TOPIC 3

ECONOMIC ISSUES

Issues

By the end of Topic 3, you will be able to examine the following economic issues:

- Examine the arguments for and against increasing economic growth rates
- Investigate the economic and social problems created by unemployment
- Analyse the effects of inflation on an economy
- Discuss the effect of a continued current account deficit on an economy
- Investigate recent trends in the distribution of income in Australia and identify the impact of specific economic policies on this distribution
- Analyse the economic and social costs of inequality in the distribution of income
- Examine the economic issues associated with the goal of ecologically sustainable development

Focus

This topic focuses on the nature, causes and consequences of the economic issues and problems that can confront contemporary economies.

Skills

Topic 3 skills questions can ask you to:

- Identify and analyse problems facing contemporary and hypothetical economies
- Calculate an equilibrium position for an economy using leakages and injections
- Determine the impact of the (simple) multiplier effect on national income
- Explain the implications of the multiplier for fluctuations in the level of economic activity in an economy
- Calculate the unemployment rate and the participation rate using labour force statistics
- Interpret a Lorenz curve and a Gini coefficient for the distribution of income in an economy
- Use economic concepts to analyse a contemporary environmental issue
- Assess the key problems and issues facing the Australian economy

Topic 3

Introduction

This section (chapters 7–12) covers Year 12 Topic 3, *Economic Issues*, and focuses on the nature, causes and consequences of the economic issues and problems that confront contemporary economies such as Australia.

Chapter 7 examines the issue of economic growth in the Australian economy. It provides a foundation of economic theory with which to examine Australia's recent growth performance. Concepts examined include aggregate demand and supply, injections and withdrawals, the simple multiplier and the measurement of growth through changes in real Gross Domestic Product (GDP). The chapter looks at the sources and effects of economic growth in Australia, recent trends in the business cycle and the impacts of economic growth.

Chapter 8 examines the issue of unemployment in the Australian economy. The chapter covers measurement of unemployment, trends in unemployment, types and causes of unemployment, the concept of a non-accelerating inflation rate of unemployment and examines which groups in the community are most affected by high unemployment levels. The chapter finishes with a review of the economic and social consequences of unemployment.

Chapter 9 examines the issue of inflation in the Australian economy. Australia has been successful in achieving low inflation outcomes since the early 1990s, but has faced a global surge in inflation in the early 2020s. The chapter looks at the measurement of inflation and its trends in recent years. It then examines the main causes of inflation and the effects of inflation on the Australian economy.

Chapter 10 examines the issue of external stability in the Australian economy. Many dimensions of Australia's relationship with the global economy are reflected in our external accounts. The chapter addresses how we measure external stability in terms of the relative size of the current account deficit, net foreign debt and net foreign liabilities. The trends in Australia's external accounts are briefly reviewed, with reference to Topic 2. Chapter 10 also examines the causes and effects of external imbalance in Australia.

Chapter 11 examines the issue of distribution of income and wealth in the Australian economy. The chapter looks at how we measure inequality, and we examine some of the factors that influence inequality by looking at the sources of income and wealth. It examines the relationship between inequality and a range of social dimensions, such as gender, age, occupation, ethnic background and family structure. It also examines the economic and social costs and benefits of inequality in the context of the Australian economy.

Chapter 12 examines the issue of environmental sustainability in the Australian economy. This is a priority because of the long-term economic impacts of climate change and water shortages. The chapter covers the issues of ecologically sustainable development, private and social costs and benefits of growth, and public and private goods. A number of issues, such as preservation of natural environments, pollution control, climate change and depletion of renewable and non-renewable resources, are also examined in the context of the Australian economy.

Economic Growth

7

7.1 Introduction

Economic growth creates jobs, allows individuals to increase their consumption, and raises living standards. Accordingly, economic growth is generally considered to be the most important single measure of an economy's performance. For this reason, the pursuit of economic growth has long been a major objective of government policy.

Economic growth can be defined as an increase in the volume of goods and services that an economy produces over a period of time. It is measured by the **annual rate of change in real Gross Domestic Product (GDP)**, that is, the percentage increase in the value of goods and services produced in an economy over a period of time, usually one year, adjusted for the rate of inflation. This is more accurate than **nominal GDP**, which does not adjust for price changes.

$$\textbf{Economic growth (\%)} = \frac{\text{real GDP (current year)} - \text{real GDP (previous year)}}{\text{real GDP (previous year)}} \times \frac{100}{1}$$

The Australian Bureau of Statistics (ABS) estimates the level of GDP in Australia every three months (that is, for every quarter of the year) in the publication called *Australian National Accounts: National Income, Expenditure and Product*. To measure GDP, the ABS uses information about household and business incomes, expenditure on goods and services, and production by firms. You might recall from the Preliminary Economics Course, when we looked at the Circular Flow model, that income, expenditure and production are all the same in an economy because all production generates an income, and all expenditure is in return for produced goods and services. To add to the confusion of three separate sources of data to calculate GDP (income, expenditure and production), there are also three different time periods used to measure Australia's rate of economic growth:

- **Quarterly economic growth:** calculated every three months by the ABS. For example, quarterly growth in the March quarter of 2023 is the percentage increase in GDP since the previous December quarter (that is, the final three months of 2022). So if quarterly GDP was $501 billion in the December quarter of 2022 and $506 billion in the subsequent March quarter of 2023, the quarterly rate of economic growth would be around 1 per cent.

- **Year-on-year growth**: a less volatile measure of economic growth, which measures the percentage change in GDP between one quarter and the corresponding quarter of the previous year. For example, if quarterly GDP was $506 billion in the March quarter of 2022 and was $520 billion in the March quarter of 2023, the year-on-year rate of growth would be 2.8 per cent.
- **Annual economic growth**: calculated using GDP statistics for the whole financial year, which runs from 1 July to 30 June. When the June quarter national accounts are released, usually in early September, annual growth is calculated as the percentage increase in GDP since the last financial year. For example, if GDP grew from $2012 billion in 2021–22 to $2072 billion in 2022–23, the annual rate of economic growth would be 3 per cent.

There are a variety of measures of economic growth because economic policymakers use growth statistics for a wide range of purposes, and each measure of economic growth is useful for different purposes. The Reserve Bank, for example, needs to know what the level of economic activity will be in the coming 12–18 months in order to forecast inflation trends and determine appropriate changes to interest rates, and therefore must look at the most up-to-date indicators of economic growth. The Productivity Commission, by contrast, is more interested in how structural policies affect economic growth in the long term, perhaps over periods of decades. It is more interested in long-term growth trends, and has little interest in volatile quarterly growth statistics that are heavily influenced by short-term factors.

7.2 Economic growth and aggregate demand and supply

To access articles and statistics about Australia's GDP growth rate, visit the website of the Australian Bureau of Statistics: **www.abs.gov.au**. *Australian National Accounts: National Income, Expenditure and Product.*

To understand more about economic growth we must first look at the factors that influence the level of economic activity. An understanding of how growth occurs can guide governments in deciding how to achieve higher rates of economic growth. This has been an issue of long-running debate among economists.

Traditionally, most economists believed that the most important factor determining economic growth was the ability of firms to produce goods and services – that is, the level of total output or **supply**. Classical and neoclassical economists in the 18th and 19th centuries believed that market economies would naturally achieve optimum economic growth without any government intervention. However, opinions changed after the Great Depression of the 1930s, a period of very low economic growth that left many people out of work. The experience of the Great Depression caused policymakers to question many of the assumptions underpinning economic policy at that time.

As economists looked for new ways to achieve economic growth, **John Maynard Keynes** developed a theory stating that the most important influence on economic growth was the total level of expenditure in the economy – that is, the level of **aggregate demand**. Keynesian economics became the most important economic theory of the 20th century, shaping the policies of advanced and emerging economies between World War II and the 1970s.

Keynesian economic theory suggested that people would not necessarily spend their income just because goods were produced and businesses paid their workers for production. If households and businesses were generally pessimistic about the future economic outlook, households would tend to spend less on consumer goods and save more, while firms would be reluctant to invest in capital goods. This would result in an overall decline in aggregate demand, with falling production and rising unemployment.

Aggregate demand – represented by the symbol AD – is the total level of expenditure in an economy over a given period of time. It includes consumption, investment, government spending and net export spending (export spending minus import spending).

Aggregate supply – represented by the symbol Y – is the total level of income in an economy over a given period of time. Part of national income is collected by the government through taxation, and the rest is either spent on consumption or is saved.

Aggregate demand refers to the total demand for goods and services within the economy. Components of aggregate demand are: consumption (C), investment (I), government spending (G) and net exports (X – M).

Aggregate supply refers to the total productive capacity of an economy, that is, the potential output when all factors of production are fully utilised.

$AD = C + I + G + (X - M)$	$Y = C + S + T$
WHERE: **AD** = aggregate demand **C** = consumer spending by households **I** = investment spending by businesses **G** = government spending **X** = export revenue **M** = spending on imports	**WHERE:** **Y** = aggregate supply or national income **C** = consumer spending by households **S** = saving by households **T** = taxation by the government

The economy is in **equilibrium**, that is, it will tend to be stable, when the level of aggregate demand is equal to aggregate supply (national income). By substituting the components of aggregate demand and supply into the equilibrium equation, we find an alternative condition for equilibrium in the economy – that the leakages of savings, taxation and imports will be equal to the injections of investment, government spending and exports. (This is the way we looked at economic growth in the Preliminary Course, with the Circular Flow of Income model). Changes in leakages and injections influence the level of economic activity. If injections are greater than leakages, economic growth will increase – but if leakages are greater than injections, economic growth will decrease.

Equilibrium occurs when:

Aggregate supply = Aggregate demand
$Y = AD$

Substituting for aggregate demand gives:

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

Substituting for aggregate supply gives:

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

By rearranging the equation:

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

reviewquestions

1 Define the term *economic equilibrium*.

2 Assume an economy is in equilibrium and investment increases by $10 billion. Describe the economic effect in terms of leakages, injections and economic growth.

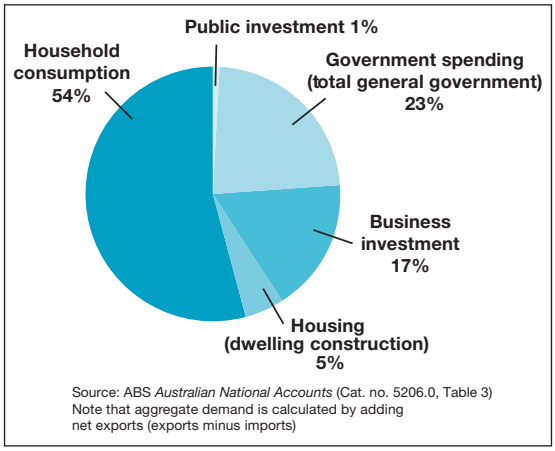
7.3 The components of aggregate demand

Changes in the level of economic growth in the short to medium term are driven largely by changes in the level of aggregate demand. To better understand what drives economic growth, we need to examine the individual components of aggregate demand. By analysing the factors that influence these individual components, we can see what factors will cause the economy to expand and contract over time – and therefore better understand what policies may be used to increase the level of economic growth.

Influences on consumption

Examining the influences on leakages and injections allows us to see what factors influence the level of economic growth.

Influences on consumption and saving



Source: ABS *Australian National Accounts* (Cat. no. 5206.0, Table 3)
Note that aggregate demand is calculated by adding net exports (exports minus imports)

Figure 7.1 – The components of domestic demand

Consumption is an important determinant of the level of economic growth because consumption by households typically makes up around 55–60 per cent of expenditure (or aggregate demand) in the economy (see figure 7.1). Anything that boosts consumption is also likely to boost expenditure (demand) and hence economic activity (that is, income or supply).

Obviously, the most important factor influencing the level of consumption is income itself. People with higher incomes tend to consume more. Economies with higher incomes tend to consume more. If a person's income rises over time, their consumption tends to rise too. However, because we want to know how consumption can influence economic activity (including income), we must look at the factors that influence consumption *for a given level of income* – that is, all the factors other than income. Put another way, our concern is with the proportion of total income that is spent on consumption, called the **average propensity to consume (APC)**, and the proportion of total income that is saved, called the **average propensity to save (APS)**. The three greatest influences on the APC are consumer expectations, the level of interest rates and the distribution of income.

Average propensity to consume (APC) is the proportion of total income that is spent on consumption.

Average propensity to save (APS) is the proportion of total income that is not spent, but is saved for future consumption.

Consumer expectations

Expectations about future price rises and the general availability of goods will influence consumers' decisions to spend or save their income. If consumers expect a rise in their incomes or in inflation, or if they anticipate future shortages of goods, then they tend to spend more and save less in the short term. On the other hand, if consumers expect that their incomes might fall, that prices might fall or that goods and services might become more available in the future, then they are inclined to spend less and save more.

The level of interest rates

An increase in the general level of interest rates would discourage individuals from spending their money (as the cost of borrowing money is now higher) and therefore encourage them to save, while a decrease in interest rates would encourage spending and discourage saving. For example, global inflationary pressures in early 2022 led to higher interest rates, prompting households to be more conservative in their discretionary spending as they budgeted for increased mortgage repayments.

The distribution of income

Generally speaking, the more equitable (even) the distribution of income, the higher the rate of overall spending, and vice versa for a more inequitable (uneven) distribution of income. This is because people on lower incomes tend to spend proportionately more of their income than those on higher incomes. This reflects a key insight of the Keynesian consumption function: the more income that an individual receives, the higher proportion they save and the lower proportion they spend. For example, a person with a net income of $400 per week might have to spend it all on basic costs of living, whereas someone receiving a net income of $4000 per week might comfortably save half of that level of income. As a result, policy changes that redistribute income from higher to lower income earners (such as increasing the rate of JobSeeker payments) are more likely to increase consumer spending than policies that increase the income of high income earners (such as a reduction in the top marginal tax rate).

Influences on investment

Business investment is one of the most volatile components of demand or aggregate expenditure, usually contributing between 10 and 15 per cent. The main factors influencing business investment are the cost of capital equipment and business expectations.

The cost of capital equipment

The cost, or relative cost, of capital equipment is influenced by the following factors:

- **Changes in interest rates**. A fall in interest rates would make it cheaper to borrow funds for the purchase of capital equipment, and a rise in interest rates would raise borrowing costs, as well as making it more attractive to save. Interest rates also represent an opportunity cost for firms who own their capital. Firms with available cash reserves will compare the returns from either saving money (for example, lending it to others, such as by buying bonds) or using it to fund the acquisition of capital or other businesses (alternatively, they may return cash to investors through increased dividends).
- A change in **government policies** relating to investment allowances and tax concessions on capital goods. For example, if the government allowed businesses to claim the full cost of capital equipment immediately, instead of claiming depreciation over several years, this would reduce their tax liability and make capital cheaper than it otherwise would have been. During the COVID-19 recession, the Australian Government allowed firms with turnover of up to $5 billion to immediately deduct the full cost of all asset purchases until July 2023. This incentive led to a 5 per cent jump in the contribution of business investment to aggregate demand between 2021 and 2022 (from 12 to 17 per cent. See figure 7.1).
- Any change in the **price or productivity of labour** (labour being a substitute for capital in the production process) or technological innovations will affect the relative cost of capital compared with labour. For example, if either the cost of labour increased or more advanced labour-saving technologies became available at the same cost, then the relative cost of capital compared with labour would have decreased, making its use more attractive.

Business expectations

Business expectations about future prospects, a factor sometimes described as entrepreneurial or as "animal spirits", influence the level of investment. The factors that affect expectations are:

- Any change in **expected demand for their products**. If entrepreneurs expected a future increase in demand, they would be more inclined to purchase new capital equipment to boost production and satisfy that demand.
- Any change in the **general economic outlook**. If economic growth is expected to increase, entrepreneurs will be more inclined to invest in capital equipment because a higher level of economic activity should improve the returns on investment.
- **Inflation** leads to uncertainty about future prices and future costs of production, and this is likely to lead to reduced investment in productive capital equipment.

Influences on government spending and taxation

Levels of government spending and taxation can also have a significant influence on the level of economic activity. Federal government spending usually makes up around 20–25 per cent of aggregate demand or expenditure, while taxation is around 20–25 per cent of aggregate supply or income.

As we will discuss in chapter 14, when we look at fiscal policy, one of the main goals of government spending and taxation policies is to **maintain a sustainable rate of economic growth**, and help achieve the goals of low unemployment and inflation. This means that governments may increase their level of spending and/or reduce the level of taxation to increase aggregate demand and growth. Alternatively, governments may reduce their level of spending and/or increase the level of taxation to reduce aggregate demand and growth.

Influences on exports and imports

Changes in export sales and demand for imports can have an impact on the level of aggregate demand and economic activity. Exports and imports are each equal to between one-fifth and one-quarter of aggregate demand. If export revenue is equal to import spending, net exports (export revenue minus import spending, that is, the trade balance) neither adds nor subtracts from aggregate demand. Australia's recent sustained trade surpluses have made a positive contribution to aggregate demand.

Australia's volumes of exports and imports are influenced by the levels of overseas and domestic income. When overseas income levels rise, Australia's exports tend to rise as well. When Australian income levels rise, Australia's imports tend to rise as well. Apart from income levels, Australia's net exports are also influenced by exchange rate inflation, levels of international competitiveness, protectionist policies of other countries, and consumer tastes and preferences:

- When Australia has a weaker exchange rate, domestic industries are more competitive as the relative cost to foreign purchasers decreases, often resulting in increased sales. This means that net exports will be higher, adding to aggregate demand and boosting economic activity.
- When Australia has a stronger exchange rate, domestic industries are less competitive and their products become more expensive for foreign consumers. As a result, net exports will be lower, detracting from aggregate demand and reducing economic growth.

As detailed in chapter 6, improving Australia's trade performance is a key policy objective due to its impact on aggregate demand and economic growth.

review questions

1. Explain how expectations can affect both consumption and investment.
2. Describe the impact of lower taxation on demand.
3. Discuss the influence of net exports on the level of aggregate demand.

7.4 Changing levels of growth: the multiplier process

We now turn to how changes in the level of aggregate demand influence the level of economic activity. This section simplifies the economy to the three-sector Circular Flow model of individuals, firms and financial institutions, but excludes the government and international sectors.

As we saw in the previous section, income (Y) that is not spent on consumption (C) must be saved (S). Likewise, expenditure in the economy (AD) is made up of consumption (C) and investment (I).

The consumption that comes from income is obviously equal to the consumption part of expenditure. However, there is no reason why savings (S) and investment (I) have to be equal all the time (see the factors influencing savings versus the factors that influence investment in the previous section as evidence of this).

Whenever S is not equal to I, the economy will be disrupted from its state of equilibrium. The Circular Flow model suggests that the economy will move towards a state of equilibrium – at a higher level of economic activity when the injection of I is greater than the leakage of S, and at a lower level of economic activity when the injection of I is less than the leakage of S.

How does this adjustment take place? By the **multiplier process**, an economic concept developed by John Maynard Keynes.

When there is a shock to the economy, such as a change in consumer or business expectations, a change in interest rates, or a change in government policies, there will be a change in injections or leakages. For example, improved business expectations for economic recovery will increase business investment and expenditure (demand). This expenditure will provide increased income for individuals, who then consume more, which will further increase expenditure and income and so on. Therefore, the initial increase in investment will have a **multiplied impact on national income**.

However, the increase in investment will not continue to increase income forever. Each time the injection moves around the economy, its impact on expenditure gets smaller because some of the income is not consumed but saved. This savings component is a leakage that reduces the effect of the higher investment on national income. The number of times the final increase in national income exceeds the initial increase in expenditure that caused it is **the multiplier**. The mechanism by which changes in aggregate demand result in changes in GDP is known as the **multiplier effect**.

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

To calculate how a change in injections or leakages has a multiplied impact on income we need to consider two more concepts:

- the **marginal propensity to consume** (MPC), that is, the proportion of each extra dollar of income that is spent on consumer products
- the **marginal propensity to save** (MPS), that is, the proportion of each extra dollar of income that is saved.

$$\text{MPC} = \frac{\Delta \text{ in consumption}}{\Delta \text{ in income}}$$

$$\text{MPS} = \frac{\Delta \text{ in savings}}{\Delta \text{ in income}}$$

In any economy, the sum MPC + MPS = 1 always holds, since each extra dollar of income must be either consumed (spent) or saved.

This can be explained using the following example: Assume that for each extra dollar of income, consumers spend 70 per cent (70 cents) and save 30 per cent (30 cents).

In this case MPC = 0.7 and MPS = 0.3

Assume also that investment in the economy has increased by $10,000. This represents an injection into the circular flow of $10,000, or put another way, an initial increase in aggregate demand of $10,000. If the economy was previously at equilibrium, this means that aggregate demand will now exceed output in the economy. This excess in aggregate demand will manifest itself in an unplanned rundown of stocks. Producers will respond by increasing output and national income will initially increase by $10,000 (since the initial increase in aggregate demand was $10,000).

However, the multiplier process ensures that national income will ultimately rise by much more than $10,000. It works like this:

- National income will increase by the initial $10,000.
- Of that $10,000, $7000 will be spent (since the MPC = 0.7) while $3000 will be saved (MPS = 0.3).
- The $7000 that is spent will be income to those who receive it as payment for goods and services.
- Of that $7000, $4900 will be spent (0.7 × $7000), while $2100 will be saved.
- The $4900 that is spent will be income to those who receive it. They in turn spend 70 per cent of it and save 30 per cent – and so on.

This process will continue, but the amount of additional consumption spending each time will decline until it eventually becomes insignificant.

The following points should be noted before the total increase in income generated by this multiplier process is calculated. First, it is the MPS that causes the amount of income generated by each successive wave of spending to decrease. Second, the sum of each successive wave of income generated will add up to the total amount by which national income increases. The final increase in national income is equal to the initial increase in aggregate demand multiplied by "**the multiplier**".

The size of the multiplier is determined by the MPS and can be expressed as:	$k = \frac{1}{MPS}$ (k being the symbol for the multiplier) or $k = \frac{1}{1 - MPC}$ (since MPC + MPS = 1)
Under the assumptions in our example (that is, MPS = 0.3):	$k = \frac{1}{MPS} = \frac{1}{0.3} = 3.3333$
The total increase in income generated by the $10,000 increase in aggregate demand is:	$\triangle Y = k \times \triangle AD = 3.3333 \times \$10{,}000 = \$33{,}333$

In other words, three and a third times the initial increase in aggregate demand.

Clearly, the larger the MPS, the smaller the value of the multiplier. If individuals save proportionately more of their extra income, they will spend less and therefore generate less additional income. It follows that the factor by which we must multiply our initial increase in aggregate demand must also be less. The reverse will also be true – the smaller the MPS, the larger the value of the multiplier.

The multiplier process also works for decreases in aggregate demand. For example, if we had a decrease in investment spending of $10,000, the multiplier effect would work in reverse, leading to a decrease in national income of $33,333.

Thus, any change in the level of planned expenditure (whether due to changes in investment, government spending, consumer spending or net export spending) will have a multiplied effect on the level of national income. Governments use the multiplier process because an initial increase in government spending can result in a much larger increase in economic activity as money circulates through the circular flow of income. For example, if government spending involves building new roads, construction firms receive funding to purchase inventory for the new roads and road construction workers receive wages which they will use for consumption and savings.

Appendix B: Advanced Economic Analysis at the back of this textbook looks at the income-expenditure diagram – an extension of the economic growth theory covered in this chapter.

Note that in the analysis above we have only used what is called the "**simple multiplier**", as required by the Year 12 Economics Syllabus. The simple multiplier is calculated by only considering savings as a leakage from the circular flow. If we were to also include the government and international sectors of the circular flow, we would also need to know what proportion of income is "leaked" into taxation and import spending. For example, if in addition to 30 per cent of income being saved, a further 10 per cent of income was paid in tax and a further 10 per cent was spent on imports, total leakages would be 50 per cent of income, and the value of the multiplier would fall to 1 divided by 0.5, that is, 2. However, the Year 12 Economics Syllabus only requires you to calculate the multiplied impacts of changes in leakages and injections on national income using the simple multiplier.

reviewquestions

1 The following numbers apply to a hypothetical economy:

($m) G = 30, C = 40, I = 15, X = 10, M = 10, MPC = 0.6

(a) Calculate the level of aggregate demand in the above economy.

(b) Calculate the value of the MPS.

(c) If the government wanted to increase national income by $100m, by how much would it have to increase its own spending levels?

2 In a hypothetical economy, a $30m increase in consumption leads to a $150m increase in national income. Calculate the value of this economy's marginal propensity to save.

7.5 The role of aggregate supply

While shifts in aggregate demand play the main role in determining the level of economic growth in the shorter term, aggregate supply also plays an important long-term role in influencing levels of economic growth. An economy's aggregate supply is determined by the quantity and quality of the factors of production – natural resources, labour, capital and the ability of entrepreneurs to combine them efficiently to produce goods and services. Economies with more or better-quality factors of production will be able to produce more goods and services.

Economists sometimes refer to aggregate supply as an economy's "potential". This means that when aggregate supply increases, an economy can grow faster. As figure 7.2 shows, an increase in aggregate supply can lead to an increase in total output (economic growth) and a reduction in the general price level (inflation). An economy can grow faster and more sustainably when aggregate supply is increased. An increase in aggregate supply will result in GDP growth and price stability through lower inflation.

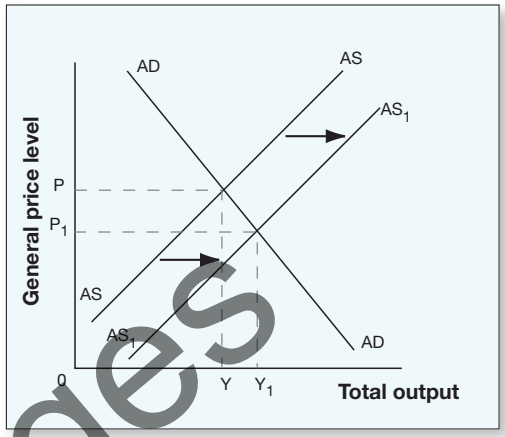


Figure 7.2 – The impact of increased aggregate supply on economic growth

Aggregate supply can be increased when a higher level of output can be produced for the same cost, that is, when there is an increase in quantity or improvement in the quality of the factors of production. This can be achieved through the changes set out in the table.

Economic change	Example
Population growth	Labour is the main input into the production process, so if there is an increase in the population (through increased immigration or birth rates) and there are more workers available, the economy will be able to produce more goods and services. For several decades, Australia's relatively high migration intake has been a major contributor to growth rates that are ahead of most advanced economies.
Discovery of new resources	New mineral and metal deposits discovered in Australia can be exploited to increase exports and increase economic growth.
Workers acquiring new skills	More highly trained doctors and health professionals may be able to diagnose illnesses more quickly and treat them more effectively.
Increased capital	Investment in capital equipment, such as machinery or artificial intelligence, that efficiently replaces labour will, in the long term, increase the capacity of the business to produce goods.
Adoption of new technology	Businesses investing in software such as Salesforce increases the efficiency of business operations, improves customer service and allows more data collection to identify areas for expansion.
Measures to improve efficiency	By establishing automated package processing centres in metropolitan Sydney, Amazon has enabled same-day delivery across the city of items purchased online.
Government policies	Changes to increase competition or reform regulation in an industry, such as the creation of Australia's national electricity grid.

If policymakers focus only on increasing aggregate demand, at some point they are likely to run into constraints with the economy's aggregate supply. If aggregate demand outstrips supply, the economy will experience **capacity constraints**, causing inflation to rise (discussed further in chapter 9). **Skills shortages** – when employers are unable to

fill specific roles – emerged as a major constraint on the Australian economy during its recovery from the COVID-19 recession. With huge reductions in immigration during the pandemic, by March 2022 ABS data showed 423,000 job vacancies – 86 per cent higher than pre-pandemic levels. Labour shortages discourage businesses from investing (other than in labour-saving technology) and expanding production. Similarly, failing to plan adequately for future expansion can result in **infrastructure bottlenecks**, such as congested roads and ports. For this reason microeconomic policies to increase aggregate supply are an important part of the economic policy mix.

reviewquestions

1 Outline the impact of an increase in aggregate supply on economic growth. Use a diagram to support your answer.

2 Explain TWO policies or changes that might increase aggregate supply in an economy.

7.6 The effects of economic growth

Traditionally, economic growth has been regarded as the most important economic policy objective. This is because economic growth makes it possible to achieve other economic and social objectives. However, too much growth can sometimes create problems.

Living standards

Faster economic growth results in an increase in real GDP per capita. Real wages can rise and households can enjoy a higher disposable income and therefore higher material living standards. This is the main reason that countries pursue higher levels of economic growth. In recent years, the Australian economy has been experiencing a slower rate of growth in real GDP per capita (with real GDP growing at an annual rate of 1.1 per cent in the period 2015 to 2020, compared to an annual growth rate of 2.1 per cent in the 1990s). This has meant that Australians' living standards have been improving at a much slower rate.

Employment

Economic growth creates jobs. In an economy that sustains strong economic growth, everyone who is willing and able to work should be able to find employment. In the long run, economic growth also changes the nature of the jobs that are available, creating jobs that are more highly skilled and contribute to increased productivity, and in turn, higher incomes. Advanced economies with strong levels of economic growth therefore tend to create more highly paid and highly skilled jobs. Following the COVID-19 recession, a strong rebound in Australia's economic growth helped drive unemployment below 4 per cent for the first time since the 1970s.

Inflation

Higher levels of economic growth can result in price increases and larger wage claims, contributing to a rise in the level of inflation. This is particularly the case when the economy is close to its full capacity and the growth in aggregate supply cannot keep pace with the growth in aggregate demand. Inflation is therefore often a side effect of economic growth. A major aim of macroeconomic policy is to sustain growth but keep growth below a level that would prompt a surge in inflation – this is known as the "sustainable rate of economic growth".

External stability

Economic growth is often accompanied by higher disposable incomes which leads to increased consumer and business spending, resulting in a higher level of imports. Unless exports keep pace with growth in imports, the balance of goods and services can worsen and the current account deficit can increase. An excessive current account deficit, in turn, can undermine confidence in an economy. For that reason, the balance of payments can sometimes become a "speed limit" on growth, reflected in the concept of a "balance of payments constraint". When a country faces a balance of payments constraint, policymakers may deliberately reduce the level of economic growth in order to improve external stability.

Income distribution

Economists generally assume that economic growth contributes to higher living standards and therefore to better outcomes for everyone. However, faster growth does not always provide universal benefits. Sometimes, the benefits of economic growth flow disproportionately to higher-income earners, high skilled workers or owners of capital, rather than flowing more broadly throughout the economy in the form of wage increases for low-skilled workers or lower prices for low-income earners. If the benefits of economic growth are not widely shared, inequality will rise. Absolute poverty should fall as the economy grows, but relative poverty may increase if income distribution becomes more unequal.

Environmental impacts

If economic growth is pursued without regard to environmental consequences, it can contribute to pollution, depletion of non-renewable resources and the catastrophic effects of climate change. In recent decades there has been a stronger focus on what is known as "ecologically sustainable development" – that is, finding ways to protect the environment while also maintaining economic growth. In many instances environmental protection can add to long-term economic growth. For example, the transition to net zero carbon emissions could boost Australia's GDP by 2.6 per cent by 2070, equivalent to a value of $680 billion, according to a 2020 Deloitte Access Economics report.

reviewquestions

1 Contrast TWO positive and TWO negative impacts of economic growth.

2 Explain how higher rates of economic growth can affect living standards and income distribution in an economy.

7.7 Recent trends in economic growth

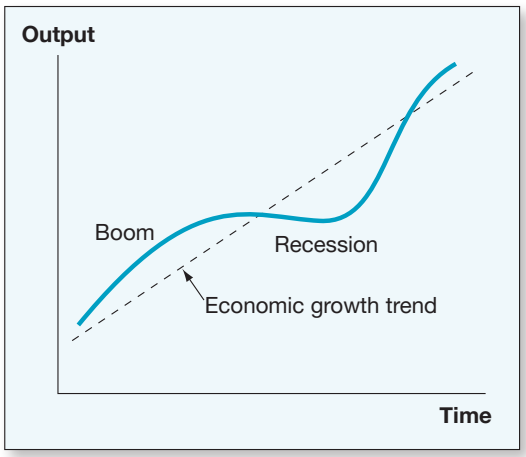


Figure 7.3 – The business cycle

The level of economic activity is never entirely stable. A market economy such as Australia's is subject to the ups and downs of the **business cycle** (that is, the general level of economic activity) caused by changes in the level of aggregate supply and demand. Figure 7.3 depicts a typical pattern of growth in real GDP for a market economy. Although showing an upward trend in real GDP, the pattern of growth is uneven, and periods of stronger economic growth are often followed by **recession**.

Recession is the stage of the business cycle in which there is a decline in economic activity, defined as two consecutive quarters (six months) of negative economic growth, that is, a fall in GDP.

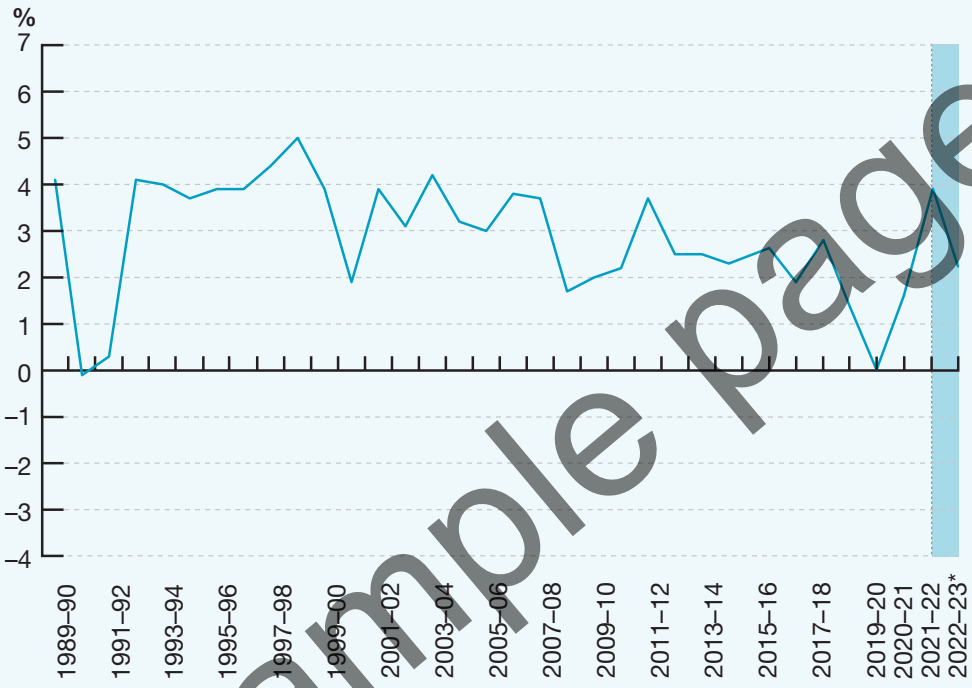
Australia's economic growth in recent decades has been relatively stable compared to both previous business cycles and other economies. Australia enjoyed a record-breaking period of 28 years of economic growth from 1991–92 to 2019–20, averaging 2.9 per cent annual GDP growth throughout the period. Although this was one of the highest average GDP rates among OECD countries over this time, real GDP per capita averaged only 1.6 per cent for the same period, which was close to the OECD average. (This is explained by the fact that Australia's high population growth makes it possible to have both a high rate of real GDP growth as an economy and an average rate of real GDP growth per capita). In 2020, Australia experienced its first recession since 1991 with contractions in the March and June quarters of 0.3 per cent and 6.8 per cent respectively as a result of the COVID-19 pandemic. The economy then staged an equally sharp recovery.

Below are eight factors that influenced Australia's growth cycle in recent years. Australia has mostly benefited from global economic trends, but has also gained from successful policy management:

- **Global economic conditions** have been mostly favourable for Australia in recent decades. Strong demand for Australia's resource exports underpinned a boom in mining investment, and subsequently a surge in export revenues. This has increased Australia's national income and helped avoid the prolonged economic downturn of the 2010s that many countries experienced after the global financial crisis, and assisted Australia's rebound from the COVID-19 recession. Rising inflation in the US and Europe following Russia's invasion of Ukraine and volatile trade relations with China may impact Australia's eocnomic growth in coming years.
- Australia experienced **terms of trade** booms from 2005–2011 and from 2017 into the early 2020s, driven by very large increases in the prices of Australia's commodity exports (specifically iron ore, coal and natural gas). As a result, export revenues have grown substantially, improving Australia's balance on goods and services and creating a current account surplus that has set aside longstanding concerns about the balance of payments constraint (see chapter 4).
- Over the last three decades, macroeconomic management in Australia has largely maintained a **sustainable rate of economic growth** – a level that does not push inflation above its target range of an average 2–3 per cent, generates employment growth and maintains external balance. The Australian Treasury estimates that Australia's long-term sustainable rate of economic growth is around 2.75 per cent of GDP. In the three decades to 2020, growth was within the range of 2–4 per cent for 22 out of 30 years.
- The Reserve Bank of Australia's (RBA) pre-emptive use of **monetary policy** and its focus on maintaining low inflation has helped maintain a sustainable rate of growth. The RBA had successfully taken quick action to ward off inflationary pressures when the economy was experiencing high levels of growth. When the economy experienced a spike in inflation in 2022 because of supply chain and global pressures, the RBA was criticised for having left interest rates too low for too long during the pandemic, and moved to tighten monetary policy with a series of sharp interest rate increases.

Conversely, during times when the economy has weakened, the RBA has reduced interest rates to support aggregate demand before the actual downturn sets in. For example, in response to weakening economic growth in 2019 (before the COVID-19 pandemic), the RBA made three reductions in the cash rate, bringing it down to 0.75 per cent. In response to the pandemic, the RBA then reduced the cash rate to a record low 0.10 per cent.

- During periods of economic downturn, the Government has successfully used **fiscal policy** to stabilise economic growth. Australia avoided a recession after the global financial crisis in 2009 because the Government responded quickly with a large-scale fiscal stimulus that had an immediate impact on household consumption and government spending. Similarly, in response to COVID-19 in 2020, the Government initiated the largest fiscal policy intervention in Australian economic history, helping to ensure a quick recovery.



Source: ABS *Australian National Accounts* (Cat. no. 5206.0, Table 3), *RBA forecast August 2022

Figure 7.4 – Australia's economic growth performance

- Australia has one of the highest sustained population growth rates among advanced economies. This is due to high immigration levels since the mid-20th century. However, international border closures arising from COVID-19 sharply reduced migration inflows and for the first time since World War II, net overseas migration was negative in 2020–21. BIS Oxford Economics estimated that Australia's population will be 1.1 million lower than was projected over the next decade, due to the reduction in migration during the pandemic. With fewer people to participate in the workforce, this could constrain aggregate supply and dampen long-term economic growth.

THE UNENDING MINING BOOM

The most significant economic development during Australia's recent long growth cycle was the mining boom. At the time, the Reserve Bank Governor, Glenn Stevens, described it as the greatest expansionary shock to the Australian economy in more than 50 years. Strong growth in China and other emerging economies resulted in soaring demand for natural resources, such as coal, gas and iron ore, leading to a sharp increase in prices and the largest increase in Australia's terms of trade for 150 years. The spike in global resource prices in the 2000s was especially large because of a long period of low investment in mining operations around the world, meaning that global supply was price inelastic: mining companies were unable to increase output quickly in response to the increased demand, and so prices soared. This meant that average prices for Australia's commodity exports tripled between 2003 and the peak of the cycle – as shown in figure 7.5.

The increase in commodity prices sparked the largest sustained improvement in Australia's terms of trade on record. Although the terms of trade slipped during the global financial crisis in 2009, it quickly rebounded to reach a 140-year high in 2011. This provided a very large stimulus to the economy. The Reserve Bank noted in 2011 that the terms of trade boom had added 15 per cent to Australia's nominal GDP, equivalent to over $190 billion per year. This meant that the resources boom had a larger impact on national income in Australia than the revolution in information and communication technologies. Although foreign-owned mining companies sent a share of their increased profits overseas, Australian taxpayers also benefited as higher company tax receipts allowed the Government to reduce personal income taxes.

A decade and a half after the beginning of the terms of trade boom, income per person in Australia was around 20 per cent higher than it was in the mid-2000s, and average real wealth per person had risen by 40 per cent. The prices for Australia's commodity exports have remained resilient even though many economists counted 2012 as the end of the resources boom, as shown in figure 7.5.

Global recessions, such as that triggered by COVID-19, usually result in a downturn in commodity prices, but prices for iron ore, copper, nickel, lithium and coal began to surge shortly after the height of the pandemic in 2020. In 2021–22, both iron ore and coal prices went beyond the record set during the mining boom in 2011. While gaps in supply chains following the pandemic played a role in boosting commodity prices, they nonetheless accelerated Australia's economic recovery and underscored how Australian economic growth in the 21st century has been driven by commodity markets. In many respects, the mining boom that began in 2003 is still underway in the early 2020s.

While Australia's short-term economic growth is likely to remain reliant on commodity exports, the overseas demand for fossil fuels will decline in coming decades as economies transition to lower carbon energy sources. Australia's relationship with China and India will also be important to future economic developments, given Australia's reliance on export income.

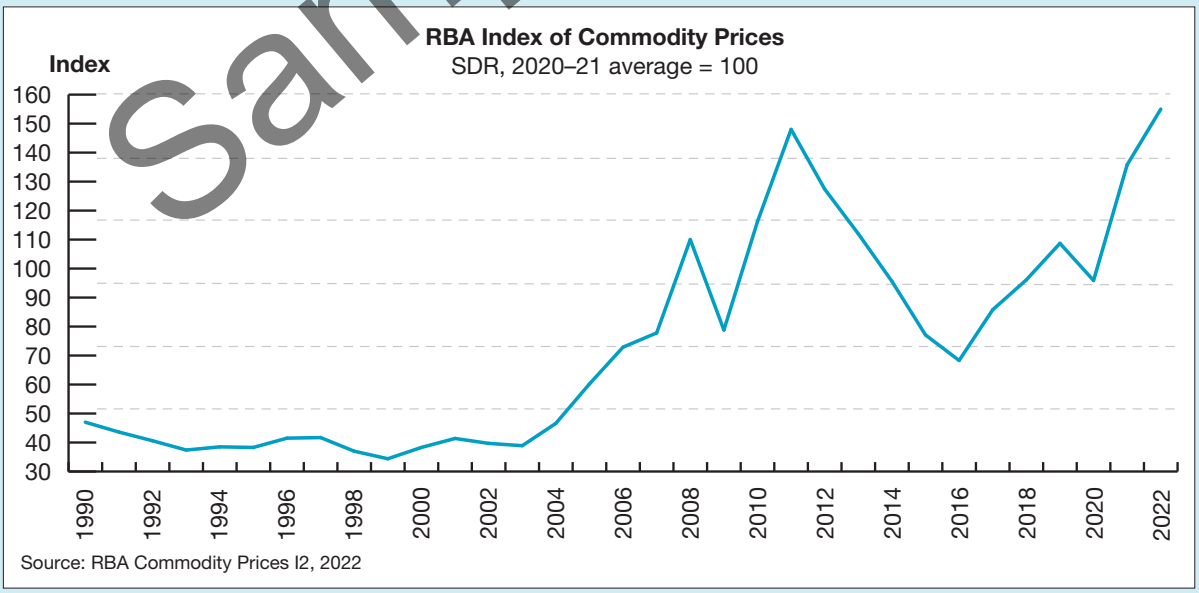


Figure 7.5 – Reserve Bank of Australia Index of Commodity Prices

- Large increases in asset prices such as real estate and shares since the early 2000s have increased the wealth of households, encouraging greater borrowing and consumption. This is known as the "wealth effect". Of course, higher housing prices also constrain the spending power of homebuyers, but overall, the wealth effect of higher asset prices tends to increase economic growth.
- A slowdown in **productivity growth** has contributed to the lower rates of growth in recent years, following a period of record growth in the 1990s. The 2022 Productivity Commission's 5-year Productivity Inquiry found that labour productivity growth averaged 1.1 per cent per year in the 2010s, compared with 1.3 per cent in the 2000s and over 2 per cent in the 1990s. Other advanced economies have also experienced slower productivity growth in recent years.

Australia has been been relatively successful in navigating changing economic conditions and external developments – including the Asian financial crisis of 1997–98, the collapse of the "dotcom" boom of 2001, the deep global recession triggered by the global financial crisis in 2008, and the global COVID-19 recession in 2020. In part, this has reflected good luck – the specific impacts of each of those events on Australia was milder than for most advanced economies, and Australia has had the benefit of a sustained boom in resources exports, offsetting downward pressures on growth. Yet with less skilful macroeconomic policy, and without the economic flexibility created by past microeconomic reforms, Australia would have had much less success in responding to those events.

Australia's longer-term economic challenges are described by the Australian Treasury as "the three Ps" – productivity, participation and population. Sustaining long-term productivity growth, high levels of workforce participation and continued population growth from natural growth and immigration will help Australia to achieve the highest possible rate of economic growth.

However, Australia's 2021 Intergenerational Report highlighted ongoing concerns for each of these indicators, projecting an average annual growth of 2.6 per cent in real GDP for the next four decades, below the average of 3.0 per cent in the past four decades. Low growth in labour productivity is a long-term concern due to slowing growth in educational attainment. Workforce participation is expected to decline as Australia's population continues to age. Population growth rates have also been reduced by the slowdown in migration during the COVID-19 pandemic as well as lower fertility rates in the population overall.

Year	Growth (%)	GDP ($bn)
2010–11	2.5	1606
2011–12	3.9	1669
2012–13	2.6	1712
2013–14	2.6	1756
2014–15	2.2	1794
2015–16	2.7	1843
2016–17	2.3	1886
2017–18	2.9	1940
2018–19	2.1	1981
2019–20	0.0	1981
2020–21	1.6	2012
2021–22	3.9	2090

Source: ABS Australian National Accounts (Cat. no. 5206.0), Table 34, GDP chain value (real)

Figure 7.6 – Australia's GDP

reviewquestions

1 Outline the recent economic growth performance of the Australian economy.

2 Discuss the effect of productivity, participation and population on Australia's economic growth.

3 Compare the recent economic growth performance of the Australian economy to ONE other high-income economy.

For further information on the recent economic growth performance of the Australian economy, visit the recent speeches and publications sections of: **www.treasury.gov.au** and **www.rba.gov.au**, the Australian Bureau of Statistics site: **www.abs.gov.au**, or the economics section of any of the major Australian banks such as **www.anz.com**.

7.8 Policies to sustain economic growth

A major aim of economic management is to sustain a high rate of economic growth to allow national wealth to grow and individuals to experience a higher standard of living. The government is able to use **macroeconomic policies** (fiscal and monetary policy) to influence economic growth in the short term with the primary aim of smoothing volatile fluctuations in the business cycle. These policies will have only a limited impact on the level of long-run growth rate. (Macroeconomic policies are discussed in detail in chapters 14 and 15).

Fiscal policy involves the use of the Commonwealth Government's Budget in order to achieve economic objectives. Government expenditure in the Budget represents an injection into the economy, whereas government revenue (taxation) is a leakage from the economy. By adjusting its expenditure and revenue, the Government is able to influence the level of aggregate demand and therefore the level of economic growth. If the Government wants to increase the level of economic growth, it can reduce taxation, increase expenditure or do both. This would increase the level of injections relative to leakages and therefore cause an upturn in the level of economic growth. Alternatively, economic growth would be constrained if taxation receipts were increased or government expenditure was reduced. Generally, fiscal policy is more effective in stimulating growth during a downturn than slowing down an economy that is growing fast, and it played the central role in the Australian Government's policy response to the COVID-19 recession in 2020–21. The JobKeeper wage subsidy plus increases to welfare benefits helped to maintain consumer spending and avoid a prolonged downturn.

The Government is also able to use **monetary policy** to influence economic growth. Monetary policy involves the Reserve Bank of Australia influencing the level of interest rates in the economy, which in turn influences the level of aggregate demand and the rate of economic growth. If the Government and the Reserve Bank want to stimulate

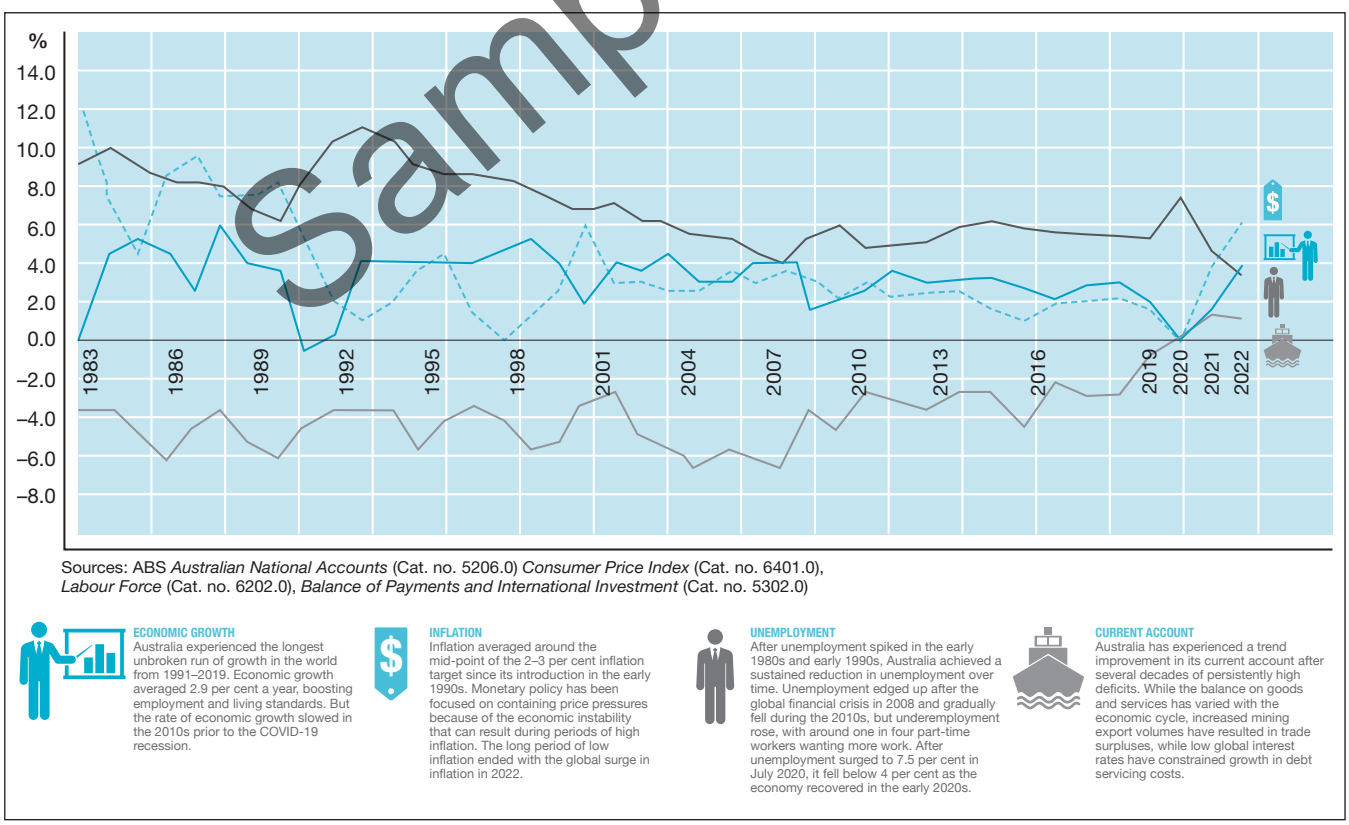


Figure 7.7 – Australia's growth and economic outcomes since 1983

growth, interest rates can be reduced to encourage consumer and business spending. Conversely, to decrease growth, interest rates can be raised. Monetary policy has been the main macroeconomic policy tool for influencing the level of economic growth in recent years, although the effectiveness of monetary policy has been questioned as interest rates were held at historically low levels between 2019 and 2022.

Microeconomic policies aim to increase the economy's sustainable growth rate by increasing aggregate supply. Microeconomic policy also reduces the extent to which higher growth causes inflationary and current account problems – the factors that may constrain higher growth. In effect, microeconomic policies increase aggregate supply in order to keep pace with rising aggregate demand. The Productivity Commission has argued that Australia's strong rates of growth in the 1990s and 2000s came about because of the far-reaching microeconomic policies that were undertaken during the 1980s and 1990s. The 2022 5-year Productivity Commission Inquiry found that none of its microeconomic policy recommendations from five years earlier had been implemented in full. Nevertheless, there has been some activity to lift productivity at the state level. There has been increased investment in physical infrastructure to relieve transport bottlenecks, with the NSW Government's 2022–23 Budget committing an additional $17.9 billion to a 10-year infrastructure pipeline. The NSW Government's infrastructure development is focused on ports, road and rail upgrades to accelerate the transport of goods. Labour market programs can help address skills shortages that otherwise constrain economic growth (discussed further in chapter 17). Additionally, reforms – such as Your Future Your Super – make it easier for consumers to identify and switch to the top performing superannuation funds, lifting productivity and economic growth in the medium term. The overall role of microeconomic policy is discussed in detail in chapter 16.

review questions

1. Discuss the use of macroeconomic and microeconomic policies to support economic growth.
2. Discuss the policies a government might use to accelerate economic growth.
3. Analyse the role of government policies in increasing aggregate supply.

chapter summary

1 **Economic growth** is measured as the percentage increase in the value of goods and services produced in an economy over a period of time, usually one year.

2 The economy is in **equilibrium** when the level of aggregate demand (total demand for goods and services within the economy) is equal to the level of aggregate supply (total productive capacity of the economy).

3 The **Circular Flow of Income** model shows that certain economic factors can be identified as either injections or leakages in the overall level of economic activity. Investment, government spending and exports are injections because they add to the circular flow of income. Savings, taxation and spending on imports are leakages because they take money out of the circular flow of income.

4 **Consumption** is influenced by consumer expectations of future economic developments, the level of interest rates, income distribution and consumer preferences between consumption and savings.

5 **Investment** is influenced by the level of interest rates, government policies, labour costs, productivity levels and business expectations.

6 **Net exports** are influenced by income levels in Australia and overseas, movements in the exchange rate and the international competitiveness of Australia's industries.

7 The **multiplier process** explains how an increase in aggregate demand will increase the overall level of national income by much more than the initial increase. This amount is known as the multiplier. The size of the multiplier is determined by the marginal propensity to save and can be expressed as:

$$k = \frac{1}{MPS} \quad \text{OR} \quad k = \frac{1}{1 - MPC} \qquad \text{where MPS} = \frac{\triangle \text{ in savings}}{\triangle \text{ in income}}$$

8 **Aggregate supply** resulting from improvements in efficiency and technology can lift productivity and can accelerate economic growth.

9 **Economic growth** results in higher living standards and increased employment, but can also contribute to increased inflation, external instability, greater income inequality and damage to the natural environment.

10 Australia's most recent economic growth cycle was the longest on record, beginning in the September 1991 quarter and ending in the March 2020 quarter with the onset of the COVID-19 pandemic and the first recession in three decades. Although economic growth slowed in the 2010s, Australia still achieved stronger growth than most advanced economies. The long sustained growth cycle reflected several factors, including the benefit of a major term-of-trade boom, demand for Australian resource exports from China, the success of macroeconomic policies in sustaining low inflation, and the legacy of substantial microeconomic reform in past decades.

chapter review

1 Explain why economic growth is important to an economy.

2 Consider an economy where: S = 40, T = 20, M = 10, G = 35, X = 5, C = 25, MPC = 0.6.

a) Determine the level of investment; and

b) Calculate the level of aggregate demand.

3 Outline the main factors that influence the levels of consumption and investment in an economy.

4 State the leakages and injections equation for an economy to be in equilibrium and explain the effect on the level of economic activity when:

a) total leakages exceed total injections; and

b) total injections exceed total leakages.

5 Define the *multiplier*. Explain how the concept of the multiplier is related to an understanding of economic growth.

6 Consider why economist John Maynard Keynes advocated an active role for the government in influencing the level of economic activity. Discuss how the government might influence the level of aggregate demand.

7 Contrast the positive and negative impacts of a higher level of economic growth for an economy.

8 Explain the importance of *aggregate supply* and how a government may be able to achieve sustainable economic growth in the long term.

9 Examine the factors that have contributed to the recent growth performance of the Australian economy.

10 Evaluate the policies available to governments to achieve economic recovery after a recession.

COVID-19 The impacts on the Australian economy

COVID-19 represented the most powerful external shock to the Australian economy since the Great Depression in the 1930s. It ended Australia's record-breaking 28-year economic growth cycle in ways that nobody could have imagined: a shutdown of state and national borders, enforced lockdowns across Australia that confined people to their houses, and a temporary prohibition on whole sectors of economic activity. The economic impact was far-reaching. Consumer spending shifted dramatically, with travel, leisure and entertainment spending curtailed, while spending increased in other areas as households stockpiled emergency supplies from supermarkets and spent more on home entertainment. Within a month the share market had fallen 37 per cent, and the dollar had depreciated to US55 cents, its lowest level in almost two decades – although both the dollar and the equity markets swiftly recovered in the months that followed.

COVID-19 prompted the largest-scale macroeconomic policy intervention in Australian economic history, costing the Budget $291 billion in economic support by mid-2021, and leading to the largest-ever Budget deficit of $132 billion in 2020–21. Its centrepiece was JobKeeper, an $89 billion program that initially subsidised wages to the tune of $1500 per fortnight per employee for businesses whose turnover had fallen by 30 per cent or more due to COVID-19, with the subsidy gradually reduced and phased out by March 2021. As states imposed further lockdowns throughout 2021, the Federal Government introduced a COVID-19 Disaster Payment totalling $13 billion to provide financial support for people who lost work because of a lockdown, with the value of the payment depending on the duration of the lockdown and the number of hours of lost work.

Other fiscal policy measures introduced during the pandemic included increased unemployment benefits, with fortnightly payments temporarily doubled, as well as providing free child care, tax-free cash payments of between $20,000 and $100,000 to eligible small and medium businesses, and one-off COVID-19 business grants.

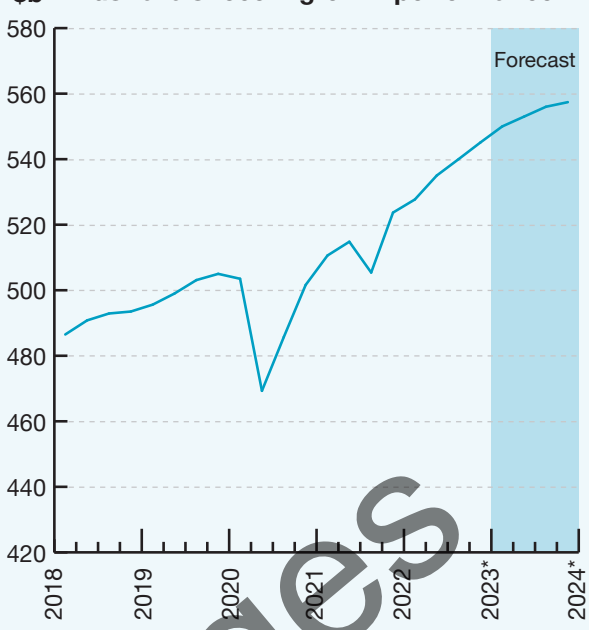
The Government's fiscal policy measures were complemented by immediate monetary policy action from the Reserve Bank. The RBA cut its cash rate three times in 2020, down to a record low of 0.1 per cent in November 2020. The RBA also supported the supply of credit to keep the economy afloat, and undertook asset purchases, involving the outright purchase of assets by the Reserve Bank from the private sector.

The effects of the COVID-19 recession were fast and far-reaching:

- **Economic growth** – GDP fell in two successive quarters of 2020, by 0.3 per cent in March and a record 6.8 per cent fall in June. By the September quarter, the economy had begun to recover, recording an increase in GDP of 3.5 per cent, followed by another 3.3 per cent increase in December 2020. However, extended lockdowns in 2021 delayed a sustained recovery until 2022.
- **Labour market** – Unemployment peaked at 7.5 per cent in July 2020, the highest rate in over 20 years, while youth underemployment surged to 23.6 per cent in April 2020. Retail and hospitality workers, along with sports and personal services workers, were the three hardest hit occupations in terms of job losses. Economic recovery from early 2021 saw unemployment fall below 4 per cent for the first times since the early 1970s. This signalled a remarkable rebound in the labour market and an acute skills shortages across hospitality, construction and other industries (in part caused by lower levels of immigration during 2020 and 2021).
- **Businesses** – COVID-19 had vastly different impacts across different industries. Business relying on international tourism suffered severe impacts. Businesses in accommodation and food services, transport, and arts and recreation services were hard hit by lockdowns and were most likely to report difficulty in meeting financial commitments. Some other businesses such as delivery and online retail benefited from expanded opportunities. As economic conditions improved in 2021 and 2022, investment grew rapidly as businesses with turnover up to $5 billion capitalised on the Government's uncapped instant asset write-off provision.

- **Inflation** – Some unusually large but temporary price movements (in particular because of the Government's decision to make child care free for several months) resulted in the first decline in year-ended CPI inflation since the early 1960s and the largest quarterly decline since 1931. While inflation had been expected to remain low, cost pressures soared well beyond the RBA's target band as a result of demand pressures and Russia's invasion of Ukraine, which sharply increased energy prices.
- **Distribution of income and wealth** – While the lasting effects of the pandemic on the distribution of wealth will take many years to emerge, cross-country IMF research into the five major pandemics of this century (SARS, swine flu, MERS, Ebola and Zika virus) found that income inequality worsened steadily after each pandemic, with disproportionate negative effects on lower-skilled workers.

While there was a huge cost to Australia's policy response to COVID-19, economists agreed that the longer-term economic costs would have been even greater without intervention. The economic damage would have been larger and more permanent, as bankruptcies and unemployment would have risen more sharply, and household consumption and business investment would have fallen much further. Figure 7.8 shows the sharp downturn and quick recovery in economic growth Australia experienced at the onset of the pandemic as well as the RBA's forecasts for a stabilisation in economic growth figures in 2023 and 2024. The success of the vaccination rollout in Australia and globally is a key factor in reducing the need for lockdowns and in achieving this recovery.



Sources: ABS, *Australian National Accounts: National Income, Expenditure and Product* (Cat. no. 5206.0), and RBA Statement on Monetary Policy August 2022 *Forecasts

Figure 7.8 – Real GDP – Australia

"The Australian economy is resilient, growing by 0.8 per cent in the March quarter and 3.3 per cent over the year. Household and business balance sheets are generally in good shape, an upswing in business investment is underway and there is a large pipeline of construction work to be completed. Macroeconomic policy settings are supportive of growth and national income is being boosted by higher commodity prices. The terms of trade are at a record high …

Today's increase in interest rates by the Board is a further step in the withdrawal of the extraordinary monetary support that was put in place to help the Australian economy during the pandemic. The resilience of the economy and the higher inflation mean that this extraordinary support is no longer needed."

Statement by Philip Lowe, Reserve Bank Governor
7 June 2022