or cyclical instability, and makes it more suited to promoting stability in the medium term. For instance, it has been estimated that a 1 per cent change in interest rates ultimately alters GDP by about 0.7 per cent, but that only 40 per cent of this impact will be felt after 12 months, with 80 per cent felt after two years and 100 per cent after three years. Such a long time lag means there is a greater chance that monetary policy could become <i>pro-cyclical</i> and destabilise the economy.
2. Monetary policy is imprecise and blunt in its impact on the economy	There are <i>three</i> potential problems associated with the degree of precision and the ability of monetary policy to target the exact cause of economic problems: <ul style="list-style-type: none"> • Changes in interest rates by the RBA affect the overall levels of savings, consumption, investment and net exports (via the impact on the Australian dollar). Because the economic impacts of the policy are so widespread, the policy cannot precisely target particular areas of concern. Using higher interest rates to slow consumption, for example, also pulls down beneficial investment spending that supports economic growth. This limits the policy's usefulness.

	<ul style="list-style-type: none"> • With interest rate changes, one policy has to fit all states and industries in Australia, regardless of their circumstances. The minerals boom in WA and NT (2009–12), for instance, accelerated inflation, justifying interest rate rises in these states. However, in Tasmania and SA, where unemployment was higher and inflation lower, fewer rises in interest rates were required. Monetary policy is not well suited to a <i>two-speed economy</i>. • Australia has substantially deregulated interest rates so that the RBA does not directly set what banks charge customers. Sometimes banks seem to be less willing to follow changes in the cash rate target set by the RBA, instead, going their own way. For instance, banks may respond to a cut of 0.5 per cent in the RBA cash rate by reducing their interest rates by only 0.4 per cent, choosing instead to widen their lending margins. With the banks choosing partly to go their own way, this could reduce the preciseness of monetary policy.
3. Monetary policy works in fairly indirect ways to affect AD and the level of economic activity	Critics note that monetary policy is possibly less effective in overcoming <i>recessions</i> when there is pessimism, because cutting interest rates in a recession only works in very <i>indirect</i> ways on the level of spending by making interest repayments cheaper. People are not <i>forced</i> to spend more, whereas with budgetary policy, the government can directly inject more spending. Indeed, extremely low interest rates near zero per cent (as seen recently in parts of Europe and Japan) hardly whipped pessimistic borrowers into a spending frenzy. With rates this low, central banks were fairly powerless to do any more to aid recovery and so increased reliance had to be placed on expansionary budget deficits.
4. Monetary policy may be undermined by budgetary policy	When the economy is weak and the government decides to run budget deficits to stimulate AD, financed by borrowing through the sale of government bonds domestically, this can increase the demand for credit in local financial markets. As an unintended result, this puts upward pressure on local interest rates at a time when it would be better to have lower interest rates to boost spending. Such higher interest rates can lead to the problem of <i>crowding-out</i> private sector C and I spending, thereby slowing the economy. This would undermine the effectiveness of monetary policy. In reverse, during a boom where there is a budget surplus designed to slow AD and economic activity, if the government decides to repay previous debt, this can lower interest rates and lead to the problem of <i>crowding-in</i> by borrowers, thereby adding to inflation and instability.
5. Goal conflicts	Sometimes monetary policy cannot be used for pursuing one particular government economic goal, because it can conflict with the pursuit of another objective. For example, in cutting the cash rate to help strengthen the goals of strong economic growth and full employment, sometimes this can add to inflation — there is a trade-off.
6. Psychological constraints	The success and strength of monetary policy depends partly on the prevailing level of <i>confidence</i> . For instance, generally weak consumer and business confidence would tend to reduce the expansionary effects of a reduction in the cash rate. In reverse, a contractionary stance adopted by the RBA can be made less effective than expected in slowing the level of AD if confidence is strong.

4.15 ACTIVITIES

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Check your understanding

1. What are the main *strengths* of using monetary policy to help promote domestic economic stability?
2. What are the main *weaknesses* of using monetary policy to help promote domestic economic stability?

Applied economic exercises

- Assume hypothetically that the RBA decided to *increase* the cash rate target because it was concerned about the rise in inflation. Identify and explain *two* important *weaknesses* or constraints that may be likely to limit the effectiveness this policy. **(3 marks)**
 - Assume hypothetically that the RBA decided to further *reduce* the cash rate target to because economic growth was slowing and unemployment rising. Identify and explain *two* important *weaknesses* or constraints that may be likely to limit the effectiveness this policy. **(3 marks)**
- Assume hypothetically that the RBA decided to *increase* the cash rate target because it was concerned about the rise in inflation. Identify and explain *one* important strength of this policy as a stabiliser. **(2 marks)**
 - Assume hypothetically that the RBA decided to further *reduce* the cash rate target to because economic growth was slowing and unemployment rising. Identify and explain *one* important strength of this policy as a stabiliser. **(3 marks)**

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4.16 Review

4.16.1 Summary

The course requires that you understand the nature and operation of both budgetary and monetary policies as aggregate demand policies used to promote domestic macroeconomic goals.

The nature of government budgetary policy as an aggregate demand measure

- Aggregate demand (or macroeconomic) policies include both budgetary (fiscal) and monetary policies.
- Budgetary* or *fiscal policy* relates to anticipated federal government revenues or receipts (such as direct taxes including personal and company tax, indirect taxes such as sales, GST and excise tax and non-tax revenue) and expenses or outlays (such as government consumption and investment spending on health, defence and education, as well as welfare and other transfers), broken down into current spending (G_1), capital spending (G_2) and transfer payments for the coming year. It is an aggregate demand management instrument designed to regulate the level of AD in a countercyclical way and thereby help to achieve domestic economic stability (namely, strong and sustainable economic growth, full employment and low inflation) and improve living standards.
- The *budget outcome* depends on the total value of receipts against the total value of outlays. There are three situations:
 - a deficit (receipts are less than outlays), normally funded by a rise in government debt or borrowing, either locally or overseas, through the sale of government bonds
 - a surplus (receipts are greater than outlays); the money can be used to retire debt, build up government savings with the RBA for a rainy day, or create special savings funds
 - a balance (receipts are equal to outlays).
- The budget outcome is especially affected by domestic rates of GDP growth, overseas economic activity, the TOT, the Australian dollar, changes in unemployment, wages growth, and political conditions. Sometimes the forecasts and assumptions underlying the budget can change dramatically during the course of the year, affecting the actual budget outcome.
- The *budget stance* can be expansionary, contractionary or neutral. It relates to whether the budget's intention is to boost or slow AD and economic activity.
 - A bigger budget deficit or a smaller surplus (expressed as a percentage of GDP) is usually seen as *expansionary*, designed to stimulate AD and economic activity.

- A smaller deficit or a bigger surplus is normally seen as *contractionary*, designed to slow AD and economic activity.
- The medium-term operating aim of budgets in recent years is to return to a budget surplus when conditions permit.

How budgets, as an aggregate demand instrument, can help to achieve low inflation, full employment, and strong and sustainable economic growth

- In theory, *budgetary policy can help improve domestic economic stability* (where strong and sustainable economic growth, low inflation and full employment are achieved simultaneously) by regulating the level of AD in a *countercyclical* manner through the operation of two types of budget stabilisers:
 - *automatic stabilisers* are triggered by cyclical changes in economic activity and require no deliberate government decision
 - *discretionary stabilisers* involve deliberate policy changes that alter the level of receipts (such as by changes in tax rates, the introduction of new taxes or the abolition of existing taxes) relative to outlays (e.g. announcements about changed funding for infrastructure projects, health and education).
- During a *recessionary downswing* in economic activity, a *more expansionary* stance to boost AD is usually applied as a result of automatic and discretionary cuts in budget receipts, and automatic and discretionary rises in budget outlays. Typically, this involves an increase in the size of the budget deficit. The aim is to stimulate AD and economic activity, and reduce cyclical unemployment. Again, domestic economic stability and living standards should be improved.
- During a *strong upswing* in AD and economic activity where there are inflationary pressures, a *more contractionary* budgetary stance is progressively applied to help slow AD to sustainable rates. Typically, this entails switching gradually from a deficit to a larger budget surplus by automatic and perhaps discretionary rises in receipts relative to outlays. The new stance helps to slow AD, moderate the inflationary upswing and improve domestic economic stability and living standards.
- Due to the GFC and ensuing events to 2019, the federal government ran up over \$360 billion in *budget deficits* and so far has been unable to return the budget to surplus as frequently promised due to weaker than expected economic activity, lower commodity prices and terms of trade, higher unemployment, lower than expected company profits and personal tax collections, the slowdown in China, and political obstacles in the Senate that slowed fiscal consolidation and the repair of the budget.
- When used to promote domestic stability, budgetary policy has various strengths and weaknesses:
 - *Strengths* include short time lags for automatic stabilisers making them very effective, the ability to precisely target areas of weakness in the economy and the possibility of beneficial aggregate supply-side effects.
 - *Weaknesses* include long implementation and impact time lags for discretionary measures which can then become pro-cyclical; some inflexible outlays in the budget that cannot easily be changed; financial constraints on higher discretionary outlays when used as stabilisers; the possibility of undermining monetary policy; and strong political considerations or constraints.

What is the nature of monetary policy?

- *Monetary policy* is an aggregate demand policy and involves the RBA changing *interest rates* (the official cash rate target) to affect the cost, availability and demand for credit. By changing levels of saving, C, I and net X spending, it can be used to regulate AD and promote Australia's three key domestic macroeconomic goals and improve living standards.
- *Official interest rates* (the *cash rate target*) can be changed by the RBA using its *open market operations* (OMO) in the short-term/overnight money market. This entails the RBA buying back/repurchasing government bonds or selling government bonds to affect the supply of cash, bank liquidity and general interest rates.
- The *medium-term operational aim of monetary policy* involves *inflation targeting* or the pursuit of low inflation (an average annual inflation rate or CPI target of around 2–3 per cent over time). Once the

goal of low inflation has been achieved, other aims including strong and sustainable economic growth and full employment often become the focus for RBA policy as seen recently.

- Monetary policy is regarded as an *aggregate demand management policy* because changes in interest rates have the capacity to affect C, I and even net X as components of AD, through various *transmission mechanisms* or channels.

Using monetary policy to pursue the government's domestic macroeconomic goals

- Theoretically, monetary policy can help *increase domestic economic stability* if it is applied as a *countercyclical* measure and used to steady the rate of increase in AD during booms and recessions. Stabilisation involves a change in monetary policy's *stance* or whether it is intended to be expansionary (looser), contractionary (tighter) or neutral in its impact on AD and activity.
- Using a *looser monetary policy during a recessionary downswing*: The RBA's monetary policy stance is eased/loosened/becomes more expansionary to stimulate AD when inflation is below the 2–3 per cent target, and GDP growth and employment are weak. There are several steps involved:
 - The RBA announces the cut in the cash rate target and justifies its decision using a checklist of indicators.
 - The RBA conducts open market operations (OMO) in the short-term money market involving its net repurchases of government securities from financial institutions.
 - The return of cash/liquidity to the short-term money market causes a surplus of credit and thus brings down interest rates that then ripple out to affect other interest rates in the capital market.
 - The various transmission mechanisms kick in to boost AD and economic activity.
- Using a *tighter monetary policy during an inflationary upswing*: The RBA's monetary policy stance is usually tightened/made more contractionary to slow AD when inflation approaches or starts to exceed the 2–3 per cent inflation target. This tightening process occurs through several steps:
 - The RBA announces the rise in the cash rate target and justifies its decision using a checklist of indicators.
 - The RBA conducts open market operations (OMO) in the short-term money market involving its net sales of government securities to financial institutions.
 - The withdrawal of liquidity from the short-term money market causes a shortage of credit and thus drives up interest rates that then ripple out to affect other interest rates in the capital market.
 - The various transmission mechanisms kick in to slow AD and economic activity.
- *Transmission mechanisms* are used to help bring about a rise or fall in the level of AD and economic activity, and better achieve domestic economic stability.
 - Following a *cut in the cash rate* in a slowdown, various transmission mechanisms help *stimulate* AD and economic activity. Lower interest rates cause a rise in the demand for credit to finance C and I, lead to an increase in the supply of credit, boost the cash flow available for household spending, add to a feeling of being wealthier and weaken the exchange. Together these channels strengthen AD, economic growth and employment, improving our general living standards.
 - Following a *rise in the cash rate* during a period of inflation, various *transmission mechanisms* help to *slow* AD, domestic economic activity. Higher interest rates cause a decrease in the demand for credit used to finance C and I, lead to a decrease in the supply of credit, reduce the cash flow available for household spending, weaken the feeling of wealth and strengthen the value of the Australian dollar in the foreign exchange market. Together these channels slow AD, economic growth and employment to sustainable levels, improving our general living standards.
- Recently, economic growth has been fairly weak and below trend, unemployment has been higher than normal and inflation has been very low. Hence, monetary policy during this period has been *highly expansionary* (particularly since at this time, there have been efforts to cut the deficit and return the budget to surplus). To this extent, it is likely that the 12 reductions in the cash rate target to May 2019 helped to stimulate AD and hence reduce domestic instability and improve living standards.

- Monetary policy has both *strengths* and *weaknesses* when used to pursue domestic economic stability:
 - Strengths include short time lag in *implementation*, greater effectiveness in controlling inflation, and possibly less political fallout from a tightening of the policy stance (relative to that with a tighter budgetary policy involving higher taxes or less outlays).
 - Weaknesses include quite long time lags in policy *impact* (up to three years for the full impact of a cut in interest rates to be felt) perhaps leading to the risk of it becoming pro-cyclical, its bluntness or imprecision in pinpointing and correcting problem areas in the economy, and more limited effectiveness than budgetary policy in recessions due to its indirectness in influencing AD.

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4.16.2 KEY TERMS

Aggregate demand management policy includes budgetary and monetary policy and is used by the government to influence the level of spending, economic activity and the achievement of key domestic macroeconomic goals.

Automatic stabilisers (also called cyclical stabilisers) are changes in tax revenues collected and welfare outlays that are built into the budget and operate correctly in a countercyclical way to help stabilise AD, without the federal treasurer deliberately changing their level or announcing new policies.

Availability of credit (or transmission channel) alters spending because interest rates affect the willingness of banks to lend, the number of clients who qualify for loans and the availability or supply of credit. This alters spending and economic activity.

Balanced budgets occur when the total value of revenue equals the total value of expenses.

Bracket creep occurs when recipients of rising income gradually move into higher marginal income tax brackets, which automatically increases their tax burden.

Budget expenses or outlays in the budget are expenses involving, for example, the provision of goods and services for the community and transfers like welfare benefits.

Budget outcome represents the difference between the total value of budget revenues and the total value of budget outlays. The budget outcome may be a balanced budget, deficit or surplus.

Budget repair refers to tax and outlay strategies designed to reduce the deficit and return the budget to surplus in the medium term.

Budget revenues are the federal government's incoming receipts of money that pay for budget outlays. Taxation, for example, is a major source of revenue for the government.

Budget stance refers to whether the budget is neutral, expansionary or contractionary in its impact on the level of AD and economic activity.

Budget surplus represents a situation where the total value of government outlays is less than the total value of its receipts for a period of time. Budget surpluses occurred between 2006–07 and 2007–08, and perhaps again in 2019–20. Larger surpluses may have a contractionary effect on aggregate demand and hence on economic activity, and are suitable for slowing inflationary booms. See aggregate demand management policies; automatic stabilisers; contractionary budget; discretionary stabilisers.

Budgetary policy is an aggregate demand measure and relates to changes in the anticipated levels and composition of government revenues (e.g. personal income tax, company tax) and expenses (e.g. outlays on welfare or education) for the upcoming year.

Cash flow effect (or transmission channel) is the impact of changes in interest rates on the level of discretionary spending on other goods and services by households with existing loans like home mortgages and overdrafts. This affects consumption spending, AD and economic activity.

Contractionary budgets (e.g. a rise in the surplus as a percentage of GDP) seek to slow AD and economic activity and thereby reduce inflationary pressures.

Cost of credit effect (or transmission channel) influences the demand for credit because it changes the cost of borrowing and repaying debt, thereby affecting the level of credit-sensitive spending, AD and economic activity.

Countercyclical application of monetary policy means that during a slowdown the RBA will cut interest rates to increase AD and lift economic activity, but during an inflationary upturn or boom, it will raise interest rates to slow AD and control inflation.

Countercyclical budgetary policy adopts an expansionary stance to increase AD in a slowdown and a contractionary stance to slow AD during an inflationary upturn, thereby helping to stabilise the level of economic activity.

Crowding out occurs in a situation where the government, for example, runs a deficit budget in a recession with the intention of stimulating spending to help promote recovery. Unfortunately, if the deficit is financed by borrowing credit locally, upward pressure is put on domestic interest rates that will push out private sector borrowers and undermine the efforts of monetary policy in promoting a recovery.

Discretionary stabilisers in the budget are the *deliberate* changes in tax rates, the tax mix and the direction and composition of budget outlays specifically announced by the federal treasurer to help steady economic activity in response to severe adverse developments.

Exchange rate effect (or transmission channel) is where changes in domestic interest rates relative to those abroad affect levels of capital inflow and outflow, changing the demand and supply of the Australian dollar and thus the exchange rate. In turn, when the exchange rate changes, this affects the levels of export and import spending, AD and economic activity.

Expansionary budgets seek to stimulate AD and economic activity.

Fiscal balance refers to a strong and sustainable financial position for the government's budget where, over the medium term (such as the duration of the business cycle), the budget surpluses generated in booms are more than sufficient to pay for the budget deficits in recessions without the need to borrow or commit future generations to heavy debt repayments.

Fiscal consolidation refers to budget measures designed to reduce the size of the budget deficit by increasing tax and/or decreasing outlays.

Government capital spending (abbreviated as G_2) includes government investment spending in the budget to facilitate the production of goods and services for the community.

Government current spending (abbreviated as G_1) includes the day-to-day expenses or budget outlays of the government on the purchase of consumer goods and services (such as the payment of staff in the public sector).

Headline balance refers to the difference between the total cash value of budget receipts minus the cash value of total outlays from all sources, without the removal of items that are affected by one-off events such as asset sales and debt repayments.

Inflation targeting means that the RBA's operational goal is to apply monetary policy to achieve an annual average inflation rate of between 2–3 per cent over time.

Interest rates refer to the annual cost of borrowing credit or the annual return on invested savings. Rates are closely related to the nation's inflation rate and are largely determined at equilibrium in financial markets by the forces of supply (by savers) and demand for credit (by borrowers).

Monetary policy is a branch of macroeconomic policy operated by the RBA involving changes in interest rates to alter the cost, availability and demand for credit. It is designed to regulate the level of AD and economic activity.

Monetary policy stance relates to whether the RBA wants to use interest rates to slow or to accelerate the level of AD and economic activity. Currently, a cash rate above about 2.5 per cent, for example, is normally regarded as a contractionary stance, but a cash rate below perhaps 2.5 per cent is currently seen as an expansionary stance.

Official cash rate is the interest rate target set by the RBA for the short-term money market and indicates its monetary policy stance.

Open market operations relate to the strategies of the RBA in the short-term money market involving the sale or repurchase of government securities or bonds with the aim of pushing up or lowering the cash rate.

Pay-as-you-go (PAYG) tax is a direct progressive tax levied on incomes received by individuals at marginal rates of zero per cent up to 45 per cent (expected rate 2016–17).

Pro-cyclical policies are discretionary changes in the budget (e.g. perhaps infrastructure projects) that increase economic instability due to their long time lags in recognition, implementation or impact. They are the opposite of countercyclical policies.

Short-term money market is a specialist financial institution where money is borrowed and lent for short periods. In this market, RBA market operations affect the supply of cash and, in so doing, influence the cash rate.

Time lags in policy can be a weakness and are of *three* types: *recognition lag* for the problem due to the existence of lagging indicators like GDP; *implementation lag* in activating the policy; and *impact lag* in waiting for the policy to actually boost or slow AD and economic activity.

Transmission mechanisms for monetary policy are the various ways that changes in interest rates work to influence AD and the level of economic activity. These include the cost of credit effect, the cash flow effect, the availability of credit effect, the exchange rate effect, the wealth effect and the inflationary expectations effect.

Underlying budget outcome represents the headline balance after subtracting the value of one-off volatile items, such as asset sales, special loans to state governments or debt repayments by other governments.

Wealth effect is a transmission mechanism resulting from a change in interest rates. For instance, a cut in interest rates usually helps to strengthen the demand for assets such as property, pushing up their price. When this occurs, rising asset prices makes asset owners feel wealthier, stimulating C spending and AD.

on Resources

 **Digital document** Key terms glossary – Topic 4 (doc-#####)

4.16 Review questions

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4.16 Exercise 1: Multiple choice questions

- As an aggregate demand policy, budgetary measures may be used to help:
 - bring about domestic economic stability by managing the growth in AD.
 - slow inflation.
 - promote a strong and sustainable rate of economic growth and low unemployment.
 - achieve all of the above.
- Aggregate demand or macroeconomic *budgetary policies* applied countercyclically to help improve domestic economic stability usually involve:
 - a contractionary policy stance during downturns and recessions.
 - an expansionary policy stance during inflationary booms or upswings.
 - introducing changes in receipts relative to expenses to help maintain a steady growth in the level of AD so that total spending levels are neither excessive nor inadequate.
 - changing interest rates.
- Which of the following is *most* correct? A budget *deficit* (such as occurred between 2008–09 and 2018–19) is where:
 - the total value of government receipts is more than the total value of government expenses.
 - the total value of government expenses is less than the total value of receipts.
 - the total value of government asset sales and taxes is more than the total value of government consumption (G_1) and government investment (G_2) spending.
 - the total value of government receipts is less than the total value of government expenses.
- The *main* difference between the *headline* budget balance and *underlying* budget balance is that:
 - the underlying balance excludes one-off volatile items like asset sales and interest repayments by state governments.
 - the headline balance excludes transfers like welfare outlays, which vary from year to year.
 - the underlying balance removes the effect of automatic stabilisers.
 - the underlying balance removes the impact of inflation on the values of receipts and outlays.

5. Concerning budgetary policy, which statement is generally *false*?
 - A. A deficit budget may be financed by foreign and/or local borrowing.
 - B. A larger deficit budget as a ratio to GDP may stimulate domestic economic activity and, if the economy is already at its capacity, this may cause demand inflation.
 - C. A deficit budget in a recession financed by local borrowing from the financial sector may unintentionally tend to drive up domestic interest rates, causing a possible degree of conflict with RBA efforts to run an expansionary monetary policy with lower interest rates.
 - D. In itself, the shift towards a bigger surplus budget or a smaller deficit is generally regarded as expansionary, and should help to lower unemployment and accelerate economic growth.
6. Between 2013–14 and 2019–20, the federal government initially planned to convert a headline deficit of \$48.5 billion into a small surplus. Theoretically, this could have been achieved using:
 - A. increased asset sales, automatic increases in tax collections and bracket creep, and the introduction of discretionary new taxes.
 - B. a discretionary reduction in government consumption (G_1) and government investment (G_2) spending.
 - C. automatic and discretionary cuts in welfare outlays and other transfer payments.
 - D. all of the above.
7. The treasurer predicted that the size of the budget deficit between 2014–15 and 2018–19 would decrease in absolute terms and as a percentage of GDP. In itself, this expected change would generally be regarded as:
 - A. a relatively less expansionary budget stance.
 - B. a relatively less contractionary budget stance.
 - C. a relatively neutral budget stance.
 - D. neither an expansionary nor contractionary stance.
8. What factor(s) might theoretically help to explain why the small budget surplus that the treasurer predicted would be achieved ended up as a budget deficit; or why the actual deficit ended up being nearly twice as big as that projected; or why the predicted surplus finished as a budget deficit?
 - A. More rapid inflation and faster economic growth than initially expected
 - B. Lower unemployment than initially expected
 - C. An unexpected boom among our trading partners overseas
 - D. Lower terms of trade, along with slower levels of domestic economic activity and higher rates of unemployment than initially expected
9. Which statement is *correct*? An increase in G_2 spending on public health, education, housing and transport will normally tend to:
 - A. decrease cyclical unemployment.
 - B. decrease job vacancies.
 - C. decrease demand inflation in the short term.
 - D. decrease the rate of economic growth by slowing AD.
10. Which of the following does *not* explain why the actual cash surplus for a year might be *smaller* than that originally projected when the budget was first announced by the treasurer?
 - A. There was an unexpected collapse in consumer and business confidence.
 - B. There was a severe recession in China and a drop in our terms of trade.
 - C. The Senate failed to approve new budget revenue measures.
 - D. Government efficiency measures reducing the level of budget outlays were much more effective than expected.
11. Which of the following fiscal measures would be *most* appropriate for *reducing* cyclical unemployment in Australia?
 - A. A rise in the budget surplus as a ratio to GDP
 - B. Large-scale public works combined with rises in income tax rates

- C. A rise in the ratio (percentage) of budget outlays to GDP and reduction in the ratio (percentage) of receipts to GDP
- D. Both (A) and (B) are appropriate.
12. Which statement about budgetary policy is generally *incorrect*?
- A. Most revenue collected from taxes, along with government outlays on welfare benefits, tend to act automatically as countercyclical stabilisers of AD.
- B. Rises in personal and company tax rates would add to demand inflation pressures in an economy operating near or at its productive capacity.
- C. Cuts in rates of personal income tax designed to make a surplus budget less contractionary may lead to increased demand inflation if the economy has little spare capacity.
- D. An increase in the GST rate to 15 per cent in the future by the federal government on behalf of the states could help return the budget to surplus, but may slow economic activity and increase the tax burden on the poor.
13. Which of the following fiscal measures is *most likely* to slow demand inflation in the short to medium term?
- A. Tariff cuts
- B. A reduction in the budget surplus
- C. Increased cash subsidies paid to local producers
- D. Increases in government capital expenditure (G_2) and rises in indirect taxes
14. Which of the following budgets is *likely* to be most expansionary in its impacts on AD and domestic economic activity?
- A. A budget where a larger proportion of outlays is spent overseas
- B. A budget where the deficit is financed by borrowing from the RBA and not from the domestic private sector
- C. A budget involving a rise in the domestic surplus
- D. A budget where total receipts rose by 15 per cent relative to outlays, which rose by 5 per cent against the previous year
15. Which statement is generally *incorrect* for an economy experiencing a prolonged boom?
- A. Discretionary rises in personal income tax rates would be appropriate.
- B. Increased public infrastructure would occur automatically during the upswing to improve domestic stability.
- C. Company tax collections would tend to rise automatically.
- D. Revenues collected from personal and sales taxes would tend to rise automatically without any deliberate change in the applicable tax rates.
16. Faced with a large and deteriorating *structural budget deficit* and no prospect of a return to surplus in the medium or long term, the treasurer might have to consider:
- A. increasing taxes on individuals and firms, even though this may prove politically unpopular.
- B. trying to slow or reduce budget outlays as a ratio to GDP, especially current expenses.
- C. reforming the taxation system and looking for budget savings measures.
- D. all of the above.
17. Which of the following budgetary measures has an impact on the rate of economic growth which *differs* from the other three?
- A. Cuts in marginal tax rates on individuals
- B. Increased outlays on infrastructure to \$100 billion over the next 10 years
- C. Increased tax rates on superannuation for those with contributions exceeding \$1 million and the abolition of capital gains tax concessions
- D. A one-off \$1000 cash bonus for all welfare recipients
18. Which budgetary measure is *most likely* to have an impact on the level of AD and the rate of demand inflation which *differs* from the other three?
- A. Increasing pension rates for the aged
- B. Raising the top rate of PAYG income tax from 45 to 47 per cent

- C. Cutting excise taxes on alcohol and reducing the company tax rate for small and medium-sized firms from 30 to 25 per cent
 - D. Cutting the size of the budget surplus from \$20 billion to \$5 billion
19. Direct and indirect taxes are two ways used to raise government revenue. Which statement about these is *least correct*?
- A. Increasing direct tax rates is less likely to add to the inflation rate, unlike increasing indirect taxes.
 - B. Rises in indirect taxes can appear less obvious to voters than rises in income tax.
 - C. The luxury car tax for passenger vehicles is a direct tax, while the Medicare levy is an indirect tax.
 - D. Direct taxes raise more revenue in the federal budget than indirect taxes.
20. Contractionary budgets involving rises in tax rates and cuts in outlays on government services would probably *not* adversely affect:
- A. the unemployment rate.
 - B. the inflation rate.
 - C. the rate of economic growth.
 - D. the underutilisation rate of labour.
21. Which of the following is regarded as an actual outlay but *not* classified as an item of government spending in the budget?
- A. The Medicare levy
 - B. Welfare support and assistance to industry
 - C. Health outlays
 - D. Payment of wages and salaries for politicians and government employees
22. Examine the hypothetical data below for a country (similar to Australia). As treasurer, you are working on the next budget.

Indicator	2019	2020
Unemployment rate (percentage)	5.0	6.7
Inflation rate (percentage of CPI)	2.7	1.5
GDP (percentage)	3.2	1.3

- Other things being equal, which future combination of budgetary policies to be announced in 2021 would *best* help to promote *domestic economic stability* given the trends in economic conditions for the two years shown?
- A. A rise in the ratio of budget receipts to GDP and a fall in the ratio of budget outlays to GDP.
 - B. A significant reduction in the budget deficit as a ratio of GDP and then a return to surplus.
 - C. An expansionary budget involving a switch to a larger discretionary deficit and a bigger overall budget deficit as a ratio to GDP.
 - D. Running a bigger budget deficit financed by government borrowing through the increased sale of government bonds domestically.
23. Which of the following does *not* normally operate as an *automatic* stabiliser in the budget during a slowdown?
- A. PAYG
 - B. GST
 - C. Outlays on health
 - D. Payments to the unemployed
24. Which of the following would generally *decrease* the size of the structural budget deficit (as opposed to the cyclical deficit)?
- A. Rises in the tax-free threshold for personal income from \$18 000 to \$24 000
 - B. Higher company profits made by exporters due to a favourable move in our TOT
 - C. A fall in the number of people unemployed from 800 000 to 650 000
 - D. A rise in the pension access age from age 64 to 67

25. The *underlying* budget outcome best represents:
- A. the difference between government receipts and outlays or expenses.
 - B. the headline budget outcome minus the value of one-off items such as the privatisation of the NBN and debt repayment by Tasmania.
 - C. the difference between the values of government tax and its annual spending.
 - D. structural changes in receipts and outlays.
26. The *medium-term* operating aim of recent budgets is:
- A. to repair the budget.
 - B. to return to surplus at a prudent rate as conditions permit.
 - C. to slow inflation to a target rate of 2–3 per cent over time.
 - D. to raise budget receipts as a percentage of GDP.
27. Which of the following is an example of a *discretionary* fiscal policy?
- A. A rise in the cash rate of interest during a recovery
 - B. A reduction in the tax rate for small to medium-sized businesses from 30 to 25 per cent
 - C. Reduced revenue collected from personal income tax due to the rise in unemployment
 - D. A rise in revenue from import duties during the recovery in economic activity
28. Assume the treasurer was required to deliver a *balanced budget* every year, despite the existence of the normal business cycle. This could require:
- A. collecting higher taxes in a slowdown.
 - B. increasing outlays in a boom.
 - C. that the budget becomes pro-cyclical.
 - D. all of the above.
29. Monetary policy refers to:
- A. microeconomic measures introduced by the Treasury.
 - B. aggregate demand management measures of the RBA.
 - C. measures that mostly affect the flows of credit between borrowers and lenders and the level of expenditure.
 - D. both (B) and (C).
30. Higher domestic interest rates will especially tend to:
- A. slow cost inflation.
 - B. slow demand inflation.
 - C. discourage overseas borrowing and weaken the exchange rate for the Australian dollar.
 - D. decrease unemployment.
31. The RBA cut the cash rate target 12 times between late 2011 and August 2016 and has since maintained a record low cash rate. This is likely to have contributed to the overall *depreciation* of the Australian dollar by around 20 per cent against the US dollar between 2013 and mid 2019. In itself, this depreciation would *tend* to:
- A. make Australian exports of goods and services cheaper in the United States relative to the price of imports in Australia, stimulating AD and domestic economic activity.
 - B. decrease the burden of repaying interest on the foreign debt denominated in US dollars.
 - C. cause a rise in the unemployment rate, especially in our export and import-competing sectors.
 - D. slow the growth rate in GDP.
32. Which monetary policy action is *likely* to be most *expansionary* on the level of AD and economic activity?
- A. The RBA increases its net sales of government bonds in the short-term money market by \$2 billion.
 - B. The RBA increases its net repurchases of government bonds in the short-term money market by \$3 billion.
 - C. The RBA decreases its net sales of government bonds in the short-term money market by \$1 billion.
 - D. The RBA decreases its net repurchases of government bonds in the short-term money market by \$6 billion.

33. The *transmission mechanism(s)* following a *cut* in the official cash rate set by the RBA from 1.5 to 1.0 per cent could involve:
- an increase in the demand for and the availability of credit.
 - an increase in the cash flow for some households with existing loans.
 - some households feeling wealthier and more confident to spend, along with a likely depreciation in the exchange rate.
 - all of the above.
34. Faced with high and rising cyclical unemployment and no threat of inflation, the RBA could:
- undertake operations in the short-term money market and adopt a more accommodating stance.
 - increase repurchases on government bonds in the overnight money market.
 - further reduce the cash rate target to help drive the Australian dollar downwards.
 - try all of the above measures.
35. Between 2016 and 2019, the RBA reduced and then maintained the official cash rate target at a record low. The *most likely* reason for this strategy was that:
- the underutilisation rate was low.
 - the inflation rate was mostly below 2 per cent, the unemployment rate tended to be too high and job vacancies were relatively weak.
 - economic activity was acceptable and there was little unused capacity.
 - domestic expenditure and confidence were strong.
36. Which of the following could tend to *impair* the effectiveness of an *expansionary* monetary policy stance involving large reductions in the cash rate?
- The existence of consumer and business pessimism
 - Large expansionary budget deficits funded by the sale of government bonds in the domestic capital market
 - Very high levels of unemployment and negative GDP growth, typical of recession rather than a boom
 - All of the above
37. Following a large *rise* in interest rates by the RBA, it is *likely* that:
- demand inflation will slow, partly due to reduced consumption and investment spending.
 - a higher dollar could help slow cost inflation.
 - inflationary expectations should tend to be crushed.
 - all the above may apply.
38. The most *likely* reason why the RBA *lowered* interest rates and kept them low between 2016 and 2019 was that:
- the level of economic activity abroad was rising strongly.
 - our terms of trade had just started to recover.
 - there was a threat from a worsening price bubble in the Sydney and Melbourne property markets.
 - to hold down government debt levels, the budget stance needed to become less expansionary.
39. Examine the hypothetical *checklist of indicators* shown in table 4.14 prepared for the government and central bank of a country similar to Australia.
- What mixture of budgetary and monetary policy best represents the actions that should be taken on the basis of the trends shown in this information?
- Further increase the budget surplus, combined with open market operations involving heavy central bank repurchases of government bonds in the short-term money market.
 - Increase the cash rate target, raise PAYG tax rates and slow budget outlays.
 - Increase the cash rate target to encourage the Australian dollar to appreciate, combined with reducing budget outlays on imports of equipment and foreign aid.
 - Reduce the budget surplus and increase repurchases of government bonds in the short-term money market.

TABLE 4.14 Checklist of economic indicators used by a central bank

Checklist indicator	2019–20	2020–21
Growth in national expenditure (percentage)	2.2	7.0
Chain volume GDP growth (percentage)	2.5	5.1
Headline CPI (percentage)	2.7	3.6
Underlying CPI (percentage)	2.5	3.9
Budget outcome (\$ billion)	10.1	15.4
Cash rate target (percentage)	4.5	5.0
Global GDP growth (percentage)	2.5	3.1

40. Concerning the RBA's actual *monetary policy stance* between 2016 and mid 2019, which of the following is *most correct*?
- The policy stance was highly expansionary.
 - The policy became neutral.
 - A more contractionary policy stance was adopted and maintained.
 - The policy was able to become less expansionary because of a substantial rise in the size of the budget deficit between 2016–17 and 2018–19.
41. Monetary policy is often regarded as being *more effective* than budgetary policy in directly helping to achieve the goal of:
- full employment.
 - strong and sustainable economic growth.
 - low inflation (price stability).
 - international competitiveness.
42. The likely effect of a more *expansionary* monetary policy setting by the RBA would be:
- a rise in the household savings ratio.
 - a slower rise in I.
 - a higher C and net X.
 - none of the above.
43. If the RBA *increases* its cash rate, this is *likely* to cause:
- GDP to rise.
 - cyclical unemployment to fall.
 - an increase in demand inflation.
 - an increase in our borrowing overseas, pushing up the value of the Australian dollar.
44. Examine the hypothetical *checklist of indicators* in table 4.15 prepared for the RBA covering a two-year period.
- This hypothetical data for the period indicate that:
- economic conditions have probably started to improve overall and there is cause for optimism.
 - labour market conditions have strengthened, with a likely fall in the unemployment rate.
 - macroeconomic conditions have probably deteriorated due to weaknesses domestically and internationally.
 - a tighter macroeconomic policy stance needs to be adopted.
45. Which statement about Australian *monetary policy* is *most correct*?
- The implementation lag is long, increasing the chance that policy may become pro-cyclical, but this is offset by the fact that the impact lag is short.
 - Monetary policy is a very precise or surgical instrument that can accurately target and correct specific problem areas in the economy.

TABLE 4.15 Hypothetical checklist of economic indicators used by the RBA

RBA checklist indicator	Year 1	Year 2
Retail sales change (percentage change)	12	2
Consumer confidence (index points)	122	91
New dwelling approvals ('000)	69 200	45 100
Job vacancies ('000)	170	140
Trade weighted index (TWI)	68	67
Terms of trade index	115	108
China's rate of GDP growth (percentage)	10	6

- C. Monetary policy can do little else to stimulate economic growth and full employment once interest rates are close to, or reach, zero per cent.
- D. Following its deregulation, there are no controls or regulations governing Australia's financial system.
46. As a rough guide in recent years, a fairly *neutral* monetary policy stance for the RBA is generally when official interest rates are:
- less than 1 per cent.
 - around 1–2 per cent.
 - around 2.5 per cent.
 - around 3.5 per cent.
47. Which of the following aggregate demand budgetary policies is *most likely* to be in *conflict* with the RBA's pursuit of low inflation using higher interest rates?
- Raising welfare benefits and G spending (expressed as a ratio to GDP)
 - Increasing PAYG tax rates and failing to compensate income earners for bracket creep
 - Cutting the size of the budget deficit
 - Substantially increasing the budget surplus
48. Which of the following is generally *false* following a *cut* in interest rates?
- The Australian dollar will tend to depreciate.
 - AD may fall due to lower investment spending.
 - The inflation rate may tend to rise if there is little unused or spare capacity available.
 - The unemployment rate should tend to fall.
49. Following open market operations by the RBA, *increased* interest rates are *likely* to:
- increase domestic savings but reduce investment spending.
 - decrease the labour force underutilisation rate.
 - reduce the inflow of foreign investment and weaken the exchange rate.
 - cause all of the above.
50. If real GDP or economic growth was running below 2 per cent and annual inflation rate was 1.2 per cent, the RBA would *probably*:
- tighten its monetary policy stance.
 - loosen its monetary policy stance.
 - not change its monetary policy stance.
 - start by tightening its policy stance before easing it.

 **Digital document** Multiple choice answer grid – Topic 4 (doc-#####)
Multiple choice answers – Topic 4 (doc-#####)

4.16 Exercise 2: Extended response questions

1. Accurately define what is meant by *budgetary* (fiscal) policy. In what ways is this policy regarded as an *aggregate demand policy*? (2 marks)
2. With reference to budget speeches, what have been the main goals or *priorities* of recent federal budgets? (2 marks)
3. Over the last two years, including 2017–18 and 2018–19, Australia’s rate of economic growth was below trend, annually averaging around 2.5 per cent rise in real GDP, unemployment was high, averaging about 5.3 per cent of the labour force, and inflation was low averaging around just 1.8 per cent per year. Explain how the *operation of automatic stabilisers* in this economic situation, should *normally* work to help strengthen *domestic economic stability* and improve *living standards*. (4 marks)
4. Budgetary policy is an important category of aggregate demand measures used to help stabilise the economy and improve Australia’s living standards.

In delivering the 2019–20 budget, the then Treasurer noted that ... ‘*the budget is back in the black and is on track. For the first time in 12 years, our nation is paying its own way ... The budget builds on our plan for a stronger economy. A stronger economy that benefits you, your family, your business, your community, your country. ... It restores our nation’s finances. Without increasing taxes...We want small business to prosper and we are backing them to do so*’.

In the 2018–19 budget, the then treasurer noted that the ‘*government is backing business to create more jobs*’. The same sort of emphasis on ‘jobs and growth’ was also part of the 2017–18 budget.

Source: Derived from the Australian Government, various Budget Papers for 2017, 2018 and 2019.

- a. In part, by pursuing these aims the treasurer does not just rely on automatic stabilisers. *Discretionary budget measures* also played a central role. What are *discretionary* measures? Identify two specific *discretionary aggregate demand* measures announced in the 2018–19 and/or 2019–20 budgets and then explain how each measure might help to ‘*grow the economy and create more jobs*’. (3 marks)
- b. Explain how ‘a stronger economy brings benefits to you, your family, your business, your community and your country’. (4 marks)
5. Examine the budget estimates and projections in table 4.16 taken from the 2019–20 budget.
 - a. Define the term *underlying budget balance* and then describe the actual and forecast trends in this balance from 2017–18 onwards. (2 marks)
 - b. Referring to table 4.16 and giving reasons, explain whether the forecast change in the federal budget outcomes for 2018–19 and 2019–20 should be seen overall as an *expansionary* or *contractionary* fiscal policy *stance* and explain how this is likely to affect AD and future levels of macroeconomic economic activity. (5 marks)
 - c. What are the main *causes* of the 12 actual and forecast federal *budget deficits* totaling over \$360 billion to 2018–19? (3 marks)
 - d. The treasurer has forecast a return to a *budget surplus* of around \$7.1 billion in 2019–20. This projected outcome is based on many assumptions. Identify and outline the *three* most important *economic assumptions* that are likely to determine whether he will be successful in returning to a budget surplus. (3 marks)

TABLE 4.16 Actual and estimated budget statistics from the Australian government

	Actual		Estimates		Projections		Total (a) \$b
	2017–18 \$b	2018–19 \$b	2019–20 \$b	2020–21 \$b	2021–22 \$b	2022–23 \$b	
Receipts	446.9	485.2	505.5	522.3	551.0	566.9	2145.7
Per cent of GDP	24.2	25.0	25.2	25.1	25.4	25.0	
Payments (b)	452.7	482.7	493.3	511.3	533.2	557.7	2095.6
Per cent of GDP	24.5	24.9	24.6	24.6	24.5	24.5	
Net Future Fund earnings (c)	4.3	6.6	5.1	na	na	na	5.1
Underlying cash balance (d)	-10.1	-4.2	7.1	11.0	17.8	9.2	45.0
Per cent of GDP	-0.5	-0.2	0.4	0.5	0.8	0.4	

Source: Data copied directly from Budget Papers, April 2019, Statement 3, Fiscal Strategy and Outlook Budget Paper No. 1 (table 2) 2019–20, see https://www.budget.gov.au/2019-20/content/bp1/download/bp1_bs3.pdf.

6. There is concern over Australia's growing level of *official* (i.e. public sector) *debt*. In 2018–19, interest on this debt was around \$17 billion with about the same again in 2019–20.
 - a. What is the *medium-term operational goal* of recent budgets? Briefly outline how this goal may be achieved. **(1 mark)**
 - b. Identify and outline two important *reasons why a return to budget surplus* in the *medium-term* is important for Australia. **(2 marks)**
 - c. What are the main *methods* available for the treasurer to *finance* ongoing large *budget deficits*? **(2 marks)**
7. Select and outline two important *discretionary* budgetary policy announcements from the 2018–19 and or 2019–20 budgets (or from the last two years), and then explain how these are likely to affect Australian *living standards*. **(3 marks)**
8. In his 2019–20 budget speech, the treasurer announced measures that would provide '*additional cost of living relief*' for some households. Identify one important *policy announcement* that might help to do this and explain how it may work. **(2 marks)**
9. Identify and outline one important *advantage* and one important *disadvantage* of using fiscal policy as a *stabiliser of domestic economic activity* in the current economic climate. **(3 marks)**
10. Carefully define *monetary policy*, outlining its '*medium-term operational goals*'. Why is this regarded as an aggregate demand policy? **(3 marks)**
11. Read the edited extract taken from the RBA *Statement on Monetary Policy* by the RBA Governor in March 2019 and answer the questions that follow.

Statement by Glenn Stevens (Governor of the RBA)

At its meeting today, the Board decided to leave the cash rate unchanged at 1.50 per cent.

The global economy grew above trend in 2018, although it slowed in the second half of the year.The outlook for the global economy remains reasonable, although downside risks have increased. The trade tensions remain a source of uncertainty. ... In most advanced economies, unemployment rates are low and wages growth has picked up.

... The Australian dollar has remained within the narrow range of recent times. While the terms of trade have increased over the past couple of years, they are expected to decline over time.

The Australian labour market remains strong ... and the unemployment rate is at 5 per cent. ... The stronger labour market has led to some pick-up in wages growth, which is a welcome development. The improvement in the labour market ... is still expected to be a gradual process.

Other indicators suggest growth in the Australian economy slowed over the second half of 2018. ... The growth outlook is being supported by rising business investment, higher levels of spending on public infrastructure and increased employment. The main domestic uncertainty continues to be the strength of household consumption in the context of weak growth in household income and falling housing prices in some cities. ... Inflation remains low and stable. ...

The low level of interest rates is continuing to support the Australian economy. Further progress in reducing unemployment and having inflation return to target is expected, although this progress is likely to be gradual. Taking account of the available information, the Board judged that holding the stance of monetary policy unchanged at this meeting would be consistent with sustainable growth in the economy and achieving the inflation target over time.

Source: RBA, Media release, 5 March 2019, see <https://www.rba.gov.au/media-releases/2019/mr-19-05.html>

- a. What is meant by the RBA's *monetary policy stance*? What did the Board decide in its meeting in March 2019? (2 marks)
 - b. Thinking of the RBA's *checklist of indicators* and referring specifically to the RBA's media statement, what *justifications* were given by the RBA Governor for the *monetary policy stance* that had been maintained over the last 2–3 years to mid 2019? (3 marks)
 - c. In the *future*, explain the steps or *process* whereby the RBA could bring about an *increase* in its the cash rate target. (3 marks)
12. Referring to at least three important monetary policy *transmission mechanisms*, explain how an RBA decision to *lower its cash rate* target further to just 1.0 per cent '*... would be consistent with sustainable growth and achieving the inflation target over time*'. (4 marks)
13. Identify and explain one important *strength* and one important *weakness* of using monetary policy to help promote *domestic economic stability*. (2 marks)
14. In April 2019, the Treasurer announced a *less expansionary/mildly contractionary* budget involving a reduced budget deficit from around \$4.2 billion (–0.2% GDP) in 2018–19 to a surplus of \$7.1 billion (0.4% GDP) in 2019–20. Given this budget stance, explain the roles currently being played by our mixture of monetary policy and budgetary policy in helping to promote *domestic economic stability* and *living standards*. (6 marks)

Fully worked solutions and sample responses are available in your digital formats.

4.16 Practice school-assessed tasks

A total of two SACs are to be completed for VCE Economics Unit 4. SAC 1 is worth 50 per cent of the total assessment for Unit 4. It assesses the skills and knowledge associated with Outcome 1 that is largely covered in topic 4. The SAC should be part of the regular teaching and learning program, and completed mainly in class and within a limited timeframe. The SAC could involve one or more of the following:

- a folio of applied economics exercises
- an essay
- a report
- structured questions
- problem-solving exercises
- a folio of media commentaries.

Courses and assessments can change, so teachers are urged to carefully check the latest VCAA *assessment guide* and various *bulletins* to ensure that all the assessment requirements are met fully.

Folio of applied economics exercises

1. Accurately define what is meant by *budgetary* (i.e. fiscal) policy. Using specific examples of recent measures, explain how this policy can be used as an *aggregate demand policy*. (3 marks)

2. Examine table 4.17 that has been extracted from the 2019–20 federal government’s 2019–20 Budget Papers. It sums up what the then Treasurer, Scott Morrison, described as ... ‘the government living within its means’. Referring to data in table 4.17 and giving clear reasons for your answer, accurately describe the expected *change* in the federal government’s *budget stance* over the years between 2017–18 and 2021–22. (3 marks)

TABLE 4.17 Actual, estimated and projected changes in the Australia’s budget outcomes

	Actual	Estimates				Projections		Total (a) \$b
	2017–18 \$b	2018–19 \$b	2019–20 \$b	2020–21 \$b	2021–22 \$b	2022–23 \$b		
Receipts	446.9	485.2	505.5	522.3	551.0	566.9	2145.7	
Per cent of GDP	24.2	25.0	25.2	25.1	25.4	25.0		
Payments (b)	452.7	482.7	493.3	511.3	533.2	557.7	2095.6	
Per cent of GDP	24.5	24.9	24.6	24.6	24.5	24.5		
Net Future Fund earnings (c)	4.3	6.6	5.1	na	na	na	5.1	
Underlying cash balance (d)	-10.1	-4.2	7.1	11.0	17.8	9.2	45.0	
Per cent of GDP	-0.5	-0.2	0.4	0.5	0.8	0.4		

Source: Data copied directly from Budget Papers, April 2019, Statement 3, Fiscal Strategy and Outlook Budget Paper No. 1 (table 2) 2019–20, see https://www.budget.gov.au/2019-20/content/bp1/download/bp1_bs3.pdf.

3. Most politicians and commentators agree that the federal government needs to return to a *budget surplus* in the medium term. Identify and clearly explain *two* important *reasons* why Australia must repair the budget and seek to return to a *surplus* over the medium term. (4 marks)
4. Examine table 4.18 sourced from the April 2019–20 budget papers showing the ‘actual’ outcome for economic growth in 2017–18, and the ‘forecast’ rates for GDP growth between 2018–19, 2019–20 and 2020–21. Assuming that the forecast changes in GDP growth between 2018–19 and 2019–20 prove to be correct, carefully explain how the operation of *automatic (cyclical) stabilisers* would normally affect the *budget outcome*. How would these forecasts be likely to affect the achievement of Australia’s key *domestic macroeconomic goals*? (6 marks)

TABLE 4.18 Actual and forecast changes in Australia’s rate of economic growth

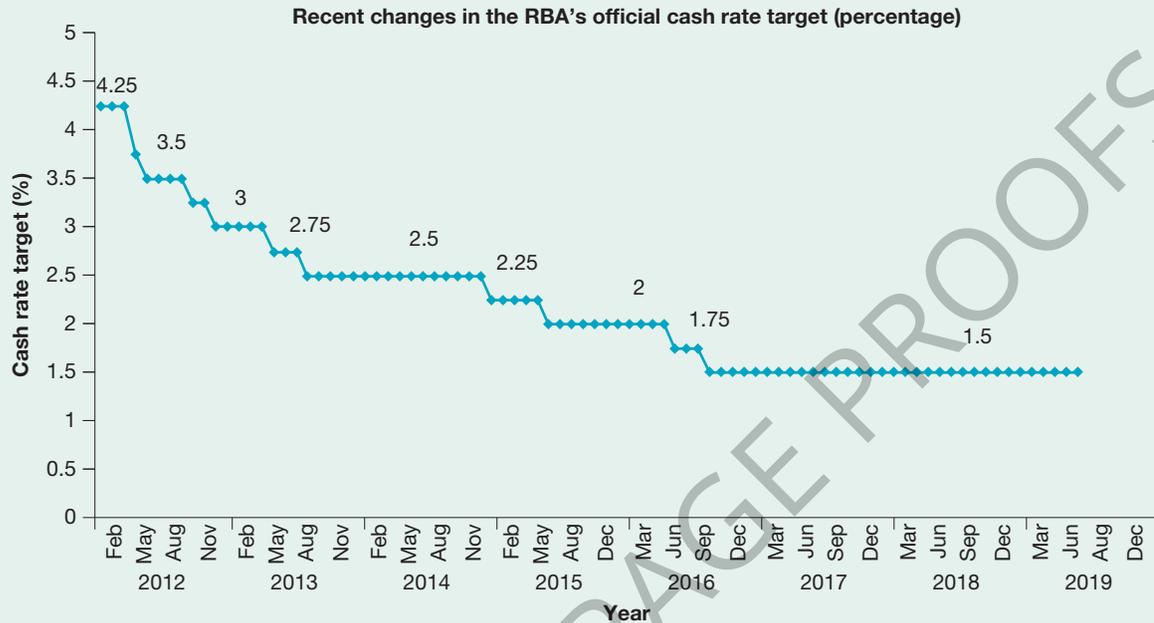
Year	Outcome 2017–18	Forecast 2018–19	Forecast 2019–20	Forecast 2020–21
Annual percentage change in real GDP	2.8	2.25	2.75	2.75

Source: Data derived from the Australian Government, Budget Papers, April 2019.

5. Select an important *discretionary stabiliser* announced from the 2018–19 and/or 2019–20 budget that you believe will especially help to boost the rate of *economic growth*, create jobs and improve overall *living standards* in the medium term. Briefly outline this specific aggregate demand measure, and then explain how this might help to boost economic growth and improve living standards. (6 marks)
6. Identify and carefully explain one important *strength* and one important *weakness* of using *budgetary policy* to help *stimulate* AD and Australia’s economic activity. (4 marks)
7. Accurately define *monetary policy*. Explain why this policy is regarded as an important macroeconomic or *aggregate demand* policy. (3 marks)
8. Examine figure 4.22 showing the RBA’s cash rate target in recent years, focusing on the recent changes in this target between June 2016 and April 2019. Referring to the data from figure 4.22, explain the change in the RBA’s monetary policy *stance* during the period between June 2016 and March 2019. In addition,

referring to the RBA's *checklist* of indicators, identify and outline the most likely *reasons* used to *justify* its recent monetary policy *stance*. **(3 marks)**

FIGURE 4.22 Changes in Australia's cash rate target



Source: Data derived from RBA Statistics.

9. Read the quote from the RBA's 1959 Charter below:

'The RBA's duty is to contribute to ... [economic] stability ... the maintenance of full employment in Australia ... economic prosperity and the welfare of the Australian people.'

Source: Charter of the RBA, <http://www.rba.gov.au/about-rba/>

As noted here, the RBA applies monetary policy to help promote economic prosperity. Given the fall in Australia's unemployment rate to around 5 per cent as reported in March 2019 and the likelihood of slowly rising inflation, some but not all commentators predict that the RBA might *increase its cash rate target*, perhaps even by late 2019.

Carefully explain the main *steps* (i.e. the *process*) whereby the RBA could *tighten* its monetary policy *stance* (referring to the completed diagram representing the short-term money market 'before' and 'after' the rise in the RBA's cash rate target). **(4 marks)**

10. Referring to two important *transmission mechanisms*, clearly explain how the maintenance of a *lower cash rate* over the last two years to mid 2019, is likely to have affected the level of AD and the government's key *domestic macroeconomic goals*. **(6 marks)**

11. Discuss the *effectiveness* of the RBA keeping interest rates low over recent years, by referring in detail to one important *strength* and one important *weakness* of using monetary policy to help promote domestic economic stability. **(4 marks)**

An essay

Select *one* of the following questions and write an essay in response.

- Unit 4, SAC 1 could require you to complete an essay about the nature and operation of a government macroeconomic policy. Structure a research essay about budgetary policy as an aggregate demand instrument as follows:
 - Provide a clear definition of budgetary policy. **(4 marks)**
 - Define domestic economic stability. **(4 marks)**
 - Discuss how recent budgetary policy can help achieve this government goal, illustrating this with reference to recent fiscal measures. **(12 marks)**
- Quoting statistics and examples of actual policy changes, explain how a mixture of budgetary and monetary policies has been used to help pursue strong and sustainable economic growth and full employment in Australia during the last two years. **(20 marks)**
- A return to federal government budget surplus is important in the medium term. How has this desire to return to budget surplus affected the conduct and operation of monetary policy in the pursuit of domestic stability? Discuss the advantages of using monetary policy in this situation. **(20 marks)**

A written report

Unit 4, SAC 1 could require you to complete a report about macroeconomic policy (budgetary policy and monetary policy). You may like to complete *one* of the following reports involving the operation of budgetary policy. Make sure you complete topic 4 before attempting the report.

- Report about using budgetary policy as an aggregate demand instrument to promote domestic economic stability. **(20 marks)**
 - Clearly define what is meant by domestic economic stability for Australia.
 - How might the achievement of domestic economic stability affect Australia's living standards?
 - To what extent has Australia enjoyed domestic economic stability in the past two years?
 - Define *budgetary policy* and explain how it can operate as an aggregate demand policy.
 - Quoting examples, explain how automatic and discretionary budget stabilisers in a slowdown would normally assist recovery and the promotion of living standards. Illustrate with actual examples of specific budgetary measures used in the past two years.
- Report about the operation of monetary policy as an aggregate demand instrument to promote domestic economic stability. **(20 marks)**
 - Define *monetary policy*, explaining how this operates as an aggregate demand policy.
 - Identify and outline the main *domestic problems* faced by the Australian economy during the past two years.
 - Explain how the RBA, when faced with these problems, has used monetary policy in the past two years to promote domestic economic stability and improvements in living standards.
 - Identify *two* important strengths and *two* weaknesses of using monetary policy to promote domestic economic stability during the past two years.
- Report about the impacts of the recent federal budget. Use media reports about the federal budget in newspapers and on the internet (such as the federal government's website containing the recent budget papers) to research information about the *latest* budget and write a brief report (containing diagrams, statistics, examples of policy and graphs). Address the following in your report: **(20 marks)**
 - Analyse the main domestic economic problems faced by the Australian economy at this time.
 - The budget is based on domestic and international assumptions and Treasury forecasts. Identify and outline these assumptions, along with the Treasury's forecasts for key economic variables for the next few years.
 - Explain whether the budget stance is expansionary or contractionary.
 - Identify and explain the key features and measures in this budget that you feel will help to promote domestic economic stability and improve living standards at this time.

Folio of media commentaries

Your task is to collect a folio of media commentaries about a range of recent macroeconomic or aggregate demand policies that have been adopted by the Australian government. These articles might include:

- budgetary policies including the most recent budget
- the RBA's monetary policy involving recent changes in interest rates.

Articles could be sourced online or in hard copy from print media. You should source and annotate these articles, and submit them as a folio.

UNCORRECTED PAGE PROOFS