FACULTY OF JURIDICAL SCIENCES

Lecture-6

GOALS OF MACROECONOMIC POLICY

Macroeconomic policy is concerned with the operation of the economy as a whole. In broad terms, the goal of macroeconomic policy is to provide a stable economic environment that is conducive to fostering strong and sustainable economic growth, on which the creation of jobs, wealth and improved living standards depend

1. Non-Inflationary Growth

In other words, this is stable and sustainable economic growth and development that is "real" (non-inflationary) over the long-term. Economic growth in an economy is an outward shift in its Production Possibility Curve (PPC). Another way to define growth is the increase in a country's total output or Gross Domestic Product (GDP). The objective of the central bank and government would be an increase in economic growth without a rise in the rate of inflation.

2. Low Inflation

Inflation is the sustained increase in the price level. The rate of inflation is the change in inflation over a period. Central banks would like to keep the growth of the rate at which prices increase at low rates. As inflation rises, every dollar you own buys a smaller percentage of a good or service. For example, the U.S. Federal Reserve targets the inflation rate at roughly 2%.

3. Low Unemployment or Full Employment

Full employment occurs when the labor force (this count is fully employed in productive work. A person is considered to be unemployed if he doesn't currently doesn't have a job and is actively searching for one. Having a lower rate of unemployment means that the economy is more productive. This objective means that as many people who want to be employed are employed, so the economy is running at or near full productivity.

4. Equilibrium in Balance of Payments

Equilibrium in Balance of Payments means that a country's exports or imports should not be much larger than its imports or exports. Having a large balance of payments deficit or surplus is not beneficial for the economy.

5. Fair Distribution of Income

A fair or equitable distribution of income means that the gap between the rich and the poor is not too large. Fair or equitable doesn't mean equal, but fair is a relative concept. What could be fair to one person may not be fair to another. The government doesn't want all the wealth concentrated with a small group of people.

The key pillars of macroeconomic policy are: <u>fiscal policy, monetary policy and exchange rate policy</u>. This brief outlines the nature of each of these policy instruments and the different ways they can help promote stable and sustainable growth.

<u>Fiscal policy</u>

Fiscal policy operates through changes in the level and composition of government spending, the level and types of taxes levied and the level and form of government borrowing. Governments can directly influence economic activity through recurrent and capital expenditure, and indirectly, through the effects of spending, taxes and transfers on private consumption, investment and net exports.

Under current institutional arrangements, fiscal policy is the only arm of macroeconomic policy directly controlled by government.

As an instrument for stabilizing fluctuations in economic activity, fiscal policy can reflect discretionary actions by government or the influence of the 'automatic stabilizers'. A fiscal stimulus package is an example of discretionary action by government intended to support aggregate demand by increasing public spending and/or cutting taxes.

The 'automatic stabilizers' refers to certain types of government spending and revenue that are sensitive to changes in economic activity, and to the size and inertia of government more generally. They have a stabilizing effect on fluctuations in aggregate demand and operate without requiring any specific actions by government. For example, if the economy slows, on the revenue side of the budget the amount of tax collected declines because corporate profits and taxpayers' incomes fall; on the expenditure side, unemployment benefits and other social spending increases. The effects of these changes tend to offset part of the decline in aggregate demand that would otherwise occur. This cyclical sensitivity makes fiscal policy automatically expansionary during downturns and contractionary during upturns in economic activity.

At least conceptually, the operation of the automatic stabilizers over the economic cycle should have no effect on the underlying structural position of the budget. A short-term cyclical deterioration in the budget bottom line should be reversed as economic conditions improve.

As well as having a short-term stabilization role, fiscal policy can also be framed against longer-term objectives. This can include ensuring the long-term sustainability of the budget and its capacity to meet future challenges, such as population ageing, and seeking to increase the long-term growth potential of the economy, through investments in areas such as infrastructure and education.

In Australia the conduct of fiscal policy is subject to the *Charter of Budget Honesty Act 1998* which imposes a formal requirement on the Australian Government to set out and report against a medium-term fiscal strategy. This framework is required to be based on 'principles of sound fiscal management' including: having regard for government debt and the management of fiscal risks, the state of the economic cycle, the adequacy of national saving, the stability and integrity of the tax base and equity between generations. The medium term focus of the Charter

does not preclude a role for either discretionary action by government intended to stabilize fluctuations in economic activity, or the automatic stabilizers.

Monetary policy

In Australia, the Reserve Bank of Australia (RBA) Board is responsible for setting monetary policy. Monetary policy decisions are implemented by changing the cash rate (the interest rate on overnight loans in the money market). The cash rate is determined in the money market by the forces of supply and demand for overnight funds. Through open market operations the RBA can target the cash rate by increasing or decreasing the supply of funds that banks use to settle transactions among themselves. For example, if the RBA wants to lower the cash rate it can supply more exchange settlement funds than the commercial banks want to hold. In this case, banks will respond by offloading funds, which pushes the cash rate lower.

By changing the cash rate the RBA is able to influence interest rates across the financial system. Changes in interest rates in turn can influence economic activity by affecting savings and investment behavior, household expenditure, the supply of credit, asset prices and the exchange rate.

If demand pressures are building up in the economy, reflected in rising prices, the RBA can tighten monetary policy, thereby dampening demand. Conversely, in the face of weak demand, reflected in deflationary pressures, the RBA can loosen monetary policy to support economic activity.

However, it is important to remember that monetary policy can exert an influence on the macro-economy even when interest rates are left unchanged. What matters is the level of interest rates. It is possible the cash rate may not have changed for some time but the level of interest rates is nonetheless exerting a strong expansionary or contractionary effect on the economy.

The RBA Board sets the cash rate with a view to achieving the objectives set out in the *Reserve Bank Act 1959*, namely: the stability of the currency of Australia, the maintenance of full employment and the economic prosperity and welfare of the Australian community. In pursuit of these objectives, the RBA aims to maintain inflation between 2% and 3%, on average, over the economic cycle, thereby anchoring inflationary expectations. By targeting low and stable inflation the RBA seeks to encourage strong and stable economic growth.

Exchange rate policy

Exchange rate policy is concerned with how the value of the domestic currency, relative to other currencies, is determined. Australia has had a floating exchange rate since December 1983. The value of the Australian dollar is determined by market forces.

In response to the mining boom, the Australian dollar appreciated, which helped moderate inflationary pressures and ensure the economy received the price signals needed to facilitate the flow of resources to the mining sector. The appreciation of the dollar also helped spread the benefits of the mining boom by increasing the purchasing power of Australian households.

However, the high exchange rate had a contractionary effect on a number of sectors of the economy (such as manufacturing).