

The Objectives of Economic Policy

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Multiple Choice

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

Short Answers

Question 1

- (a) At point A there is 5% unemployment and no inflation - if unemployment falls below this level prices will rise.
- (b) Higher economic growth results in more demand which creates jobs and lowers unemployment. However, higher economic growth also increases demand and can increase prices, resulting in inflation. Therefore, there can be a conflict between achieving lower unemployment and lower inflation.
- (c) Any attempts to reduce unemployment below the NAIRU in the short term will lead to a higher level of inflation. The NAIRU is comprised of structural and frictional unemployment. These two types of unemployment can only be reduced over the long term through structural reform rather than short-term macroeconomic policy measures.
- (d) The government could adopt expansionary macroeconomic policy in order to boost the level of aggregate demand and reduce cyclical unemployment. Expansionary monetary policy, lowering interest rates, would stimulate consumption and investment, increasing aggregate demand and reducing cyclical unemployment. The government could also use labour market programs to assist in the process of retraining the unemployed, thereby reducing structural unemployment which is caused by the mismatch of skills in the economy. An example is the National Partnership Agreement on Skills Reform introduced in the 2011-12 Budget, which strives to develop the skills of the Australian people and ensure the present and future needs of Australian businesses and industries are met.

Question 2

- (a)** Between 1989 and 1992, unemployment dramatically increased to almost eleven per cent following a credit crisis in the U.S.A that triggered a recession in Australia. Leading up to early 2007, unemployment fell steadily to just above four per cent on the back of strong growth in Chinese demand for Australian exports.
- (b)** Macroeconomic policies, such as fiscal and monetary policies, operate on an economy-wide scale to influence the level of aggregate demand in the short to medium term. They generally operate in a counter-cyclical fashion to smooth fluctuations in the business cycle to achieve economic growth with low inflation and low unemployment. Microeconomic policies, such as tariff cuts and industrial relations reform, on the other hand, operate on an industry-specific basis to influence the level of aggregate supply. Microeconomic policies have a long term focus, addressing structural problems and improving the productivity, efficiency and international competitiveness of firms throughout the economy.
- (c)** As shown in the stimulus, Australia's unemployment rate in recent years is close to estimates of the non-accelerating inflation rate of unemployment (NAIRU). Microeconomic policies are most effective in targeting unemployment which is primarily structural, seasonal and frictional in nature. Active labour market programs, such as the National Partnership Agreement on Skills Reform announced in the 2011-12 Budget could target structural unemployment, by developing the skills of the Australian workforce and ensuring the present and future needs of Australian businesses and industries. Labour market reform, including deregulation and decentralisation, also have the effect of removing labour market distortions and reducing structural unemployment. Reform of job search services, such as Job Services Australia, may assist in reducing frictional unemployment.

Question 3

- (a)** The balance of goods and services usually fluctuates between a deficit of two and a half per cent and a small surplus of one per cent. The trends illustrates a fairly positive relationship with the business cycle. The positive balance in the early 2000s represented strong export performance particularly due to industrial growth in China.
- (b)** The two main components of the current account are the balance on goods and services and the net primary income balance; the net secondary income balance is less significant. The net income deficit represents is the largest component of Australia's current account deficit. This is because of structurally low national savings combined with high levels of investment inflows, which lead to an increase in overseas borrowing. The balance of goods and services contributes a much smaller to the current account deficit. At times the balance of goods and services reaches a small surplus. There are also structural causes for Australia's balance of goods and services, namely narrow export base, low international competitiveness and the lack of elaborately transformed manufactured exports.
- (c)** Achieving external stability is generally a constraint on the level of economic growth. Higher economic growth results in more demand. This spills over into increased demand for imports, worsening the current account deficit and external stability. Strong growth can also result in increased investment, which can increase foreign investment- either debt or equity - and worsen external stability. If these measures are considered a problem it can result in weaker confidence in the currency. Governments may try to limit growth so that external stability does not become a major problem.