Macroeconomic Policy in Australia

by Dan Nguyen

Australian governments over recent decades have traditionally aimed to achieve three major objectives of economic growth, internal balance, and external balance within an economy. Together, these three objectives aim to sustain national economic growth while maintaining low inflation as well as limiting the size of foreign debts and liabilities. The level of economic growth in an economy is never constant however and is subject to the ups and downs of the international business cycle. Government macroeconomic management is designed to minimise these fluctuations through influencing demand, so that sustained growth could be possible, with low inflation and low unemployment. However, due to its demand-side nature, macroeconomic policies cannot be used exclusively, and therefore are used in conjunction with the supply-side influencing microeconomic reforms. In influencing demand with and economy, the government uses the two instruments of fiscal and monetary policy.

Fiscal policy essentially involves the use of the government's budget in order to influence the economic objectives by varying the amount of government spending and revenue, in turn altering the level of economic activity, with a fiscal surplus, fiscal deficit, or a balanced budget. As the budget can influence the economy, in turn, the economy can influence the budget outcomes. This budget outcome is formed through both the cyclical component, where automatic stabilisers such as tax receipts and government spending through transfer payments adjust accordingly to the state of the economy, and also through the structural component, where discretionary, proposed changes by the government such as reduced spending deliberately alter economic activity.

Automatic stabilisers play a counter-cyclical role within the budget, but are rarely strong enough to counter the full effects of the cycle, and so discretionary fiscal policy will always be relied upon heavily. Over a short-term period, an expansionary fiscal stance is employed when the government aims to stimulate growth. This is done through increased government spending and reduced taxation, causing a multiplied increase in consumption and investment according to Keynes' multiplier process. Similarly, a contractionary fiscal stance is undertaken to slow the economy down, and also to limit foreign liabilities and Current Account Deficit (CAD). The level of income distribution and the direction of resource use can also be attributed somewhat to the results of a fiscal stance.

In association with the use of fiscal policy, monetary policy involves action by the Reserve Bank of Australia (RBA) to influence the cost and availability of money and credit within the economy. Traditionally, monetary policy's objective is to achieve internal balance by influencing the level of interest rates using domestic market operations including the sale and purchase of government bonds, correcting a shortage or surplus of funds respectively, in the short-term money market. To ease or loosen monetary policy, the RBA would buy bonds in order to create excess liquidity, putting downward pressures on interest rates, allowing boosted consumer and investment spending and eventually lower unemployment. Tightening monetary policy in response to increasing inflationary pressures would induce the RBA to sell bonds, soaking up funds, and therefore pushing up interest rates to dampen expenditure. Over the course of the business cycle, the RBA will continually tighten and loosen monetary policy in order to prevent inflation spilling over it's 2-3% average target range. At times, the RBA influences the exchange rate in order to maintain stability, but without altering the monetary policy stance. This is achieved through sterilised intervention, where the RBA would have to buy or sell bonds equivalent to the amount of $A bought or sold in order to maintain a constant amount of cash, resulting in a constant monetary policy stance.

Macroeconomic policies have traditionally been effective in impacting the short-term demand economy, and over the last decade, fiscal policy has played a key role in the policy mix, where the government has used this aim of policy to improve Australia's national savings and to control government public debt in order to keep external factors under control and maintain external stability, providing opportunities for economic growth. In short, the government has previously used fiscal policy to achieve external balance, however, private sector savings and investment decisions are now better bases, as a result of more successful microeconomic reform, and now the government acknowledges Australia's position as a capital-importing nation, inviting foreign savers to invest within Australia, causing capital surpluses and by definition, current account deficits. Due to the current favourable position of the economy, the Howard government has quietly abandoned the use of fiscal policy to achieve external stability, as it is no longer among the government's current policy objectives. Instead, the government ensures that it makes no contribution, through private sector borrowing and public sector debt, to the CAD. In doing so, the government now aims for the achievement of fiscal balance on average over the economic cycle.

The government still encourages private sector savings, but according to the 2003/04 budget, the government has shifted the role of fiscal policy toward acting as a backup to monetary policy in the pursuit of internal balance and "maximising sustainable economic growth".

After several years of budget surpluses, the last two years have seen marginal deficits of around $1 billion, reflecting the government's changing stance toward maximising growth. The government's return to a neutral fiscal stance results in significant upward or downward pressure from the public sector (G-T), on the circular flow. As a result of these changes, the circular flow will simply be determined through private sector demand (C+I), and net exports (X-M). In 2003, private sector demand, through private consumption spending, contributed 1.6% to real GDP growth of about 3.25%, with public sector demand and business investment also contributing roughly 1.6%. In 2003/04, the removal of the boost in public sector spending is expected to be offset by a boost in total investment, with business investment expected to rise by 7%. Net exports however, remain a negative. As a result of this shift in focus of macroeconomic policy, monetary policy now plays the dominant role, to stabilise aggregate demand and control inflation and unemployment. Achieving internal balance has now become the primary objective of macro policy and so monetary policy plays its traditional role, to keep inflation within its target range of 2-3%. Monetary policy has seen much success in keeping inflation within its target, with the current rate of inflation, as measured through the CPI, at 2.6%, well within the target range of the RBA. The RBA's pre-emptive approach of targeting monetary policy to raise the cash rate from 4.75% to 5% would ensure inflation would not spill over its target range. In regards to unemployment, the slower rate of economic growth of the early to mid 90's resulted in unemployment remaining at around 8.5%. However through successful monetary policy, growth picked up again in 1998 and unemployment has since gradually fallen to its current level of 5.6%. By maintaining "sustainable economic growth", and keeping inflation low, unemployment is at its lowest level in 22 years. However, while successful monetary policy may reduce cyclical unemployment, it has little effect on the structural side of unemployment, and therefore, resulting in supply-side micro reforms.

So while proving successful in controlling negative influences of demand, the government's macroeconomic policy mix, in the broadest sense, has had limited impact on Australia's structural problems, and that is why microeconomic reform has come into prominence over the last decade, in helping macro policies deal with supply-side constraints to help Australia's international competitiveness. However all policies take a significant amount of time to achieve their aims due to time lags, such as the 6 to 18 month delay with monetary policy changes feeding through to consumer and business behaviour. Nevertheless, economic indicators suggest the economy will perform strongly, driven by surging business investment, healthy consumer spending and accelerated employment growth. The current lack of concern over the CAD now effectively removes the so called "speed limit" to growth, allowing for stronger rates of expansion above the 3.75% to 4% rates, placing Australia on the right track toward maximising economic sustainability.