ECONOMICS

Outline the factors affecting Australia's economic growth, and analyse the relationship between economic growth and changes in Australia's employment rate.

Economic growth refers to the increase in the volume of goods and services that an economy produces over a given period of time, measured by the annual rate of change in real Gross Domestic Product (GDP). Following the Great Depression, Keynes realised that the total level of expenditure in the economy, or aggregate demand (AD), is the main driver of economic growth. The components of AD include: consumption, investment, government spending, and net export spending (export spending minus import spending). Since the demand for labour is a derived demand, that is, it is derived from the demand for the goods and services that labour helps to produce, changes in AD are reflected in Australia's employment rate.

Consumption represents approximately sixty percent of AD in the Australian economy and is the most stable component of AD. Although the most important factor influencing the level of consumption is income, economists are more concerned with the Average Propensity to Consume (APC) and Save (APS). Consumer expectations, the level of interest rates and the distribution of income greatly affect Australia's APC. For example, if consumers expect a price rise, a rise in their real incomes or a shortage of goods in the future, consumption will increase in the short term. Alternatively, an increase in interest rates will cause a decrease in the APC and therefore, an increase in the APS (since income can only be spent or saved). Furthermore, the more equitable the distribution of income in an economy, the higher the rate of overall spending because people on lower incomes tend to spend proportionately more of their income than those on higher incomes. An increase in consumption ultimately causes an increase in aggregate demand (and vice versa). Currently, low interest rates and consumer confidence have caused a slowdown in economic growth.

As the most volatile component of AD, the level of investment in the Australian economy is influenced by a number of factors. The level of interest rates, for instance, affects the price of borrowing funds for the purchase of capital equipment. Therefore, a fall in interest rates may result in an increase in investment, reflected in a subsequent increase in AD. Similarly, government policies relating to investment allowances and tax concessions on capital goods may also be used to manipulate the level of investment in the Australian economy. For example, if the Government allowed businesses to claim a higher rate of depreciation on their capital equipment, this would reduce their tax liability, causing capital to decrease in price. Alternatively, the price or productivity of labour affects the relative cost of capital compared to the cost of labour so that when the cost of labour increases while the cost of capital remains the same, capital is more attractive and investment spending increases. Lastly, business expectations about future prospects play perhaps the most important role in determining the level of investment in the Australian economy. That is, if firms expect a future increase in the demand for their products, strong economic growth, a discovery of new resources or new technology, or low inflation rates, they will be more inclined to purchase new capital equipment.

Although the level of government spending will to a degree depend on the government in power, it tends to represent approximately one-fifth to one-quarter of AD. One of the main goals of fiscal policy is to maintain a strong and stable rate of economic growth. For example, the Australian Government may decide to increase the level of spending and/or reduce the level of taxation in order to boost AD and therefore, economic growth.

Since Australia's trade balance on the current account is usually in deficit, net exports usually make a small negative contribution to aggregate demand (where exports and imports are each equal to between one-fifth and one-quarter of AD). Australia's net exports are influenced by domestic and overseas incomes, the exchange rate, levels of international competitiveness and consumer tastes and preferences. For example, a rise in overseas incomes tends to be mirrored by a rise in

Australia's exports whereas a rise in domestic incomes tends to be reflected in a rise in Australia's imports. Moreover, when Australia has a weaker exchange rate, domestic industries appear more competitive and therefore, their products are in greater demand by foreign consumers. This leads to a higher level of net exports and consequently, greater AD and faster economic growth.

Any change in the level of planned expenditure, due to changes in any of the components of aggregate demand, will have a multiplied effect on the level of national income. For example, lower interest rates will increase business investment and therefore, AD. Consequently, individuals will earn higher incomes, prompting higher consumption levels and further increases in expenditure (AD) and income lead the cycle to continue. However, the Marginal Propensity to Save (MPS) causes the amount of income generated from each time the injection flows through the economy to decrease as savings represents the only leakage in the assumed three-sector economy.

In the past, high unemployment rates have been consistent with low levels of economic growth and vice versa. For example, the main reason behind the 10.7% unemployment rate recorded in 1992, which was Australia's highest level since the Great Depression of the 1930s, was the severe global recession. By contrast, between 1991 and 2008, Australia's unemployment rate fell gradually, with fifteen years of sustained economic growth bringing it down to below 5%. Furthermore, until 2008, the global resources boom spurred increases in national income and business investment, causing the demand for labour in Australia to increase. This was particularly the case for the resource-rich states of Queensland and Western Australia as they experienced 4% unemployment in mid-2006 compared to the 5% experienced by NSW and Victoria. Currently, poor consumer and business confidence have contributed to slowing economic growth, leading to higher rates of unemployment (5.2% in Feb 2009).

As employment and unemployment are lagging indicators of economic activity, however, they will typically show a change following a variation in the overall level of economic growth. For example, the significant rise in Australia's unemployment rate (from 4.8% in Jan 2009 to 5.2% in Feb 2009) reflects easing demand levels in the economy earlier in 2008.

Based on this relationship, the Australian Government's most important strategy to reduce (primarily cyclical) unemployment has been the use of macroeconomic policy to ensure a sustainable rate of economic growth (within 3-4% of GDP). Even the Minister for Employment and Workplace Relations, Ms. Gillard, recently emphasised the importance of fiscal policy measures in managing unemployment. It follows that the Rudd Government has decided to implement expansionary macroeconomic policies in response to the current economic slowdown. For example, it announced five key $950 one-off payments for low and middle income households and individuals in December 2008 in addition to spending measures that allocated $15.1 billion to education and health programs and $4.7 billion to road, rail and education infrastructure.

According to Okun's Law, however, Australia requires economic growth rates, which exceed growth in labour productivity and in the size of the labour force (around 3.5% or higher) in order to make progress on reducing unemployment. Although this was a problem during the 1990s, since the early 2000s productivity growth has been much slower, enabling unemployment to continue falling despite economic growth averaging around 3%. Although in the long term a higher level of productivity growth should lead to stronger eco growth and more job creation, in the shorter term more jobs are created during a period of low productivity growth because employers require more workers if they want to increase production.

Interestingly, the relationship between economic growth and employment works both ways – the continued avoidance of high rates of unemployment will be important in containing the extent of the economic downturn in the current cycle. This is because increased levels of unemployment can trigger the economy to enter a "vicious cycle", whereby higher unemployment leads to lower consumption levels, which lead to further increases in unemployment.

Overall, Australia's economic growth is affected by the components of aggregate demand. Since the demand for labour is a derived demand, it will always reflect changes in economic growth. Similarly, low unemployment levels can perpetuate downturns in economic growth.