Effectiveness and Limitations of Economic Policy

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Multiple Choice

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

Short Answers

Question 1

(a) In order to reverse the downward trend in economic growth in this economy, the government should adopt an expansionary fiscal policy stance, by increasing expenditure, reducing taxation or both, in order to increase aggregate demand.

(b) Fiscal policy is effective as a countercyclical tool to smooth out fluctuations in the business cycle. If the economy is growing too slowly, the government can use expansionary fiscal policy to stimulate aggregate demand and economic growth in the short term by increasing government spending or cutting taxation or both. Alternatively, if the economy is growing too quickly, the government can adopt a contractionary fiscal stance, through decreasing expenditure or increasing taxation or both. This will reduce aggregate demand and decrease the growth rate in the short term. In this way, fiscal policy can stabilise short-term fluctuations in the growth rate.

(c) This economy is experiencing simultaneous increases in inflation and unemployment and a slowdown in economic growth. This results in conflicts between the goal of lower inflation and the goals of lower unemployment and stronger economic growth. In implementing its macroeconomic policies it will need to address this conflict since the goal of lower inflation would best be achieved through contractionary policy, while the goal of lower unemployment would best be achieved through expansionary policy. The government may attempt to resolve this conflict through adopting an inflation-targeting monetary policy, which may help reduce inflationary expectations and demand-pull inflation in the short term, while also implementing microeconomic reforms that can help reduce cost-push inflation in the longer term. If those microeconomic reforms are effective in lifting efficiency and competitiveness, this may help to stimulate job growth over the medium to longer term. Other policies to support job growth such as re-training programs and wage subsidies may help support job growth in the short to medium term.

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(d) Fiscal policy is generally regarded as an effective tool for managing the level of aggregate demand and therefore reducing the level of cyclical unemployment, but it is less effective as an instrument to reduce structural unemployment. If an economy is experiencing cyclical unemployment, the government can adopt an expansionary fiscal policy, by increasing government expenditure or decreasing taxation. This will stimulate aggregate demand, which will increase demand for labour and reduce cyclical unemployment. Successful management of aggregate demand may result in eliminating cyclical unemployment and reducing the rate of unemployment to its natural rate (the non-accelerating inflation rate of unemployment). Efforts to push the rate of unemployment down below the NAIRU through further expansion of aggregate demand are likely to accelerate growth in inflation. At this point, fiscal policy will not be effective and the government must rely on microeconomic reforms such as labour market policies and other steps to improve the economy's competitiveness and efficiency. Nevertheless, targeted labour market programs that have an impact on fiscal policy (such as as job retraining programs, which require expenditure in the budget) can contribute to further reductions in the rate of unemployment.

Question 2

(a) An implementation time lag refers to the time taken to implement a change in economic policy after a government has decided to change that policy. An impact time lag refers to the time between the government implementing the policy and its full effect on the economy.

(b) Monetary policy has an impact time lag of around 6 to 18 months, as it takes time for cash rate changes to flow through and affect the rest of the economy. Changes in the cash rate will only affect aggregate demand after households change their consumption decisions and firms change their investment plans.

(c) The Reserve Bank uses a pre-emptive approach to address the limitations on monetary policy caused by the medium-term impact lag from increasing or decreasing the cash rate. The RBA forecasts the expected level of inflation for the year ahead and adjusts the stance of monetary policy so that it can keep inflation within the target range of an average 2 to 3 per cent over the medium term. In adjusting the stance of monetary policy its focus is the expected inflation rate in six to eighteen months rather than the current rate. Because the Reserve Bank has been successful in achieving the inflation target during the past two decades, inflationary expectations remain low, which reduces the extent to which the Reserve Bank needs to keep adjusting monetary policy settings.

(d) In a world of open international financial markets, the conduct of domestic monetary policy is strongly influenced by global economic conditions. Mostly these factors have an indirect effect on monetary, by influencing the expected rate of inflation in Australia and the level of economic growth. If economic conditions are weakening for Australia's major trading partners, because this is likely to lower growth and inflation in Australia, the Reserve Bank will be more likely to reduce interest rates. Shocks to the global economy can result in immediate policy changes by the Reserve Bank, as occurred during the global financial crisis in 2008 and 2009. To the extent that Australia needs to sustain its interest rate differential with other nations to sustain financial inflows to cover its current account deficit, upward or downward movements in overseas interest rates will generally influence the interest rate trend in Australia. In some circumstances, if the Australian dollar is coming under strong pressure from global markets, the Reserve Bank may adjust monetary policy, either through adjusting interest rates (for example, if a sharp depreciation threatens the inflation target through rising import prices) or intervention in the foreign exchange market to buy or sell Australian dollars.

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Question 3

(a) Microeconomic policies often involve short-term costs, such as structural unemployment arising from a reduction in protection levels as inefficient firms are forced to shut down. Since the benefits of microeconomic reform are often not realised until many years after implementation, political constraints caused by the short-term costs of microeconomic policy can discourage governments from implementing these policies.

(b) A range of reforms to services delivered by state governments, overseen by the Council of Australian Governments (COAG), aim to achieve a long-term boost to productivity growth in Australia. Another recent microeconomic policy is further reduction in tariff levels for the automotive and clothing industries from 1 January 2010, which is the most recent step in a process of reducing tariffs that began in 1988.

(c) Microeconomic reforms aim to increase the efficiency of firms and industries by encouraging increased competition and structural change across the economy. The reallocation of resources away from inefficient firms towards the most efficient areas of the economy should boost productivity growth.

(d) The main difference between microeconomic policy and fiscal policy is that while microeconomic policy is focused on long-term goals, fiscal policy is generally more focused on short to medium-term goals. Microeconomic policies such as national competition policy and labour market policies target structural issues in the economy such as productivity and efficiency, and there is a long time lag in both implementing these policies (for example, because they often require cooperation between federal and state governments) and in achieving their benefits. In contrast, fiscal policy's primary role is to help sustain a stable rate of economic growth over the short to medium-run. The time lag for implementing fiscal policy is short (a spending increase or tax cut can come into effect very quickly) and the time lag for impact is generally the medium to longer term. While fiscal policy is primarily aimed at improving economic conditions in the short to medium term, microeconomic reform may actually worsen economic conditions in the short-term, because of short-term costs such as structural unemployment from cuts to trade protection as inefficient firms are forced to shut down. While the long-term benefit of successful fiscal policy is reflected in sustaining economic growth in the range of around 3 to 3.5 per cent, the long-term benefit of successful microeconomic policy is reflected in lifting the sustainable rate of economic growth.

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