Economics

Global Interdependence

- linkages between economies (incl. trade, investment, tourism and immigration)
  - **foreign investment** - complements domestic savings to help fund economic development.
  - **immigration** - important source of skilled labour and helps to boost population growth (28%)
  - **trade** - creates wealth and jobs, raises living standards and income and encourages innovation.
  - **tourism** - grown in importance due to improvements in transport and communications

- the patterns and trends in global trade
  - GFC
  - improvements in transport and communication lowering the costs
  - more open to trade and investment → economic growth and living standards have accelerated
  - lower prices for consumers and higher prices for producers
  - domestic producers gain from exports, domestic consumers gain from imports

- the concept of international competitiveness
  - the achievement and maintenance of competitiveness has come to determine the difference between success and failure in international economic performance.

- the determinants of international competitiveness
  - **trade liberalization:** removing trade barriers
  - **establishing free trade agreements**
  - **structural change:** (for example, reducing transport costs, communication and technology => increase size and speed of trade)
  - **individual demand:** wider tastes and preferences
  - **corporate behavior:** increased competition drives need for companies to reduce costs to pursue an increase in profits
  - **effective wages policy** - through MER policy
  - **improve economic efficiency**: allocative, dynamic and technical efficiency

- the concept, and extent, of globalization
  - globalisation is the process by which businesses or other organizations develop international influence or start operating on an international scale
  - people benefit in the form of, access to a wider variety of goods, lower prices, more and better paying jobs, improved health and higher standards of living as well as computer and communications
  - in recent decades, globalisation has accelerated due to a variety of factors, but important ones include improved trade, increased labour and capital mobility and improved technology
  - causes the market to be more volatile – if trading partners suffer a fall in growth, both suffer
  - promotes a common culture
  - greater environmental damage

- economic effects of globalization
  - economic growth
  - income
  - world poverty
  - ethical behavior
  - national sovereignty
  - environment

Free Trade and Protection

- the significance of trade for the Australian economy
  - trade is important because it can expand a nation's consumption possibilities by providing access to other countries
  - free trade means that countries can import and export goods without any barriers to trade.
  - essentially enabling lower prices for consumers, increased exports, benefits from economies of scale and a greater choice of goods.

- absolute advantage
  - able to produce more of a good with the same amount of resources or
  - able to produce the same amount of a good with fewer resources

- comparative advantage
  - able to produce at a lower opportunity cost than its trading partner
    - specialize in the production of a good they are least inefficient at
  - sources of comparative advantage:
    - two-country, two-product world
    - factors of production are mobile
    - no transport costs
    - no tariffs
    - costs are constant
    - perfect knowledge

- using the the DandS model
  - if a country has comparative advantage, the domestic price will be below the world price and the country will be an exporter (pg. 18 of WACE study guide)

  - if a country does not have comparative advantage, the domestic price will be above the world price and the country will be an importer (pg. 18 of WACE study guide)

- demonstrate the gains from specialisation and trade
  - countries specialize in the production of certain goods which they are best suited
  - comparative advantage = domestic price will be higher than the world price, best to export. If not, the domestic price will be lower and they will best to import the good
  - helps reduce the problem of scarcity in individual countries and enables countries PPF to shift outwards

an absolute advantage example: *a comparative advantage example:*

- gains from specialisation
  - gains from exports
    - domestic producers receive a higher price and sell more – producers gain
    - consumers in the exporting country pay more for less – consumers lose

(pg. 19 of WACE study guide)

  - gains from imports
    - domestic producers receive a lower price and produce less – producers lose
    - consumers in the importing country pay a lower price for more – consumers gain

(pg. 19 of WACE study guide)

- identify different forms of protection
  - **tariff:** indirect taxes on imports (reduces imports, protects domestic industries, raises gov. revenue)
  - **subsidies:** financial assistance from the government (shifts the supply curve to the *right*)
  - **embargoes:** complete ban on importation of a good
  - **quota:** restriction on the quantity of goods allowed to be imported

- demonstrate the use of tariffs/subsidies as protection and effects on trade and market efficiency
  - subsidies are a payment/grant to domestic producers by the government lowers the domestic producers' costs so that they can compete more favorably against imports
    (pg. 25 of WACE study guide)

  - tariffs create revenue for government unless the tariff raises the price to its domestic equilibrium
    (pg. 24 of WACE study guide)

- removal of tariffs reduces government revenue but can benefit producers and consumers
  (pg. 27 of WACE study guide)

- tariffs and subsidies are inefficient (DWL) producer gains, government gains, consumer surplus is less

- arguments for trade protection
  - prevent dumping (the practice of selling exports below their production cost and below market price in the country of origin)
  - maintain domestic employment in a recession
  - correct persistent deficit in the balance of payments
  - protect infant industries
  - diversification
  - to avoid unfair competition
  - key industry (political)
  - keep money in the country

- arguments for and against trade liberalisation (the opposite of protection)
  - trade liberalisation involves removing barriers to trade between different countries and encouraging free trade. It involves:
    - reducing tariffs
    - reducing / eliminating quotas
    - reducing non-tariff barriers.
  - non-tariff barriers are factors that make trade difficult and expensive. For example, having specific regulations on making goods can give an unfair advantage to domestic producers. Harmonising environmental and safety legislation makes it easier for international trade.

continued…

- arguments for and against are centered on increased employment, higher world output, taking advantage of economies of scale

FOR

- higher GDP
- more employment
- lower prices and inflation rates
- higher consumption and spending
- increased productivity and efficiency
- higher real incomes and living standards

AGAINST

- structural unemployment
- decrease domestic economic stability
- surplus of production
- unfair competition
- causing environmental issues
- request for more protection in GFC

- the influence of trade agreements, organisations and blocs on world trade
  - trade agreements help remove barriers but may result in trade diversion
    - JAEPA eliminate tariffs on imports of cars, electronic and household appliances
  - organisations:
    - according to WTO, there are 10 benefits to globalisation
      - peace
      - disputes
      - rules
      - growth
      - cost of living
      - lobbying
      - good government
      - employment
      - efficiency
      - choice
      - income
    - according to WTO, there are 10 misunderstandings of globalisation
      - WTO dictates
      - anti-greens
      - anti-health
      - undemocratic
      - blindly for trade
      - wrecks jobs
      - small are left out
      - ignores development
      - tools for lobbies
      - weak forced to join
  - trading blocs increasingly shape the pattern of world trade

ADVANTAGES

- **Free trade:** with free access to each other's markets, members are encouraged to specialize
- **Market access and trade creation:** with easier access to each other's markets, trade between members is likely to increase
- **Jobs** may be created from increased trade between member economies
- **Protection:** Firms inside the bloc are protected from cheaper imports from outside

DISADVANTAGES

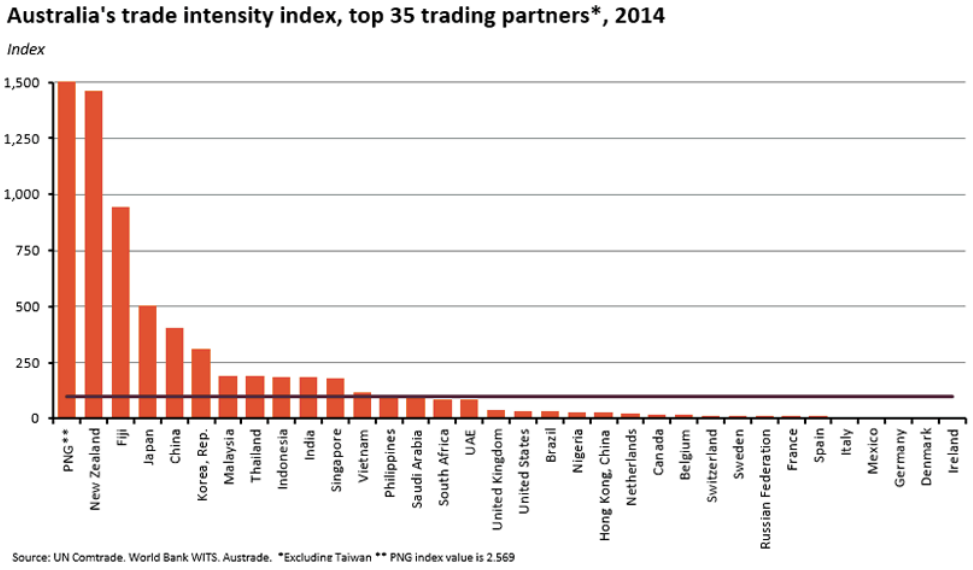
- **Loss of benefits:** The benefits of trade with countries in different blocs is lost.
- **Distortion of trade:** reduce the beneficial effects of specialisation and the exploitation of *comparative advantage*.
- **Inefficiencies and trade diversion:** inefficient producers within the bloc can be protected from more efficient ones outside the bloc. Trade diversion arises when trade is diverted away from efficient producers based outside the trading area

Pattern of Trade

- Australia's trade intensity
  - (IMPORTS-EXPORTS as a % of GDP) x 100

- patterns and trends in the composition of Australia's trade
  - the major trends in the composition of Australia's trade exports are:
    - a dramatic decline in rural exports
    - a significant increase in resource (minerals and fuels) exports
    - a relative decline in manufacturing and services exports

- patterns and trends in the composition and direction of Australia's trade
  - the shift in direction has been primarily from Europe to the pacific-east Asian region (east Asia, north America and Oceania).
  - geographically, Australia is part of the Asia-pacific region but historically, Australia has strong ties with the United Kingdom and Europe
  - in general, and all else equal, we would tend to expect to see our more intense trading relationships with markets that are closer to us.
  - consistent with this expectation, a look at values of the Trade Intensity Index for all of Australian trade partners as of 2014 shows that some of Australia's most intense trading relationships were with the small island nations in our region, with high index values for Christmas Island, Nauru, the Cocos Islands, Papua New Guinea (PNG) and the Solomon Islands.



Balance of payments

- structure of Australia's balance of payments and the concept of the current account balance
    - the balance of payments is the record of a country's transactions / trade with the rest of the world. It consists of:
        - Current Account (trade in goods, services + investment incomes + transfers)
        - Capital Account / Financial Account (capital and financial flows, net investment, portfolio investment)
        - Errors and omissions. It is hard to collect all data so some is missed out.
    - in theory there should be a balancing between capital and current / financial account. If there is a current account deficit, there should be a surplus on the capital / financial account.
    - components of Current account
        - trade in goods
        - trade in services
        - primary income (e.g. earnings from direct investment, shares, debt, bonds)
        - secondary income (e.g. General government transfers)
    - components of Financial Account
        - direct investment
        - portfolio investment
        - financial derivatives (net)
        - other investment
        - reserve assets
- The current account balance is the difference between a country's savings and its investment. "[If the current account balance is] positive, it measures the portion of a country's saving invested abroad; if negative, the portion of domestic investment financed by foreigners' savings."

- why the BOP always balances
    - for each transaction, there is a matching credit and debit entry, the overall BOP must always balance. This means the sum of all credit entries will be exactly offset by the sum of all debit entries. but each of the two accounts can record either a deficit or a surplus.
    - the overall balance of payments must always sum to zero. if the current account is in deficit, the capital and financial account will be in surplus and equal to the current in absolute value (plus net errors and omissions)
    - *EXAMPLE, an Australian resident buys a TV from Japan for AUD$1000 and a Japanese resident buys a TV from Australia for AUD$5000. The value of the imported TV will be recorded in the current account while the import will be recorded in the capital and financial account as a credit*
    - Australia often records a deficit in the current account and a surplus in the capital and financial account

- structural and cyclical reasons for Australia's CAD
  - cyclical reasons: when there is an upswing we tend to buy more imports and when there is a downswing we buy less imports and have less exports
    - use business cycle
  - structural reasons: changes in foreign investments and components of current account (changes in income, changes in goods and services)

- differing views as to the significance of Australia's current account
  - should we worry about a deficit?
    - yes, we should worry
      - it is a sign of uncompetitiveness, which will lead to lower economic growth and poorer prospects in the long run
      - if capital / financial flows dry up, it could lead to depreciation in the exchange rate and a fall in living standards
      - it is a sign of an unbalanced economy.
    - no, we shouldn't be concerned
      - we have had a persistent deficit for decades. Countries with large current account surplus have not necessarily done better, e.g. Japan had a long period of stagnation
      - in era of globalisation, financial flows are easier to attract and therefore the deficit is financed by these capital inflows.
      - if the current account was too large, there should be a depreciation in the exchange rate to restore the balance. A current account deficit is a bigger concern in a fixed exchange rate (like Euro) because there is no option of depreciation.

- recent (the last ten years) trends in Australia's current account
  - in 2007-08 it recorded a large deficit of $26 billion
  - in 2010-11, the goods balance recorded a significant surplus of $22 billion
  - since 2009, the goods account has recorded large surpluses due to strong growth in resource exports
  - Australia recorded relatively large deficits in the net goods balance between 2002 and 2008 as a result of the increased investment associated with the mining boom

- policies to reduce a current account deficit
  - to reduce a current account deficit, we need to pursue policies involving some or all of the following:
    - reducing consumer spending – through tight fiscal and tight monetary policy. *E.g. higher income tax will reduce disposable income and therefore reduce spending on imports (however, it will also lead to lower economic growth)*
    - supply side policies to improve competitiveness.
    - devaluation of the exchange rate. This makes exports cheaper and imports more expensive.

Terms of Trade

- the concepts of the terms of trade and the terms of trade index
  - terms of trade (TOT): the average price of exports / by the average price of imports. It is a measure of a countries relative competitiveness.
  - terms of trade index: the proportion of overseas trade in relation to the GDP

  Calculation:

$$TOT = \frac{\text{index of export prices}}{\text{index of import prices}} \text{x } 100$$

- factors that affect the terms of trade
  - increase exports, increase TOT
  - increase imports, decrease TOT

- recent (the last ten years) trends in Australia's terms of trade
  - decrease during the GFC
  - increase during the boom
  - TOT in Australia averaged 67.18 Index Points from 1959 until 2016, reaching an all time high of 118.50 Index Points in the third quarter of 2011 and a record low of 49.30 Index Points in the fourth quarter of 1986

- the significance of changes in Australia's terms of trade
  - a rise in the terms of trade can lead to a fall in the trade balance as spending on imports will increase which may offset the increase in export income.
  - a prolonged fall in the terms of trade will reduce living standards
  - a devaluation does make exports more competitive and can increase economic growth.
  - changes have important effects on;
    - the trade and current account balance
    - the exchange rate
    - investment
    - inflation

Exchange Rates

- the concepts of an exchange rate
  - the price of one currency in terms of another
  - for a country to be involved in international trade, finance and investment it is necessary to have access to currencies of other country es.

- factors influencing exchange rates
  - interest rates – higher interest rates encourage hot money flows and demand for currency. This causes an appreciation.
  - inflation – higher inflation makes exports less competitive and reduces demand for currency. This causes a depreciation.
  - confidence in the economy / currency.

- demonstrate the determination of, and movements in, the ER (i.e. an appreciation and a depreciation of the exchange rate) under a freely floating system using the DandS model
  - floating means the exchange rate is determined by the forces of the market
    - an appreciation of exchange rate will see…
      - exports more expensive abroad – leading to lower demand.
      - Imports into the country will be cheaper, increasing demand for imports
      - a reduction of inflation, but also lower economic growth.

(pg 61 of WACE study guide)

- here, increase in demand led to an appreciation and the quantity of AUD traded also increase
- this shift could have been caused by an increase in the demand for Australian exports or an increase in the capital flow

- here, there is a decrease in supply which has led to an increase in the value of the AUD
- this decrease in supply may have been caused by a decrease in demand for imports or a decrease in capital outflow

- a depreciation can be caused by a decrease in demand for AUD caused by a decrease in foreign demand for Australian goods and services or a decrease in foreign capital inflow
  - a depreciation will see…
    - exports become more competitive, increasing demand for exports
    - imports become more expensive, leading to lower demand for imports
    - an increase economic growth, but also inflation.

- here, there's a decrease in the price of AUD in terms of the USD
- this decrease could have been generated by a slowdown in the global economy (decreasing demand for Australian exports) or foreign investors lacking confidence in the Australian economy and investing elsewhere

- here, there's an increase in supply of AUD
- the value of the AUD has decreased and the quantity of AUD traded has also increased

- the trade weighted index
  - measures the Australian dollar against a basket of 22 currencies of Australia's main trading partners
    - a more comprehensive measure of the purchasing power of the Australian dollar as it takes into account the relative importance of each of our major trading partners and the performance of Australia's BOP
    - reflects changes in global economic conditions

- demonstrate the impact of changes in the factors that affect the ER using the DandS model
  - price of imports and exports
    - depreciation makes the foreign exchange price of exports decrease and the aud price of imports increase
    - exports and domestic import competing industries should become more competitive
    - depreciation encourages structural change and helps reduce CAD
  - inflation
    - depreciation causes AUD prices of imports to increase
      - some imports are included in the CPI
      - many imports are capital goods → increases cost of production for domestic firms → cost push inflation
      - domestic import competing industries faced with less price competition can increase their prices
  - foreign debts
    - depreciation causes the AUD value of foreign debt denominated in foreign exchange to increase → the valuation effect → increases interest saving costs on foreign debt → increasing income debt on the CAD
  - external shocks
    - depreciation can protect the domestic economy from external shocks – the competitive boost to exports and import competing industries can help prevent domestic recession

- the relationship between the balance of payments and the ER
  - a change in a country's BOP can cause fluctuations in the exchange rate between its currency and foreign currencies. The reverse is also true where a fluctuation in relative currency strength can alter the BOP
  - these conditions only exist under a free or floating exchange rate regime. The balance of payments does not impact the exchange rate in a fixed-rate system

- effects of movements in the exchange rate on various sectors of the economy
    - at an industry level, we find that the most trade-exposed industries, including the mining and manufacturing industries, are the most responsive to exchange rate movements. But large responses are not confined to industries that export or compete with imports. Some industries, such as business services, have little direct trade exposure but produce inputs into the production processes of trade-exposed firms. We find that these industries also respond to exchange rate movements. In contrast, the responses of industries with little direct or indirect exposure to foreign trade, such as social services, are generally smaller.

- recent (the last ten years) trends in Australia's exchange rate

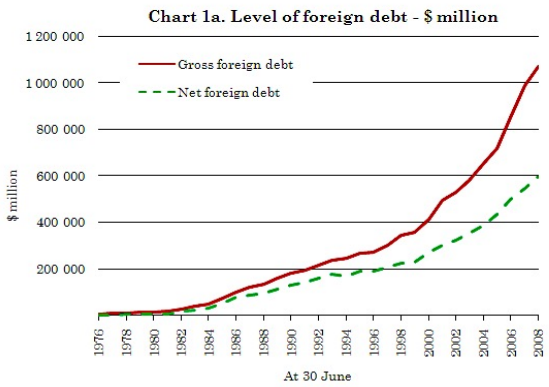
Foreign Investment

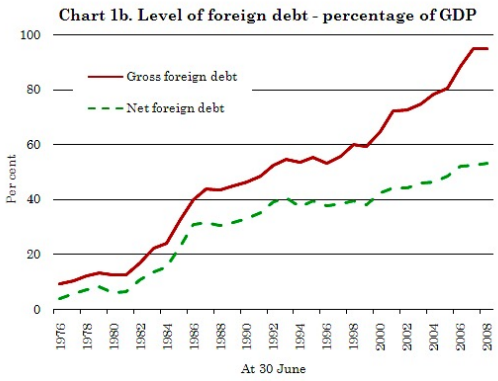
- the concept of foreign investment in terms of foreign assets and foreign liabilities
  - **foreign investment:** the stock of financial assets in Australia owned by foreign residents
  - **net foreign assets:** the value of overseas assets owned by a nation, minus the value of its domestic assets that are owned by foreigners, adjusted for changes in valuation and exchange rates.
  - **foreign liabilities:** include both foreign debt and foreign equity

- the concept of foreign liabilities i.e. foreign debt and equity
  - every time Australia records a CAD, total foreign liabilities increase, but this may be either debt or equity
  - **foreign equity: OWN** the extent to which foreign residents own Australian assets
  - **foreign debt (external debt): OWE** the amount of money that Australia residents, public and private, owe to the rest of the world

- the relationship between the current account outcome and foreign liabilities
  - our liabilities grow as foreign investment grows – more debt and job opportunities

- recent (the last ten years) trends in, Australia's foreign direct investment and foreign debt





- benefits and costs of foreign direct investment and foreign debt to Australia
  - Costs: High debt levels may lead to:
    - Australia's credit rating being downgraded

- arguments for and against foreign investment and foreign debt to Australia
  - arguments for
    - foreign investment is a source of finance for industry
      - allows Australia to access new capital which would otherwise not have been available → Australia is a resource rich country with low savings
      - foreign investment has allowed Australia to supplement its domestic savings and this has allowed higher levels of investment
    - foreign investment that it directed towards productive investment has a multiplier effect on national income, and output (employment) and therefore economic growth
    - foreign investment can be used to develop import competition industries or to increase production of output and therefore exports
    - the inflow of foreign investment provides foreign exchange to help finance the purchase of imports (finance the cad)
    - new investment from overseas brings with it new ideas in management practices or introduces new technologies and knowledge that leads to increased productivity in the workforce
    - foreign investment has increased the diversity of Australia's industry by allowing for investment in industries with high capital establishment costs and which do not show a high rate of return for some time such as mineral exploration

  - arguments against
    - direct investment involves a loss of control and ownership of Australian resources and industry:
      - decision making can occur overseas without consideration of the interests of Australians can lead to public hostility, eg. Vegemite ® going offshore
    - interest, dividend and profit payments flow overseas and out of the domestic economy creating a net leakage and adding to the net income deficit on the current account
    - the multiplier effect on national income may also serve to weaken the CAD by increasing spending on imports
    - portfolio investment can be destabilizing in that the funds may leave the country as quickly as they arrived
    - some of the investment funds do not go to wealth creating activity:
      - funds used for speculative property investment do not enhance the productive potential of the economy

The Business Cycle

- the concept of the business cycle
  - the pattern of expansion, contraction and recovery in the economy
  - generally speaking, the business cycle is measured and tracked in terms of GDP and unemployment – GDP rises and unemployment shrinks during expansion phases, while reversing in periods of recession.

- causes of the business cycle
  - economic Booms are caused by monetary policy that is too 'loose'. e.g. interest rates are too low and this encourages consumer spending and economic growth.
  - economic downturns occur when the economy runs out of steam or the monetary authorities seek to reduce demand to prevent inflationary pressures.

- characteristics of the phases, and causes, of the business cycle
  - boom: when the rate of economic growth and general level of economic activity is above average
  - recession: the downswing will often happen much more quickly than the upswing phase and may appear more dramatic if accompanied by other economic headlines (ie. Falling stock prices)
  - trough: the level of aggregate spending is below the economy's potential
  - upswing: the level of economic activity gradually rises as the economy resumes its long term growth path

- the relationship between the business cycle and economic indicators
  - indicators expose trends and help to forecast economic events in the future, they are an important input for business decision-making and planning
  - the only way we know whether the economy is expanding or contracting is by reviewing the economic indicators that are regularly collected by government bodies and the private sector.

The Aggregate Expenditure Model

- the components of aggregate expenditure (AE)
  - consumption: expenditure on non-durable goods, services, consumer durables
  - investment: business expenditure on new capital equipment which will produce final goods and services in the future; includes expenditure on new building and housing
  - government spending: current expenditure which provides for day-to-day functions of government; capital expenditure for future needs
  - net exports: value of exports minus the value of imports

- factors affecting each of the components of aggregate expenditure
  - consumption:
    - disposable income
    - interest rates
    - expectations
    - cost of credit
    - personal wealth
    - government policy
  - investment:
    - business expectations
    - interest rates
    - level of past profits
    - government policies
  - government:
    - determined in accordance with government policy objectives (health, education)
    - used to stabilize macroeconomics fluctuations
  - net exports:
    - domestic and overseas economic activity
    - tariffs, quotas, exchange rates, terms of trade

- the relationship between the consumption function, the marginal propensity to consume and the marginal propensity to save
  - consumption function: describes the relationship between income (Y) and what is spent on consumption (C)
  - the increase in consumption occurs with an increase in disposable income (income after taxes and transfers)
  - the fraction of an increase in income that is not spent on an increase in consumption. That is, the marginal propensity to save is the proportion of each additional dollar of household income that is used for saving. It is the slope of the line plotting saving against income.

- the concept of macroeconomic equilibrium
  - when the quantity of aggregate demand equals the quantity of aggregate supply

- demonstrate the impact of changes in aggregate expenditure on the equilibrium level of income/output using the AE model
    - significant changes in either aggregate demand or aggregate supply will have important effects on price, unemployment, and inflation

- the impact of changes in each of the components of aggregate expenditure i.e. the multiplier process using the AE model
    - if any one of the components increases, the aggregate expenditure will also increase
    - investment if most volatile and is so subject to the multiplier (needed for economic growth)
        - if investment is low, the government spending will increase
    - an increase in exports brings money into the economy
    - an increase in capital good imports is productive
    - an increase in consumer good imports is a leakage

The Aggregate Demand and Aggregate Supply Model

- the aggregate demand (AD) curve and factors that can cause movements along and shifts of the AD curve
  - changes in any of the elements of AE will bring about a shift of the AD curve:
    - changes in consumer spending due to a change in taxes, stock of wealth, expectations
    - changes in investment spending as a result of a change in interest rates, profit expectations, corporate taxes, etc.
    - changes in net exports due to changes in the exchange rate or the terms of trade

- the aggregate supply (AS) curve and factors that can cause movements along and shifts of the AS curve demonstrate macroeconomic equilibrium using the AD/AS model
  - the factors that bring about changes in the AS curve normally change slowly in the short run. They are:
    - changes in input prices such as labour or capital equipment, or the prices of commodities such as oil
    - changes in productivity as a result of improvements in technology or management
    - changes in the constitutional environment such as business regulations and the law

- demonstrate the impact of changes in aggregate demand and aggregate supply on the equilibrium level of income/output using the AD/AS model
  - the intersection of the AD and AS curve determines the equilibrium level of real output and the price level. AS represents the potential capacity of the economy at various price levels, while AD represents the aggregate level of demand for goods and services

- the use of the AD/AS model to explain the business cycle economic policy objectives
  - Fluctuations of economic growth about the trend level mainly reflect changes in the level of AD
  - Real output is lower, less upward pressure on prices
    (pg. 93 of WACE guide)

- the economic objectives of the Australian Government
  - to maintain an acceptable rate of growth – that is sustainable, 3-4% p.a.
  - to maintain a low rate of inflation (targeted by the RBA) at 2-3% p.a.
  - to keep unemployment as low as is naturally possible (without putting pressure on inflation) – now regarded to be around 4%
  - external balance: foreign debt – 40% of GDP and sustainable CAD – able to meet financial obligations to the rest of the world
  - to redistribute income
  - to allocate resources more efficiently

- the economic policy objectives of the Reserve Bank of Australia (RBA)
  - sustainable economic growth
  - price stability
  - full employment
  - external stability
  - income redistribution
  - efficient resource allocation
    [ALL BUT EXTERNAL STABILITY ARE REFERRED TO AS INTERNAL GOALS WHICH AIM TO ACHIEVE INTERNAL BALANCE IN THE DOMESTIC ECONOMY]

- three main economic policy "weapons" of the RBA and Federal Government
  - fiscal policy – Federal Government
  - monetary policy – controlled by the RBA
  - microeconomic reform (MER) Policy – Federal Government

- the extent to which the economic objectives of the Australian Government may conflict and complement each other
  - some of the economic objectives may be complementary with each other while others may be conflicting.
  - Makes the role of the Federal Government and the RBA very difficult because it requires a great deal of fine tuning in order to achieve the six economic objectives using the three main policy weapons at their disposal
  - They rely heavily on economic indicators and economic modelling in order to reach the best possible policy decisions and policy mix

- the time lags which occur in the use of economic policies i.e. recognition, decision (implementation) and effect (impact) lags
  - recognition lag: the economic indicators often fall behind the real trends
  - action lag: the time that passes whilst the appropriate policy is decided as it is influenced by the political as well as the economic process
  - implementation lag: the time between the announcement of a policy and that policy actually having an impact on the state of economic activity
  - outside lag (effect): time taken for the policy to have an effect on the economy

Fiscal Policy

- the concept of fiscal policy
  - the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy

- the components of government revenue and expenditure in the budget
  - government revenue:
    - direct tax (personal and company)
    - indirect tax (such as customs and excise duties and the GST)
    - other revenues (such as from public trading enterprises)
  - expenditure:
    - social welfare
    - health
    - education
    - defense
    - public administration

- the different budget outcomes i.e. balanced, surplus and deficit budgets
  - cash accounting method – underlying cash outcome (cash surplus or deficit)
    - calculated as total revenue less total overlays plus net advances (i.e. excluding sales tax)
    - net advances are one-off items such as purchases and sales of assets and debt transfer between Commonwealth and State governments.
    - headline – assets sales = underlying cash outcome
  - accrual accounting – the fiscal outcome (fiscal deficit or fiscal surplus)
    - calculated the same way but using the 'accrual accounting method', *for example, it includes the superannuation owed by the government to its workers, even if they are not actually paid out until their retirement.*
    - regarded as the most accurate long term indicator of fiscal policy
  - both remove the effect of one-off transactions that can distort the budget outcomes, such as the sale of government assets of the repayment of State government debts
  - headline budget outcome: one-off transactions (not useful indicator) assets simply transfer ownership of productive resources from the public sector to the private sector

- reasons that account for differences between planned and actual budget outcomes
  - each year the budget outcome changes from the forecast outcome due to changing economic conditions (cyclical or non-discretionary changes) and changes in fiscal policy (structural or discretionary factors)

- methods of financing a budget deficit and the uses of a budget surplus
  - non-discretionary changes in fiscal policy (gives rise to the cyclical component): when an economy is in recession, the budget deficit will increase, whereas during a period of strong economic growth the deficit will contract or the budget will shift into surplus
  - discretionary changes in fiscal policy (this affects the structural component): discretionary changes involve deliberate changes to fiscal policy, such as reduced spending or changing taxation rates

- the distinction between automatic fiscal stabilisers and discretionary fiscal policy
  - automatic stabilisers: can be defined as those changes in the level of government revenue and expenditure that occur as a result of changes in the level of economic activity. They are referred to as "automatic" because they are built into the system, and are activated by a change in the level of economic activity, and not a change in government policy relating to their revenue or expenditure. These are non-discretionary changes in fiscal policy

- the distinction between budget outcomes associated with automatic fiscal stabilisers and budget outcomes associated with discretionary fiscal policy
  - unemployment benefits: an increase in unemployment leads to greater government expenditure on unemployment benefits. Thus, a decline in the level of economic activity automatically leads to an increase in government expenditure (and vice versa)
  - progressive income tax system: rising incomes moves workers into higher income tax brackets, and previously unemployed persons start paying income tax. Both situations automatically lead to an increase in government taxation revenue (and vice versa)

- the concepts of expansionary, contractionary and neutral fiscal policy stances
  - expansionary stance: when the government is planning to reduce taxation revenue and/or increase government expenditure, creating either a smaller surplus, or a larger deficit than it had previously. This expansion leads to a multiplied increase in consumption and investment and stimulates aggregate demand which will increase the level of economic activity
  - contractionary stance: when the government is planning to increase taxation revenue and/or decrease government expenditure, creating either a smaller deficit or a bigger surplus than it had the previous year. The contraction leads to a multiplied decrease in consumption and investment, dampening demand which will decrease economic activity
  - neutral stance: when the government plans to maintain the gap between revenue and spending at around the same level as the previous year, there will be no effect on the overall level of economic activity

- the impact of different fiscal policy stances on the level of economic activity

  impact of fiscal policy on
  - resource use:
    - fiscal policy changes can influence the use of resources in the economy directly or indirectly
    - directly – affects resource use through government spending in a particular area of economic activity
    - indirectly – this influence covers tax and spending decisions that do not involve government directly changing resource use, but make it more or less attractive for resources to be used in a particular way
    - more likely to use direct measures if they expect that markets will not provide the resources quickly enough without government intervention
    - might pay directly to provide a public good which the private sector is unlikely to pay for, and which is difficult to prevent anyone else from using
  - income distribution
    - people on higher incomes pay higher rates of income tax, allowing a government to use this money for social welfare, community services and other types of social expenditure, which is particular assists people on lower incomes
    - taxation arrangements – a reduction in tax rates at the upper end of the income scale would make the system less progressive and ay create a less equal distribution of income
    - raise GST

- strengths and weaknesses of fiscal policy
  - advantages:
    - it can significantly impact the national income and therefore have immediate effect on the economy
    - taxes on negative externalities decreases consumption of negative externalities or demerit goods
    - subsidizing merit goods or public goods will increase the consumption
    - tax cuts on wages encourages people to work and therefore, shift the long run aggregated supply curve to the right
    - different rate of taxes on different levels of income reduces gap between the rich and the poor
    - in long term can benefit the society in many different ways

continued…

- disadvantages:
  - inflexibility. Changes in direct taxes or government spending may take considerable time because of both political and moral reasons. For example, taxing rich people more than the others might be unfair for them
  - another problem can rise when solving the other. For example, stimulating aggregated demand to decrease the demand-deficient unemployment may worsen inflation because right shift in aggregated demand will cause rise in price level
  - decreasing aggregated demand in order to decrease inflation will cause demand-deficient unemployment

- contemporary (the last three years) fiscal policy stances in Australia Monetary policy
  - budget (every May)
  - current stance = deficit budgets = G > T
  - budget designed to be adjusted to where we are in the business cycle
  - discretionary fiscal policy = budget, deficit, G>T
  - non-discretionary fiscal policy = business cycle, where we are on the cycle, automatic stabilisers (e.g. the dole)

Monetary Policy

- the concepts of monetary policy and the cash rate
  - monetary policy: the macroeconomic policy laid down by the central bank, involving the management of money supply and interest rate and is the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth and liquidity
  - cash rate: the interest rate charged on overnight loans between banks. Australia uses an explicit inflation target, which in the past has been around 2 to 3 percent a year
  - a decrease in cash rate will stimulate the economy

- circumstances under which the RBA may change the cash rate
  - decrease cash rate to stimulate the economy through the transmission mechanism
  - increase cash rate to slow the economy through the transmission mechanism

- how monetary policy affects the level of economic activity i.e. the transmission mechanism
  - there are a number of different aspects to the transmission mechanism, because changes in interest rates effect:
    - saving and investment decisions;
    - the cash flow of households and firms;
    - wealth and asset prices; and
    - the exchange rate
  - a rise in interest rate will increase the incentive to save because it will increase the return on deposits with financial institutions. At the same time, a rise increases the cost of borrowing funds and so will reduce spending by households and reduce the demand finance. A rise will reduce the demand for investment funds because it will affect the profitability of many investment projects.
  - interest rates also affect the cash flow position of both households and firms
  - interest rates also affect the exchange rate

- the concepts of expansionary, contractionary and neutral monetary policy stances
  - expansionary monetary policy: an increase in government expenditures and/or a decrease in taxes that causes the government's budget deficit to increase or its budget surplus to decrease
  - contractionary monetary policy: expands the money supply more slowly than usual or even shrinks it
  - neutral monetary policy: a rate or range of rates that neither stimulates nor contracts the economy

- the impact of different monetary policy stances on the level of economic activity
  - on inflationary expectations…
    - spending decisions are affected by perceptions about the stance of monetary policy. Perceptions of likely price stability will be influenced by monetary policy actions.
  - on wealth and asset prices…
    - a rise in interest rates will make shares less attractive compared to bonds:
    - prices on shares on the stock market will fall which will decrease the wealth
  - on the exchange rate…
    - higher interest rates will encourage an inflow of financial capital
    - this should lead to a currency appreciation, forcing up the price of Australia's exports on world markets
    - import prices should fall making imports more attractive
    - as a result, there should be a contraction in domestic economic activity
      this effect will reinforce the decrease in AE
  - on the level of economic activity…
    - consumption
      - a rise in interest rates increases the attractiveness of saving – increases the reward for postponing consumption
      - encourages households to defer consumption on spending- especially in areas which are sensitive to interest rate changes *i.e. consumer durables and housing*
      - a rise in interest rates will also cause existing borrowers to have less liquidity *e.g. if mortgage rates rise, households have less to spend on other things*
      - some households who don't owe money enjoy an increase in their income (from the higher interest paid on assets)
      - overall the RBA believes the net effect of an interest rate rise is contractionary – particularly because our borrowers are hugely indebted

continued…

- investment
  - in making the investment decision, business compare the anticipated returns on a project (MEC) with the cost of borrowed funds (the interest rate)
  - marginal efficiency of capital (MEC) = expected profits/costs of investment x 100
  - if the MEC is greater than the interest rate, the project is viable
  - higher interest rates reduce the number of investment projects

A rise in interest rates from r1 to r2 will reduce investment spending from Q1 to Q2, causing the AE function to fall from AE1 to AE2. This will lead to multiplied decrease in output and employment from Yr1 to Yr2.
A fall in interest rates will have the opposite effect.

- strengths and weaknesses of monetary policy
  - advantages:
    - The rate of interest may be changed at short notice and regular intervals and may have a significant impact on short-term economic activity. In particular, it has been found to be relatively effective at controlling inflation.
    - changes in the money supply and exchange rate may also exert a considerable influence on the level of aggregate demand
    - An increase in lending would subsequently increase economic activity in the economy.
  - disadvantages:
    - Time lags: it may take considerable time for the policy measures to influence aggregate demand. *For example, a change in the rate of interest is unlikely to immediately influence consumption and investment plans*
    - Conflict between policies: a rise in the rate of interest, *for example, designed to reduce inflation may lead to increased unemployment*
    - Discriminatory impact: a rise in interest rates may increase business costs (cost of borrowing increases) and increase the exchange rate (demand for the currency increases) thus making exports more expensive which may discriminate against manufacturers engaged in exporting, as well as borrowers

continued…

- Limited scope for change in reality: if one country's interest rates get too much out of line with those of other countries, there will be considerable inflows or outflows of funds. In addition, countries which are part of a monetary union, *for example the European Monetary Union*, have their interest rates dictated to them by the European Central Bank and are not free to alter their interest rates independently.

- contemporary (the last three years) monetary policy stances in Australia
  - 2013-2016: monetary policy was tight
  - cash rate is currently at 1.75%
  - cash rate had fallen 2% over this time
  - banks and building societies, etc. are not passing on the full amount. For example, 3 August, Westpac, Commonwealth Bank passed on 0.15% of the 0.25% to customers. This slows and reduces the effectiveness of the transmission mechanism.

Structural Change

- the concept, and main causes, of structural change
  - an economic condition that occurs when an industry or market changes how it functions or operates
  - Factors of structural change:
    - economic development
    - global shifts in capital and labor
    - changes in resource availability due to war or natural disaster or discovery or depletion of natural resources
    - a change in political system

- the effects of structural change
  - short term unemployment (structural)
  - long term growth in new industries
  - wages growth

- the relationship between economic growth and structural change
  - an increase in structural change will increase economic growth
  - improvement in efficiency will improve economic growth
  - structural change needs to lead to economic growth, otherwise it is not sustainable
  - efficiency leads to growth
    - three kinds of efficiency:
      - dynamic: keeping up with changes
      - market efficiency: prices
      - productivity at the lowest input cost and achieving the highest output

Measures to Improve Productivity

- the concept of productivity
  - the effectiveness of productive effort, especially in industry, as measured in terms of the rate of output per unit of input

- the distinction between labour productivity and multifactor productivity
  - labor productivity: measures the output per unit of labor input
  - multifactor productivity: measures the changes in output per unit of combined inputs of labor, materials, and capital

- the relationship between productivity and economic growth
  - productivity = output / time
  - growth in productivity leads to a growth in goods and services and real GDP
  - long term increase in output will produce more goods and services and increase real GDP (a measure of growth)

- recent (the last ten years) government policies that promote productivity and economic growth, such as labour market reform, taxation reform, trade liberalisation, deregulation and competition policy, investment in infrastructure, education and training, research and innovation
  - all these are examples of increased productivity (MER)
  - all designed to improve factors of production

- the impact of productivity on the achievement of macroeconomic objectives
  - full employment: increase in productivity leads to more jobs
  - price stability: efficiency will decrease prices and costs
  - economic growth: lead to an increase in jobs which will see an increase in efficiency and real GDP

absolute advantage:	ability to produce more of a good with the same amount of resources or; ability to produce the same amount of a good with fewer resources
appreciation:	the currency has increased in value and price
boom	when the rate of economic growth and general level of economic activity is above average
business cycle	the pattern of expansion, contraction and recovery in the economy
cash rate	the interest rate charged on overnight loans between banks. Australia uses an explicit inflation target, which in the past has been around 2 to 3 percent a year
comparative advantage:	ability to produce at a lower opportunity cost than its trading partner; specialize in the production of a good they are least inefficient at
consumption	expenditure on non-durable goods, services, consumer durables
contractionary fiscal policy	a decrease in government expenditures and/or an increase in taxes that causes the government's budget deficit to decrease or its budget surplus to increase
contractionary monetary policy	expands the money supply more slowly than usual or even shrinks it
depreciation:	the currency has decreased in value and price
embargoes:	complete ban on importation of a good
expansionary fiscal policy	an increase in government expenditures and/or a decrease in taxes that causes the government's budget deficit to increase or its budget surplus to decrease
expansionary monetary policy	increases the total supply of money in the economy more rapidly than usual
fiscal policy	the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy
foreign debt (external debt):	the amount of money that Australia residents, public and private, owe to the rest of the world
foreign equity:	the extent to which foreign residents own Australian assets
foreign investment:	the stock of financial assets in Australia owned by foreign residents
foreign liabilities:	include both foreign debt and foreign equity
globalisation:	the process by which businesses or other organizations develop international influence or start operating on an international scale
government spending	current expenditure which provides for day-to-day functions of government; capital expenditure for future needs

international competitiveness:	the achievement and maintenance of competitiveness has come to determine the difference between success and failure in international economic performance
investment	business expenditure on new capital equipment which will produce final goods and services in the future; includes expenditure on new building and housing
labor productivity	measures the output per unit of labor input
macroeconomic equilibrium	when the quantity of aggregate demand equals the quantity of aggregate supply
monetary policy	the macroeconomic policy laid down by the central bank, involving the management of money supply and interest rate and is the demand side economic policy used by the government of a country to achieve macroeconomic objectives like inflation, consumption, growth and liquidity
multifactor productivity	measures the changes in output per unit of combined inputs of labor, materials, and capital
net exports	value of exports minus the value of imports
net foreign assets:	the value of overseas assets owned by a nation, minus the value of its domestic assets that are owned by foreigners, adjusted for changes in valuation and exchange rates.
neutral fiscal policy stances	fiscal neutrality occurs when taxes and government spending are neutral, with neither having an effect on demand. Fiscal neutrality creates a condition where demand is neither stimulated nor diminished by taxation and government spending
neutral monetary policy	a rate or range of rates that neither stimulates nor contracts the economy
productivity	the effectiveness of productive effort, especially in industry, as measured in terms of the rate of output per unit of input
quota:	restriction on the quantity of goods allowed to be imported
recession	the downswing will often happen much more quickly than the upswing phase and may appear more dramatic if accompanied by other economic headlines (ie. Falling stock prices)
regional trading blocs:	a group of countries within a geographical region that protect themselves from imports from non-members
structural change	an economic condition that occurs when an industry or market changes how it functions or operates
subsidies:	financial assistance from the government (shifts the supply curve to the right)
tariff:	indirect taxes on imports

terms of trade index:	the proportion of overseas trade in relation to the GDP
terms of trade:	relative price of imports and exports
the trade weighted index:	measures the Australian dollar against a basket of 22 currencies of Australia's main trading partners
trough	the level of aggregate spending is below the economy's potential
upswing	the level of economic activity gradually rises as the economy resumes its long term growth path