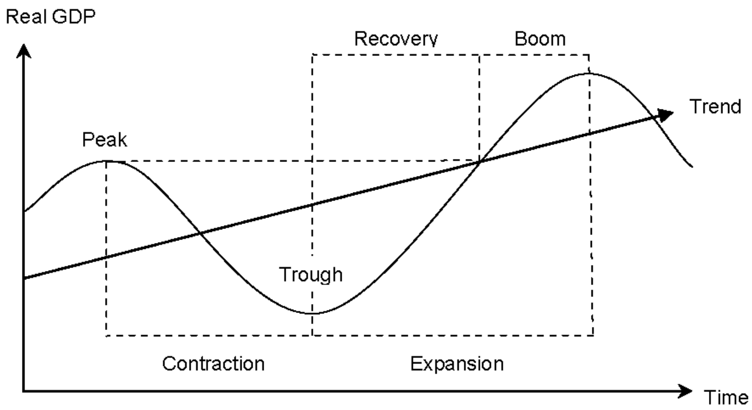
ECONOMICS

Analyse the effectiveness of a budget surplus and an expansionary monetary policy in Australia's current economic climate.

A budget surplus is when government revenues exceed expenditures. Fiscal policy is the government's use of the budget to change the level of aggregate demand (AD) in the economy. Monetary policy is the Reserve Bank of Australia's (RBA's) manipulation of the cost and supply of loanable funds in the economy to indirectly influence AD. The current global economy is weak, and because of Australia's globalised economy, the domestic economy is also weakened due to its synchronicity with the global business cycle:

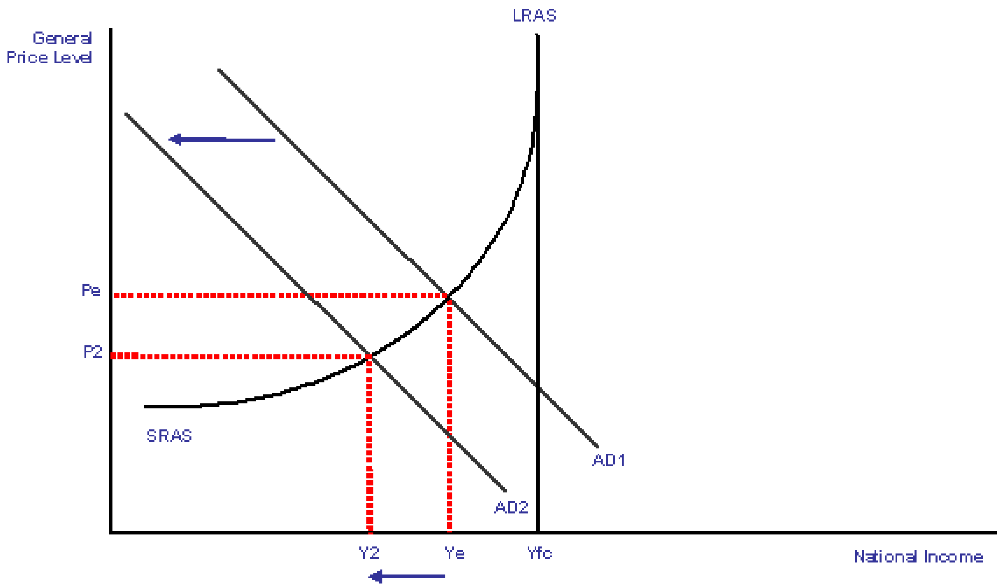
Fig 1



Australia's growth since 2000 has been fuelled by the mining boom which improved the (X-M) component of AD, for AD=C+I+G+(X-M). This is due to heightened commodity prices due to the global resources boom, which Australia profited from due to its large resource endowments. The terms of trade almost doubled between 2000 and 2010 as a result. However, the demands of China – Australia's main trade partner since 2011 underpinned this boom, and the slowing of China's growth rates from an average of 10% per annum for the past 3 decades to just 7.5% year on year (YoY) to June 2013 is one of the primary reasons for the slowing of these booms. Hence the terms of trade have fallen from a height of 106.5 index points in July 2011 to 90.8 index points in January 2013, possibly causing a peak in the domestic business cycle as in Fig 1. Australia's other major trade partners have reduced economic activity. The US is experiencing a dilatory recovery from the GFC (2008-09), the 'PIIGGS' countries in Europe are experiencing the European Sovereign Debt Crisis and Australia's second main trade partner Japan is experiencing large levels of public debt, an ageing population and a low birth rate. Australia has historically pursued Keynesian countercyclical macroeconomic policy, such as in the GFC when the government injected the economy with the $42b Economic Stimulus Package and the RBA cut the cash rate to a low of 3.0% in March 2009. In the post-GFC expansion, contractionary macro-policy was once again adopted. This is to moderate the fluctuations of the business cycle to achieve a stable rate of trend growth. Hence in this current economic climate of slowing growth, it seems illogical for the government to implement a contractionary budget in order to pursue the objective of external stability, for the government aims to achieve a budget surplus by 2016/17 and this involves less government spending (G) and more taxation (T). These act to reduce AD and hence it is a pro-cyclical policy. To counteract this, the RBA has maintained an historically low cash rate of 2.5% for the last two months. This acts to stimulate the economy by putting downward pressure on interest rates on the short-term money market. Through the transmission mechanism this should increase AD by causing higher consumption and lower saving due to the lower cost of borrowing and lower returns on saving. This acts to make the policy mix more effective in the current economic climate, and would be most effective if monetary stimulus outweighed the fiscal dampening of AD.

Economic growth is below trend in the Australian economy, with forecasts of just 2.5% GDP growth for 2013-14. This is from a height of 4.3% growth in the first quarter of 2012. Evidently the slowing mining boom and contractionary fiscal stance is reducing AD in the economy as represented by the classical model:

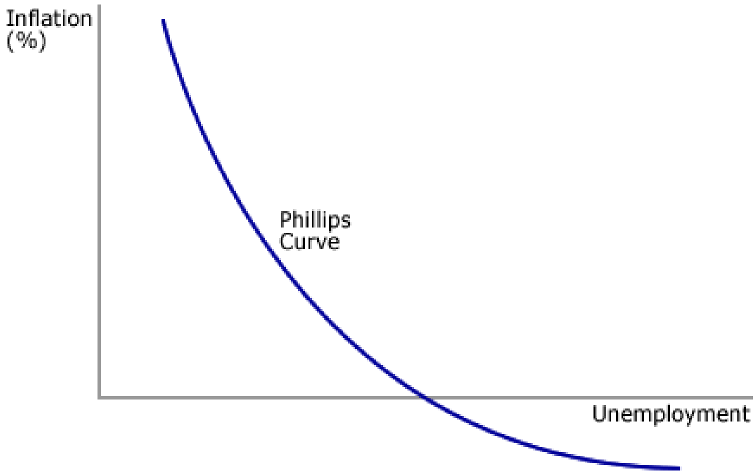
Fig 2



Labour is a derived demand of production and hence the falling growth rates have resulted in rising unemployment, which was 5.7% in June 2013, rising slowly from a low of 4.9% in May 2012. This is above the NAIRU of 4-5% (Gittins), for this denotes full employment of all the labour resources that are willing and able to be employed. This provides further impetus for an expansionary policy mix, but due to the government's continued commitment to surplus, it remains contradictory and uncertain in its stance. Whilst the RBA is evidently trying to stimulate the economy, it is being hindered by the limitations of monetary policy. Its time lag of 6-18 months is inconvenient, for economic stimulus is needed in the present. The RBA, in having such a low cash rate is acting pre-emptively, for it evidently expects further slowing of the domestic economy, especially as the mining boom continues to slow and contractionary fiscal policies are implemented. Monetary policy is also a 'blunt instrument', meaning that in stimulating the economy, it is stimulating ailing domestic industrials just as much as export-oriented industries which are actually benefitting from the falling $A, even though they do not need this support. This reduces the effectiveness of monetary policy, however, due to pro-cyclical fiscal policy stance, it is the only means by which to counteract the negative effects of a slowing economy.

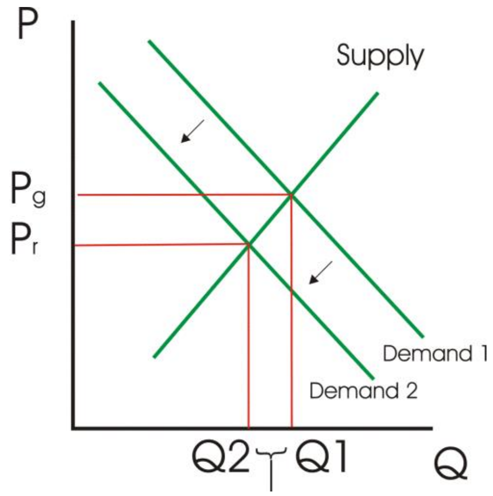
Inflation is a conflicting economic objective with full employment, and hence also economic growth. This is represented by the Philip's Curve:

Fig 3



This is because in the labour market, a reduced demand for the labour factor of production results in lower wage-increase pressures as according to the classical model of supply and demand in which a new and lower equilibrium is reached:

Fig 4



The benefit of unemployment being above the NAIRU is the low cost-push inflationary pressures. This in turn leads to lowered increases in disposable income by households and hence lower consumption, resulting also in low demand-pull inflation. Hence inflation is within the RBA's target band of 2-3%, being just 2.4% in July 2013 and is predicted to be stable at this level for at least the next year. This is due to the 'effectiveness' (however wittingly) of fiscal policy. This allows the RBA, which usually targets inflation, to pursue other objectives, and these are its objectives of full employment and economic growth which it is trying to achieve, with uncertain effectiveness.

External stability is the main focus of the government at the moment, and the objective of balancing the budget by 2016/17 is conflicting with the objectives of growth and employment. It is the clear intent to return to surplus however that has been effective in allowing Australia to maintain its AAA credit rating even in such an uncertain economic climate. Budgeting for a surplus has been largely ineffective however due to fact that the budget is composed of both discretionary and non-discretionary factors. It is the latter that is influenced by economic conditions as opposed to government planning. Such were the revenue write-downs as a result of the weak economy. These are namely the reduced price of carbon, reducing revenues from the Emissions Trading Scheme and the slowing mining boom reducing revenues from the Mineral Resources Rent Tax. Due to decreasing economic activity, revenues from progressive taxation have fallen and welfare payments have risen. This has resulted in the budget blowing-out two estimates. The first was that a budget surplus has been postponed from 1 to 4 years. The fact that an estimate one year into the future could be so incorrect only increases the dubiety of an estimate 4 years into the future being correct. This was proven by the second blow-out which was the rise in the predicted deficit for 2013 from $18b to $30b.The underlying goals of this fiscal policy stance however is to avoid a spiralling debt trap scenario as is happening in the Eurozone, and for the government to have more funds to stimulate the economy in the future in a time of crisis, or if economic activity further slows. In these ways, fiscal policy is working effectively, though still not as effectively as predicted.

Equality in the distribution of income and wealth was not a major consideration in the budget or the RBA's monetary policy decisions. A commitment to surplus by the Labor Party involves reducing the growth in redistributive payments. With the election of the right-wing Liberal Party, this objective will likely be even more overlooked, especially if they take more hard-line cost-cutting measures to achieve a surplus, as they have indicated they may. Monetary policy, being a blunt instrument is not traditionally used to effect this objective. The stimulation of the economy does act to increase inequality however, for the growth in incomes is usually weighted towards the wealthy. This is due to the tendency for wealth to beget income and vice versa. This results in an increasing income inequality in the economy. Due to the slowing of the economy, this will likely not be a problem, however income equality will not improve due to the government's lack of redistributive policies.

Environmental sustainability is also not a major objective currently. This is a conflicting objective with economic growth because this causes increased production, which can deteriorate the environment through natural resource use and externalities as a result of market failure, for example the emission of CFCs that cause global warming. Monetary policy is stimulating the economy, therefore having a detrimental effect on the environment. This is being counteracted by fiscal policy however. The Liberal Party will have a contradictory effect on the environment. Whilst it may slow down economic activity further by committing more rigorously to a surplus, it promises to remove the Emissions Trading Scheme which aimed to internalise the negative externality of pollution to incentivise its producers to decrease emissions. The overall environmental impact of this policy mix is hence uncertain because it is not one of the main current economic objectives.

The contradictory policy mix of a budget surplus and expansionary monetary policy attempts to achieve conflicting economic objectives simultaneously, however only some of these are being achieved effectively. Inflation is low, however this is only because of low growth and rising unemployment. The main objective of fiscal policy of achieving external stability has not been as successful as predicted and the objectives of income equality and environmental sustainability are not being targeted and this is having mixed and uncertain impacts on them.