RESERVE BANK OF AUSTRALIA

Performance of the Australian Economy

Education

Cash rate

Reserve Bank of Australia

Inflation

Monetary policy

Unemployment rate

Gross Domestic Product (GDP)

Fiscal policy

Consumer Price Index (CPI)

Consumption

The Australian economy

Different countries have different economic models. In some countries, the government has a prominent role in deciding what goods and services will be produced.

The Australian economy is **market-based**.

Most decisions to produce or consume goods and services reflect demand (what people want to buy) and supply (how much businesses can provide) in the market.

Why is the economy important?

The economy is important to all of us.

What's happening in the economy can affect our lives, for example, how much we pay for things, how easy it is to find a job, or even deciding what job we ought to do.

It can influence the decisions we make. Our decisions can also influence how the economy is performing.

Assessing the performance of the Australian economy

Conditions in the economy affect all our lives, so assessing and predicting its performance is very important.

But how can we know if our economy is doing well?

The job of some economists is to monitor economic activity. Economists review data, looking for trends; build mathematical models and charts; and use these to figure out what is happening in the economy. They also try to predict how the economy might perform in the future.

Key indicators of economic activity

Economists investigate many different indicators to build up a picture of how the Australian economy is performing. Some of the key indicators include:

- Economic (or GDP) growth rates
- Unemployment rates
- Inflation rates

You're going to explore each of these and what it tells us about the Australian economy.

Economic growth

Economic growth measures how much the size of a country's economy increases.

Economic growth is important to help people earn an income and businesses make a profit.

Economic growth

The economy has an optimal range over which it can grow – we can call this range its 'speed limit'.

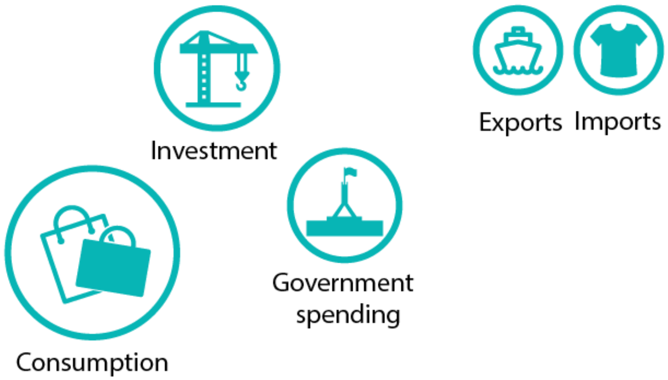
If it grows faster than its 'speed limit', people may be worse off through high inflation.

It is also harmful if the economy grows too slowly, because people lose their jobs and businesses struggle to make profits.

Economic growth

One way to measure economic activity is by looking at how much different decision-makers spend on goods and services that have been produced in Australia and overseas. This measure of economic activity is called gross domestic product (GDP).

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

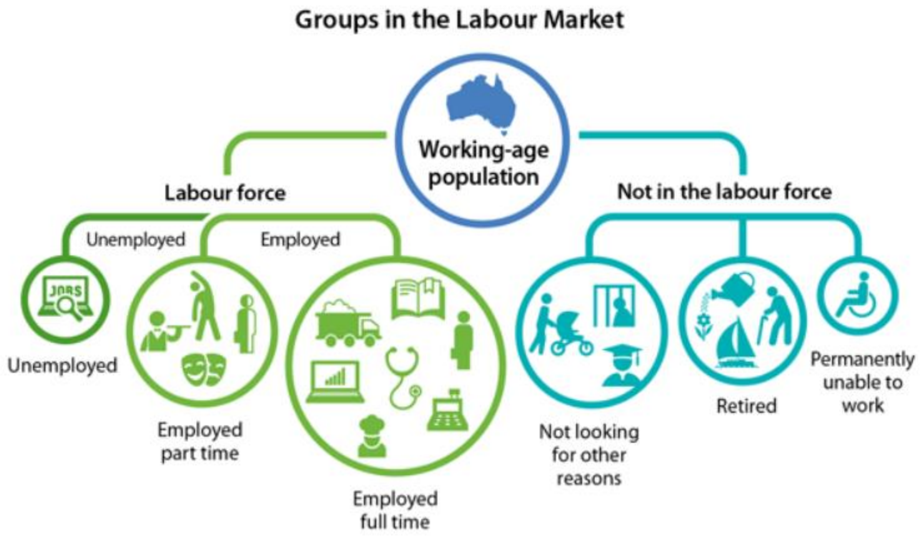


The change in GDP over time is called *GDP growth* or *economic growth*.

Unemployment

Unemployment occurs when someone is available and actively looking for work, but does not have a paid job.

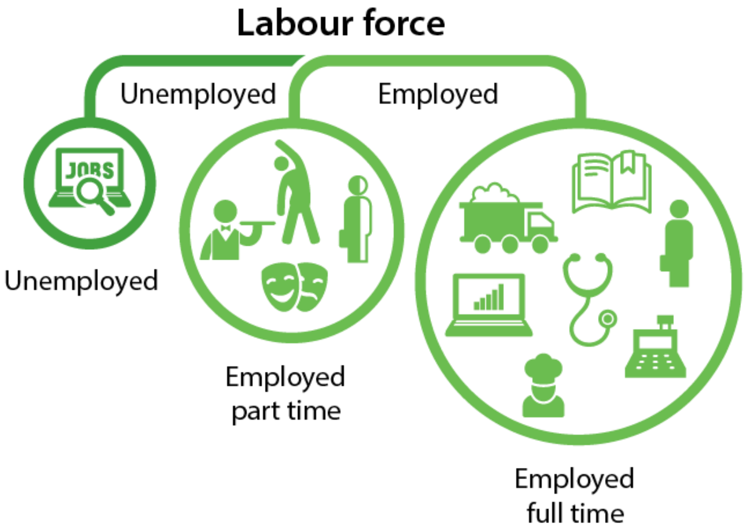
The diagram shows the different groups in (and not in) the labour force. The labour force measures everyone **participating** in the labour market – either by working or looking for work.



Unemployment

Unemployment is measured by the **unemployment rate**, which is the share of people in the labour force who are unemployed.

$$\text{Unemployment Rate} = \frac{\text{Unemployed}}{\text{Labour force}} \times 100$$



Unemployment

The unemployment rate is a key economic indicator because it is a measure of **spare capacity** in an economy.

If everyone who wants to work has a job and is working as many hours as they like, then an economy is operating at full capacity and should grow around its optimal speed.

Labour market with spare capacity

Labour market at full capacity

Inflation

Inflation is an increase in the prices of the goods and services that households buy. It is measured as the change in those prices over time.

Keeping inflation within a certain range is important for the economy.

Cost of a bag of sweets

30 years ago

$0.20

Today

$2.00

Inflation

If inflation is **too high**, then prices might rise faster than incomes. This means people can afford fewer goods and services than before, making them worse off.

Some reasons high inflation could occur is if:

- the economy grows faster than its speed limit. Demand for goods and services may exceed what businesses can supply and businesses may increase wages if it is difficult to find workers. Both of these factors will lead to higher prices.
- the supply of some goods and services is disrupted (e.g. a natural disaster destroys crops) then their price may increase. This can have widespread effects on other prices if that good or service is an input into making other goods and services (such as oil).

Inflation

If inflation is **too low**, then prices might stay the same or even fall (**deflation**).

While this might sound good for consumers, falling prices harm the economy because:

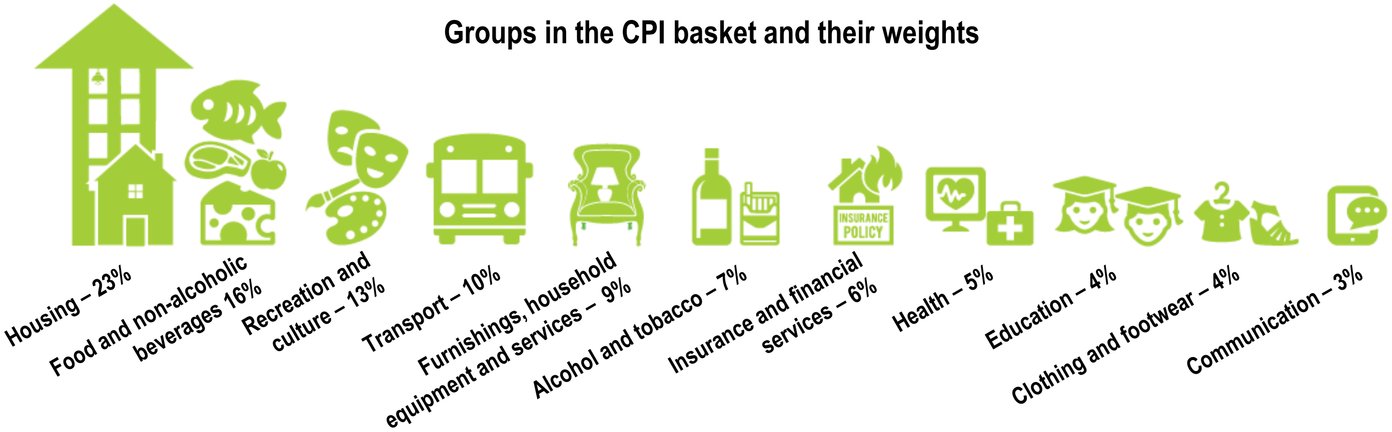
- if businesses make smaller profits, they can't afford to employ as many people. Higher unemployment leads to less spending on goods and services, further damaging business profits, economic growth and increasing unemployment.
- decision-makers may decide to reduce spending today, to wait until goods and services are cheaper in the future. Lower spending today harms economic growth and can also lead to a rise in unemployment.

Historically, deflation is uncommon in Australia.

Inflation

One indicator of inflation is the Consumer Price Index (CPI), which measures the change in the price of a 'basket' of goods and services consumed by the average household. Inflation is measured as the change in the price of this basket over time. If inflation is 3%, a basket of goods and services that cost $100 last year will cost $103 this year.

Groups in the CPI basket and their weights



Tools to influence economic performance

If the economy is not performing as well as it could, the Government and Reserve Bank of Australia (RBA) can use a number of tools to help speed it up or slow it down.

Macro

Monetary policy
(RBA)

Fiscal policy
(Government)

Micro
(examples)

Education
(Government)

Trade
(Government)

Productivity
(Government)

Monetary policy

The RBA is Australia's central bank. It carries out '**monetary policy**' to influence the economy (either speeding up economic growth or slowing it down).

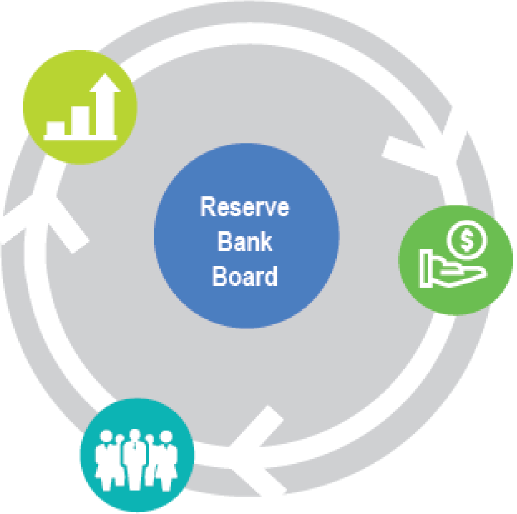
The main way the RBA conducts monetary policy is by setting a target for the **'cash rate'**, a very important interest rate.

The cash rate influences interest rates that households, businesses and governments pay to borrow money and receive for saving money. This can affect their decisions around how much money they spend and save.

Objectives of monetary policy

Economic prosperity and welfare

(This means promoting a stable economic environment that supports the prosperity and welfare of Australians.)



Stability of the currency

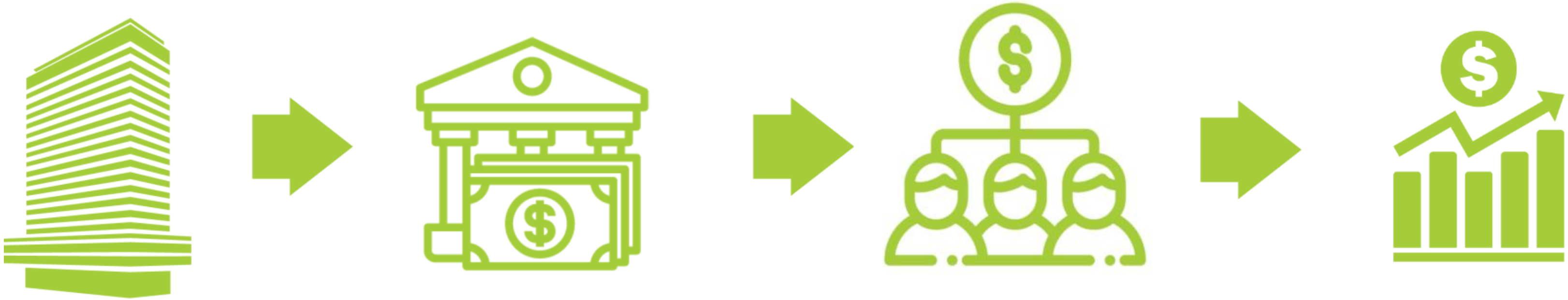
(This involves keeping inflation in consumer prices low and stable.)

Full employment

(This means that everyone who wants a job has one and is working as much as they'd like to.)

Monetary policy

If the economy is growing too slowly, inflation is too low and unemployment is too high…



The Reserve Bank is likely to **lower the cash rate target**.

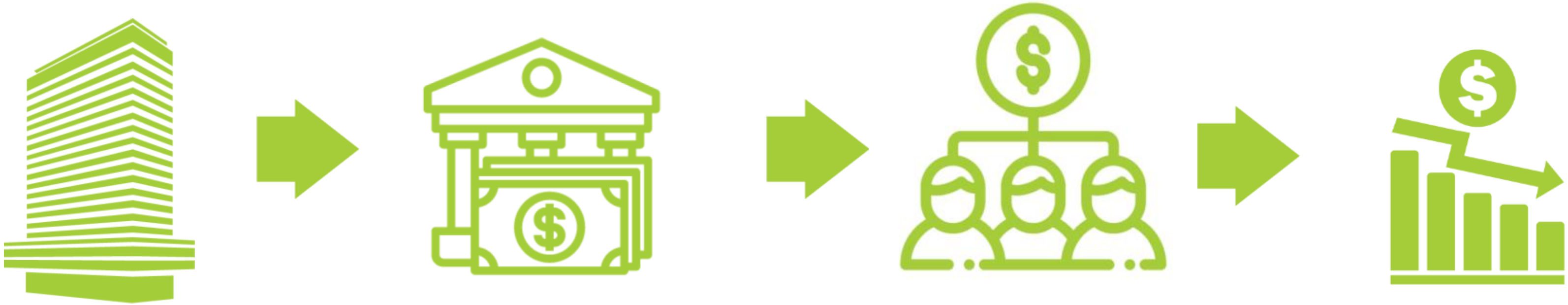
Other interest rates will fall. Borrowing money becomes cheaper and saving less attractive.

Households and businesses will decide to spend more. **Economic growth** increases.

Inflation increases. **Unemployment** falls.

Monetary policy

If the economy is expanding too quickly and inflation is too high…



The Reserve Bank is likely to **raise the cash rate target**.

Other interest rates will rise. Borrowing money becomes more expensive and saving more attractive.

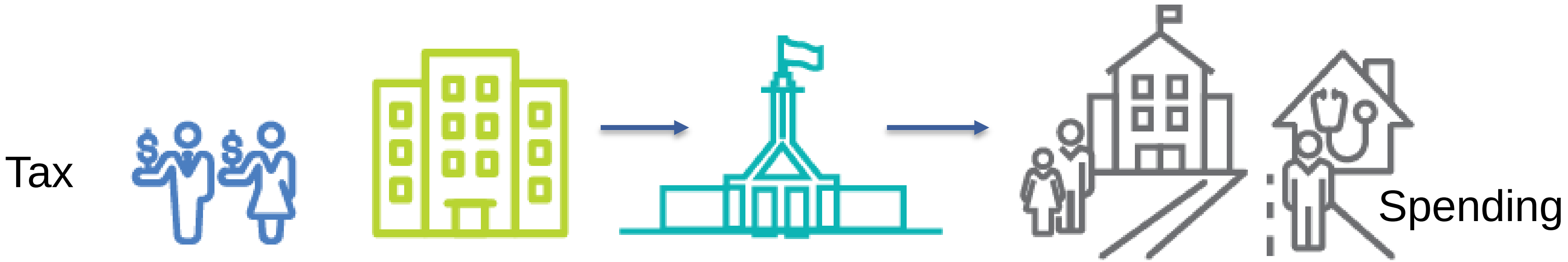
Households and businesses will spend less. **Economic growth** decreases.

Inflation decreases. **Unemployment** may rise.

Fiscal policy

Fiscal policy summarises the government's spending commitments and collection of taxes from households and businesses. Government spending is a component of GDP.

If the government spends more than it receives from taxes, this is called a **deficit**. The government may borrow funds to make up the extra spending. The opposite occurs if the government spends less than it receives from taxes, which is called a **surplus**. The government can save this surplus to spend in the future.

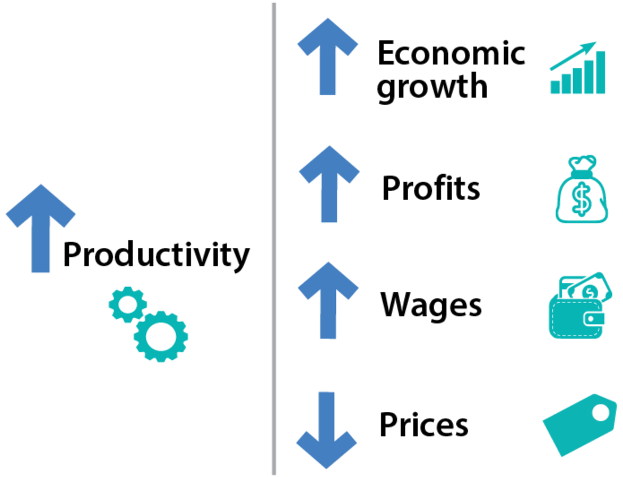


Micro-economic policy

The government can also introduce polices that help increase the economy's **productivity**.

These policies are sometimes called **micro-economic reforms** and involve issues like trade, education, healthcare and many others. Sometimes, it can take many years for the benefits of reforms to take effect.

If productivity increases this means that the economy can obtain a higher speed limit, where stronger economic growth supports higher wages and profits and does not necessarily lead to higher inflation.



Activity: Assessing Australia’s Economic Performance

Using the RBA’s Snapshot Comparison tool, complete **Activity: Assessing Australia’s Economic Performance**. You will be researching the performance of the Australian economy by reading and interpreting charts on four key economic indicators:

- Economic growth (GDP growth) rates
- Inflation rates
- Unemployment trends
- The cash rate

You will be considering recent trends, as well as assessing current performance against the longer-term average.

Activity: Comparing the Australian and Indian Economies

To better understand the performance of the Australian economy and how it is likely to develop in future, it can be useful to compare it with economies from other countries, especially those with whom Australia trades.

Complete **Activity: Comparing the Australian and Indian Economies**, which asks you to compare economic growth in Australia and India.