

HSC Economics 2010

Summary Notes

Jamie Kennedy

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The Global Economy

FEATURES OF THE GLOBAL ECONOMY

NATURE OF THE GLOBAL ECONOMY AND GLOBALISATION

THE GLOBAL ECONOMY

- Trade in Goods and Services had grown rapidly increasing from 38% of GWP in 1990 to 63% of GWP in 2007.
- GWP is now 9 times the level in 1950 however the volume of world trade has grown 33 times it's 1950 level
- During times of economic downturns, the growth of global trade has contracted faster than world economic output highlighting the **greater volatility of trade** compared to GWP.
- Important development that has contributed to these flows is the increased influence of **Transnational Corporations**.
- **Transnational Corporations**: global companies that dominate global product and factor markets. TNCs have production facilities in at least two countries and are owned by residents of at least two countries.
- Trade has also lifted in response to major trade agreements:
 - **World Trade Organisation (WTO)**: is an organisation of 153 member countries that implements and advances global trade agreements and resolves trade disputes between nations. Established in 1995
 - North American Free Trade Agreement (NAFTA)
 - Association of South East Nations (ASEAN)
 - European Union (EU)

GROSS WORLD PRODUCT

- **Gross World Product (GWP)**: the sum of total output of goods and services by all economics in the world over a period of time.
- In the industrialised world the value of what many countries buy and sell from overseas is greater than half of the country's economic output

GLOBALISATION

- **Globalisation**: the process of increased integration between different countries and economies and the increased impact of international influences on all aspects of life and economic activity.
- Involves layers of influences in all directions
- Major indicators of integration between economics include:
 - International trade flows
 - International financial flows
 - International investment flows and transfers of technology
 - The movement of workers between countries

International Finance

- Finance is the most globalised feature of the world economy as money can move in seconds around the world, far more quickly than goods and services or people
- International finance flows have expanded following financial deregulation around the world (mainly during the 70's and 80's)
- Technological change also played a role with new technologies and global communication allowing financial markets to be linked throughout the world.
- International financial flows have all shown a dramatic increase during the globalisation era

Growth of international investment and technology

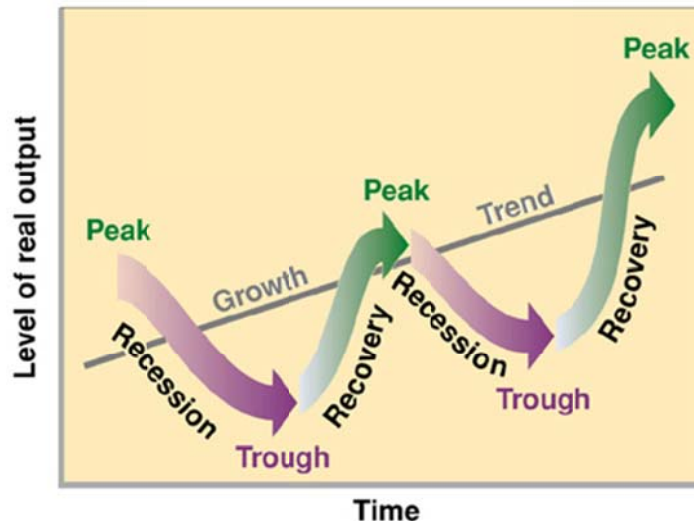
- Another indicator of globalisation is the rapid growth of investment between countries over the past 20 years.
- One measure of globalisation investment is the expansion of **Foreign Direct Investment (FDI)**.
 - **Foreign Direct Investment (FDI)**: the movement of funds between economies for the purpose of establishing a new company or buying a large portion of shares in an existing company (10%+). FDI is considered to be a long term investment.
 - FDI flows are strongly influenced by the level of economic activity.
 - FDI flows have heavily favoured the developed nations of the Organisation for Economic Co-operation and Development (OECD).
- A significant cause of the growth of international investment is the increased level of international mergers and takeovers.
- However, FDI in 2007 only accounted for 18% of total investment, 80% still came from within national economies.
- Technology has played a significant role in the expansion of trade and investment between countries. Countries can export their technologies and other countries have to pay royalties for them until they are able to produce the technology themselves.

The Internationalisation of the labour market

- Labour markets are far less internationalised. People do not move jobs freely.
- A recent trend in industrialised countries has to become more restrictive about immigration of people from poorer countries.
- World Bank estimates that 3% of the world's population have migrated to work in different countries in the world.
- Movement appears to be at the top and low end of the labour market.
 - At the top end, skilled workers are attracted to jobs in countries that pay a higher income
 - The "brain drain" effect where skilled workers leave a country to work in another country.
 - At the low end, there is demand of unskilled labour to perform jobs that people born locally may not want to perform
- There are many restrictions to the movement of labour including: immigration restrictions, cultural factors, and education and professional qualifications.
- Shift of businesses between economies: just as people move to find jobs, businesses may move to other countries to find labour. Producers may operate a global supply chain with production facilities in many countries. This is called "off shoring" and allows producers to reduce costs. This means that export oriented economies can compete due to low labour costs.

THE INTERNATIONAL BUSINESS CYCLE

- Economic growth moves in cycles. The ups and downs of the business cycle are caused by changes in the level of economic aggregate demand and supply. Over time, economies usually experience an overall trend of growth in output (increase in GDP).



- International Business Cycle:** the ebb and flow of world economic growth. Refers to changes in the level of economic activity in the global economy over time. Economies are synchronized hence economic growth is stronger when the rest of the world is growing and weaker when other countries are experiencing a downturn.
- The transmission of economic conditions from one country to another is made more immediate by the increased integration of economies during the globalisation era:
 - Trade flows: the level of economic growth will have flow on effects on the economic activity of its trading partners.
 - Investments flows: stronger economic conditions in one country will make it more likely that it will invest in another country adding to their economic growth.
 - Transnational corporations: Good economic conditions in one country may lead to increased investment in other countries as TNCs seek to increase their productive capacity and expand.
 - Financial flows: short term financial flows also play an important role in transmitting the international business cycle
 - Financial market and confidence: consumer confidence and investors are influenced by conditions in other countries. Correlation between movements in share prices of the major stock exchanges
 - Global interest rate levels: Monetary policy in individual economies are influenced by the policy of other countries
 - International organisations: such groups as the G8 can have significant impacts on global economic activity and can have major impacts on policy decisions for other countries

- Factors that influence the business cycle but differ between economies:
 - Interest rates: are determined by each country (but can be influenced by others)
 - Fiscal policy: significant effect on economic growth in the short to medium term. Set by individual governments (but may be influenced by others)
 - Exchange rates: differ between countries and impact on the level of trade competitiveness.
 - Structural factors: different levels of resilience, population growth rates, regulations, education etc.
 - Regional factors: some economies are closely integrated with their neighbours and are influenced by the economic performance of their major trading partners

Factors that strengthen the international business cycle	Factors that weaken the international business cycle
• Trade flows	• Domestic interest rates
• Investment flows, investor sentiments	• Government fiscal policies
• Transnational corporations	• Other domestic economic policies
• Financial flows	• Exchange rates
• Technology	• Structural factors
• Global interest rates	• Regional factors
• International organisations	

TRADE AND FINANCIAL FLOWS

CHANGES IN THE SIZE, PATTERN AND DIRECTION OF TRADE AND INVESTMENT

- Global trade flows have changed during the globalisation era, increasing in overall size and as a proportion of world economic activity. The composition and direction of trade flows has also changed during recent years.
- Composition of international trade: the mix of goods and services that nations trade with each other. Mainly manufactured goods.
- Direction of trade flows: During the globalisation era, high income economies saw their overall share fall while fast growing economies in East Asia and the Pacific saw their share rise.

THE FOREIGN EXCHANGE MARKET

- **Foreign Exchange Markets (FOREX):** a network of buyers and sellers exchanging one currency for another where the value of a currency is expressed in terms of another currency (i.e.: the exchange rate).
- The value of a country's currency has significant impacts upon the international competitiveness of the country.
 - Countries with overvalued economies tend to experience a decline in exports
 - Currency values can also influence the level of inflation and interest rates
 - Changes in the value of exchange rates also have an effect on financial flows in the short term
 - If a larger number of investors sell their holdings of a country's currency to make a quick profit, it can destabilise an entire economy.

THE MAIN PARTICIPANTS IN FOREIGN EXCHANGE MARKETS

- Three main categories: speculators, traders, those who are making long term investments.
 - Currencies are bought and sold to make possible the purchase and sale of goods and services between an economy and other economies. Exporters in world trade want to be paid in their own currency; importers need to be able to convert their currency into a foreign currency to make a payment. This only represents a small portion of overall foreign exchange transactions.
 - Foreign Investors: purchase assets in another country such as property or shares and need to convert into the local currency. Only represents a small amount of foreign exchange transactions.
 - Speculators: make short term currency trades through shifting money in and out of a currency or through derivatives. The aim is to make gains from short term movements in the currency. Represents over 95% of the daily trade on FOREX markets.

THE IMPACT OF CHANGES IN TRADE AND FINANCIAL FLOWS ON ECONOMIES

- Shifts in trade will affect the structure of a domestic economy over time.
 - If an economy is experiencing increased demand for particular exports, resources in that economy will shift towards increasing the production of the good or service
 - If an economy is experiencing a decline in overseas demand for a good or service, producers may shift resources away from the production of the good or service
 - Trends in the direction of trade can have an impact on individual economies (i.e.: Australia responding to the increasing direction of trade to China)
- Changes in financial flows in the short term can have an effect on the financial markets but in the long term they can have a substantial effect on the real economy.
- They have an effect on confidence within a country. Weak confidence may slow down the rate of economic growth and vice versa.
- Large currency movements can also destabilise financial markets

FREE TRADE AND PROTECTION

THE BASIS OF FREE TRADE — ITS ADVANTAGES AND DISADVANTAGES

- Fundamental assumption that trade is a good thing and that economies will achieve the fastest level of growth in a free trade environment.
- **Free trade:** a situation where governments impose no artificial barriers to trade that restrict the free exchange of goods and services between countries.
- Argument for free trade is based on the idea of comparative advantage:
 - **Comparative advantage:** economic principle that nations should specialise in areas of production in which they have the lowest opportunity cost and trade with other nations.
 - **Opportunity cost:** the alternative use of resources. Represents the cost of satisfying one want over an alternative want – the cost of the alternative foregone.

Advantages of free trade	advantages of free trade
<ul style="list-style-type: none"> Allows countries to obtain goods and services that they themselves cannot produce or in sufficient quantities. 	<ul style="list-style-type: none"> Increase in short term unemployment as domestic companies find it difficult to compete
<ul style="list-style-type: none"> Allows countries to specialise in the production of goods and services for which they are more efficient 	<ul style="list-style-type: none"> More difficult to establish businesses
<ul style="list-style-type: none"> Encourages the efficient allocation of resources (allocation efficiency) when specialising 	<ul style="list-style-type: none"> Productions surpluses may be dumped
<ul style="list-style-type: none"> Specialisation leads to greater economies of scale lowering average costs of production 	<ul style="list-style-type: none"> May encourage environmentally irresponsible production methods if goods are produced at a lower cost due to environmentally damaging practices
<ul style="list-style-type: none"> International competitiveness will increase as domestic businesses face greater international pressure → increased efficiency 	
<ul style="list-style-type: none"> Encourages innovations the spread of technology and production processes 	
<ul style="list-style-type: none"> Leads to higher living standards, increased consumer choice 	

REASONS FOR PROTECTION

- **Protection:** any type of government action that has the effect of giving domestic producers an artificial advantage over foreign competitors
- Main methods are: **tariffs, import quotas and subsidies**
- Most countries tend to have some sort of protection to protect their local industries
- There are a few arguments in favour of protection:
 - **Infant industries:** new industries face many difficulties and risks in their early years so governments protect these industries until they are large enough to be more competitive. This type of protection should only be temporary.
 - **Dumping:** when foreign firms attempt to sell their goods in another country's market at unrealistically low prices. This could be used to get rid of large surpluses to establish a market position in another country. Using protectionist methods to prevent dumping is one of the few accepted arguments by economists. However, the WTO has been questioning if some countries have been abusing their entitlement to prevent dumping by falsely accusing low cost producers of dumping.
 - **Protection of domestic employment** is one of the most popular arguments in favour of protection is that it saves local jobs. If local firms are protected against cheaper foreign imports then demand for local goods will be greater leading to more domestic employment.
 - **Defence and self-sufficiency** is one of the non-economic reasons that a country may want to retain certain industries. For example, the US would want to retain its defence production in times of war to ensure that it has ready access to defence equipment in times of war. Japan places high tariffs on rice imports because they want to protect their local industry to ensure that they have a reliable supply of food if ever a blockade were placed on it.
- Other factors can include:

- Trade unions against low cost labour from other countries
- Environmental factors such as the environmental hazard involved in the production of some goods.
- Spill over effects that certain industries may have on other industries within a country.

METHODS OF PROTECTION AND THE EFFECTS OF PROTECTIONIST POLICIES ON THE DOMESTIC AND GLOBAL ECONOMY

- **Tariff:** a government imposed tax on imports. It has the effect of raising the price of the imported good making the domestic producer more competitive.
- **Quotas:** control the volume of a good that is allowed to be imported over a given period of time. This means that the domestic producers are guaranteed a share of the market
- **Subsidies:** involve financial assistance to domestic producers which enables them to reduce their selling price and compete more effectively with imported goods. Economists generally prefer subsidies instead of tariffs as it is government expenditure and not a tax so it will be more likely to be reviewed.
- **Voluntary Export Restraints:** As part of trade negotiations, some countries may voluntarily agree to restrict the number of exports to another country in return for a similar concession.
- **Local Content Rules:** Specify that a good must contain a minimum percentage of locally made parts. In return, the imported good will not attract a tariff.
- **Export incentives:** programs that give domestic producers assistance such as grants, loans or technical advice to encourage businesses to penetrate the global market or expand their market share.

CONTEMPORARY TRADING BLOCS AND AGREEMENTS

THE ROLE, IMPORTANCE AND INFLUENCE IN THE GLOBAL ECONOMY OF BLOCS AND AGREEMENTS

- Countries have formed agreements to attempt to gain from growing trade opportunities and avoid being excluded from regional trading blocs.
- Two major types exist:
 - **Preferential** free trade agreements (regional or bilateral)
 - **Multilateral** agreements which are open to all nations
- A **trading bloc occurs** when multiple countries join together and form a preferential trade agreement to the exclusion of other countries such as the European Union
- Free trade agreements are formal agreements between countries designed to break down barriers to trade between those nations. The agreement is said to be bilateral when it is between two countries and regional when it is between three or more countries in close geographical proximity.
- These preferential free trade agreements do not benefit non-members and do not create a better environment for free trade at all whereas multilateral agreements conducted through the WTO are designed to break down all trade restrictions and free up world trade.
- Many economists argue that regional and bilateral trade agreements that lead to the formation of trading blocs and hinder the progress of world trade because they slice the world up into separate trading areas. Other economists argue that regional trading agreements are a stepping stone towards free trade.

- Regional trade agreements have grown in recent decades with Mongolia the only WTO country that is not a signatory to a regional or bilateral trade agreement. Economists have termed this regionalisation instead of globalisation.
- Regional trade agreements have not done much to help smaller developing countries accessing rich countries' markets. Regional trade agreements tend to entrench global inequalities.

EU, NAFTA, APEC, ASEAN, CERTA

- APEC (Asia Pacific Economic Cooperation) Forum: made up of 21 member nations in the Asia-Pacific established in response to other regional trading blocs such as the EU and NAFTA. Accounts for 40% of the world's population, 53% of the world GDP and 48% of world trade
- EU (European Union): Member countries span across Europe with 27 member countries. The aim is to have a single market for European goods and services however the EU has also raised tariffs against non-member countries (resulting in accusations that the EU is a closed trading bloc). Its protectionist methods have forced other larger players (such as the US) to respond with similar methods forcing out smaller players such as Australia.
- NAFTA (North American Free Trade Agreement): was established in 1994 in which agricultural protection is being completely eliminated and other tariffs are being phased out over a period of 5-15 years. NAFTA has resulted in a significant increase in trade among its members with access to the US resulting in significant exports for other members while the US has benefitted by accessing the cheaper labour markets available in some of the other member nations such as Mexico.
- Bilateral Trade Agreements: agreements between two countries such as Closer Economic Relations Trade Agreement (CERTA) between Australia and NZ which has led to the elimination of trade restrictions between the two countries. CERTA has been extended in recent years to include business regulations and tax laws
- ASEAN (Association of South East Asian Nations): covers the NIEs in South East Asia but does not include any of the large economies. ASEAN is a counter weight to APEC.

INTERNATIONAL ORGANISATIONS

THE ROLE, IMPORTANCE AND INFLUENCE IN THE GLOBAL ECONOMY OF INTERNATIONAL ORGANISATIONS

- One of the problems created by globalisation is the inability of domestic institutions to regulate the increasing complex nature of business transactions. Many economic problems can only be addressed at a global level such as:
 - Managing global instability in financial markets
 - Providing economic assistance
 - Developing global standards for environmental protection
 - Freeing up world trade and resolving trade disputes
- In the long term, the global economy will need a strong global institution to deal with these problems. However, today there are three major institutions in the global economy. These are:
 - WTO: World Trade Organisation
 - IMF: International Monetary Fund
 - World Bank
- In addition there are several other groups:

- G8: Group of Eight nations
- World Economic Forum
- UN bodies

WTO, IMF, WORLD BANK

- WTO (World Trade Organisation):
 - 153 member nations in 2009
 - Role of the WTO is to implement and advance global trade agreements and to resolve trade disputes.
 - Generally effective in its task.
 - Questions raised about the WTO dispute resolution mechanism as shown by the US and EU lodging appeals and delaying any rulings.
 - Recent focus has been on the Doha Round of trade liberalisation however there have been many disagreements and talks broke down in 2008.
- IMF (International Monetary Fund):
 - Consists of 186 members
 - Role is to maintain international financial stability particularly in the forex markets
 - IMF plays a role in minimising the impacts of a financial crisis anywhere around the world
 - Played a significant role during the 2008 GFC by suspending interest payments, injecting cash into the global economy to promote liquidity.
 - IMF supports the free trade of goods and services and often requires countries to structurally change their policy before receiving financial assistance from the IMF. The **structural adjustment policies** have played a key role in the globalisation process
 - IMF has been criticised for sometimes for making incorrect decisions eg: demanding that governments adopt a contradictory macroeconomic policy during the Asian Financial Crisis of the 1990's
- World Bank:
 - Role is primarily concerned with helping poorer countries with their **economic development**. Fund investment for infrastructure, reduce poverty, help countries adjust their economies to the demands of globalisation
 - Funded by contributions from member countries and its own borrowings
 - Makes loans to developing countries at below standard rates
 - Recently, the major aim (as per the **Millennium Development Goals**) has been to reduce the proportion of people living on less than \$1/day as well as achieve universal primary education, reduce child mortality, preserve the natural environment, improve the status of women.
 - Support of **Heavily Indebted Poor Countries** to reduce debt by 2/3 of the world's poorest countries.

IMPACT OF GLOBALISATION ON THE STANDARD OF LIVING IN THE GLOBAL ECONOMY

VARIATIONS IN THE STANDARD OF LIVING IN THE GLOBAL ECONOMY

- Despite the advances over the past century, there are harsh inequalities between wealthy and poor countries:
 - 1.4 billion people live in **extreme poverty** on less than US\$1.25/day
 - Richest 5% of people in the world earn 165x the income of the poorest 5%
 - 30,000 children die each day from poverty-related preventable diseases
- However, living standards have been improving in both developing and developed nations:
 - Between 1982-2005 those living in extreme poverty fell from 52% to 25%
 - Life expectancy in developing nations from 56 to 67 years between 1970 and 2007
 - Primary education completion rate increased in developing countries to 85% in 2007

INCOME AND QUALITY OF LIFE INDICATORS

- The most popular method to compare living standards between nations is to compare income as it measures the ability of citizens to satisfy their needs.
- **Gross National Income (GNI)** is the sum of value added by all resident producers in an economy plus receipts of primary income from foreign sources.
- **Real GNI** is calculated by accounting for the effects of inflation
- **Purchasing Power Parity (PPP)**: used to make adjustments before comparing the GNI between countries. PPP adjusts measurements of the size of an economy to reflect the purchasing power of currencies within a national economy.
- The size of the population and rate of population growth vary between countries and allowances can be made by dividing the real GNI of each country by its population – **GNI per capita**.
- **Human Development Index (HDI)**: An alternative to the GNI is the HDI to measure economic development. It takes into account:
 - **Life expectancy at birth**: Indicative of the health and nutrition standards of a country
 - **Levels of education attainment**: HDI measures adult literacy and ratio of people that have completed primary, secondary and tertiary education
 - **GDP per capita**: Used as a measure of a decent standard of living and is essential in determining access that people have to goods and services

CONTRASTS IN LEVELS OF DEVELOPMENT

DIFFERENCE BETWEEN GROWTH AND DEVELOPMENT

- Economic growth is simply a percentage increase in GDP/capita
- Economic development is broad measure of welfare in a nation that includes indicators of health, education, and environmental quality as well as material living standards.

REASONS FOR DIFFERENCES BETWEEN NATIONS

Global Factors:

- Global Trade System: Some features of the global trade system reinforce rather than reduce global inequalities
 - Western economies protect their domestic agriculture sector because it is not competitive with producers in developing nations. Developing countries experience high levels of **global protectionism in the agricultural sector**.
 - **Expanding regional trade blocs** such as the EU and NAFTA exclude poorer nations from access to these lucrative markets. This has an enormous impact on poor countries.
 - High-income nations have resisted making concessions on issues that would provide great benefit to developing countries such as at the Doha Round. They can then use regional and bilateral agreements to gain access to markets where developing nations cannot bargain as a group.
 - Benefits of free trade agreements are not always available to developing nations due to the high costs of administration and the complexity of the WTOs procedures.
- Global Financial Architecture:
 - Long term international flows of investment heavily favour developed countries. High income economies received around 2/3 of all FDI in 2007
 - Short term financial flows often favour those “emerging markets” that offer better returns for speculators however these areas also experience the greatest economic volatility which can set back economic development decades while speculators move onto other markets.
 - The IMF is criticised that its structural adjustment policies serve the interests of high income economies.
 - As a result of greater access to financial markets, many developing countries have massive **foreign debt burdens** – irresponsible lending practises by rich-country financial institutions.
- Global Aid and Assistance:
 - The total level of development aid provided by high income economies was only 0.3% of GWP in 2008. This level is well below the goal of 0.7% of GDP that high income economies have been committed to. There is also a risk that high income economies may cut aid to help pay off the deficits caused by the GFC.
 - Critics claim that the majority of the aid given is “phantom aid” – aid that does not improve the lives of the poor. Money is spent on paying for “technical cooperation” (consultants) as well as being wasted on administration costs
 - The distribution of aid usually represents strategic and military considerations rather than the need of the world’s poorest countries.
- Global Technology Flows:
 - High income economies choose the priority areas of scientific research and development. Much of this technology deals with the health problems of an ageing population in rich countries and little to do with poor nations whose health risks involve common infectious diseases.
 - Developing nations find it difficult to gain access to new technology. IP rights restrict the benefits of technological transfer to poor nations because they cannot pay developed country prices for the technology.

Domestic Factors:

- Economic Resources:
 - **Natural resources:** are important inputs for the production of higher-value added manufactured goods and services. Economies that have an abundant and reliable supply of cheap natural resources have better opportunities for economic development than those who do not. Abundance of natural resources may also be a negative which can hamper a country's economic development if it leads to an overvalued exchange rate, narrow export base and becoming over reliant on a small number of industries to drive economic growth
 - **Labour supply and quality:** Labour is an important factor in becoming the most important input to the production process. High income economies tend to have highly educated and skilled labour resources whereas low income nations are characterised by high population growth, poor education levels and low health standards which reduces the quality of labour.
 - **Access to capital and indebtedness:** Difficulty in gaining access to capital for investment and development in low income nations also contributes to lowered living standards. Low levels of savings are largely a result of low income levels and this creates a self-perpetuating cycle of low investment levels and slow expansion. Enterprises in countries with high levels of foreign debt often find it difficult to gain access to funds.
- Entrepreneurial culture:
 - Evidence suggests that a country's history and social institutions can impact on its economic success such as the values of individual responsibility, enterprise, wealth creation and a strong work ethic. These values can assist the industrialisation process towards sustainable economic development
- Institutional factors:
 - Institutional factors in individual economies can have influences for businesses. Political instability, corruption, and law of law enforcement tend to undermine investor confidence who will be reluctant to undertake risks if their business interests are threatened by inadequate structure for resolving legal disputes.

DEVELOPING ECONOMIES, NEWLY INDUSTRIALISED COUNTRIES (NICS), TRANSITION ECONOMIES, HIGH INCOME ECONOMIES

- Developing Economies: These countries suffer from low income levels, weak human resources and have only experienced limited industrialisation. A large number of people live in absolute poverty (less than US\$1.25/day).
 - High levels of income inequality
 - Dependence on agricultural production for income, employment and trade
 - Reliance on foreign aid and development assistance
 - Low levels of labour productivity, industrialisation, technological innovation and infrastructure development
 - Weak political and economic institutions
- Newly Industrialised Countries: Economies experiencing rapid economic change and in transition from being developing economies to high-income economies. NICs have been the fastest growing group of economies pursuing growth through export led development and encouraging large inward flows of FDI.

- Transition Economies: Were socialist economies prior to the collapse of socialism. These economies have attempted an extraordinary transformation from centrally planned economies to market economies. Reforms include privatisation of state own enterprises, financial market liberalisation and shift towards western-style economic and political institutions
- High-Income Economies: Countries with high levels of economic development and close economic ties with each other as well as liberal-democratic political and economic institutions. High-income countries have a GNI per capita about US\$11, 906. Includes 27/30 of the OECD countries.

IMPACT OF GLOBALISATION

INTERNATIONAL CONVERGENCE

- Globalisation appears to be contributing to a convergence in living standards. Over the last few decades, developing economies have been “catching up” to developed high-income economies.
- Transition economies are now growing faster and economic growth in the first wave of NIE’s has slowed now that living standards in those countries have risen to similar levels as for high income economies.

ECONOMIC GROWTH, DEVELOPMENT AND THE QUALITY OF LIFE

- Globalisation is said to offer the nations of the world the opportunity to experience economic growth and development and to improve the quality of life for their citizens however, not all countries have benefitted equally from globalisation.
- The “winners” from globalisation are those countries that have embraced international trade, foreign investment and the participation of TNC’s however some features of globalisation have had negative impacts on the global economy. For example, countries in Africa have suffered negative growth due to high levels of foreign indebtedness.
- If globalisation raises economic growth and therefore raises income levels then this can have a positive effect. If however, the distribution of income is uneven then this will have a negative effect on the quality of life.

TRADE, INVESTMENT AND TRANSNATIONAL CORPORATIONS

- The process of globalisation has resulted in substantial increases in the size of trade flows and foreign investment. Because of the key role played by TNC’s in trade and investment flows, they are increasingly dominating business activity around the world.
- Due to the nature of the global economy, there can be multiple international trade transactions in the process of manufacturing a good.
- The globalisation of financial markets has seen an increased reliance on foreign sources of finance for investment. FDI is now playing a greater role in creating more economic activity around the world.
- However, the flow of FDI funds are usually targeted at those countries with favourable economic prospects and only a trickle to those LDC’s (Least Developed Countries).
- A major criticism of TNC’s is that because they do not operate under the laws of one country, they can move production facilities to countries with weak government regulations.

DISTRIBUTION OF INCOME AND WEALTH

- Globalisation has resulted in increased world income and wealth but the distribution of this increase has been very unequal. A number of countries have gained very little or even nothing from globalisation.
- Even though increased FDI flows fuel economic growth, they tend to be focused on the higher skilled and technology sectors favouring those who are already better off increased inequality.
- Globalisation has increased openness to trade which provides more export opportunities raising the income of agricultural workers in developing countries. A lower tariff on imports reduces the prices of goods and improves living standards.

ENVIRONMENTAL CONSEQUENCES

- Globalisation can have a negative impact on the environment. Developing countries may engage in economic behaviour that is detrimental to the environment to attract foreign investors.
- Globalisation also offers the chance to protect the world's environment from harm by forcing countries to own up to their environmental responsibilities.
- It makes the costs of preservation able to be shared and facilitates the transfer of environmentally friendly technology.

FINANCIAL MARKETS

- Financial markets shift large amounts of money very quickly and this can sometimes have devastating effects when a sudden loss in confidence arises. The exchange rate can collapse leading to a shock in the economy, recession, rising unemployment and increased poverty.
- The financial markets behave in unpredictable ways and this can pose a large threat to the global economy like a "giant wrecking ball".

THE INTERNATIONAL BUSINESS CYCLE

- Close linkages between economies hold both benefits and risks:
 - Benefits: achieve faster rates of growth by specialisation and engaging in trade
 - Risks: exposed to downturns in the international business cycles and developments in the region.

IMPLICATIONS FOR GOVERNMENT ECONOMIC POLICIES

- Globalisation has led to greater similarity of economic policies around the world. The Washington Consensus outlines market-friendly policies:
 - Fiscal discipline
 - Redirection of public expenditure towards education, health and infrastructure investment.
 - Tax reform – broadening the tax base and cutting marginal tax rates
 - Interest rates determined by market forces and are positive but moderate
 - Competitive exchange rates
 - Trade liberalism
 - Openness to foreign direct investment
 - Privatisation of state enterprises

- Deregulation: such as those that impede entry or restrict competition except for those justified on safety, environmental and consumer protection grounds.
- Legal security for property rights

CASE STUDY

A CASE STUDY ON THE IMPACT OF GLOBALISATION ON VIETNAM, ALONG WITH THE STRATEGIES THAT VIETNAM IS USING TO PROMOTE ECONOMIC GROWTH AND DEVELOPMENT

Australia's Place in the Global Economy

AUSTRALIA'S TRADE AND FINANCIAL FLOWS

VALUE, COMPOSITION AND DIRECTION OF AUSTRALIA'S TRADE AND FINANCIAL FLOWS

Trading Partner	% of Australian Imports	% of Australian Exports
USA	12	5
EU	21	10
ASEAN	20	9
China/Hong Kong	18	19
South Korea	3	8
Japan	8	23
New Zealand	3	4

TRENDS IN AUSTRALIA'S TRADE PATTERN

- Australia primarily traded agricultural goods as a country to nations such as the United Kingdom and other European Nations due to our traditional roots. However, when the UK joined the EU it was required to impose tariffs on Australian exports.
- After this, Australia changed the focus of exports to the developing countries in South East Asia which required resources to grow.
- Our exports have decreased in the agricultural sector (as a percentage of total exports) but have increased significantly in the mining and resources sector with a shift away from countries such as Japan towards China and other ASEAN countries.
- Although we still export to the EU, UK and US we mainly import from these countries (as well as countries like China and Japan)

TRENDS IN FINANCIAL FLOWS

- Due to globalisation and the floating of currencies around the world, there has been an increased amount of foreign investment into Australia.
- Globalisation and technology has allowed the transfer of money very quickly around the globe benefitting foreign investment (as capital moves easily between nations).
- Australia has always been a **net capital importer**. The financial flows into Australia are about twice that of flows out of Australia reflecting on the lack of domestic savings in Australia.
- A recent trend has been the shift in the composition of financial flows between direct investment and portfolio investment. During the 1980's, direct investment was greater than foreign investment as governments regulated financial flows. Today, the reverse is true with the removal of restrictions injecting money into Australian companies through loans and share purchases.

AUSTRALIA'S BALANCE OF PAYMENTS

- The **balance of payments** summaries all the transactions that Australia has with the rest of the world over a period of time.

STRUCTURE

Current Account

- The capital account shows the money flow from all exports and import of goods and services, income and current transfers for a period of time in one year. It essentially covers all external transactions that are **not reversible**.
- Net goods: Refers to the difference between what Australia receives for its exports and pays for its imports.
- Net services: Refers to the services that are bought and sold without people receiving an actual good such as transport, telephone calls, accommodation. Services Australia sells are an inflow and services Australia buys are an outflow.
- Balance on goods and services: Arrived at by adding net goods and net services
- Net Income: Refers to earnings on investments covering interest payments on borrowings and returns on other foreign investments. When foreigners invest in Australia, income flows overseas (debits). When Australians invest abroad, there is a flow of money back into the Australian economy (credit).
- Net current transfers: occur when products or financial resources are provided without a specific good or service being provided in return.
- Balance on current account: Addition of the balance on goods and services, net income and net current transfers.

Capital and Financial Account

- The Capital and Financial Account is concerned with financial assets and liabilities – the money flows that result from international borrowing, lending and purchasing of assets. These transactions are **reversible**.
- Capital Account: Consists of capital (money) transfers with three main parts:
 - Capital transfers from people migrating into or out of Australia
 - Capital transfers in the form of foreign aid to other countries
 - Purchase and sale of non-produced, non-financial assets such as intellectual property.
- Financial Account: shows Australia's transactions in foreign financial assets and liabilities and is characterised by four types of investment. Credits represent net inflows such as increased foreign investment in Australia or reduced foreign investment overseas. Debits represent net outflows and Australia consistently records a positive financial account balance as we draw on the savings of the rest of the world to finance a deficit on the current account.
 - Direct investment: Foreign financial transactions to fund new investment in Australia or overseas or to buy more than 10% of shares in existing Australian companies
 - Portfolio Investment: Buying of land, share and other marketable securities in existing companies (most foreign debt recorded here).
 - Other investment: investment not captured in other categories such as loans, deposits, trade credits

- Reserve Assets: Foreign assets that are available to and controlled by the central authorities for financing or regulating payment imbalances. Gold held by the RBA, FOREX held by the RBA, Special Drawing Rights.
- Balance on capital and financial account: adding the categories together. The amount should be approximately equal to the deficit on the CA.

LINKS BETWEEN KEY BALANCE OF PAYMENTS CATEGORIES

$$\text{Supply of \$A} = \text{Demand for \$A}$$

Supply is represented by:

- Payments for imports of goods and services (M)
- Income/transfers overseas (Y debits)
- Capital and financial outflow (K outflow)

Demand is represented by:

- Receipts for exports of goods and services (X)
- Income transfers overseas (Y credits)
- Capital and financial inflows (K inflow)

$$M + Y \text{ debits} + K \text{ outflow} = X + Y \text{ credits} + K \text{ inflow}$$

$$M - X + Y \text{ debits} - Y \text{ credits} = K \text{ inflow} - K \text{ outflow}$$

$$\text{Deficit on the CA} = \text{Surplus on the KFA}$$

- Over a period of time, a high level of KFA surpluses will result in a widening CAD because of the servicing costs associated with increased foreign liabilities. The Vicious Cycle of Accumulating Debt.

TRENDS IN THE SIZE AND COMPOSITION OF AUSTRALIA'S BALANCE OF PAYMENTS

- The Balance of Payments is a key indicator of the health of an economy. Australia has experienced consistently large CAD since the mid 1980's. Each year, Australia has paid out more for goods, services and other income and transfer payments than it has received.
- The degree to which a high CAD is sustainable is subject of great debate. A high CAD could result from high levels of direct investment that allows for higher economic growth and exports in the long term.
- The Current Account Balance and Balance on goods and services is heavily influence by cyclical factors such as changed in global demand for commodities however the long term structural component of the CAD, the net income deficit, remains high regardless of the cyclical swings in the CAD.

REASONS FOR THESE TRENDS

- There are many reasons for having a high CAD. Some economists believe that during the mid-80's and 90's Australia's lack of international competitiveness (i.e.: the current account) led to the current situation we are in now.

- Recently, there has been a focus on the lack of domestic saving levels because low savings means that foreign capital inflows are required to fund investment in Australia (i.e.: a capital and financial account problem)

ISSUES ASSOCIATED WITH TRENDS IN THE BALANCE OF PAYMENTS

- There are some associated risks of running a high CAD:
 - The growth of foreign liabilities: contribute to an increased level of foreign liability over time. Lenders may become more reluctant to lend to Australia or invest in Australia. Decisions made that affect Australia will become increasing made by international businesses.
 - Increased service costs: A high level of foreign liability imposes substantial servicing costs – larger net income deficit on CAD. Higher levels of foreign debt can result in foreign lenders demand “risk premiums” on loans (i.e.: higher interest rates). There is a risk of falling into the debt trap or VCAD where we need to borrow more money to service our foreign liabilities.
 - Increased volatility for exchange rates: This may undermine the confidence of overseas investors in the Australian economy. This reduced demand for currency may depreciate the \$A leading to increased import/decreased export prices which in turn worsens the CAD
 - Constraint on future economic growth: a high CAD can slow economic growth in the future as high economic growth usually involves an increase in imports leading to deterioration in the CAD. Economies with a CAD problem limit growth to keep the CAD sustainable (known as the **balance of payments constraint**).
 - More contractionary economic policy: If the CAD needs to be reduced in the short term, macroeconomic policy needs to be tightened while microeconomic policy needs to be reformed. Tighter fiscal policy can also lower the CAD but also reduce economic growth. In the long term, slow economic growth can lead to increased unemployment.
 - Loss of International Investors Confidence: Investor confidence can shift rapidly and countries with a high CAD are more vulnerable to shifts. These shifts can often have a dramatic effect and sometimes can trigger a major crisis.

TERMS OF TRADE

- The terms of trade show the relationships between the prices Australia receives for its exports and the prices that it pays for its imports.
- The terms of trade improve when export prices are rising relative to import prices and deteriorate when import prices are rising relative to export prices
- $$\text{Terms of Trade Index} = \frac{\text{Export Price Index}}{\text{Import Price Index}} \times \frac{100}{1}$$
- Changes in the TOTI can influence Australia's balance of payments. If the terms of trade deteriorate, then the same volume of exports buys fewer imports. This can lead to a large deficit on the balance of goods and services increasing the CAD and foreign liabilities.

SIZE OF THE CURRENT ACCOUNT BALANCE AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT

- By any comparison (CAD as a proportion of GDP), Australia sustains a high CAD averaging 2.7% in the mid 80's to over 4% of GDP.

FOREIGN DEBT AND FOREIGN LIABILITIES

- Australia's foreign liabilities are what Australia owes to the rest of the world. This includes the money that we have borrowed from overseas. We must pay interest on this money and the cost of servicing these loans (interest payments) appears as a debit on the Current Account.
- If we have large foreign liabilities then this means that we have larger debits on the current account. If this debit exceeds the balance on goods and services and the credit on the net income transfers then we will have a CAD.
- A prolonged CAD can result in the debt trap where money needs to be borrowed to fund the costs of servicing the loans and then more needs to be borrowed again resulting in greater foreign liabilities and a higher CAD etc. – the VCAD
- Low levels of national savings contribute to higher levels of foreign liabilities as well. Over the last twenty years, the level of national savings has been dropping from 15% of household income in 1980/81 to -3% in 2002/03 and back up to 3% in 2008/09.
- Because of the low level of savings within Australia, we must rely on the savings of other countries to fund local investment and budget deficits. By borrowing from overseas we must then service these loans and the interest payment on these loans make up a significant portion of our CAD.
- Foreign borrowings are subject to changes in overseas interest rates and other fluctuations in the exchange rate of the \$A unlike like domestic borrowings.

Debt and Equity

- Net Foreign Debt: is the total stocks of loans owed by Australians to foreigners minus the total stock of loans owed by foreigners to Australians
- Net Foreign Equity: is the total value of assets in Australia (land, shares) minus the total value of assets overseas that are owned by Australians.

INTERNATIONAL COMPETITIVENESS

STRUCTURAL CHANGE IN THE AUSTRALIAN ECONOMY

- To improve Australia's CAD we need to diversify the export base and move from mainly commodity based exports into other areas such as services and Elaborately Transformed Manufactures (ETM's).
- Microeconomic reform in the short to medium term can also improve our international competitiveness by lowering costs and improving the quality and reliability of Australian products. Microeconomic reform measures include:
 - Reducing the inflation rate to that of one below countries we compete with. This advantages our exporters by reducing their costs of production.
 - Innovation requires a highly educated, highly skilled workforce. High levels of investment in R&D for export success in high value-added services.
 - To compete internationally, Australia must sustain productivity growth to use resources and the workforce more efficiently.
 - Competitive labour costs as labour is the largest component of business costs. Excessive wage growth (when $\Delta Real\ Wage > \Delta Productivity$) will increase the costs of production.

- Change role of government and more efficient public sector including keeping budget deficits under control and a minimal level of government ownership in business.

EXCHANGE RATES

MEASUREMENT OF RELATIVE EXCHANGE RATES

- Exchange rates are necessary because exporting firms want to be paid in their own currency so importers need to be able to convert their domestic currency into the foreign currency.
- The exchange rate works due to the floating exchange rate mechanism in which the value of a country's currency is determined by the factors of demand and supply in foreign exchange markets.

To Other Individual Currencies

- The exchange rate is the price of Australia's currency in terms of another country's currency e.g.: 1AUD = 0.97USD.

Trade Weighted Index

- The Trade Weighted Index gives an indication of how the value of the \$A is moving against all currencies in general. It is calculated by measuring the value of the \$A against the currencies of Australia's major trading partners compared with a base year.
- The currencies of the countries that are more prominent in Australia's trade are given a higher weighting so that they have a greater influence on the TWI.
- One weakness of the TWI is that it is weighted according to volumes of trade regardless of the currency in which export and import contracts are invoiced. Most of our trade is in \$US and the \$A/\$US exchange rate is more important than the weight it receives in the TWI.

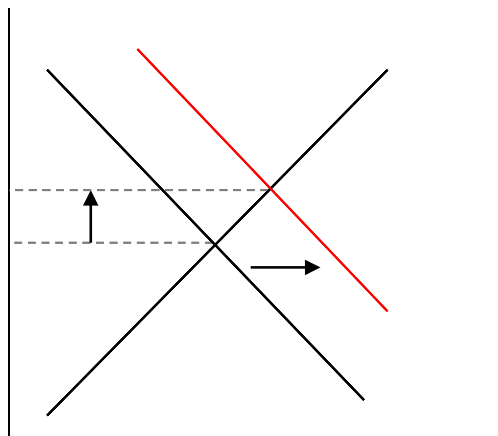
FACTORS AFFECTING THE DEMAND FOR AND SUPPLY OF AUSTRALIAN DOLLARS

- Demand for \$A is represented by all those people who wish to buy \$A. Demand is affected by:
 - The size of financial flows into Australia from foreign investors who wish to invest in Australia and need to convert their currency into \$A.
 - The level of Australian interest rates relative to overseas interest rates.
 - The availability of investment opportunities.
 - Expectations of a future appreciation of the \$A will increase demand by speculators.
 - The demand for Australian exports:
 - Changes in commodity prices and in the terms of trade
 - Demand for exports influenced by the degree of international competitiveness
 - Changes in global economic conditions.
 - Tastes and preferences of overseas consumers.
- Supply for \$A is represented by those people who wish to sell \$A.
 - The level of financial flows out of Australia by Australian investors who wish to invest overseas and must sell \$A to purchase foreign currency.
 - The level of Australian interest rates relative to overseas interest rates
 - The availability of investment opportunities.
 - Expectations of a future depreciation of the \$A will fuel speculators to sell \$A contributing to the expected depreciation.
 - Domestic demand for imports:
 - Level of domestic income

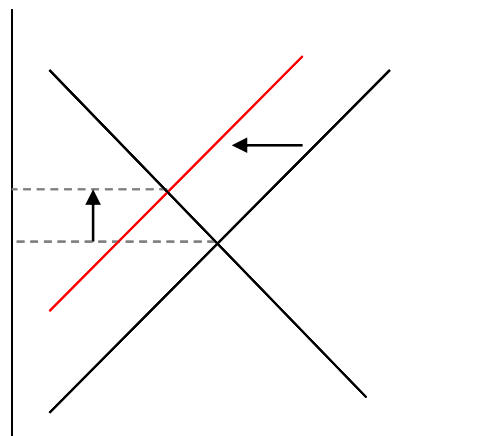
- The domestic inflation rate and the competitiveness of domestic firms that compete with imports
- Tastes and preferences of domestic consumers.

CHANGES IN EXCHANGE RATES

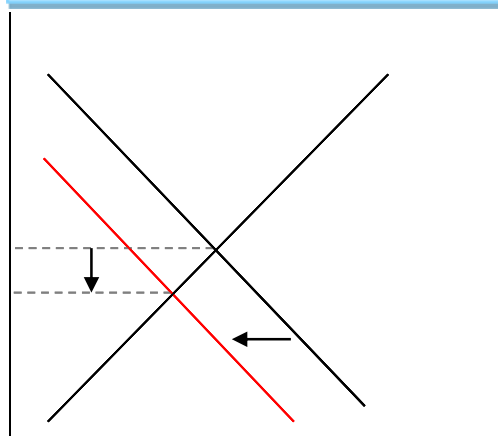
Appreciation/Depreciation



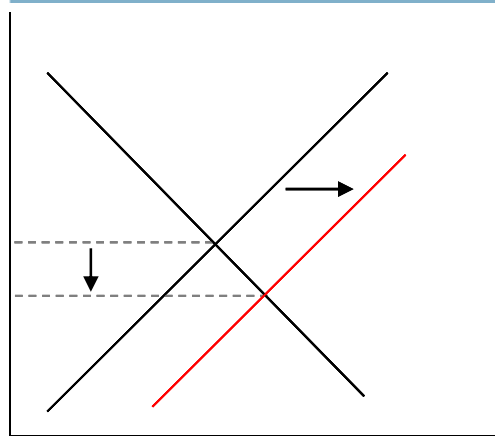
Increase in demand leading to appreciation in the \$A



Decrease in supply leading to appreciation in the \$A



Decrease in demand leading to depreciation in the \$A



Increase in supply leading to Depreciation in the \$A

DETERMINATION OF EXCHANGE RATES INCLUDING FIXED, FLEXIBLE AND MANAGED RATES

THE INFLUENCE OF THE RESERVE BANK OF AUSTRALIA ON EXCHANGE RATES

- Although the Australian currency is mainly determined by the forces of demand and supply, the RBA sometimes can play a role in influencing the value of the currency. While it cannot change the value of the \$A in the long term, it is able to smooth out swings in the \$A in the short term by “dirtying” the float.

- Dirtying the float:
 - The RBA can become a buyer and seller in the forex market if it feels that a large short term change in the exchange rate will be harmful to the economy.
 - To prevent a rapid depreciation

THE EFFECTS OF FLUCTUATIONS IN EXCHANGE RATES ON THE AUSTRALIAN ECONOMY

FREE TRADE AND PROTECTION

AUSTRALIA'S POLICIES REGARDING FREE TRADE AND PROTECTION

THE IMPLICATIONS OF AUSTRALIA'S POLICIES FOR INDIVIDUALS, FIRMS AND GOVERNMENTS

IMPLICATIONS FOR AUSTRALIA OF PROTECTIONIST POLICIES OF OTHER COUNTRIES AND INTERNATIONAL ORGANISATIONS

Economic Issues

ECONOMIC ISSUES IN THE AUSTRALIAN ECONOMY

ECONOMIC GROWTH

- Economic growth creates jobs, allows individuals to increase their consumption
- Economic growth is usually seen as the single most important measure of an economy's performance.
- Economic growth: an increase in the volume of goods and services that an economy produces over a period of time.

AGGREGATE DEMAND AND ITS COMPONENTS: $Y = C + I + G + X - M$

- Aggregate demand is the total level of expenditure in the economy over a period of time including consumption, investment, government spending and net export spending (exports – imports)
- $AD = C + I + G + (X - M)$
- Aggregate Demand = Consumption + Investment + Government Spending + (eXports – iMports)
- Economy is in equilibrium when $AD = AS$
- Factors influencing consumer consumption:
 - Consumer expectations: if consumers expect prices to rise, high real incomes or future shortages, they will tend to spend more and save less. Applies in reverse.
 - Level of interest rates: increase in interest rates will discourage individuals from spending their money and encourage saving. A decrease will have an opposite effect.
 - Distribution of income: the more equitable the distribution of income, the higher the rate of spending and vice versa. People on lower incomes have a higher MPC than those on higher incomes.
- Factors influencing business investment are the cost of capital equipment and business expectations:
 - Changes in interest rates: lower rates makes it cheaper to borrow funds to purchase capital equipment and vice versa
 - Government policies: relating to investment allowances and tax concessions on capital goods. A higher rates of depreciation on capital means that capital becomes relatively cheaper
 - Price or productivity of labour: relative costs of labour compared with capital and labour is a capital substitute. If the cost of labour increased while price of capital remained the same, capital has become relatively cheaper
 - Business expectations: If businesses expect more demand for a product they will investment to boost production. If the economy is expanding then businesses will invest to as risk associated is declining. Newer technologies would encourage greater business investment. Inflation leads to uncertainty about the future leading to reduced investment
- Factors influencing government spending and taxation: the government wish to change their level of spending to influence AD depending on the economic activity in an economy.
- Factors influencing Exports and Imports: The level of overseas and domestic income, exchange rates, consumer trends and preferences.

INJECTIONS AND WITHDRAWALS (I+G+X; S+T+M)

- Injections > Leakages: expansion
- Leakages > Injections: contraction

Aggregate Supply = Aggregate Demand

$Y = AD$

$Y = C + I + G + (X - M)$

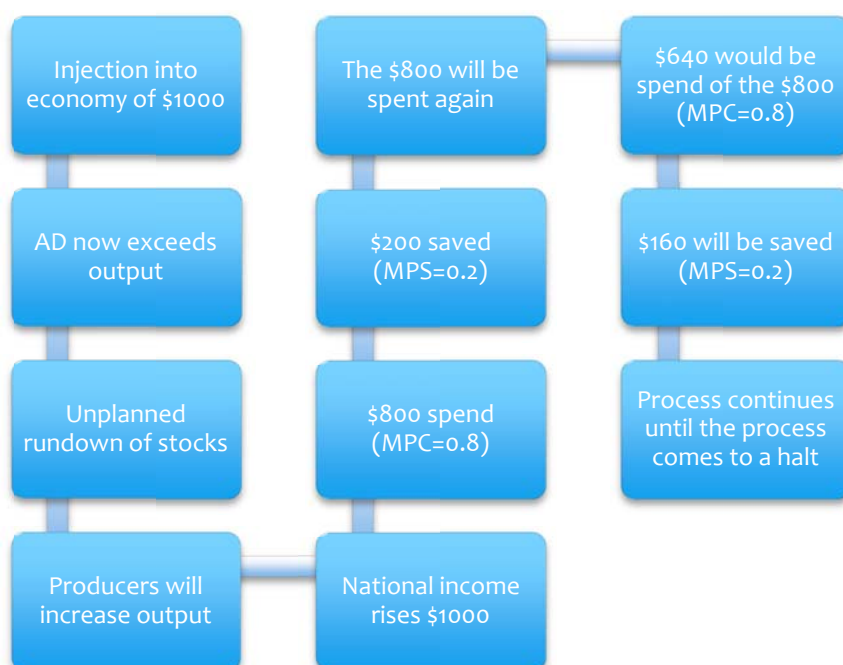
$C + S + T = C + I + G + (X - M)$

$S + T + M = I + G + X$

Leakages = Injections

THE SIMPLE MULTIPLIER: $K = 1/(1-MPC)$

- The multiplier is the greater than proportional increase in national income resulting from an increase in aggregate demand.



- $k = \frac{1}{MPS} \text{ or } \frac{1}{1-MPC}$
- $\Delta Y = k \times \Delta AD$

MEASUREMENT OF GROWTH THROUGH CHANGES IN REAL GROSS DOMESTIC PRODUCT

- Economic growth measured by the annual rate of change in GDP:
- $\text{Economic Growth (\%)} = \frac{\text{real GDP}_{\text{current year}} - \text{real GDP}_{\text{previous year}}}{\text{real GDP}_{\text{previous year}}} \times \frac{100}{1}$

SOURCES AND EFFECTS OF ECONOMIC GROWTH IN AUSTRALIA

- Living Standards: faster economic growth results in an increase in real GDP/capita. Real incomes rise leading to a higher disposable income and material living standards

- **Employment:** economic growth creates jobs and can ensure that everyone who is willing and able to work is able to.
- **Inflation:** high levels of economic growth can result in prices increases and larger wage claims contributing to inflation. Happens when growth in AS cannot keep pace with growth in AD.
- **External Stability:** stronger economic growth is usually associated with increased consumer and business spending leading to higher levels of imports. Due to proportionally higher spending on imports, this can result in a rise in the CAD posing a risk to the external stability of the economy.
- **Income distribution:** economic growth contributes to higher living standards and better outcomes but not necessarily for everyone. Some benefits of economic growth may only flow to a certain sector.
- **Environmental impacts:** can have a negative impact on the environment if pursued without considering its impact. Such as pollution, depletion of resources and damage to local environment. Policies are needed that address ecologically sustainable development.

BUSINESS CYCLE — TRENDS

- **Business cycle:** the fluctuations in the level of economic growth due to either domestic or international factors.
- Counter cyclical policies are designed to minimise the fluctuations in the business cycle so that the economy experiences low inflation, unemployment and stable economic growth.
- Australia's economic growth performance over recent times has been stable and sustained over a long period of time particularly during 1991-2008. During the 2008 GFC, Australia avoided a technical recession with only one quarter of negative growth.

UNEMPLOYMENT

MEASUREMENT

Labour Force

- The labour force is the section of the population 15 years old and above who are either working (1 hour +) or seeking work. Includes self-employed persons but excludes non-working students 15 years+, people who perform domestic duties, retired persons, and persons not looking for work.

Participation Rate

- The percentage of the population aged 15+ in the labour force either employed or unemployed
- $\text{Labour Force Participation Rate}(\%) = \frac{\text{Labour Force}}{\text{Working Age Population}} \times \frac{100}{1}$

Unemployment Rate

- A person is unemployed when they are out of work but actively seeking work.
- $\text{Unemployment Rate}(\%) = \frac{\text{Number of persons unemployed}}{\text{Total labour force (emp+unemp)}} \times \frac{100}{1}$

TRENDS

- Underemployment: employed persons with a limited amount of work who wants to work more hours.
- Hidden unemployed: people who have not been able to find work and have left the labour force or “discouraged job seekers”
- The last time unemployment was as low as it was during 2006-07 was in 1975-76
- Unemployment fell steadily during the years after 2000 until the onset of the GFC that reduced the demand for labour causing unemployment to head back upwards.
- Okun’s law: explains the relationship between unemployment and economic growth. It states that to reduce unemployment, the annual rate of economic growth must exceed the sum of percentage growth in productivity plus increase in the size of the labour force in any one year.

TYPES AND CAUSES:

- The level of economic growth: demand for labour is derived demand from that of goods and services
- Stance of macroeconomic policy: can influence the level of cyclical unemployment in the short to medium term through the influence on the business cycle
- Constraints on economic growth: if there are constraints on economic growth the economy will struggle to create enough jobs to reduce unemployment. Includes CAD and inflationary concerns.
- Rising participation rates: an increase in labour force participation will increase unemployment in the short term as more people start actively seeking work.
- Structural change: often involves significant short term costs (loss of jobs) in less efficient industries and areas undergoing reforms.
- Technological change: rapid technological change can cause short term unemployment. Labour/Capital substitution can cause some workers to become redundant.
- Productivity: high productivity growth will lead to slow employment growth as fewer employees are required per unit of output in the short term.
- Inadequate training and investment: structural unemployment related to the mismatch between the skills of the unemployed and skills demanded by employers.
- Rapid increase in labour costs: unemployment may rise because of a sudden increase in labour costs.
- Inflexibility in the labour market: high labour costs can result from the inflexibility of the labour market. Deregulation may lead to lower minimum wages and lower unemployment.

Cyclical

- Occurs because of a downturn in the level of economic activity and falls during strong economic growth
- Has increased in recent years as a result of deteriorating economic conditions.

Structural

- Occurs because of structural changes in the economy
- Caused by changes in technology or the pattern of demand for goods and services
- Most of Australia’s long term unemployment is attributed to structural unemployment

Frictional

- The people who are temporarily unemployed as they change jobs
- Frictional unemployment is inevitable as people change jobs

Seasonal

- Occurs at predictable and regular times throughout the year due to the seasonal nature of some types of work (eg: fruit picking)
- Also accounts for influx of students finishing school in December

Hidden

- Those people considered unemployed but do not fit into the ABS definition of unemployed and not included in the statistics eg: discouraged jobs seekers
- Presence is shown through a decline in labour force participation rate.

Long Term

- Those people who have been out of work for 12 months+ and usually a part of structural unemployment.
- One of the most entrenched parts of unemployment since 1990's

NATURAL RATE OF UNEMPLOYMENT

- The natural rate of unemployment refers to the level of unemployment at which there is not cyclical unemployment (i.e.: where the economy is at "full employment"). It includes frictional, seasonal, structural and hard core unemployment
- NAIRU (Non-accelerating Inflation of Unemployment): The natural rate represents the supply constraint of the economy. Once the natural rate is reached and further cuts in wages or stimulus to aggregate demand will not lead to permanent reductions in the rate of unemployment instead leading to high inflation as wages growth accelerates. The NAIRU can only be reduced through structural reforms such as education and training policies.

MAIN GROUPS AFFECTED BY UNEMPLOYMENT

- Youth: because employers are seeking workers with greater skill and experience and as a result students are remaining in education for longer periods of time
- Indigenous Australians
- Older workers
- Specific regions that experience higher unemployment rates
- People born outside Australia

EFFECTS OF UNEMPLOYMENT — ECONOMIC AND SOCIAL COSTS

- Economic Costs:
 - Opportunity Costs: Unemployment means that the economy's resources are not being used to their full capacity, therefore output is below what it could be. Lower output means lower household income and expenditure leading to lower sales and profits

- Lower living standards: Unemployed people are unable to contribute to the production process. Higher rates of unemployment → reduction in goods production → reduction in economic growth → lower living standards.
- Decline in labour market skills for the long term unemployed: Unemployment leads to a loss of skills among existing workers. Persistent unemployment will lead those workers to lose their skills and become less employable. Cyclical or short term unemployment can turn into long term structural unemployment.
- Costs to the government: High levels of unemployment can have an impact on the government's revenue and expenditure. Falling incomes means less tax revenue and higher unemployment means greater welfare expenditure.
- Lower wage growth: High levels of unemployment mean that there is an excess of supply of labour that should lead to a fall in the wage level. Regulations restricting wage movements mean that higher unemployment leads to slower wage growth instead of reductions.
- Social costs:
 - Increased inequality: Unemployment tends to occur more frequently among the lower income earners such as the young and unskilled. As unemployment means a loss of income for these people, they become relatively worse off compared to higher income earners.
 - Other social costs: Unemployment is also associated with social problems such as financial hardship and poverty, increased levels of debt, homelessness and housing problems, loss of work skills, and increased levels of crime. Economic costs result from this as resources need to be diverted to deal with these problems.

INFLATION

- Inflation is a sustained increase in the general levels of prices in an economy.

MEASUREMENT — CURRENT AUSTRALIAN BUREAU OF STATISTICS MEASURE

- Inflation is measured in Australia using the Consumer Price Index (CPI)
- The CPI summarises the movement in the prices of a basket of goods and services, weighted according to their significance for the average Australian household.
- $$\text{Inflation Rate}(\%) = \frac{CPI_{\text{current year}} - CPI_{\text{previous year}}}{CPI_{\text{previous year}}} \times \frac{100}{1}$$
- The CPI covers a wide selection of goods and services that reflect average household spending patterns and this means that it gives a good indication of the overall movement in the prices of consumer goods and reflects general changes in the cost of living.
- Underlying inflation removes the effects of one off or volatile price movements and as a result the measure of underlying inflation tends to be less variable than the headline rate.

TRENDS

- Peaks in inflation during: 1986-87, 1989-90, 2000-01
- The RBA target inflation rate is 2-3% over the course of the business cycle.

CAUSES

Demand Inflation

- When AD exceeds the productive capacity of the economy, prices rise, as output cannot expand any further in the short term. Consumer force prices up by bidding against each other for the limited supply available, as they are willing to pay a higher price.

Cost Inflation

- Caused by an increase in the costs of the factors of production. When costs rise, firms attempt to pass onto consumers these costs by increasing the prices of their products thus raising the rate of inflation.

Imported Inflation

- Inflation transferred to Australia through international transactions. Eg: rising import prices will increase inflation in a similar way to an increase in domestic prices. Changes in the exchange rate will affect the domestic price of imports which will impact on inflation

Inflationary Expectations

- If individuals expect higher inflation, they may act in a way that causes an increase. Eg: if prices of goods and services are expected to rise, consumers will attempt to purchase before the rise increasing consumption and demand-pull inflation.

EFFECTS

- Economic Growth:
 - Inflation is the main constraint on economic growth.
 - Excessive economic growth tends to raise inflationary pressures → demand on wages and consumer bidding.
 - Lower, sustained inflation allows for more moderate economic growth without needing higher interest rates.
 - Higher inflation distorts economic growth, discourages business investment, and reduces future profit levels.
 - Low inflation has a positive impact, incentive to invest in big term productive assets.
 - High inflation may distort consumer's decisions to spend
- Wages: During periods of higher inflation, employees will seek larger wage increases in order to be compensated for the erosion in the purchasing power of their nominal wage. Emergence of a wage-price inflationary spiral.
- Income distribution: High inflation tends to have a negative impact on the distribution of income because low income earners find their incomes do not rise as quickly as prices. May face higher interest rates on borrowings. High inflation hurts those whose wage is not indexed to inflation.
- Unemployment: Inflation and unemployment are closely related especially in the short term. Higher inflation leads to contractionary monetary and fiscal policy leading to slower economic growth and higher unemployment in the short to medium term. Stagflation: when inflation and unemployment rise simultaneously.
- Exchange rate impacts: high inflation may result in an appreciation of the exchange rate in the short term. May cause the currency to depreciate in the long term.

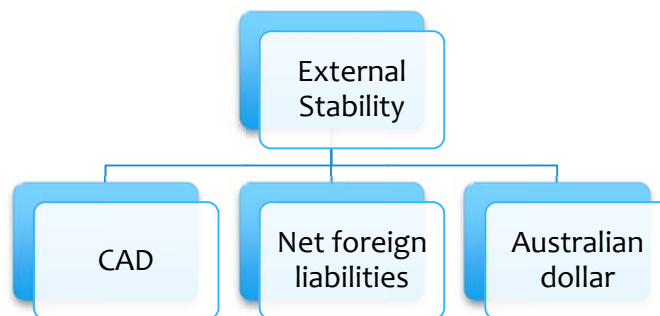
- International Competitiveness: higher inflation results in increased prices for Australia's exports reducing international competitiveness and quantity of exports.
- Interest rates: lower inflation brings about reductions in nominal interest rates

POLICIES TO SUSTAIN LOW INFLATION

- Monetary policy: major tools used to reduce inflation and attempts to sustain growth at a level that does not create excessive inflationary pressures.
- Pre-emptive monetary policy: takes action against inflation before it emerges as a problem such as increasing rate during periods of economic growth.
- Fiscal policy: If the government increases revenue and decreases spending, this reduced demand pressures in the economy reducing demand pull inflation.
- Microeconomic reform: reduced protection → lower import prices → increased competition means prices rises are harder to justify.

EXTERNAL STABILITY

- Four things involved in achieving external stability:
 1. Monitoring the size of the CAD
 2. Monitoring the sustainability of the level of foreign debt and equity
 3. Ensuring the economy is able to service its foreign liabilities
 4. Stabilising any dramatic movements of the exchange rates

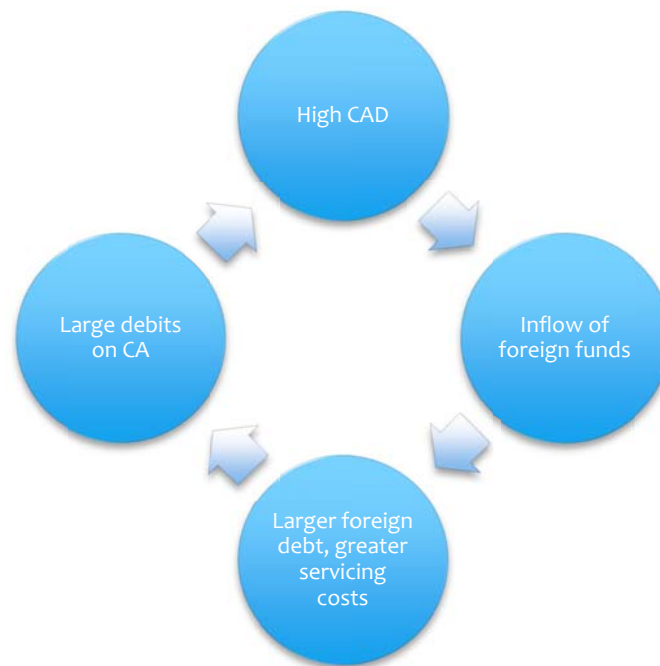


MEASUREMENT

CAD as a percentage of Gross Domestic Product

- Servicing of debt is an outflow on the CA and increases the CAD. This will then have an effect on Australia's persistently high debt levels.

- VCAD – Vicious Cycle of Accumulating Debt



Net foreign debt as a percentage of Gross Domestic Product

- The total stocks of loans owed by Australians to foreigners, minus the total stock of loans owed by foreigners to Australians
- Selling assets to foreigners does not add directly to Australia's foreign debt. Australia does not have to repay the price of purchasing equity unless the company or assets are sold back to Australians
- Borrowing from overseas adds directly to Australia's debt because the initial sum needs to be repaid and the debt must be serviced. An outflow of funds on the CA (Net Income component) and increases our CAD

Net foreign liabilities as a percentage of Gross Domestic Product

- Net foreign liabilities reflect Australia's total financial obligations to foreigners minus the total financial obligations of foreigners to Australia
- Made up of two components:
 - Net Foreign Debt (as per above)
 - Net foreign equity: the total value of assets in Australia such as land, shares and companies in foreign ownership, minus the total value of assets overseas that are owned by Australians.

TRENDS

- Our net foreign liabilities have increased dramatically from 33.4bn to 725.9bn over 30 years to a total of 61% of GDP. Net foreign debt has also increased dramatically from 9.4bn to 633.2bn to 52.9% of GDP. Net foreign debt and liabilities grew most significantly during the 80's and has been steadily and slowly increasing since then.

CAUSES AND EFFECTS

- During the 1980's the common view was that cause of Australia's CAD were as a result of export problems and lack of export competitiveness.
- During the 1990's, the view was that the CAD was due to an excess of domestic investment over domestic savings.
- Australia is a young economy with a small population but large land mass and extensive resources. To develop the economy, we have relied on overseas capital to fill the gap between domestic savings and investment.
- Problems with causing running consistent deficits: causes the increase in net foreign liabilities such as those experienced by Australia over the last couple of decades. And foreign liabilities have servicing costs that create an additional burden on the CA in the future.
- As long as the investment that is being funded by overseas capital generates significant return to pay for the servicing costs in the future, the increase in foreign liabilities should be viewed as sustainable in the long term.
- Pitchford thesis: noted that Australia's CAD and foreign liabilities are almost entirely generated by the private sector. Foreign borrowings helped to fund private investment projects or are direct investments. As long as private sector decision making is not distorted by other factors and the borrowers and lenders are responsible. No need to the government to be too concerned about the level of foreign liabilities any more than the level of domestic liabilities. If some projects are not successful, the firm will go bankrupt and there would be no need to repay this foreign debt.
- A change in the exchange rate affects the BoP by affecting international competitiveness and the size of servicing costs of our foreign debt. If the AUD constantly changes (volatile) this may undermine domestic confidence.
- External stability is now addressed through the general economic framework (promoting international competitiveness, increasing exports, encouraging savings, containing foreign debt growth, maintaining investor confidence, reducing fluctuations in the exchange rate) rather than being addressed directly by fiscal and monetary policy.

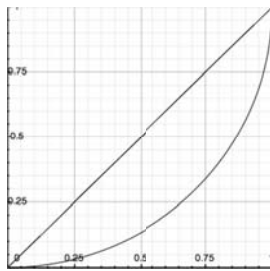
DISTRIBUTION OF INCOME AND WEALTH

- Main challenge facing governments: to promote structural change creating a more efficient and competitive economy. But to also ensure that the costs of adjustments and benefits of prosperity are shared fairly between different groups in society.

MEASUREMENT — LORENZ CURVE AND GINI COEFFICIENT

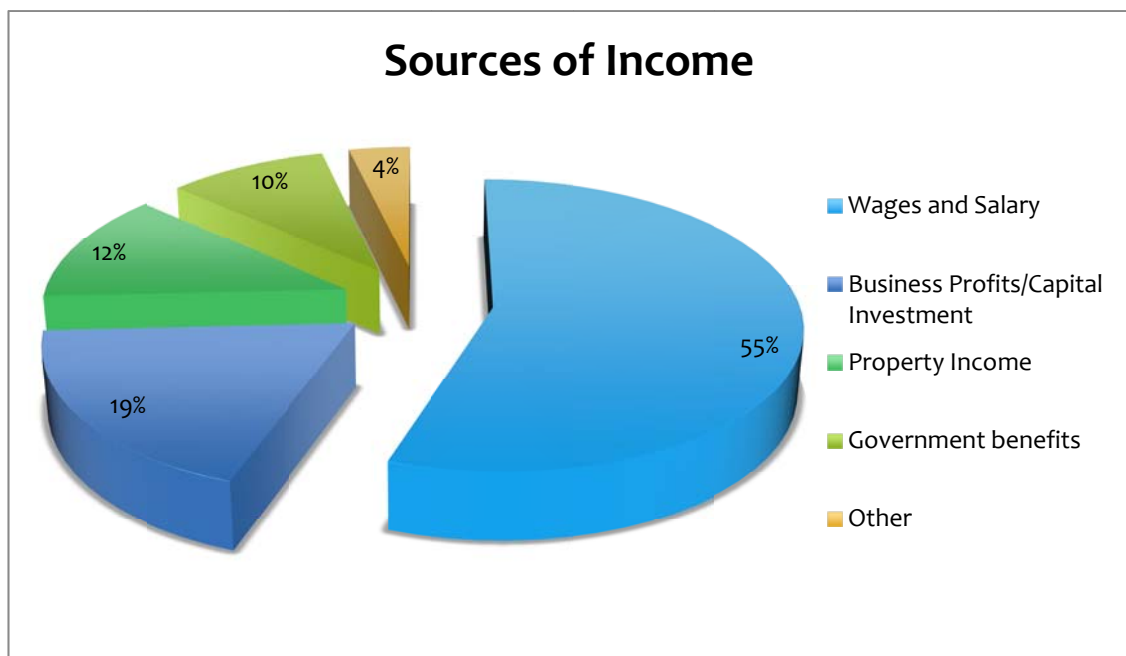
- Personal income: is the amount of funds, or other benefits measured in money terms, that flow to individuals or households over a period of time.
- Income inequality: the degree to which income is unevenly distributed among people in the economy
- Lorenz Curve: is constructed by plotting the cumulative percentage of total income received against the cumulative percentage of income recipients
- Line of equality: the line that shows an even distribution of income across the whole population
- Gap: The further the Lorenz curve is from the line of equality is the greater the degree of inequality in society.

- Lorenz Curve:

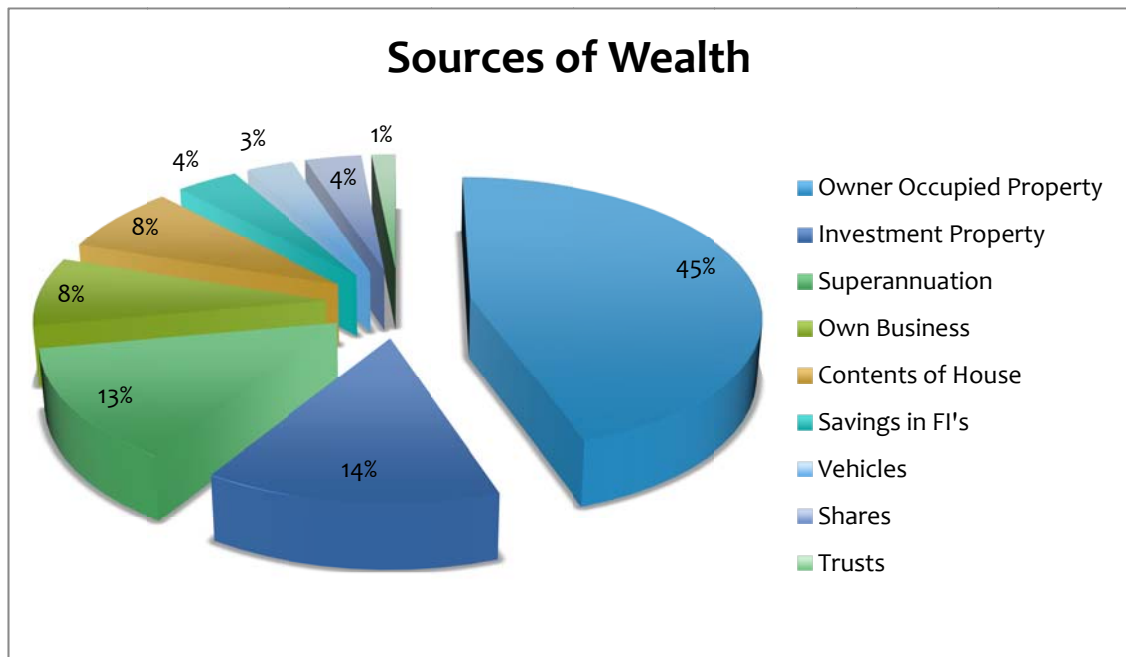


- $Gini\ Coefficient = \frac{A}{A+B}$
- Gini Coefficient means that all incomes are equal.
- Gini Coefficient means that a single household receives all the income
- The smaller the Gini Coefficient, the more even the distribution of income

SOURCES OF INCOME AS A PERCENTAGE OF HOUSEHOLD INCOME



SOURCES OF WEALTH



DIMENSIONS AND TRENDS, ACCORDING TO GENDER, AGE, OCCUPATION, ETHNIC BACKGROUND AND FAMILY STRUCTURE

- Over half of the population earn less than the mean income of \$811 per week, indicating that the income distribution is asymmetric.
- Wealth is more evenly distributed than income
- Age and education: income highest between the ages of 25 and 64 peaking at 35-44 with the lowest income earners 15-19 yo. Higher education usually means higher levels of income
- Gender and occupation: Men earn on average more than women with little change in wage relativity (possible workforce discrimination). Jobs that require higher levels of education earn more.
- Ethnic and cultural background: those born in English speaking countries earn more than Australians. Migrants from non-English speaking countries earn less than Australians
- Family structure: one person and single parents receive below median incomes. Single parents are worst off and couples with dependent children best off.
- Geography: Inequality balance between states and within states. But figures do not take into account costs of living in each area.

ECONOMIC AND SOCIAL COSTS AND BENEFITS OF INEQUALITY

Economic

- Costs:
 - Inequality reduces overall utility as it reduces the total satisfaction in the economy. (Principle of diminishing satisfaction).
 - Inequality can reduce economic growth as low income earners have a higher MPC and higher overall economic savings leading to reduced economic activity

- Inequality creates conspicuous consumption as higher income earners purchase “status” goods
- Inequality creates (relative) poverty and social problems, which will result in the economy not working at full capacity.
- Inequality increases the cost of welfare support as people on lower incomes receive benefits from the government
- Benefits:
 - Inequality encourages the labour force to increase education and skill levels to gain higher rewards
 - Inequality encourages the labour force to work longer and harder to earn higher incomes
 - Inequality makes the labour force more mobile as it can act as an incentive to move to where jobs are required most
 - Inequality encourages entrepreneurs to accept risks more readily due to the prospect of higher rewards
 - Inequality creates the potential for higher savings and capital formation as the higher the income earned the greater the proportion saved.

Social

- Costs:
 - Social class division: distribution of income and wealth creates class distinctions, which can result in tensions between people and different religions. Divisions can lead to social and economic instability
 - A high level of relative poverty: vicious cycle of low incomes
- Benefits:
 - It could be argued that the potential benefits on inequality (such as savings) could produce a larger pie from which all society can benefit. There may be social from an economic system that encourages inequality

GOVERNMENT POLICIES TO ADDRESS INEQUALITY

- Redistributing income: the government reduces inequality by having higher taxes on wealthy and redistributing it to lower income groups
- Compulsory superannuation: reducing wealth inequality and employers must make a 9% minimum contribution and these funds cannot be accessed until retirement
- Monetary policy: interest rate rises may lead to greater inequality
- Microeconomic reform: may cause short term unemployment and the closure of some industries.

ENVIRONMENTAL MANAGEMENT

- In recent times, environmental issues have assumed greater prominence within the study of economics and have had a greater influence on policy decisions

ECOLOGICALLY SUSTAINABLE DEVELOPMENT

- Environmental economics emphasises the view that we need to pursue a sustainable level of growth, taking into account the effects that economic activity has on the economy. Unless the hidden costs of economic growth are taken into account, fast growth may lead to a rapid depreciation of resources and decreased quality of life.
- Ecologically sustainable development involves conserving and enhancing the community's resources so that ecological processes and quality of life are maintained. A level of economic activity which is compatible with the long term preservation of the environment rather than the maximum level of growth possible in the short term.
- Problems arising from a depleted natural environment include: harmful effects on the health of humans and less enjoyable living environment, depletion of natural environment reduces potential future growth by limit its natural resources
- Key principles of ecologically sustainable development:
 - Integrating economic and environmental goals in policies and activities
 - Ensuring that environmental assets are appropriately valued
 - Ensuring fairness in the shifting of costs and assets within and between generators
 - Managing environmental risks with caution
 - Taking into account the global effects of environmental issues

PRIVATE AND SOCIAL COSTS AND BENEFITS — MARKET FAILURE

- Market failure occurs when the price mechanism takes account of private benefits and costs of production to consumers and producers but fails to take into account indirect costs such as damage to the environment.
- The price mechanism does not take into account the private costs and indirect costs such as damage to the environment.
- The price mechanism does not take into account future demand for goods and services that may not be satisfied or how the economy's ability to grow in the future may be affected because a resource has been used up or destroyed.
- When environmental resources become scarce, the cost of natural resources increases reducing the number of resources consumed. However, the price mechanism does not apply to the allocation of resources that are free (eg: the atmosphere)

PUBLIC AND PRIVATE GOODS — FREE RIDERS

- Public goods are non-excludable: one public goods are provided, the producer cannot exclude consumers from enjoying the benefit of that good even if they are not prepared to pay eg: national defences, street lights.
- Public goods are non-rival: consumption of the good by one individual consumer does not reduce the quantity of the good available for other consumers eg: the use of a park by one person does not exclude another person from using the park.
- Free riding: groups or individuals who benefit from a good or service without contributing to the cost of supplying the good or service. As a result, the good or service is likely to be under supplied in relation to total demand

ISSUES:

Preservation of natural environments

- Measures that can be taken: restrictions on development in environmentally friendly sensitive areas, controls over emissions of waste products, requiring new plantation in areas where logging has occurred, actively protecting the natural environment from threats such as non-native plants and animals.
- Problems faced: short term reduction in economic growth that may cause higher prices or reduced supply. Certain industries may face higher costs, which may make us less international competitive missing out on export and growth opportunities. Cost of repairing environmental damage is often borne by taxpayers not those who have done the damage.

Pollution control

- Pollution: occurs when the natural environment is degraded in some way eg: harmful chemicals, noise
- Can be solved by the introduction of an emissions trading system (cap and trade, ETS, CPRS)

Externalities

- Externalities are the social and environmental costs associated with the economic production that are not reflected in the private costs of production.
 - Negative externalities: adverse spill over effects. Eg: the use of road instead of rail may be cheaper but social must bear the cost of road damage, noise and air pollution
 - Positive externalities: beneficial spill over effects. Eg: new job opportunities

Depletion of renewable and non-renewable resources

- Renewable resources: can naturally regenerate or replace themselves in a relatively short period of time but can deplete to the point when they become non-renewable eg: overfishing
- Non-renewable resources: there are limited in supply because they can only be replenished over a long period of time or cannot be replenished at all eg: fossil fuels

Economic Policies and Management

ECONOMIC OBJECTIVES

ECONOMIC GROWTH

- Economic growth involves an increase in the annual rate of change in real GDP. Economic growth offers a country substantial benefits including:
 - Increased standard of living for the population
 - Improved job prospects for the labour force
 - Opportunity for increased investment in infrastructure and public services

FULL EMPLOYMENT

- The full employment of labour
- Does not mean that there is no unemployment rather than an economy is at the natural rate of unemployment (there will always be a certain level of non-cyclical unemployment in the economy)
- Natural rate can be reduced through the use of macroeconomic policies or microeconomic reform over the long term.
- Benefits of full employment include:
 - Maximising the economy's capacity to produce, and therefore maximising living standards
 - Minimising the adverse economic and social problems associated with unemployment

PRICE STABILITY

- Refers to keeping inflation, or the sustained increase in the general price level, at an acceptable level.
- Does not mean that the government aims to eliminate inflation altogether rather aims to keep inflation at a sustainable level.
- The government and RBA aim to keep inflation within a target band of 2-3% over the course of the business cycle.
- High inflation may:
 - Reduce the real value of income and wealth
 - Reduce our international competitiveness
 - Cause a depreciated in the exchange rate
 - Create uncertainty about future costs
 - Distort the pattern of resource allocation

EXTERNAL STABILITY

- Involves a country meeting its long term financial obligations to the rest of the world.
- Three elements:
 - Achieving a sustainable position on the current account of the balance of payments
 - Maintaining international confidence in the Australian economy (including the AUD)

- Maintaining an acceptable level of foreign debt (best measure, the debt servicing ratio)
- Australia has a large CAD which can impact on its ability in maintaining external stability

ENVIRONMENT

- In the process of achieving economic objectives, economic activity may create side effects such as pollution, resource depletion.
- Governments establish environmental regulations and objects to address some of these problems.
- With growing recognition of the impact of climate change on economic activity, a growing focus on ecologically sustainable development.

DISTRIBUTION OF INCOME

- Overall objective of government policy is to create a fairer distribution of income and wealth in the economy.
- Governments do not aim to remove all of the inequalities but makes provisions for those who are not able to provide for themselves
- Aims to reduce the gap between high and low income earners through the redistributive tax system
- Recent years, there has been a focus on low inflation, sustained growth and low unemployment which can provide benefits to low, middle and high income earners

GOALS OF GOVERNMENT POLICY IN 2010

SUSTAINING ECONOMIC GROWTH DURING THE GLOBAL RECESSIONS

- After the GFC of 2008, the government changed its policy settings from mildly contractionary to strongly expansionary
- Consistent with medium term goal of achieving 3-4% growth
- Reduced interest rates and increased government expenditure aimed to keep the economy out of recessions

SUPPORTING EMPLOYMENT DURING THE GLOBAL DOWNTURN

- Unemployment fell during the GFC
- Higher unemployment tends to increase the severity of an economic downturn
- Expansionary measures of the 2009-10 budget aimed to support 210,000 jobs
- Expansion of re-skilling programs to reduce duration of unemployment

MAINTAINING STABILITY AND INTERNATIONAL CONFIDENCE IN AUSTRALIA'S ECONOMY AND FINANCIAL SYSTEM

- Ensuring an availability of credit in the financial markets so that financial institutions can lend to households and businesses
- In 2008, the government established a scheme to guarantee the overseas borrowings of Australia's banks to ensure an ongoing supply of funds.
- Aim to return the budget to surplus by 2013 announced in the 2010-11 budget.
- Aims to strengthen long term confidence in the Australian economy

KEEPING INFLATION STABLE, WITHIN THE RANGE OF 2-3%

- The pursuit of low inflation is important because it will help reduce interest rates, encourage investment and savings, maintain economic growth and sustain international confidence.

BOOSTING AUSTRALIA'S PRODUCTIVITY GROWTH AND INTERNATIONAL COMPETITIVENESS

- In the long term, increased productivity growth and international competitiveness are important for improved economic performance
- Recently, Australia's productivity growth has been below the long term average which is undermining the competitiveness of our exports.
- Increasing productivity through investment in education and infrastructure should improve competitiveness and increase living standards

INCREASING THE SUSTAINABLE RATE OF GROWTH IN THE LONG TERM

- Major focus recently to implement structural changes that will allow Australia to grow at a higher sustainable rate.
- Current constraints include: low productivity growth, low workforce participation

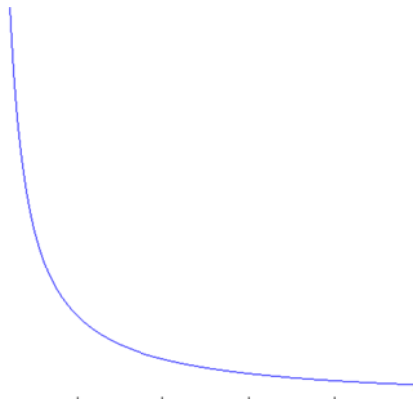
PROMOTING ENVIRONMENTAL SUSTAINABILITY

- Long term prosperity depends on addressing environmental challenges such as climate change and water shortages
- Policies include: possible introduction of an CPRS/ETS, investment in renewables, improving efficiency, moving to a low carbon economy, more efficient use of land/resources

POTENTIAL CONFLICTS BETWEEN OBJECTIVES

ACHIEVING A SIMULTANEOUS REDUCTION IN UNEMPLOYMENT AND INFLATION

- Strong aggregate demand causes jobs growth and reduces unemployment but also places upwards pressure on prices.
- Weaker aggregate demand forces businesses to restrain price rises but tends to increase unemployment
- Philips curve shows the relationship between inflation and unemployment



ACHIEVING ECONOMIC GROWTH AND EXTERNAL BALANCE

- Strong economic growth often results in deterioration in the current account on the balance of payments. Higher economic growth is associated with increased consumption and investment which will cause the volume of imports to rise.
- This is the balance of payments constraint and refers to the limitations on the rate of growth because of the impact high growth places on the CAD

OTHER CONFLICTS

- Economic Growth vs. Environmental Damage
- Economic Growth vs. Greater Inequality in Income Distribution

THE MAIN POLICIES AVAILABLE FOR ECONOMIC MANAGEMENT

MACROECONOMIC POLICIES

- Main role of macroeconomic policy is to manage the business cycle
- Is designed to minimise fluctuations in the business cycle so that an economy will enjoy low rates of inflation and unemployment and relatively stable growth
- Use of government policies to influence the economy with the aims of reducing large fluctuations in the level of economic activity and achieving certain economic goals

RATIONALE FOR MACROECONOMIC POLICIES — STABILISATION AND SHIFTS IN AGGREGATE DEMAND

- Can help stabilise the level of economic growth by smoothing the peaks and troughs of the economic cycle (counter-cyclical)
- Macroeconomic policies work by changing the level of aggregate demand in the economy such as stimulating the economy (tax cuts etc.) to increase economic activity.
- Works in the short term
- Ineffective in dealing with longer term problems such as lack of international competitiveness

MICROECONOMIC POLICIES

- Microeconomic policy is action taken by the government to improve resource allocation in order to maximise output from scarce resources (solves economic problem?)
- Long term aim: addressing potential constraints on growth such as the CAD and inflation

RATIONALE FOR MICROECONOMIC POLICIES INCLUDING SHIFTS IN AGGREGATE SUPPLY, EFFICIENCY

- Due to limited effectiveness of macroeconomic policies in the long term, a shift to focusing on supply side economics.
- Increase aggregate supply by improving competitiveness, productivity and efficiency of Australian industries
- The overall aim of microeconomic policy is to encourage the efficient operation of markets.

FISCAL POLICY

- Fiscal policy is a macroeconomic policy involving the use of the Commonwealth Government's Budget in order to achieve the government's economic objectives.
- By varying the amount of government expenditure and revenue, the government can alter the level of economic activity in the economy; this in turn will influence growth, inflation, unemployment and external indicators.
- Macroeconomic policy that can influence resource allocation, redistribute income and reduce the fluctuations of the business cycle.
- Done mainly through the federal budget (table of expenditure and revenue for the Australian government)
- Historically, fiscal policy has played a supporting role to monetary policy however it has become a much more important weapon since the 2008 GFC.

FEDERAL GOVERNMENT BUDGETS AND BUDGET OUTCOMES

- Three possible budget outcomes:
 - Fiscal surplus (budget surplus): Revenue > Expenditure
 - Fiscal deficit (budget deficit): Expenditure > Revenue
 - Fiscal balance (balanced budget): Expenditure = Revenue
- Two ways of measuring the budget outcome:
 - Fiscal outcome: (eg: budget surplus) is calculated using the accrual method and excludes one off items. It is the better long term indicator of fiscal policy.
 - Underlying cash outcome (eg: cash surplus) is calculated using the cash accounting method and excludes one off items. It is the better short term indicator of the impact of fiscal policy.
- One off transactions are shown on the headline cash budget outcome.
- Aim to achieve fiscal balance, on average, over the course of the economic cycle.

EFFECTS OF BUDGETARY CHANGES ON RESOURCE USE, INCOME DISTRIBUTION AND ECONOMIC ACTIVITY

- Two key factors which can change the budget outcome:
 - Changing economic conditions (cyclical or non-discretionary): changes in the budget outcome due to changes in the level of economic activity
 - Changes in fiscal policy (structural or discretionary): deliberate changes to changes in fiscal policy such as changes in taxation rates.
- Also influence by automatic stabilisers in the budget, the two main ones being unemployment benefits and the progressive taxation system. These act counter-cyclically however the effect that they have is not enough to counter the full effects of a boom or recession but can reduce the severity. The government still needs to make discretionary changes.
- Impact on economic activity: Three stances being:
 - Expansionary: When expenditure > revenue (compared to previous year) leading to an increase in consumption and stimulated aggregate demand. This leads to an increase in the level of economic activity.
 - Contractionary: when revenue > expenditure which leads to a decrease in consumption and investment, dampening aggregate demand and leading to reduced economic growth.

- Neutral: when revenue = expenditure. Should have no impact on the level of economic activity.
- Impact on resource allocation:
 - Direct impact such as spending on roads. Can be used to provide resources that markets may not or to provide public goods.
 - Indirect impact such as placing a tax on a good or service (cigarettes) to discourage consumption. Indirect methods are used to change how resources are used (eg: petrol)
- Income distribution: Progressive tax system designed to redistribute money from the rich to the poor. The introduction of the GST was reduced income distribution because it was a regressive tax. Budgetary changes such as spending on health and education and reduce the income distribution gap.
- Impact on savings and CAD: Budget deficit decreases national savings (due to private sector money being used to fund the deficit). With reduced national savings, this can lead to the crowding out effect which means that there is more competition for funds placing upwards pressure on interest rates. Funds then need to come from overseas and these appear on the KFA increasing net foreign liabilities. Long term deficits can lead to an increased CAD (due to increased servicing costs).

METHODS OF FINANCING DEFICITS

- Borrowing from private sector: through the issuing of treasury bonds but this can lead to the crowding out effect.
- Borrowing from overseas: if the exchange rate means that it is actually cheaper compared to domestic costs.
- Borrowing from RBA (monetary funding): when the RBA prints money however this leads to increased money supply leading to upwards pressure on inflation and interest rates resulting in reduction economic growth.
- Selling assets such as the sale of Telstra.

USE OF A SURPLUS

- The government can use a surplus in a number of ways. It can either:
 - Deposit it with the RBA
 - Pay off public sector debt
 - Place it in an investment fund such as the Future Fund

CURRENT STANCE OF FISCAL POLICY

- During the GFC, the govt used heavily expansionary policy to increase AD.
- Expansionary macroeconomic stance with the budget to remain in deficit until 2013
- Cyclical factors: reduction in taxation receipts and increase in unemployment benefits
- Structural factors: Jobs and Education program, stimulus packages including the BER, DER etc
- Off set by some savings in the budget such as a reduction in the Private Health insurance rebate for higher income earners.

IMPACT OF RECENT FISCAL POLICY

- Short term impact: increased AD and economic growth
- Long term: external stability, income distribution and environmental outcomes

- Economic growth: Keynesian policies of increased spending to stimulate AD have led to increased economic growth (and is also true for the reverse). Over the long term, there is a theory of a reverse crowding out effect in which a surplus leads to lower inflation, interest rates, increased investment. In turn this leads to increased economic activity.
- Unemployment and workforce participation: Stimulating AD can help reduce unemployment in particular reduce cyclical unemployment. Long term structural measures such as retraining programs and paid parental leave can help to reduce structural unemployment.
- National savings and CAD: Increased national savings can lead to a reduction in the CAD. The budget is used to ensure fiscal stability so that the government does not add to the savings imbalance.
- Distribution of income: reduction in inequality is achieved due to structural measures as well as specific incentives such as the increase in the pension.

MONETARY POLICY

- Monetary policy involves action by the RBA, on behalf of the government to influence the cost and availability of money and credit in the economy.
- Monetary is macroeconomic policy that may be used to smooth the effects of fluctuations in the business cycle and influence the level of economic activity, employment and prices.
- Tightening of monetary policy: Higher interest rates → slow down economic activity → reduction in consumer spending → fall in aggregate demand
- Loosening of monetary policy: lower interest rates → increase consumer and business spending → increase in aggregate demand → increase in economic activity.

PURPOSE OF MONETARY POLICY

- The formal objectives as laid out in the Reserve Bank Act 1959:
 - The stability of Australia's currency – maintaining low inflation and minimising fluctuations in the value of the Australian dollar.
 - The maintenance of full employment in Australia – reducing the level of unemployment
 - Promoting economic prosperity and welfare of the people of Australia – encouraging a sustained level of economic growth.
- Inflation targeting: Where the central bank sets a target rate for inflation and then operates independently of the government in determining the interest rate movements to keep inflation in this range.

IMPLEMENTATION OF MONETARY POLICY — RESERVE BANK OF AUSTRALIA

- Monetary policy involves influencing the cost and availability of money in the economy.
- The RBA may control the growth in the money supply in the economy through its control over the money base or by influencing the general level of interest rates in the economy by setting the short run cash rate.
- Domestic Market Operations:
 - Cash rate: the interest rate paid on overnight loans in the short term money market.
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IMPACT OF CHANGES IN INTEREST RATES ON ECONOMIC ACTIVITY, EXCHANGE RATE

CURRENT STANCE OF MONETARY POLICY

STRUCTURAL CHANGE

EFFECTS OF MICROECONOMIC POLICIES ON INDIVIDUAL PRODUCT AND FACTOR MARKETS AND THE ECONOMY

REGULATION AND DEREGULATION

TRADE POLICY

DIRECT AND INDIRECT POLICIES TO PROMOTE OR RESTRICT TRADE TRADE AND INDUSTRY POLICIES IN AUSTRALIA

PRICES AND INCOMES POLICY

REASONS FOR PRICES AND INCOMES POLICIES

POSSIBLE PRICES AND INCOMES POLICIES IN AUSTRALIA

ADVANTAGES AND DISADVANTAGES OF CENTRALISED AND DECENTRALISED POLICIES

LABOUR MARKET POLICIES

CURRENT INDUSTRIAL RELATIONS FRAMEWORK

Safety net, wage cases, enterprise bargaining, workplace agreements, individual contracts

Role of the courts, tribunals and the employment advocate

Arguments for and against the current mix of market and non-market forces used to determine the returns to labour

WORK PRACTICES

DISPUTE RESOLUTION

EDUCATION AND TRAINING, EMPLOYMENT PROGRAMS

LIMITATIONS ON POLICY IMPLEMENTATION

TIME LAGS

GLOBAL INFLUENCES

POLITICAL CONSTRAINTS

POLICY RESPONSES AND THEIR EFFECTS IN DEALING WITH THE ECONOMIC ISSUES

ECONOMIC GROWTH

UNEMPLOYMENT

INFLATION

EXTERNAL STABILITY

DISTRIBUTION OF INCOME AND WEALTH

MANAGEMENT OF THE ENVIRONMENT
