UNIT 4
Managing the economy

AREA OF STUDY 1
Aggregate demand policies and domestic economic stability (duration about 7–8 weeks)

OUTCOME 1
On completion of area of study 1, the student should be able to discuss the nature and operation of aggregate demand policies and analyse how the policies may influence the Australian Government’s domestic macroeconomic goals and living standards.

AREA OF STUDY 2
Aggregate supply policies (duration about 6–7 weeks)

OUTCOME 2
On completion of area of study 2, the student should be able to discuss the nature and operation of aggregate supply policies and analyse how the policies may influence the Australian Government’s domestic macroeconomic goals and living standards.

SCHOOL-ASSESSED COURSEWORK (SAC)

In SACS 1 and 2 for unit 4, the student’s performance on each outcome should be assessed using one or more of the following:
- structured questions
- a folio of applied economic exercises
- a folio of applied media commentaries
- problem-solving exercises
- a report
- an essay.

SAC 1 will be worth 60 per cent and SAC 2 will be worth 40 per cent of unit 4 school-based assessment. These tasks should be part of the normal teaching program and completed mainly in class within a limited timeframe.

These two SACs will contribute 25 per cent to the overall study score, with another 25 per cent coming from the three SACs in unit 3 and 50 per cent from the two-hour, end-of-year examination.
KNOWLEDGE FOR UNIT 4

AREA OF STUDY 1, OUTCOME 1
• The need for aggregate demand management policies in terms of stabilising the business cycle

FISCAL POLICY (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
• 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.

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.

AREA OF STUDY 2, OUTCOME 2
• the nature, operation and aims of aggregate supply policies and their relationship to the domestic macroeconomic goals, international competitiveness and living standards
• the relationship between the efficient allocation of resources and aggregate supply
• how the following aspects of budgetary policy are designed to influence aggregate supply and the achievement of domestic macroeconomic goals:
  - spending on training and education
  - research and development grants
  - subsidies
  - investment in infrastructure
• how welfare and tax reform policies are designed to influence aggregate supply and living standards
• the effect of immigration policies on the labour market and aggregate supply, and the way in which this influences the achievement of domestic macroeconomic goals
• the strengths and weaknesses of using aggregate supply policies to achieve the Australian Government’s domestic macroeconomic goals and how these goals may affect living standards.

SKILLS FOR UNIT 4

AREA OF STUDY 1, OUTCOME 1
• 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.

AREA OF STUDY 2, OUTCOME 2
• define key economic concepts and terms and use them appropriately
• describe the aims of aggregate supply policies in terms of the domestic macroeconomic goals and living standards
• gather relevant data and information about the nature and operation of aggregate supply policies in Australia
• analyse the effect of aggregate supply policies on the domestic macroeconomic goals and living standards
• discuss the strengths and weaknesses of aggregate supply policies.

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TOPIC 4

Aggregate demand policies and domestic economic stability

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

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 polices (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 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 — that does not accelerate inflation)
• the goal of low inflation (a slow average rise in general consumer prices of 2 to 3 per cent a year over the economic cycle).

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. So 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. Together these two measures 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 microeconomic 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, ensuring 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, it should be possible for the government to improve Australia’s prosperity and ensure the economy’s performance is optimal.

4.1 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 like 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 (G1) and government investment spending (G2), 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 primarily 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 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 like that in 2016, and when governments don’t have a strong majority in the parliament. As we have seen in recent years, the closing budget numbers might be quite different, reflecting unexpected developments. For instance, budget deficits have often been bigger than anticipated due to weaker economic growth, higher unemployment, 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 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) update usually in December each year.

4.2 Sources of government revenue (receipts)

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. Currently, revenues consist of the following types:
• direct taxes levied on the incomes received by individuals and companies
• indirect taxes placed on the sale of goods and services and added onto the price of items at the point of sale
• non-tax revenue from sources other than taxation.
The bar graph in figure 4.1 shows the relative importance of each type of federal government revenue.

![Bar graph](image)

**FIGURE 4.1** Sources of estimated federal budget receipts of $417 billion for 2015–16, calculated as percentage of total revenue

Source: Data derived from Budget Paper 1 (overview, appendix B), 2016.

**Direct taxation**

- **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 2015–16, 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 47 per cent on annual taxable incomes in excess of $180 000 (49 per cent if the 2 per cent Medicare levy is added). In addition, the 2016–17 budget announced the removal of the temporary 2 per cent levy on those in the top tax bracket, bringing the top rate back down to 45 per cent. This source of revenue raises around 48 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 2016, 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), with an effective top marginal rate of around 24.5 per cent (although announced changes in the 2016–17 budget would lower this top rate to 23.5 per cent).

- **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 is levied at a rate of 2 per cent of personal taxable incomes.

- **Withholding tax** is applied to individuals who fail to register their tax file number when receiving income such as dividends and interest. In 2015–16 it was levied at the top marginal tax rate (including the Medicare levy) of 49 per cent (although changes announced in the 2016–17 budget would lower this top rate to 47 per cent).

- **Company tax** is a flat or proportional tax levied directly on business profits. In 2015–16, the tax rate was 30 per cent of the profits of large companies and 28.5 per cent for smaller companies. However, the 2016–17 budget announced a ten-year plan to further reduce company tax, starting with a reduction to 47.5 per cent for small and medium-sized companies with a turnover of up to $10 million. Company tax raises around 17 per cent of all budget revenue.

- **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 2015–16, it was levied at 49 per cent of the taxable benefit (although changes announced in the 2016–17 budget would lower this top rate to 47 per cent).

- **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 soon change.

**Indirect taxation**

- **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 (for example, 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 duty 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 2016–17. 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, prescription medicines and public health goods, nursing home charges, child care and financial services. Currently, both the GST tax rate and tax base are under review.

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

Non-tax receipts currently raise around 6 per cent of all federal government revenues. They come from the profits gained from the operation of government business enterprises (such as Australia Post). Revenue can also come from asset sales when government business enterprises (GBEs) are privatised (such as Medibank Private in 2014). However, receipts from asset sales will only be included in the headline budget outcome and not the underlying outcome. In addition, non-tax revenue also comes from interest 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.

### Other features of our 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 94 per cent of all federal revenues are derived from taxation of which around 68 per cent is from direct taxes on incomes. Of the remainder, just over 26 per cent comes from indirect taxes with the 6 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.

**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.

### Principles of taxation and tax reform

In general, three principles of good taxation should be used to guide government tax changes or reform:

1. **Simplicity.** For each tax we should ask the question: is it easily understood by income earners and simple to administer, with minimal compliance costs, including paperwork?

2. **Fairness.** Equity has long been an accepted principle of taxation — people should be taxed according to their capacity to pay. For instance, should indirect taxes be levied on necessities such as food, health or education? Should the marginal rates of personal tax be made less steeply progressive so that richer households pay a smaller proportion of their income in tax, or should the opposite happen? Should tax loopholes or breaks relating to the favourable taxation of superannuation, or on capital gains primarily enjoyed by the rich, be tightened? And should multinational companies operating in Australia be allowed to shift profits to lower taxing countries?

3. **Efficiency.** An efficient tax has a fairly neutral impact on the decisions of both consumers and producers. Generally, this allows the market to work more effectively to allocate resources. Is it efficient for the government to interfere with resource allocation by taxing luxury cars at 33 per cent while cask wine is taxed at
around 11 per cent and toothpicks at 10 per cent? Is a tax on income derived from savings and investment ultimately efficient when there is a shortage of domestic savings and a rising foreign debt? Unfortunately, not all the tax reforms introduced by federal treasurers to early 2016 met most of these three criteria.

**Tax reform**
Tax reform is an ongoing necessity so there are incentives to work hard and invest, and to ensure that Australia is internationally competitive and fair. In 2010 for instance, there was the Henry Review of Australia’s future tax system that made many recommendations for changes to our tax system including cutting the rate of company tax. However, this was piecemeal and most proposals did not see the light of day. In March 2015, the government released its Re-think tax discussion paper that suggested a much broader review of our tax system designed to build jobs, growth and opportunity by having taxes that are lower, simpler and fairer.

### 4.3 Types of government expenses (outlays)

*Budget expenses* represent federal outlays of money to directly or indirectly provide goods and services for the household and business community. These include the following areas:

- **Social security or welfare outlays** are government cash transfer payments to the neediest groups who meet the means and assets tests (that is, those whose incomes and assets are below certain cut-off levels). These benefits represent over 35 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. Together, they represent more than 1 per cent of all expenses.
- **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 GFC (between 2008–09 and 2016–17, and perhaps beyond 2020–21), the federal government ran up massive budget deficits totalling over $355 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 2016–17).
- **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 4.2 shows that the government’s main priorities 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 price system.
Essentially, all these budget outlays can also be broken down into three main types.

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 like 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 (around $85 billion).

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 broadband network system, 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.

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 35 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 (for example, 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).

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**Figure 4.2** Direction of estimated federal budget expenses of $451 billion by function for 2016–17, calculated as percentage of total outlays

*Source:* Data derived from Budget Paper 1 (overview, appendix B), 2016.

<table>
<thead>
<tr>
<th>Outlays by function</th>
<th>% of total outlays of $451 billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>General public services</td>
<td>5</td>
</tr>
<tr>
<td>Defence</td>
<td>6</td>
</tr>
<tr>
<td>Education</td>
<td>7</td>
</tr>
<tr>
<td>All other functions (e.g., transport, communications)</td>
<td>11</td>
</tr>
<tr>
<td>Health</td>
<td>16</td>
</tr>
<tr>
<td>Other</td>
<td>20</td>
</tr>
<tr>
<td>Social security and welfare</td>
<td>35</td>
</tr>
</tbody>
</table>

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**eBookplus**

**Weblinks** The weblinks in these activities are available in this topic’s student resources tab.

- Keynesian economics with Jacob Clifford
3. There are over $350 billion. Current Treasury forecasts suggest that this may continue at least until 2020–21 (or beyond).

When the budget outcome is negative or in deficit, the total value of government revenue is less than 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.

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. It is, therefore, said to be a relatively neutral stance.

Budget deficit and how it 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 2016–17, with cumulative deficits well over $350 billion. Current Treasury forecasts suggest that this may continue at least until 2020–21 (or beyond).

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 expansionary budget deficits during and following the GFC between 2008–09 and 2016–17 (or beyond). 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 2017. 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.

- 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.
- Deficits financed by borrowing involve the payment of interest and this diverts money and resources away from more productive uses like education, welfare and health.
- Persistent large budget deficits weaken the government’s ability to deal with an economic crisis. They reduce its capacity to borrow and lower cash reserves in the government’s ‘fighting fund’.
- Ongoing large budgets 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.

**Budget surplus and how it might be used**

A budget surplus is where the total value of government revenues exceeds the total value of its expenses (as happened over several years prior to 2007–08). Typically, a surplus occurs when economic activity is too strong and there are 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 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 (for example, 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 2016 the federal government had five of these special savings funds managed under the umbrella of the Future Fund.

<table>
<thead>
<tr>
<th>TABLE 4.1</th>
<th>The Australian government’s special purpose savings funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund</td>
<td>Balance (b, March 2016)</td>
</tr>
<tr>
<td>Future Fund</td>
<td>117.3</td>
</tr>
<tr>
<td>Education Investment Fund</td>
<td>3.7</td>
</tr>
<tr>
<td>Building Australia Fund</td>
<td>3.7</td>
</tr>
<tr>
<td>Medical Research Future Fund</td>
<td>3.1</td>
</tr>
<tr>
<td>Disability Care Australia Fund</td>
<td>5.2</td>
</tr>
<tr>
<td>Total</td>
<td>133.0</td>
</tr>
</tbody>
</table>


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

- 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.
- 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.
- 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 like infrastructure.
- Surpluses help to support international confidence among investors, and strengthen Australia’s external situation.

**Impact of unexpected events on the final budget outcome**

When estimating a particular budget outcome, the federal treasurer makes assumptions about the likely level of receipts and expenses for the year ahead, based on the best information and forecasts available at the time. On occasions, these assumptions prove to be correct and the estimate is close to the actual budget outcome.
However, at other times predictions are completely off target because of unexpected events that impact on the levels of budget receipts and expenses.

Many factors can cause estimates of receipts and outlays to be incorrect. For example, in recent years the forecasts for the following variables were often overoptimistic, so the actual budget outcome was much weaker than expected on budget night:

- The rate of economic growth was slower than expected. This meant reduced personal and company tax receipts and higher welfare outlays for the unemployed.
- Unemployment was higher and the participation rate lower than estimated. This caused reduced receipts to be collected from income tax and GST, and meant higher welfare outlays.
- Commodity prices (iron ore, coal, wool, wheat) and the terms of trade fell below projections. This led to lower company profits and tax receipts. Additionally, lower terms of trade caused a rise in unemployment and hence reduced PAYG tax revenue and raised welfare outlays.
- Business profits and investment were weaker than expected thereby slowing economic and employment growth. In turn, this reduced budget receipts and raised welfare outlays.
- An unforeseen reduction in household and business optimism meant reduced sales of goods and services, and lower C and I spending. This slowed AD and GDP, and thus weakened tax receipts relative to welfare outlays.
- Unexpected natural disasters including drought, cyclones and floods slowed GDP. In turn, these events lessened tax receipts.
- The political obstacles of passing the budget through the Senate were underestimated. This meant that discretionary rises in receipts and/or cuts in budget outlays were delayed or rejected. The budget bottom line was weakened.
- The Chinese and other overseas economies slowed more than expected. This slackened export sales. It also undermined business profits and employment, and reduced company and personal tax receipts. In addition, welfare outlays rose more than expected.

The domestic and international assumptions behind the 2016–17 budget are shown in table 4.2.

### TABLE 4.2 Forecasts and assumptions behind the federal government budget outcome, 2015–16, 2016–17 (percentage change on previous year)

<table>
<thead>
<tr>
<th>Part A — Domestic economy forecasts</th>
<th>Outcomes</th>
<th>Forecasts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real gross domestic product</td>
<td>2.2</td>
<td>2 1/2</td>
</tr>
<tr>
<td>Household consumption</td>
<td>2.7</td>
<td>3</td>
</tr>
<tr>
<td>Dwelling investment</td>
<td>7.9</td>
<td>8</td>
</tr>
<tr>
<td>Total business investment</td>
<td>–6.2</td>
<td>–11</td>
</tr>
<tr>
<td><strong>By industry</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-mining investment</td>
<td>–17.3</td>
<td>–27 1/2</td>
</tr>
<tr>
<td>Private final demand</td>
<td>1.0</td>
<td>1/2</td>
</tr>
<tr>
<td>Public final demand</td>
<td>0.0</td>
<td>2 1/4</td>
</tr>
<tr>
<td>Change in inventories</td>
<td>0.2</td>
<td>0</td>
</tr>
<tr>
<td>Gross national expenditure</td>
<td>0.9</td>
<td>1</td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>6.5</td>
<td>6</td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>0.0</td>
<td>0</td>
</tr>
<tr>
<td>Net exports</td>
<td>1.4</td>
<td>1 1/4</td>
</tr>
<tr>
<td>Nominal gross domestic product</td>
<td>1.6</td>
<td>2 1/2</td>
</tr>
<tr>
<td><strong>Prices and wages</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumer price index</td>
<td>1.5</td>
<td>1 1/4</td>
</tr>
<tr>
<td>Wage price index</td>
<td>2.3</td>
<td>2 1/4</td>
</tr>
<tr>
<td>GDP deflator</td>
<td>–0.6</td>
<td>0</td>
</tr>
<tr>
<td><strong>Labour market</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Participation rate (per cent)</td>
<td>64.8</td>
<td>65</td>
</tr>
<tr>
<td>Employment</td>
<td>1.6</td>
<td>2</td>
</tr>
<tr>
<td>Unemployment rate (per cent)</td>
<td>6.1</td>
<td>5 3/4</td>
</tr>
<tr>
<td>Balance of payments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Terms of trade</td>
<td>–10.3</td>
<td>–8 3/4</td>
</tr>
<tr>
<td>Current account balance (per cent of GDP)</td>
<td>–3.7</td>
<td>–4 3/4</td>
</tr>
</tbody>
</table>

(continued)
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 repaying past debt.

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 the budget receipts to be 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 rises in receipts and/or cuts in outlays.

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.
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 like 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** (that is, 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).
There is an additional indicator available to expose the federal treasurer’s true intention. Rough guide to the changes in receipts relative to outlays (we will look at these shortly). While such variations are often used as a automatic surplus, and is often used as a rough guide to the budgetary policy stance being adopted by the federal treasurer. An expansionary budgetary or fiscal policy stance.

Budgets that seek to stimulate AD and economic activity (because there is a slowdown in the economy) and expenses (money injected into the economy). This outcome usually involves a budget deficit or surplus, and is often used as a rough guide to the budgetary policy stance being adopted by the federal treasurer. Here the term budget outcome 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.

- An expansionary budgetary or fiscal policy stance. Budgets that seek to stimulate AD and economic activity (because there is a slowdown in the economy) and expenses (money injected into the economy). This outcome usually involves a budget deficit or surplus, and is often used as a rough guide to the budgetary policy stance being adopted by the federal treasurer. Here the term budget outcome 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.

- A contractionary budgetary or fiscal policy stance. Budgets that seek to slow the growth of AD and economic activity (because there is an inflationary threat) are said to be 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).

Changes in the overall size of the budget deficit or surplus between one year and the next occur because of automatic (caused by changes in economic activity) and discretionary (caused by deliberate changes in policy) changes in receipts relative to outlays (we will look at these shortly). While such variations are often used as a rough guide to the direction of the budgetary policy’s stance, these measures on their own can be misleading. There is an additional indicator available to expose the federal treasurer’s true intention.

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 stabilisers). In this case, if there was an increase in the discretionary budget deficit (due to deliberate reductions in tax and/or higher outlays), it could confirm the treasurer’s intention even more clearly, and whether it was felt that additional stimulus was needed to private sector spending in order to lift production and lower unemployment.

The changing size of the economy is another limitation in 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, recent budget deficits to 2016–17 have been equal to more than 2 per cent of GDP.
4.6 The budget as a stabiliser of economic activity, and the effect of stabilisers on the budget outcome and level of government debt

Budgetary policy is an important macroeconomic or aggregate demand measure. 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. As seen recently 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.
One of the functions of the Australian government is to stabilize the level of AD, and hence economic activity, making it optimal for the achievement of key domestic macroeconomic goals. 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 needs to be applied, as illustrated in Figure 4.3. This means that:

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

Using countercyclical budgetary policy to help flatten out the business cycle

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).

By changing budget receipts and/or outlays, these two stabilisers can especially affect levels of household consumption spending (C), business investment spending (I), government consumption spending (G₁), government capital spending (G₂), national savings (S) and hence AD. At least in theory, fiscal or budgetary policy 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?

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 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 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.

**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 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 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 level of government outlays on areas like welfare payments to families, education, purchases of defence equipment, foreign aid to Fiji and the building of a new hospital, or announce particular national infrastructure building projects like 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 cuts 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 is that they are politically difficult for the government to remove, especially if they have 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 is required.

**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.
Reviewing how automatic and discretionary stabilisers work together

Putting automatic and discretionary budget stabilisers together and using the AD–AS diagram for the economy shown in figure 4.4, it is possible to see theoretically how these measures might operate in a countercyclical way to improve Australia’s prosperity.

Using budgetary policy in a countercyclical way helps to reduce cyclical instability in economic activity

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 effective expansionary budgetary 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.

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 \( AD_0 \) to \( AD_2 \)), 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. Failure to adopt these difficult but necessary discretionary policy changes would create a structural deficit and increase public sector debt. As a result of effective contractionary budgetary stabilisers, the economy again shifts towards domestic economic stability (moves towards \( AD_2 \), \( GDP_2 \) and \( P_1 \)) where, simultaneously, there is low inflation, strong and sustainable economic growth and full employment.

eBookplus

Weblinks The weblinks in these activities are available in this topic’s student resources tab.

- Fiscal & monetary policy review — AP Macroeconomics
- Keynesian economics and the Great Depression
- Fiscal policy
- Keynesian economics
- A look at fiscal and monetary policy
- Economic activity, unemployment & fiscal policy
Recent trends in Australia’s domestic macroeconomic conditions

1. What are automatic stabilisers and how do they work to help promote domestic economic stability in:
   a. boom
   b. recession?

2. What are discretionary stabilisers? Identify three examples of discretionary stabilisers that could be used to promote domestic stability in:
   a. boom
   b. recession.

APPLIED ECONOMIC EXERCISES

Apply your understanding of this subtopic by accessing and completing the Applied economic exercise(s).
- School-assessed coursework > Applied economic exercises > Question 4

4.7 The effect of recent budget initiatives on the government’s key domestic economic goals during the past two years

This section is devoted to how the Australian government’s budgetary or fiscal policy has been used during the past two years as a demand-side 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 new VCE course means that this subtopic will need continual updating. However, it will provide you with a suitable framework by concentrating on the 2016–17 and 2017–18 budgets.

Let us start with figure 4.5, which shows recent trends in Australia’s domestic macroeconomic conditions involving the rates of economic growth, unemployment and inflation.

Indicators of Australia’s domestic macroeconomic conditions in recent years

![Graph showing indicators of Australia’s domestic macroeconomic conditions]

- Rate of unemployment (percentage of the labour force, 12 month average)
- Rate of economic growth (annual percentage change in chain volume GDP, reference year 2012–13)
- Rate of inflation (June-on-June percentage change in CPI)

In particular, note the following developments during 2014–15 and 2015–16:
- Economic growth slowed to average around 2.5 per cent during the two years to 2015–16 (with 2.5 and 3 per cent forecast respectively by the Treasury for the next two years, 2016–17 and 2017–18).
- Unemployment rose 5.9 per cent for the two years to 2015–16 (with 5.5 per cent forecast for each of the next two years, 2016–17 and 2017–18).
- The inflation rate slowed to 1.5 per cent during the past two years to 2015–16 (with 2 and 2.25 per cent forecast respectively for the next two years, 2016–17 and 2017–18).

Overall, these trends in the last two years are indicative of a weaker economy operating below its productive capacity, and in need of some fiscal stimulus to help support AD and restore domestic stability. In other words, at the very least, cyclical budget deficits were to be expected (rather than budget surpluses) due to automatically weaker budget receipts and stronger outlays. Figure 4.6 shows that indeed there were large ongoing deficits during 2014–15 and 2015–16, annually averaging around $39 billion or about 2.4 per cent of GDP.
have beneficial aggregate supply-side impacts that would boost productive capacity and our potential GDP, while strengthening domestic economic stability. At least some of these discretionary actions would be likely to stimulate expansionary aggregate demand. Given the existence of spare productive capacity at this time, rising expenditure, sales and orders — along with falling stocks — 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, many of these specific expansionary aggregate demand-side policies would tend to have beneficial aggregate supply-side impacts that would boost productive capacity and our potential GDP, while also slowing inflationary pressures. We will consider this supply-side policy channel of influence in topic 5.

**FIGURE 4.6** The countercyclical change in the federal government's budget outcome to help reduce the severity of booms and recessions, 2004–05 to 2019–20

*Note: Estimates only.*

Despite these relatively weak recent macroeconomic conditions, a decision was made to try and slowly reduce the size of the budget deficit at a responsible rate. This is illustrated in figure 4.6 and it meant that the last few budgets were overall mildly contractionary. 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. In addition, most economists felt that there was a growing problem of structural deficits that would prevent a return to budget surplus in the foreseeable future unless there were discretionary rises in receipts relative to outlays. Table 4.4 shows some of the key discretionary announcements designed to rein in the deficit (see the ones in red).

Although the recent reductions in the budget deficit were mildly contractionary overall (thereby tending to slow economic growth, job creation and inflation), table 4.4 also shows that there were at least some discretionary measures (see the ones in green) that in themselves would tend to have an expansionary effect and thus help to strengthen domestic economic stability. At least some of these discretionary actions would be likely to stimulate C, G and hence AD. Given the existence of spare productive capacity at this time, rising expenditure, sales and orders — along with falling stocks — 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, many of these specific expansionary aggregate demand-side policies would tend to have beneficial aggregate supply-side impacts that would boost productive capacity and our potential GDP, while also slowing inflationary pressures. We will consider this supply-side policy channel of influence in topic 5.

**TABLE 4.4** Some discretionary measures announced in the 2014–15, 2015–16 and 2016–17 budgets that affect the structural deficit, and the level of AD and economic activity

<table>
<thead>
<tr>
<th>Budget</th>
<th>Discretionary policy measures that were announced (some of these were implemented while others were abolished or amended)</th>
<th>Main effect on the budget and level of AD</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Likely to lift AD</td>
<td>• Likely to slow AD</td>
</tr>
<tr>
<td>2014–15 budget</td>
<td>• Introduction of a temporary, three-year, 2 per cent budget repair levy on high incomes above $180 000 per year</td>
<td>Increase receipts and decrease C</td>
</tr>
<tr>
<td></td>
<td>• Tightening of income eligibility for the Family Tax Benefit Part B</td>
<td>Increase receipts and decrease C</td>
</tr>
<tr>
<td></td>
<td>• Lower rate of company tax for small business with a turnover of less than $2 million per year from 30 per cent to 28.5 per cent starting from July 2015. In the case of larger companies, the reduction will offset the 1.5 per cent tax to fund the new paid parental leave scheme that is capped at $100 000 per year.</td>
<td>Decrease receipts and possibly increase I</td>
</tr>
</tbody>
</table>

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### Discretionary policy measures that were announced (some of these were implemented while others were abolished or amended)

<table>
<thead>
<tr>
<th>Budget</th>
<th>Discretionary policy measures that were announced</th>
<th>Main effect on the budget and level of AD</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Likely to lift AD</td>
<td>• Likely to slow AD</td>
</tr>
<tr>
<td></td>
<td>• Up to $20,000 given as a tax write-off for small firms purchasing new equipment/assets at 15 per cent in year 1 and 30 per cent after that</td>
<td>Decrease receipts and increase I</td>
</tr>
<tr>
<td></td>
<td>• Carbon tax abolished to lower power and some other costs for families and businesses</td>
<td>Decrease receipts and increase C and I</td>
</tr>
<tr>
<td></td>
<td>• Minerals resource rent tax (MRRT) abolished on the value of coal and iron ore extracted</td>
<td>Decrease receipts and increase I</td>
</tr>
<tr>
<td></td>
<td>• Introduction of a $7 co-payments charge per visit to see a GP</td>
<td>Increase receipts and decrease C</td>
</tr>
<tr>
<td></td>
<td>• Unincorporated small businesses can get a 5 per cent tax discount up to a cap of $1000 per individual.</td>
<td>Decrease receipts and increase I and C</td>
</tr>
<tr>
<td></td>
<td>• A plan to privatise some government business enterprises</td>
<td>Receipts may be used to finance increased G2 outlays</td>
</tr>
<tr>
<td></td>
<td>• The superannuation guarantee charge (SGC) paid by businesses to rise to 9.5 per cent from July 2014 as previously announced, but it would be temporarily frozen at that rate before resuming a stepped rise to 12 per cent by 2025</td>
<td>Possibly reduce outlays and I in the long term</td>
</tr>
<tr>
<td></td>
<td>• Re-indexation of the fuel excise</td>
<td>Increase receipts and perhaps reduce C</td>
</tr>
</tbody>
</table>

### Discretionary changes in budget outlays

<table>
<thead>
<tr>
<th>Budget</th>
<th>Discretionary changes in budget outlays</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• A massive national infrastructure project in all states — extra $11.6 billion to make a total of $50 billion over the next six years starting in 2014–15</td>
</tr>
<tr>
<td></td>
<td>• To create self-reliant competitive Australian industries, set up the $50 million manufacturing transition grants program to help industry make the transition to competitive industries and drive new innovative opportunities for growth</td>
</tr>
<tr>
<td></td>
<td>• $155 million to support regions adversely affected by recent business closures</td>
</tr>
<tr>
<td></td>
<td>• $200 million boost to the Export Finance and Insurance Corporation and an increase of $50 million to the export development grants program</td>
</tr>
<tr>
<td></td>
<td>• Proposed changes to index pension rises to the CPI rather than to wages (would have slowed the growth in pensioners’ income)</td>
</tr>
<tr>
<td></td>
<td>• Creation of a giant medical research fund (eventually up to $20 billion, funded by the proposed $7 GP co-payments charge)</td>
</tr>
<tr>
<td></td>
<td>• Increase the pension age to 67 (by 2023) and then to 70 (by 2035)</td>
</tr>
<tr>
<td></td>
<td>• A new paid parental leave scheme that is capped at $100,000 per year income (paid from a 1.5 per cent levy on large companies)</td>
</tr>
<tr>
<td></td>
<td>• Tightening of payments to the state governments for education and health, and requiring them to be more accountable for spending in these areas</td>
</tr>
<tr>
<td></td>
<td>• Changes in higher education including deregulation of fee caps, along with some extra government funding to improve access to tertiary training.</td>
</tr>
<tr>
<td></td>
<td>• A drought support package worth more than $300 million to provide financial and other types of help for drought-affected families</td>
</tr>
<tr>
<td></td>
<td>• Tighter welfare access for the unemployed to be required to be involved in training or work for the dole</td>
</tr>
</tbody>
</table>

(continued)

### TOPIC 4 Aggregate demand policies and domestic economic stability

221
TABLE 4.4 (continued)

<table>
<thead>
<tr>
<th>Discretionary policy measures that were announced (some of these were implemented while others were abolished or amended)</th>
<th>Main effect on the budget and level of AD</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2015–16 budget</strong></td>
<td><strong>Discretionary changes in budget receipts</strong></td>
</tr>
<tr>
<td>• As part of the Small Business Assistance Package to boost business investment and expansion, from July 2015 the tax rate was reduced from 30 per cent to 28.5 per cent for small companies with a turnover of less than $2 million per year. There was also a 5 per cent tax reduction for small unincorporated businesses.</td>
<td>Decrease receipts and increase I</td>
</tr>
<tr>
<td>• Help small businesses by allowing an instant asset write-off on tax up to $20,000 of the cost of purchasing each capital asset (also part of the Small Business Assistance Package)</td>
<td>Decrease receipts and increase I</td>
</tr>
<tr>
<td>• Tax integrity measures to raise more revenue to include recovering tax from multinational companies shifting profits offshore to low-tax countries, and applying the GST to more online purchases including digital downloads</td>
<td>Increase receipts and decrease I</td>
</tr>
<tr>
<td>• A decision was made not to reverse the effects of tax bracket creep for personal incomes by cutting marginal PAYG tax rates.</td>
<td>Increase receipts and decrease C</td>
</tr>
<tr>
<td>• Measures to simplify and reduce compliance and regulatory costs for businesses</td>
<td>Decrease receipts and increase I</td>
</tr>
<tr>
<td>• Abandon the $7 medical co-payment proposal in the 2014 budget</td>
<td>Decrease receipts</td>
</tr>
<tr>
<td>• Application from mid-2017 of the GST for international transactions involving digital services and products</td>
<td>Increase receipts but increase local C</td>
</tr>
<tr>
<td><strong>Discretionary changes in budget outlays</strong></td>
<td></td>
</tr>
<tr>
<td>• Announcement of a $3.5 billion family assistance package to help low-income families. Among other things, it involves a new childcare subsidy, and making access to childcare cheaper and more affordable by paying up to 85 per cent of childcare costs for families with incomes under $65,000.</td>
<td>Increase outlays and C</td>
</tr>
<tr>
<td>• A $5 billion concessional loan to finance private sector infrastructure in northern Australia, along with an extra $100 million for funding the cattle road</td>
<td>Increase I</td>
</tr>
<tr>
<td>• Increased funding for aged homecare</td>
<td>Increase G</td>
</tr>
<tr>
<td>• A decision not to re-index the pension rises to a lower rate as proposed in the 2014 budget</td>
<td>Overall likely to increase C</td>
</tr>
<tr>
<td>• A proposed tightening of pension access for those who are better off with considerable assets (assets pension cut-off threshold reduced from $1.15 million to $823,000)</td>
<td>Decrease C</td>
</tr>
<tr>
<td>• Increased funding of childcare places for working parents</td>
<td>Increase G, outlays</td>
</tr>
<tr>
<td>• Increased funding of pre-school education</td>
<td>Increase G</td>
</tr>
<tr>
<td>• Reduction in overseas aid (could perhaps leave more revenue for higher domestic spending)</td>
<td>Possibly increase domestic spending</td>
</tr>
<tr>
<td>• Increased defence and national security spending to total $35 billion</td>
<td>Increase G</td>
</tr>
<tr>
<td>• $33 million for the Youth Employment Strategy, including a program to get disengaged 15–21 year olds job-ready</td>
<td>Increase G</td>
</tr>
<tr>
<td>• Introduce a four-week waiting period for those under 25 who are unemployed and seeking access to welfare payments</td>
<td>Decrease C and outlays</td>
</tr>
<tr>
<td>• $10 million allocated to the new Medical Research Future Fund (special purpose savings fund providing seed capital to grow research money available over time)</td>
<td>Increase budget outlays in the long term</td>
</tr>
<tr>
<td>• Extra funding for new prescription drugs under the Pharmaceutical Benefits Scheme</td>
<td>Increase G</td>
</tr>
<tr>
<td>• New measures worth over $370 million designed to assist the unemployed to find employment</td>
<td>Increase outlays</td>
</tr>
<tr>
<td>• An increase of $1.2 billion in funding for national security</td>
<td>Increase G</td>
</tr>
<tr>
<td>• Further funding for the drought concessional loan and recovery schemes</td>
<td>Increase outlays, C and I</td>
</tr>
</tbody>
</table>
## Discretionary policy measures that were announced

<table>
<thead>
<tr>
<th>Budget</th>
<th>Discretionary policy measures that were announced (some of these were implemented while others were abolished or amended)</th>
<th>Main effect on the budget and level of AD</th>
</tr>
</thead>
</table>
| 2016–17 budget | - **Likely to lift AD**  
  - **Likely to slow AD**  
    - Company tax: Announcement of a ten-year Enterprise Tax Plan to reduce the rate of company tax. The tax rate would be cut to 27.5 per cent from July 2016 for small businesses (which were paying 28.5 per cent in 2015–16) and for medium-sized companies with a turnover up $10 million. The plan is to progressively reduce the tax rate for all companies to 25 per cent by 2026–27, including large businesses that currently pay 30 per cent tax. Until July 2017, small and medium-sized businesses can also continue to take advantage of instant tax write-offs for the purchase of capital equipment up to $20,000 per item.  
    - Personal income tax: Reductions were announced for PAYG income tax. For high-income earners above $180,000, the 2 per cent temporary budget repair levy is to be abolished as promised starting July 2017, taking the top marginal tax rate (before the 2 per cent Medicare levy is added) back to 45 per cent. Additionally, it was announced that from July 2016, some middle-income earners on incomes below $80,000 who are currently paying tax at 32.5 per cent will not move into the next tax bracket of 37 per cent until their income exceeds $87,000. The aim is to reduce some of the effects of bracket creep and delay some individuals moving into higher tax brackets.  
    - Excise tax: Tobacco excise tax is to rise by 12.5 per cent each year from 2017 to 2020, along with cuts to the limit of duty-free cigarettes by travellers. This is expected to raise around $4.5 billion.  
    - Tax avoidance and minimisation: The ATO will crack down on tax avoidance by wealthy individuals, multinationals and private companies. The ATO is to employ a taskforce of around 1,000 extra specialist personnel to help with this. In addition, profit transfers or shifting from Australian operations to low-tax havens abroad will incur tax at a nominal rate of 40 per cent, called the Diverted Profits Tax.  
    - Superannuation and tax: The cap or limit for superannuation contributions eligible for the low, concessional tax rate will be reduced from $30,000 to $25,000 per year. High-income retirees will pay a higher contributions tax rate of 30 per cent, not 15 per cent. Low-income individuals will gain from a superannuation tax offset. There is to be a cap of $1.8 million that can be transferred into retirement accounts, along with a cap of $500,000 on lifetime non-concessional contributions.  
  - **Increase I**  
    - **Decrease C**  
    - **Increase C**  
    - **Possibly decrease C and I**  
    - **Overall, possibly less C** |
| 2016–17 budget | - **Likely to lift AD**  
  - **Likely to slow AD**  
    - Infrastructure: Infrastructure to get a further boost by an additional $33 billion — on top of the $50 billion previously announced for the period 2014–19 — for roads, rail, airports and dams infrastructure including the Monash Freeway upgrade, M80 Ring Road, Murray Basin Rail Freight, Bruce Highway, Pacific Highway and the Melbourne–Brisbane inland fast rail link. In addition, a $2 billion infrastructure loan facility for private enterprise was announced.  
    - Education: It was announced that while the Gonski education reforms would not proceed, there will be some funding over the period 2018–20. In addition, there is to be a 9.6 per cent increase in early education and childcare funding, taking the total to $8.6 billion. Outlays on public and private schools are to rise by $1.2 billion during 2018–20 (or 3.8 per cent per year) to $17.6 billion. Outlays on higher education are to increase by 0.9 per cent to $12.3 billion. A decision was made not to deregulate university fees for at least another year. Outlays on work skills are to rise by 7.7 per cent to $3.3 billion.  
  - **Increase G**  
  - **Mixed effects, perhaps some increase in G** |

(continued)
### TABLE 4.4 (continued)

<table>
<thead>
<tr>
<th>Budget</th>
<th>Discretionary policy measures that were announced (some of these were implemented while others were abolished or amended)</th>
<th>Main effect on the budget and level of AD</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Health: The states are to get an extra $2.9 billion extra for hospitals over three years.</td>
<td>Mixed effects</td>
</tr>
<tr>
<td></td>
<td>• Medicare rebates to GPs are to be frozen, forcing GPs to charge patients more (a rise in co-payments). In addition, $1.2 billion in cuts to aged care health were announced, along with a rise in the cost of prescriptions.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Defence: Defence spending was announced for the building of 12 new submarines, 9 frigates and 12 patrol vessels and other equipment, mostly in Australia, creating 3600 jobs.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Welfare: Announcement of the deferral until 2018 of the promised 2015 increase in childcare subsidies (from a cap of $7500 to $10 000) designed to allow parents to better afford childcare, and gain employment and income. Paid parental leave for those double-dipping the system is to be reduced.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Youth employment: The $840 million Youth Employment Package was announced, including the Jobs PaTH Program (Prepare-Trial-Hire). The main focus is to assist at-risk young people (under 25 years of age) to transition better from welfare to work, and to improve the employability of those aged under 25 years by creating an internship program catering for up to 100 000 placements with employers over four years for young job seekers. These individuals would receive an extra $200 every two weeks on top of their ordinary income support while in the program. In addition, employers will be paid $1000 as a subsidy for each internship, along with the possibility of further payments up to $10 000 if firms decide to actually employ the young person.</td>
<td>Increase G2 and I</td>
</tr>
<tr>
<td></td>
<td>• Innovation: Announcement of the $1.1 billion National Innovation and Science Agenda to support innovation.</td>
<td>Increase G and C</td>
</tr>
<tr>
<td></td>
<td>• Paid maternity leave: Cuts affecting up to 80 000 families receiving paid maternity leave are likely to be implemented, to reduce double-dipping by some individuals.</td>
<td>Decrease G and C</td>
</tr>
</tbody>
</table>

### An overview of the effects of the 2015–16 and 2016–17 budgets on domestic economic stability

We have seen that the government typically uses a combination of automatic and discretionary stabilisers in the budget to help reduce the severity of booms and recessions, thereby promoting increased levels of domestic economic stability (namely, the simultaneous achievement of strong and sustainable economic growth, full employment and low inflation) and optimising material and non-material living standards. To work effectively, these stabilisers must be applied in a countercyclical manner with a looser stance in downswings to boost AD and economic activity.

In the past two years to 2016, economic activity was generally below trend (combined with higher than usual unemployment and low inflation). Given this, sizable budget deficits remained (expected to average around 2.3 per cent of GDP a year) due to the operation of automatic and discretionary changes in receipts and outlays. However, because the medium-term operating goal was a return to budget surplus, a particular mixture of discretionary measures was adopted to maintain considerable support for spending while at the same time gradually reducing the deficit at a rate that would not seriously jeopardise growth and jobs. As we shall soon see, the slack left by starting to withdraw some of the budget stimulus (which would normally tend to slow AD) was offset by a highly expansionary monetary (interest rate) policy stance designed to accelerate AD.

Taking on board the recent change in both the budget outcome and particular discretionary measures, how might budgetary policy have helped to promote domestic economic stability?

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

The government seeks a strong and sustainable rate of economic growth (around 3 per cent a year or a little more), along with full employment (a low unemployment rate of perhaps 5 per cent of the labour force). Given that there was an overall small reduction in the deficit, as a demand-side policy, recent budgets probably tended to slightly...
weaken economic growth and the demand for resources, and may have been inclined to cause a small rise in cyclical unemployment. However, working against this mildly contractionary impact, weaker economic activity meant that automatic stabilisers kept the budget in deficit. In addition, there were some specific discretionary measures that supported AD and thus helped to strengthen economic growth and promote fuller employment:

- **Business assistance.** Recent budgets have announced special measures designed to assist small business. For instance, the rate of company tax from small businesses (with an annual turnover of less than $2 million) was reduced from 30 to 28.5 per cent from July 2015. There were also generous instant tax write-offs provided for the purchase of business equipment. More recently, as part of the ten-year $9.2 billion Enterprise Tax Plan, the 2016–17 budget included a further reduction in the tax rate to 27.5 per cent, starting July 2016, for small and medium-sized companies with a turnover of less than $10 million. Additionally, most unincorporated small businesses will gain an increased tax discount from 5 to 8 per cent from July 2016, and there was a commitment to progressively lower the rate of company tax for large businesses, starting 2023–24, to 25 per cent by 2026–27. By lowering tax and increasing the returns for businesses, it is hoped to encourage the higher levels of private investment spending needed to stimulate AD, GDP and employment (to say nothing about the growth in productive capacity on the supply side).

- **Reductions in income tax.** The 2016–17 budget announced that there would be a widening of the 32.5 per cent marginal tax bracket so that middle–upper income earners would pay less tax. In addition, the 2014–15 temporary budget repair levy on high-income earners is to be abolished, effectively reducing the top tax rate to the previous level of 47 per cent (including the Medicare levy). This should add to spending, production and employment.

- **Infrastructure.** There was a huge increase in capital spending on national infrastructure of over $50 billion in the four years to 2019–20 (see figure 4.7 for road, railways, ports, airports, water and NBN infrastructure projects) that helped to boost G2 and I. There was also a further boost to funding in the 2016–17 budget, including the establishment of a $2 billion special infrastructure loan facility. 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.

**FIGURE 4.7** Some national infrastructure projects in the 2015–16 federal budget

*Source: Map copied directly from Budget Overview 2015, p. 21.*

- **Family assistance.** The 2015–16 budget announced a generous $3.5 billion family assistance package that would tend to increase outlays and (for some) may have helped to lift disposable income and C. However, this measure was deferred in the 2016–17 budget.

- **Defence spending.** There is to be an increase in defence spending involving the building of 12 new submarines, 9 frigates and 12 patrol vessels and other equipment, mostly in Australia, helping to create around 3600 jobs and adding to GDP.

- **Youth employment.** While mostly a supply-side policy, the 2016–17 budget announced $840 million in government outlays on a new Youth Employment Package centred around the Jobs PaTH Program- (Prepare–Trial–Hire). This is designed to assist at-risk young people under 25 years of age to transition from welfare to work. It seeks to improve the employability of young people by creating an internship program catering for up to 100,000 employer placements. Generous financial incentives are to be paid to both job seekers and employers involved with the program, adding to AD and GDP, and thus helping to lower unemployment.
Other changes. The decision was made to abandon the unpopular 2014–15 budget measures that would have tightened welfare access and generosity for the unemployed and pensioners. Official backdown in the 2015–16 budget backdown helped to assist incomes and C.

To the extent that there was still considerable support for spending through automatic and discretionary budgetary measures, this would have encouraged some firms to produce at a higher rate, thereby promoting stronger economic growth and an increase in the demand for labour resources. Added to this, we will see in topic 5 that some of these demand-side budgetary measures had important supply-side effects that would also be likely to help strengthen economic growth and jobs.

**The effect of recent budgets on the goal of low inflation (price stability)**

Another domestic goal of the RBA and government is for low inflation (where the annual rise in consumer prices is around 2 to 3 per cent average over the cycle). Because recent budgets have been mildly contractionary, with general reductions in the underlying deficit (including the structural deficit), the overall effect should be to slow inflation pressures and promote price stability. In addition, with the economy operating below its productive capacity, the risk of either demand or cost inflation is minimal. So in this situation, cutting the deficit and slowing AD tended to cause weaker sales, an unplanned rise in stocks and widespread price discounting, slowing inflation.

Higher levels of unemployment also tend to slow wage rises, reducing cost inflation. Other recent fiscal initiatives (such as the abolition of the carbon tax, outlays on transport and communications infrastructure projects, funding of some childcare costs) helped to reduce costs, again slowing inflation. However, there were also some specific policy initiatives that may have added to inflation. For example, the re-indexation of the excise tax on fuel would have been partly passed on to consumers in the form of higher prices to fill up their car. In addition, large rises in the excise on tobacco in the 2016–17 budget would add to prices and living costs for smokers.

**CHECK YOUR UNDERSTANDING**

1. During the past two years, what type of domestic economic conditions existed in Australia?
2. Overall, has budgetary or fiscal policy been expansionary or contractionary during the past two years? Why has this been the case? Has this created any economic problems?
3. Identify three important discretionary budgetary policy measures from the past two years and explain how these may have affected the:
   a. rate of economic growth
   b. rate of unemployment
   c. rate of inflation.

**APPLIED ECONOMIC EXERCISES**

Apply your understanding of this subtopic by accessing and completing the Applied economic exercise(s).

- School-assessed coursework > Applied economic exercises > **Question 5**

**4.8 Strengths and weaknesses of using budgetary policy to achieve the government’s domestic macroeconomic goals and the effect on living standards**

Budgetary policy has a number of strengths and weaknesses when it is used to promote domestic macroeconomic goals and living standards. A few of these are summarised in table 4.5.
TABLE 4.5 Some strengths and weaknesses of using budgetary policy to promote domestic macroeconomic goals and living standards

<table>
<thead>
<tr>
<th>Possible strength</th>
<th>Description of strength</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Automatic stabilisers have short time lags</td>
<td>Many government economic policies involve three types of time lags and so can take years to work. There is the recognition lag for the problem — this is due to the existence of lagging indicators like GDP; the implementation lag in activating the policy; and the impact lag in waiting for the policy to actually boost or slow AD and economic activity. An advantage of automatic budget stabilisers is that they work very quickly in a counter-cyclical 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 fall and welfare outlays will rise, causing the budget to quickly become more expansionary. However, there are also a few discretionary stabilisers (such as one-off cash payments to households or welfare recipients) that can quickly boost AD and economic activity with only a limited impact lag.</td>
</tr>
<tr>
<td>2. Automatic stabilisers do not create a permanent deficit</td>
<td>Unlike discretionary stabilisers, automatic stabilisers used during a slowdown will disappear once the economy recovers and there is a return 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.</td>
</tr>
<tr>
<td>3. Discretionary policy can precisely target areas of weakness</td>
<td>Budgetary policies involving changes in receipts and expenses can precisely target particular economic problems. 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.</td>
</tr>
<tr>
<td>4. Works fairly directly on AD</td>
<td>The budget can work in a very direct 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 (Gd) and investment spending (G2) 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.</td>
</tr>
<tr>
<td>5. Some measures also affect aggregate supply-side conditions</td>
<td>While we know that budgetary policy can help regulate aggregate demand and improve domestic stability, a real bonus is that changes in some budget receipts (such as a lower rate of company tax) and outlays (such as an increase in infrastructure projects, education) can also improve aggregate supply-side 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.</td>
</tr>
</tbody>
</table>

Possible weakness

<table>
<thead>
<tr>
<th>Possible weakness</th>
<th>Description of weakness</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Discretionary stabilisers may become pro-cyclical due to long time lags</td>
<td>There are often long time lags associated with the recognition, implementation and impact of many government policies, so measures run the risk of becoming pro-cyclical. Most discretionary stabilisers are in this category and 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 to 6 years or even longer. Discretionary changes are often more suited to promoting medium- to long-term stability. Examples of discretionary measures here might include government spending projects involving large-scale public or capital infrastructure works (for example, building the National Broadband Network, 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 pro-cyclical (worsening instability) rather than counter-cyclical (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 the economy may have recovered and moved into a boom phase. More spending in a boom could add to inflationary pressures and actually undermine economic stability.</td>
</tr>
<tr>
<td>2. Lack of flexibility to alter some parts of the budget</td>
<td>Some budget receipts and outlays are inflexible and cannot suddenly be increased or decreased in response to changes in the level of domestic economic activity. For example, in a boom it would be hard for the federal treasurer to raise tax receipts (by increasing personal income or company tax rates) or cut budget outlays (by reducing the level of pensions or the wages of public servants). In theory it is possible to change all variables, but in practice it is most unlikely. The same political and practical problems would not apply in a slowdown since lower taxes and higher spending are generally popular.</td>
</tr>
</tbody>
</table>

(continued)
TABLE 4.5  (continued)

3. Financial constraints and the creation of a structural budget deficit can limit budget options

Like individuals, governments face financial constraints where there is limited money available for spending 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 the weakness of the economy, and shift the main burden of stimulus onto monetary policy (involving record low interest rates).

4. Budgetary policy can undermine monetary policy

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 crowding-out 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 crowding-in by borrowers, adding to spending, inflationary pressures and instability.

5. Constraints due to conflicts between government economic goals

Some fiscal policies cannot be used to pursue one particular government economic goal because they conflict with the pursuit of another policy objective. For example, although mildly contractionary budgets like some of those in 2012–13 or 2016–17 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.

Possible weakness Description of weakness

6. Adverse political constraints can limit budget options

As seen in recent years, there are three types of political constraints that can act as deterrents and reduce the effectiveness of budgetary policy as a stabiliser of economic activity.

• The absence of a federal government majority in the Senate. 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.

• Adverse voter reaction. Some changes in receipts and outlays can have significant adverse ramifications at election time. 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 will 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 weakens the government’s ability to respond to future economic crises.

• The federal government has limited powers. 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 affect the budget’s impact

The success and strength of any budget depends partly on the prevailing level of confidence. For instance, reduced consumer and business confidence during 2014–16 tended 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.
Improvements in living standards are the ultimate government aim. Our overall wellbeing is most likely to be maximised when there is strong and sustainable economic growth, full employment and low inflation (namely, domestic economic stability). While budgetary policy has recently been used to help stabilise the economy and pursue these goals, it needs to be recognised that it has both strengths and weaknesses.

As slower growth and higher unemployment are detrimental, especially for material living standards, it seems that budgetary or fiscal policy has not been as successful as we would have liked during the past two years. Certainly our material wellbeing (as judged by the annual change in real net national disposable income per head) has fallen every year for the past three years, limiting consumption and the extent to which ordinary individuals can satisfy their wants. Of course, government budgetary policy is not solely to blame for this, since the economy is affected by many factors and there are limits to what government stabilisation can achieve.

CHECK YOUR UNDERSTANDING

1. Identify and outline two strengths of using budgetary policy to help promote domestic economic stability.
2. Identify and outline two weaknesses of using budgetary policy to help promote domestic economic stability.
3. Explain how in a recession, time lags limit the effectiveness of budgetary policy in stimulating economic growth and reducing unemployment.

APPLIED ECONOMIC EXERCISES

Apply your understanding of this subtopic by accessing and completing the Applied economic exercise(s).
- School-assessed coursework > Applied economic exercises > Question 6

PART B AGGREGATE DEMAND MONETARY POLICY AND THE PURSUIT OF DOMESTIC ECONOMIC STABILITY

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 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 eleven 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.
4.9 Definition and aims of monetary policy, and the role of the RBA

Monetary policy is an aggregate demand management strategy implemented by the Reserve Bank of Australia (RBA).

Definition of monetary policy

Monetary policy is defined as a macroeconomic instrument (or tool) operated by the Reserve Bank of Australia (RBA) that is designed to manage the level of aggregate demand. It involves the regulation of the nation’s money and the rate at which credit flows into the economy via the financial sector. Monetary policy relies heavily on changes in interest rates to alter the cost, availability and demand for credit (borrowed money).

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-side 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.

Role of the Reserve Bank of Australia

The RBA is our country’s independent central bank and is accountable to the parliament. 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. 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.

The macroeconomic aims of monetary policy

The RBA uses monetary policy involving changes in interest rates to pursue three key domestic macroeconomic goals to ultimately strengthen 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 business 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 may be a better guide to future inflationary trends.

Hence, when inflationary expectations exist and there are signs that inflation will 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 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 the 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 to 2016, economic growth has been slower than trend, unemployment higher and inflation below or within the target range. As a result, the RBA's priority has been to adopt a highly expansionary stance designed to strengthen economic growth and lower unemployment by encouraging higher levels of credit-based spending.

4.10 The role of open market operations in altering interest rates

Interest rates are central to monetary policy and are used by the RBA to regulate the level 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 (for example, 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.

How the RBA can lower interest rates using OMO involving the repurchase of government bonds

Suppose that the RBA wanted to reduce interest rates to 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 buying back government securities 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 4.8, this increases the supply of cash or the level of deposits held by financial institutions in their exchange settlement accounts (the shift from S1 to S2), 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 certain level, perhaps 4 per cent, usually signals a looser or more expansionary monetary policy stance that would tend to make borrowing and spending cheaper and more attractive, thereby boosting AD and economic activity.

![Figure 4.8](image-url)

**Figure 4.8** How OMO involving the RBA buying back government securities in the short-term money market can decrease the cash rate (a more expansionary stance)

How the RBA can increase interest rates using OMO involving the sale of government bonds

Assume that the RBA needed to raise interest rates because it wanted to slow AD and curb inflationary pressures. How would this rise in the cash rate happen?

Step 1: The RBA would announce a rise in the cash rate target and provide a detailed explanation of the reasons for its decision (for example, 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 selling government securities 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 4.9. 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 above a certain level, perhaps 5 per cent, is usually indicative of a tighter monetary policy stance designed to slow AD and reduce inflationary pressures.

**How the RBA can keep interest rates steady — a neutral stance**

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 steady, perhaps at around 4–5 per cent, 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. 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 (for example, 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.

**The connection between interest rate policy and our exchange rate**

By taking action to either lower or raise the cash and other interest rates, the RBA is also likely to bring about a decrease or increase in Australia’s exchange rate and thereby affect net X, AD and the level of economic activity.

- **The effect of lower interest rates on the Australian dollar.** When the RBA cuts interest rates relative to those abroad (for example, 2013–16), foreign funds tend to be repelled and even our local lenders look overseas for better opportunities. This outflow of money means a rise in the sale or supply of the Australian dollar in the foreign exchange market, along with a drop in the demand for the Australian dollar from investors or lenders abroad, pushing the exchange rate down. A weaker dollar makes our exports cheaper overseas, while imports are dearer for us. The likely rise in the value of net exports (X – M) will then tend to strengthen AD and domestic economic activity.

- **The effect of higher interest rates on the Australian dollar.** In reverse, when the RBA increases domestic interest rates relative to those overseas, this makes us more attractive to foreign lenders seeking better rates of return on their money. Seeing higher rates on offer here, these foreign and local lenders are more willing to invest in Australia, and local residents are also keener to borrow overseas. Either way, when extra funds
are sucked into the Australian economy from overseas, the demand for the Australian dollar increases in the foreign exchange market while the supply of the dollar falls. This tends to push up our exchange rate, which in turn slows the value of net exports \((X - M)\), AD and economic activity.

As seen in recent times, in its attempt to stabilise the economy, the RBA sometimes exploits this handy connection between its changes in domestic interest rates and the exchange rate for Australian dollar.

**eBook plus**

**Weblinks** The weblinks in these activities are available in this topic’s student resources tab.
- Tools of monetary policy

**CHECK YOUR UNDERSTANDING**

1. What is the key monetary policy instrument operated by the RBA?
2. With the help of a D-S diagram representing the short-term money market, explain the process whereby the RBA can use OMO to increase or decrease domestic interest rates.
3. How might a change in the cash rate affect the exchange rate for the Australian dollar?

**APPLIED ECONOMIC EXERCISES**

Apply your understanding of this subtopic by accessing and completing the Applied economic exercise(s).
- School-assessed coursework > Applied economic exercises > **Question 8**

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

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

- transmission by changing the demand for and cost of 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
- transmission through the inflationary expectations effect.

**Transmission by changing the demand for and cost of credit**

The most obvious transmission mechanism whereby a change in interest rates affects AD and economic activity is 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 ease.

**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 like 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.
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.

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 stimulated.

Transmission through the wealth or asset values effect

Interest rates affect how wealthier people with shares and property view 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 cause 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.

Transmission through the inflationary expectations effect

When people have full confidence that the RBA is determined to control inflation, this depresses inflationary expectations. This attitude reduces the likelihood of rising prices in the future, even when there is no change in actual interest rates. If it is felt that inflation will remain low, individuals behave in ways that are less likely to push prices up (such as demanding more modest pay rises). By contrast, if there are inflationary expectations, individuals will take action (push for wage rises) to protect their purchasing power and thereby actually increase inflationary pressures.

**eBookplus**

Weblinks The weblinks in these activities are available in this topic's student resources tab.

• How interest rate cuts affect consumers
• What's all the Yellen about? Monetary policy and the Federal Reserve: Crash course economics #10
• Despicable Me (monetary policy)

**CHECK YOUR UNDERSTANDING**

1. What are transmission mechanisms or channels?
2. Identify and explain three important transmission mechanisms that might follow the RBA’s decision to reduce the cash rate target, noting how these might help promote domestic stability in a slowdown.

**APPLIED ECONOMIC EXERCISES**

Apply your understanding of this subtopic by accessing and completing the Applied economic exercise(s).

• School-assessed coursework > Applied economic exercises > Question 9
4.12 The stance of monetary policy and how the RBA decides this

Monetary policy is an aggregate demand management strategy used to help stabilise the level of economic activity. It is applied countercyclically. 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?

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 level or setting is designed to slow or stimulate AD and the level of economic activity.

At a very simple level, there are three possible stances that might be adopted:

- An expansionary stance. When the RBA’s cash rate is low (perhaps less than 4 per cent) and there are fewer cuts in the rate, this is often seen as a relatively expansionary stance.
- A contractionary stance. If the cash rate is high (say above 5 per cent) and there are additional rises, this is usually regarded as a relatively contractionary stance.
- A neutral stance. A fairly neutral stance is one that does not deliberately attempt to either accelerate or slow AD. Here the cash rate is typically around 4–5 per cent.

These three positions are summarised in table 4.6.

<table>
<thead>
<tr>
<th>TABLE 4.6 Describing the RBA’s three main monetary policy stances</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monetary policy stance</td>
</tr>
<tr>
<td>------------------------</td>
</tr>
</tbody>
</table>
| 1. Expansionary or loosen monetary policy stance (for example, in mid-2016 the cash rate was just 1.75 per cent). This stance may be adopted by the RBA if there is:  
  - very low inflation  
  - slow GDP growth  
  - rising unemployment  
  - a rise in the labour force understaturation rate  
  - slow growth in AD  
  - weaker confidence  
  - a slowdown overseas  
  - a drop in the terms of trade  
  - a tighter budget. | The RBA has an expansionary stance when the cash rate is relatively low (perhaps below the normal range of around 4–5 per cent) and then cuts the rate using open market operations involving net repurchases 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, 4 to 1.75 per cent. | 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. |
| 2. Contractionary (tighter or restrictive) monetary policy stance (for example, in 2002–08 the cash rate reached 7.25 per cent). This stance may be adopted by the RBA if there is:  
  - high inflation  
  - strong spending and confidence  
  - very fast GDP growth  
  - low unemployment  
  - strong global growth. | The RBA has a contractionary stance when the cash rate is relatively high (perhaps above the normal range of perhaps 4–5 per cent) and the RBA using open market operations involving net sales 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 5 to 7 per cent. | The aim is to use higher interest rates and various transmission mechanisms or channels to slow AD and economic activity, thereby reducing inflation to within the 2–3 per cent target range. |
| 3. Neutral or normal monetary policy stance (for example, in 2010–11 the cash rate was held at 4.5 to 4.75 per cent). This stance may be adopted if reasonable domestic economic stability already existed with:  
  - low inflation  
  - strong and sustainable growth  
  - full employment. | The RBA has a neutral stance when the cash rate target is within the normal range for a healthy economy of around 4–5 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. | 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. |
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 4.7.

<table>
<thead>
<tr>
<th>Checklist indicator</th>
<th>Description of indicator</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Trends in inflation</td>
<td>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.</td>
</tr>
<tr>
<td>2. Levels of national spending and confidence</td>
<td>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.</td>
</tr>
<tr>
<td>3. Labour market conditions</td>
<td>Changes in labour market conditions (indicated by trends in the unemployment rate, labour force participation 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 a less expansionary stance if labour market conditions are getting weaker, while a more contractionary stance is likely if conditions are very strong.</td>
</tr>
<tr>
<td>4. Budgetary policy stance</td>
<td>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.</td>
</tr>
<tr>
<td>5. International developments</td>
<td>The RBA reviews overseas trends in inflation, economic activity, interest rates, the terms of trade and other events like 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.</td>
</tr>
</tbody>
</table>

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

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? Identify three important factors on this checklist that might or have affected the RBA's cash rate decisions in the past two years.

APPLIED ECONOMIC EXERCISES

Apply your understanding of this subtopic by accessing and completing the Applied economic exercise(s).

- School-assessed coursework > Applied economic exercises > Question 10
4.13 Using monetary policy over the past two years to help regulate aggregate demand and promote key domestic macroeconomic goals

**Domestic economic stability** is a desirable or ideal situation for a nation because it is likely to maximise living standards. Domestic stability exists when low inflation (an annual average CPI rise of 2–3 per cent over the economic cycle), 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.

During the last few years to 2016, domestic economic stability was not fully achieved. Although inflation was slow, economic growth was below trend and unemployment was quite high. These and other indicators of weakness on the RBA’s checklist were recently noted (for instance, lower commodity prices, weaknesses in global economic activity, slow domestic investment and public sector spending). To help correct this situation, an expansionary monetary policy stance has been recently adopted with cuts in the cash rate target to a record low level of just 1.75 per cent (in July 2016).

The RBA’s stance was forced to become even more expansionary by the fact that there was a need to gradually wind back the size of the budget deficit and return to surplus in the medium term to avoid an excessive level of government debt. As a result, monetary policy (rather than budgetary policy) became the main instrument used to stimulate AD and economic activity. Figure 4.10 clearly shows that the RBA did adopt an expansionary stance in the past two years to 2016, with eleven cuts in the cash rate target between late 2011 and mid-2016.

The effects of the RBA’s expansionary stance in the two years to 2016 can be illustrated hypothetically on the AD–AS diagram shown in figure 4.11. Starting at AD₀ and GDP₀, 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 in 2015 and 2016. In itself, this should have helped to stimulate spending towards AD₁ and lift GDP and employment in the direction of GDP₁ (where there is domestic economic stability). There should be little risk of serious inflation (there is only a small rise from P₀ to P₁) 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.
The recent effect on the goals of strong and sustainable economic growth and full employment

Seeing that economic growth was weak and there was no risk of serious inflation, the RBA announced reductions in its cash rate target to just 1.75 per cent by May 2016. It then conducted open market operations involving the repurchase of government bonds in the short-term money market. This increased the amount of cash or liquidity held by banks, causing a fall in the cash rate, along with other lending rates in the financial sector. In themselves, lower interest rates should have helped to stimulate AD, strengthen the rate of economic growth and promote fuller employment. As noted previously, the boost to national spending happens through various transmission channels or mechanisms. These include the following:

- **The credit effect.** Lower interest rates have recently made households and businesses more willing to take out loans, increasing the demand for credit and stimulating C and I spending.
- **The availability of credit effect.** Lower interest rates have recently increased the supply of bank credit available for spending on goods and services because more people meet bank lending criteria and so qualify for bank loans. This helps to stimulate household C and I spending.
- **The cash flow effect.** Lower interest rates tend to increase the level of disposable income remaining after individuals with existing mortgages and overdrafts meet their interest repayments. This extra income is now available for C and I spending.
- **The exchange rate effect.** Lower interest rates have contributed to a lower exchange rate for the Australian dollar in recent years by slowing capital inflow from abroad. This has weakened the demand for our currency and increased its supply. In turn, a fall in the Australian dollar in recent years has helped to stimulate X spending while slowing M spending.
- **The wealth effect.** Lower interest rates may have helped to strengthen the demand for assets such as property, pushing up their price. Rising demand and asset prices helped to make some people feel wealthier, possibly stimulating C spending.

Through a combination of these transmission mechanisms, recent cuts in interest rates to 2016 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 2015 and 2016 there was considerable spare capacity in the Australian economy, evidenced by the rise in unemployment and underutilisation rates, and by the very low inflation rate. Under these circumstances, cutting interest rates was unlikely to add to either demand or cost inflation, and should not have contributed to inflationary expectations. In addition, while lower interest rates weakened the Australian dollar and so made imports more expensive, this was partly offset by the slowdown in global inflation resulting from falling commodity and oil prices.
 Monetary policy has a number of strengths and weaknesses when it is used to pursue domestic macroeconomic goals and improve living standards. A few of these are summarised in Table 4.8.

### Table 4.8

<table>
<thead>
<tr>
<th>Possible strength</th>
<th>Description of strength</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Short implementation time lag helps make monetary policy flexible and convenient</td>
<td>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 counter-cyclical 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 be implemented 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 counter-cyclical, thereby improving stability.</td>
</tr>
<tr>
<td>2. Monetary policy may work better at controlling inflation</td>
<td>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 forced 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.</td>
</tr>
<tr>
<td>3. Monetary policy has fewer political considerations than budgetary policy</td>
<td>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.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Possible weakness</th>
<th>Description of weakness</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Long impact time lags could make monetary policy pro-cyclical</td>
<td>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 implementation lags given that the RBA board meets regularly, they have quite long impact lags. 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 pro-cyclical and destabilise the economy.</td>
</tr>
<tr>
<td>Possible weakness</td>
<td>Description of weakness</td>
</tr>
<tr>
<td>-------------------</td>
<td>-------------------------</td>
</tr>
</tbody>
</table>
| 2. Monetary policy is imprecise and blunt | There are three potential problems associated with the degree of precision and the ability of monetary policy to target the exact cause of economic problems:  
- 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.  
- With interest rate changes, one policy has to fit all states in Australia regardless of their circumstances. The minerals boom in WA and NT (2006–08 and again 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 two-speed economy.  
- 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 activity | Critics note that monetary policy is possibly less effective in overcoming recessions when there is pessimism, because cutting interest rates in a recession only works in very indirect ways on the level of spending by making interest repayments cheaper. People are not forced 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, Japan and the US) hardly whipped pessimistic borrowers into a spending frenzy. With rates this low, central banks were fairly powerless to do anything 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 crowding-out 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 crowding-in 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 and lead to a trade-off. |
| 6. Psychological constraints | The success and strength of monetary policy depends partly on the prevailing level of confidence. 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. |

Remember that improvements in living standards are the ultimate government aim. Our overall wellbeing is most likely to be maximised when there is strong and sustainable economic growth, full employment and low inflation (namely, domestic economic stability). While monetary policy has recently been used to help stabilise the economy and pursue these goals, it needs to be recognised that it has both strengths and weaknesses. As slower growth and higher unemployment are detrimental for living standards, it seems that monetary policy has not been as successful as we would have liked during the past two years. Certainly our material wellbeing (as judged by the annual change in real net national disposable income per head) has fallen every
year for the past three years, limiting consumption and the extent to which average individuals can satisfy their wants. Of course, government monetary policy is not solely to blame for this, since the economy is affected by many factors and there are limits to what stabilisation policies can achieve.

**CHECK YOUR UNDERSTANDING**

1. Identify and outline two important strengths of using monetary policy to help promote domestic economic stability.
2. Identify and outline two key weaknesses of using monetary policy to help promote domestic economic stability.

**APPLIED ECONOMIC EXERCISES**

Apply your understanding of this subtopic by accessing and completing the Applied economic exercise(s).
- School-assessed coursework > Applied economic exercises > Question 12

## 4.15 School-assessed coursework

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
- Structured questions
- Problem-solving exercises
- A folio of media commentaries.

*Note to teachers: Courses and assessments can change. Please check the latest VCAA assessment guide and various bulletins to ensure that all assessment requirements are met fully.*

### Multiple-choice test questions

**Instructions:** Using the multiple-choice answer grid available in the Resources section, select the letter (A, B, C, D) that represents the most appropriate answer for each question by marking this with a tick (√).

**eBookplus**

The answer grid for the multiple-choice questions is available this topic’s student resources tab.

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**Question 1**

As an aggregate demand-side policy, budgetary measures may be used to help:
- A bring about domestic economic stability by managing the growth in AD.
- B slow inflation.
- C promote a strong and sustainable rate of economic growth and low unemployment.
- D achieve all of the above.

**Question 2**

Aggregate demand or macroeconomic budgetary policies applied countercyclically to help improve domestic economic stability usually involve:
- A a contractionary policy stance during downturns and recessions.
- B an expansionary policy stance during inflationary booms or upswings.
- C 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.
- D changing interest rates.
**Question 3**
Which of the following is most correct? A budget deficit (such as occurred between 2008–09 and 2016–17) is where:

- A the total value of government receipts is more than the total value of government expenses.
- B the total value of government expenses is less than the total value of receipts.
- C the total value of government asset sales and taxes is more than the total value of government consumption (G₁) and government investment (G₂) spending.
- D the total value of government receipts is less than the total value of government expenses.

**Question 4**
The main difference between the headline budget balance and underlying budget balance is that:

- A the underlying balance excludes one-off volatile items like asset sales and interest repayments by state governments.
- B the headline balance excludes transfers like welfare outlays, which vary from year to year.
- C the underlying balance removes the effect of automatic stabilisers.
- D the underlying balance removes the impact of inflation on the values of receipts and outlays.

**Question 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.

**Question 6**
Between 2014–15 and 2019–20, the federal government initially planned to convert a headline deficit of $48.5 billion into a small surplus. Theoretically, this could be 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 (G₁) and government investment (G₂) spending.
- C automatic and discretionary cuts in welfare outlays and other transfer payments.
- D all of the above.

**Question 7**
The treasurer predicted that the size of the budget deficit from 2014–15 to 2019–20 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.

**Question 8**
What factor(s) might theoretically help to explain why the small budget surplus that the treasurer predicted would be achieved by 2019–20 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.

**Question 9**
Which statement is correct? An increase in G₂ 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.
Question 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.

Question 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.

Question 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.

Question 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) and rise in indirect taxes

Question 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

Question 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.

Question 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.

Question 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 by $50 billion
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
Question 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 47 to 50 per cent
C Cutting excise taxes on alcohol and reducing the company tax rate for large firms from 30 to 25 per cent
D Cutting the size of the budget surplus from $20 billion to $5 billion

Question 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.

Question 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.

Question 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

Question 22
Examine the hypothetical data below for a country (similar to Australia). As treasurer, you are working on the next budget.

<table>
<thead>
<tr>
<th>Indicator</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unemployment rate (percentage)</td>
<td>5.0</td>
<td>6.7</td>
</tr>
<tr>
<td>Inflation rate (percentage of CPI)</td>
<td>2.7</td>
<td>1.5</td>
</tr>
<tr>
<td>GDP (percentage)</td>
<td>3.2</td>
<td>1.3</td>
</tr>
</tbody>
</table>

Other things being equal, which future combination of budgetary policies to be announced in 2019 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.

Question 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

Question 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 $18 200 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 further rise in the pension access age from age 67 to 70
Question 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 like the privatisation of the National Broadband Network (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.

Question 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 the economic cycle.
D to raise budget receipts as a percentage of GDP.

Question 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 businesses from 30 to 28.5 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

Question 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.

Question 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).

Question 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.

Question 31
The RBA cut the cash rate target eleven times between late 2011 and mid-2016. This is likely to have contributed to the depreciation of the Australian dollar by around 20 per cent against the US dollar between 2013 and early 2016. In itself, this depreciation would tend to:
A make Australian exports of goods and services cheaper in the US 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-competitive sectors.
D slow the growth rate in GDP.

Question 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.
Question 33
The transmission mechanism(s) following a cut in the official cash rate set by the RBA from 2.25 to 1.75 per cent could involve:
A an increase in the demand for and the availability of credit.
B an increase in the cash flow for some households with existing loans.
C some households feeling wealthier and more confident to spend, along with a likely depreciation in the exchange rate.
D all of the above.

Question 34
Faced with high and rising cyclical unemployment and no threat of inflation, the RBA could:
A undertake operations in the short-term money market and adopt a more accommodating stance.
B increase repurchases on government bonds in the overnight money market.
C further reduce the cash rate target to help drive the Australian dollar downwards.
D try all of the above measures.

Question 35
During 2014 and 2016, the RBA reduced the official cash rate target to a record low. The most likely reason for this strategy was that:
A the underutilisation rate was low.
B the inflation rate was around 2 per cent, the unemployment rate tended to rise and job vacancies were weak.
C economic activity was acceptable and there was little unused capacity.
D domestic expenditure and confidence were strong.

Question 36
Which of the following could tend to impair the effectiveness of an expansionary monetary policy stance involving large reductions in the cash rate?
A The existence of consumer and business pessimism
B Large expansionary budget deficits funded by the sale of government bonds in the domestic capital market
C Very high levels of unemployment and negative GDP growth, typical of recession rather than a boom
D All of the above

Question 37
Following a large rise in interest rates by the RBA, it is likely that:
A demand inflation will slow, partly due to reduced consumption and investment spending.
B a higher dollar could help slow cost inflation.
C inflationary expectations should tend to be crushed.
D all the above may apply.

Question 38
The most likely reason why the RBA cut interest rates between 2014 and 2016 was that:
A the level of economic activity abroad was rising strongly.
B our terms of trade had just started to recover.
C there was a threat from a worsening price bubble in the Sydney and Melbourne property markets.
D to hold down government debt levels, the budget stance needed to become less expansionary.

Question 39
Examine the hypothetical checklist of indicators below prepared for the government and central bank of a country similar to Australia.

<table>
<thead>
<tr>
<th>Checklist indicator</th>
<th>2016–17</th>
<th>2017–18</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth in national expenditure (percentage)</td>
<td>2.2</td>
<td>7.0</td>
</tr>
<tr>
<td>Chain volume GDP growth (percentage)</td>
<td>2.5</td>
<td>5.1</td>
</tr>
<tr>
<td>Headline CPI (percentage)</td>
<td>2.7</td>
<td>3.6</td>
</tr>
<tr>
<td>Underlying CPI (percentage)</td>
<td>2.5</td>
<td>3.9</td>
</tr>
<tr>
<td>Budget outcome ($ billion)</td>
<td>10.1</td>
<td>15.4</td>
</tr>
<tr>
<td>Cash rate target (percentage)</td>
<td>4.5</td>
<td>5.0</td>
</tr>
<tr>
<td>Global GDP growth (percentage)</td>
<td>2.5</td>
<td>3.1</td>
</tr>
</tbody>
</table>

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?
A Further increase the budget surplus, combined with open market operations involving heavy central bank repurchases of government bonds in the short-term money market.
B Increase the cash rate target, raise PAYG tax rates and slow budget outlays.
C Increase the cash rate target to encourage the Australian dollar to appreciate, combined with reducing budget outlays on imports of equipment and foreign aid.
D Reduce the budget surplus and increase repurchases of government bonds in the short-term money market.
Question 40
Concerning the RBA’s actual monetary policy stance between 2014 and mid-2016, which of the following is most correct?
A The policy stance became highly expansionary.
B The policy became less expansionary.
C A more contractionary policy stance was adopted.
D The policy was able to become less expansionary because of a substantial rise in the budget deficit in 2014–15 and 2016–17.

Question 41
Monetary policy is often regarded as being more effective than budgetary policy in directly helping to achieve the goal of:
A full employment.
B strong and sustainable economic growth.
C low inflation (price stability).
D international competitiveness.

Question 42
The likely effect of a more expansionary monetary policy setting by the RBA would be:
A a rise in the household savings ratio.
B a slower rise in I.
C a higher C and net X.
D none of the above.

Question 43
If the RBA increases its cash rate, this is likely to cause:
A GDP to rise.
B cyclical unemployment to fall.
C an increase in demand inflation.
D an increase in our borrowing overseas, pushing up the value of the Australian dollar.

Question 44
Examine the hypothetical checklist of indicators prepared for the RBA covering a two-year period.

<table>
<thead>
<tr>
<th>RBA checklist indicator</th>
<th>Year 1</th>
<th>Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail sales change (percentage change)</td>
<td>12</td>
<td>2</td>
</tr>
<tr>
<td>Consumer confidence (index points)</td>
<td>122</td>
<td>91</td>
</tr>
<tr>
<td>New dwelling approvals (‘000)</td>
<td>69200</td>
<td>45100</td>
</tr>
<tr>
<td>Job vacancies (‘000)</td>
<td>170</td>
<td>140</td>
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<tr>
<td>Trade weighted index (TWI)</td>
<td>68</td>
<td>67</td>
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<tr>
<td>Terms of trade index</td>
<td>115</td>
<td>108</td>
</tr>
<tr>
<td>China’s rate of GDP growth (percentage)</td>
<td>10</td>
<td>6</td>
</tr>
</tbody>
</table>

This hypothetical data for the period indicate that:
A economic conditions have probably started to improve overall and there is cause for optimism.
B labour market conditions have strengthened, with a likely fall in the unemployment rate.
C macroeconomic conditions have probably deteriorated due to weaknesses domestically and internationally.
D a tighter macroeconomic policy stance needs to be adopted.

Question 45
Which statement about Australian monetary policy is most correct?
A 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.
B Monetary policy is a very precise or surgical instrument that can accurately target and correct specific problem areas in the economy.
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.

Question 46
As a rough guide, a fairly neutral monetary policy stance for the RBA is generally when official interest rates are around:
A 1–2 per cent.
B 2–3 per cent.
C 4–5 per cent.
D 6–8 per cent.
Question 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?
A Raising welfare benefits and G spending (expressed as a ratio to GDP)
B Increasing PAYG tax rates and failing to compensate income earners for bracket creep
C Cutting the size of the budget deficit
D Substantially increasing the budget surplus

Question 48
Which of the following is generally false following a cut in interest rates?
A The Australian dollar will tend to depreciate.
B AD may fall due to lower investment spending.
C The inflation rate may tend to rise if there is little unused or spare capacity available.
D The unemployment rate should tend to fall.

Question 49
Following open market operations by the RBA, increased interest rates are likely to:
A increase domestic savings but reduce investment spending.
B decrease the labour force underutilisation rate.
C reduce the inflow of foreign investment and weaken the exchange rate.
D cause all of the above.

Question 50
If GDP or economic growth was running below 2 per cent and annual inflation rate was 1.2 per cent, the RBA would probably:
A tighten its monetary policy stance.
B loosen its monetary policy stance.
C not change its monetary policy stance.
D start by tightening its policy stance before easing it.

Applied economic exercises

Instructions: Complete a selection of the following short-answer questions.

Question 1
A Define what is meant by budgetary (fiscal) policy. (2 marks)
B Explain why budgetary policy can be regarded as an aggregate demand management policy. (2 marks)
C Identify and outline the three main categories of government budget receipts and the three main categories of government budget expenses. (3 marks)
D Giving examples, distinguish between the following pairs of terms related to budgetary policy:
   (i) direct tax and indirect tax (1 mark)
   (ii) tax burden and tax mix (1 mark)
   (iii) G1 and G2 (as part of budget outlays or expenses) (1 mark)
   (iv) government spending and government transfer payments. (1 mark)
E What is bracket creep and how does this affect budget revenues over a period of time? (2 marks)

Question 2
A What is meant by the term budget outcome? (1 mark)
B Distinguish a budget deficit from a budget surplus. (2 marks)
C Assume the government runs a budget deficit of $40 billion. Identify and outline the various options available to the government for financing the deficit. (3 marks)
D Identify two important economic problems associated with running budget deficits. (2 marks)
E Identify and outline two important uses of a budget surplus. (2 marks)
F Identify two important advantages of returning to budget surplus as soon as possible. (2 marks)
G What is the medium-term operational goal of budgetary policy? (2 marks)
H Outline how any four of the following events would be likely to affect the federal budget’s outcome. (3 marks)
   (i) A rise in domestic consumer and business confidence
   (ii) The deepening of a recession overseas
   (iii) A rise in the unemployment rate from 4.2 per cent to 6.4 per cent
   (iv) Increased tax evasion by multinational corporations operating in Australia
   (v) An acceleration of the inflation rate
   (vi) An ageing population with a declining proportion of people of working age
   (vii) A reduction in 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 bird flu pandemic spreading to Australia
(xi) With the global recession, the end of the export boom for Australia’s mining industry and the collapse of the terms of trade index
(xii) A tightening of rules relating to welfare access
(xiii) The worsening of the drought or the onset of severe floods, fires and storms.

**Question 5**

**Source:** Data derived from Budget Paper 1 (statement 10) 2016.

Examine Figure 4.12.

(ii) the expected change in 2016–17 against 2015–16.

Giving reasons and quoting data from the table, describe the change in the budgetary policy stance adopted

(iii) the budget’s headline balance and underlying balance.

**Question 3**

**A** Distinguish between the following pairs of terms associated with the operation of budgetary policy:

(i) expansionary stance and contractionary stance

(ii) deficit budget outcome and surplus budget outcome

(iii) the budget’s headline balance and underlying balance.

**B** Examine table 4.9 showing changes in the federal underlying budget outcome.

**TABLE 4.9 The federal government’s underlying budget outcome**

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<td>19.7</td>
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<td>underlying</td>
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<td>(GDP)</td>
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**Source:** Data derived from Budget Paper 1 (statement 10) 2016.

*Note: Budget estimates at May 2016.*

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

(i) the change in 2012–13 against 2011–12

(ii) the expected change in 2016–17 against 2015–16.

**Question 4**

**A** What are *automatic stabilisers*? Carefully explain how the operation of automatic stabilisers in the budget during an economic slowdown, could help improve domestic economic stability. Illustrate your answer with reference to examples drawn from the past two years.

**B** What are *discretionary stabilisers*? Give two examples of these drawn from the past two budgets and explain how you would expect each to affect the level of economic activity.

**Question 5**

Examine figure 4.12.

*FIGURE 4.12 The countercyclical change in the federal government’s budget outcome to help reduce the severity of booms and recessions, 2004–05 to 2019–20*

**Source:** Data derived from Budget Paper 1 (statement 10) 2016.

250 Economics Down Under 2
A Identify and explain the likely causes of large budget deficits in recent years (as shown in figure 4.12). (4 marks)

B How would you expect any two of the following discretionary budgetary measures to affect the rates of
• demand inflation? (2 marks)
• economic growth and unemployment? (2 marks)
(i) A discretionary reduction in the rates of company and PAYG taxes (2 marks)
(ii) Increased defence spending on new imported equipment and overseas peacekeeping (2 marks)
(iii) An increase in the GST from 10 per cent to 12.5 per cent (2 marks)
(iv) The construction of a nuclear desalination plant to ease water shortages (2 marks)
(v) Further encouragement of superannuation and national savings (2 marks)
(vi) The introduction of a co-payments charge of $7 per visit to the doctor (2 marks)
(vii) Increased rates of excise tax on fuel, alcohol and tobacco (2 marks)
(viii) A huge increase in funding for national infrastructure projects (2 marks)

C Outline two general ways whereby a budget deficit could be returned to a budget surplus. (2 marks)

D Identify and explain two reasons why a return to a budget surplus in the medium term could be desirable. (2 marks)

E 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.
   (i) Identify and outline the three most important factors or events that have affected the stance of the budgetary policy you intend to adopt at this time. (3 marks)
   (ii) 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)

Question 6
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)

Question 7
A Define what is meant by monetary policy. (2 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 already slow, what are the other likely goals or aims of monetary policy? (1 mark)
E What were the main priorities of the RBA’s monetary policy during the past two years? (2 marks)

Question 8
A What are interest rates? Outline the general factors that affect the level of interest rates in Australia. (2 marks)
B What is the cash rate target? (2 marks)
C Define open market operations. (1 mark)
D 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). (3 marks)
E Explain how a cut in the cash rate target would tend to affect the exchange rate for the Australian dollar. (2 marks)

Question 9
A Referring to monetary policy, explain what is meant by transmission mechanisms. (2 marks)
B Explain how each of the following transmission mechanisms would apply after a rise in the cash rate target.
   (i) The cost of credit (2 marks)
   (ii) The cash flow of households and businesses (2 marks)
   (iii) The availability of credit (2 marks)
   (iv) The exchange rate (2 marks)
   (v) The wealth or asset values effect (2 marks)

Question 10
A Explain what is meant by the RBA’s monetary policy stance. (3 marks)
B Identify and outline four important factors that the RBA would normally take into account before changing its monetary policy stance. (4 marks)
C Under what circumstances would the RBA
   (i) reduce its cash rate target? (2 marks)
   (ii) increase its cash rate target? (2 marks)
Distinguish an expansionary monetary policy stance from a contractionary stance. (2 marks)

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 to 6.2 per cent during late 2015 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 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

Question 11
Examine figure 4.13 showing recent changes in the RBA’s cash rate target.

![Figure 4.13](image.png)

**FIGURE 4.13** Recent changes in the RBA’s official cash rate target (percentage)

Source: Data derived from RBA Statistics.

Read the edited extract below from the RBA’s decision to cut the cash rate target in May 2016, before answering the questions that follow.

Statement by Glenn Stevens, Governor: Monetary Policy Decision, 3 May 2016.

At its meeting today, the Board decided to lower the cash rate by 25 basis points to 1.75 per cent, effective 4 May 2016. This follows information showing inflationary pressures are lower than expected.

The global economy is continuing to grow … at a … lower pace … China’s growth rate moderated further … Commodity prices have firmed noticeably from recent lows, but this follows very substantial declines over the past couple of years. Australia’s terms of trade remain much lower … however, uncertainty (remains) about the global economic outlook … In Australia, the available information suggests that the economy is continuing to rebalance following the mining investment boom. GDP growth picked up over 2015, particularly in the second half of the year, and the labour market improved. Indications are that growth is continuing in 2016 …

Inflation has been quite low … with ongoing very subdued growth in labour costs and very low cost pressures elsewhere in the world … Monetary policy has been accommodative for quite some time. Low interest rates have been supporting demand and the lower exchange rate overall has helped …

In reaching today’s decision, the Board took careful note of developments in the housing market, where indications are that the effects of supervisory measures are strengthening lending standards and that price pressures have tended to abate. At present, the potential risks of lower interest rates in this area are less than they were a year ago.

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.


Referring to this statement by the RBA:
   (i) Describe the change in the RBA’s monetary policy stance in May 2016. (3 marks)
   (ii) From the extract, identify and explain three important reasons from the RBA’s checklist of indicators that were used by to justify its 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 ten times (from 4.75 per cent in November 2011 to 1.75 per cent in May 2016) might have helped to promote strong 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 aggregate demand-side factors contributing to these domestic conditions? (2 marks)

D 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. (4 marks)

E Explain how a reduction in interest rates by the RBA would tend to affect any three of the following. (1 + 1 + 1 = 3 marks)

(i) The level of business investment spending
(ii) Residential building approvals and new car sales
(iii) Cost and demand inflation
(iv) Imports of consumer goods and services
(v) The level of cyclical unemployment

Question 12

A Identify and explain three important weaknesses or constraints that limited the effectiveness of the RBA’s cut in the cash rate as a stabilisation policy between 2011 and 2016. (3 marks)

B Assume the RBA decided to raise the cash rate target to slow inflation. Discuss two important economic advantages of using monetary policy to promote domestic economic stability. (1.5 + 1.5 = 3 marks)

An essay

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

A 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:

(i) Provide a clear definition of budgetary policy.
(ii) Define domestic economic stability.
(iii) Discuss how recent budgetary policy can help achieve this government goal, illustrating this by reference to recent fiscal measures. (20 marks)

B 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)

C 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.

A Report about using budgetary policy as an aggregate demand instrument to promote domestic economic stability.

(i) Clearly define what is meant by domestic economic stability for Australia.
(ii) How might the achievement of domestic economic stability affect Australia’s living standards?
(iii) To what extent has Australia enjoyed domestic economic stability in the past two years?
(iv) Define budgetary policy and explain how it can operate as an aggregate demand policy.
(v) Quoting actual 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. (20 marks)

B Report about the operation of monetary policy as an aggregate demand instrument to promote domestic economic stability.

(i) Define monetary policy, explaining how this operates as an aggregate demand policy.
(ii) Identify and outline the main domestic problems faced by the Australian economy during the past two years.
(iii) 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.
(iv) Identify two important strengths and two weaknesses of using monetary policy to promote domestic economic stability during the past two years. (20 marks)
The budget outcome is affected by domestic GDP growth rates, overseas economic activity, the TOT, and strong and sustainable economic growth, low inflation and full employment are achieved simultaneously by regulating the level of AD and achieve domestic economic stability (namely, strong and sustainable economic growth, full employment and low inflation) and improvements in living standards. It 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 (G1), capital spending (G2) and transfer payments for the coming year.

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 is an aggregate demand management instrument designed to regulate the level of AD and achieve domestic economic stability (namely, strong and sustainable economic growth, full employment and low inflation) and improvements in living standards. It 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 (G1), capital spending (G2) and transfer payments for the coming year.

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 affected by domestic GDP growth rates, overseas economic activity, the TOT, the Australian dollar, changes in unemployment, 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 rather than by any deliberate government decision.
– *discretionary stabilisers* are 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 (for example, 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 2016, the federal government ran up over $350 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, the ability to precisely target areas of weakness in the economy and the possibility of beneficial effects on aggregate supply.
  - *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 one branch of macroeconomic or aggregate demand management measures used to pursue key domestic macroeconomic goals. It involves the RBA using changes in interest rates to affect the cost, availability and demand for credit, thereby affecting the level of aggregate demand, economic activity and 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 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 the cycle). 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.

- *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 to 2016, economic growth has been below trend, unemployment higher than normal and inflation has been very low. Hence, monetary policy during this period has been highly expansionary (particularly since there have been efforts to cut the deficit and return the budget to surplus). To this extent, it is likely that it has helped to 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 policy changes.
  - Weaknesses include quite long time lags in policy impact (up to three years for full impact to be felt), indirectness of influence, bluntness or imprecision in pinpointing problem areas, and limited use in severe slowdowns.

**Key terms**

A **budget surplus** occurs when the value of government revenues exceeds the value of government expenses, leading to a contractionary impact on aggregate demand.

**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** 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.

**Budgetary policy** is an aggregate demand measure and relates to changes in the anticipated levels and composition of government revenues and expenses for the upcoming year.

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

**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.

**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** seeks to slow AD and economic activity and thereby slow 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.

Direct tax is levied as a proportion of income received by individuals (personal income tax) or companies (company tax).

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.

Expansionary budgets seek to stimulate AD and economic activity.

Fiscal balance refers to budget measures designed to reduce the size of the budget deficit by increasing fiscal consolidation.

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 G2) includes government investment spending in the budget to facilitate the production of goods and services for the community.

Government current spending (abbreviated as G1) includes the day-to-day expenses or budget outlays of the government on the purchase of 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.

Indirect tax is added onto the price of a good or service at the point of sale, making the item more expensive (such as excise tax on tobacco and alcohol). These are often regressive and fall more heavily on low-income households.

Inflationary expectations occur where the community comes to expect the continuation of rising prices, which causes people to press for higher wages, salaries, rents and interest to compensate them and protect their real disposable incomes. In turn, these expectations and actions actually lead to inflation.

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 the duration of the business cycle.

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 and designed to regulate the level of AD and economic activity. It relies most heavily on changes in interest rates to alter the cost, availability and demand for credit (borrowed money).

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. A cash rate above about 5 per cent, for example, is normally regarded as a contractionary stance, but a cash rate below perhaps 4 per cent is usually seen as an expansionary stance.

Non-tax revenue is revenue derived from sources other than taxation, such as from the profits made by government enterprises, interest on loans paid by other governments, or the sale of a government enterprise.

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 that increase economic instability; 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.
The 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.

The 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.

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.

Transfer payments are usually government cash benefits paid to the neediest individuals. They are usually provided on the basis of means (income) and assets (wealth) tests designed to exclude people who are relatively well off. They also include grants and industry assistance.

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.