STRONG AND SUSTAINABLE ECONOMIC GROWTH

DEFINITION OF ECONOMIC GROWTH

The government aims for a rapid but steady rise in the volume of goods and services produced from year to year. The aim is to achieve a rate of economic growth between 3 and 4%. The government no longer states a target rate for economic growth but rather, aim for the highest rate possible without having negative consequences on inflation, external stability and the environment.

THE GOAL OF STRONG AND SUSTAINABLE ECONOMIC GROWTH

The goal of strong and sustainable economic growth needs to be looked at from two perspectives:

- The fastest rate of growth in the national production in the economy that is consistent with achieving the other macroeconomic goals such as low inflation, full employment and external stability.

- The rate at which national production can increase while not depleting the economy’s non-renewable resources (air, forests, land, oceans and waterways). The environmental impacts of increased production need to be taken into account. Sustainable economic growth is where living standards of future generations will not be compromised by the current growth in production.

A clear definition of the government’s goal of strong and sustainable economic growth is:

The government aims to achieve a sustained increase in the real rate of production of goods and services over a period of time. A rate of around 3-4% per annum is considered to be appropriate in order to avoid rising levels of unemployment. Rates in excess of this can lead to inflation and current account problems and jeopardise future living standards due to depletion of environmental resources.

ECONOMICALLY SUSTAINABLE DEVELOPMENT

Economically sustainable development is a more recent focus of economic policy and is a broader concept than economic growth. More emphasis is now placed on non-material or ‘quality of life’ factors with a concern for future generations.

Sustainable economic development is where the society is maximising its current material and non-material welfare while not compromising the living standards of future generations by the depletion of the natural resources of the economy.

The natural environment places limits on economic growth so it is important to ensure that growth is sustainable so as to minimise those limits into the future. Some recent ‘natural limits to growth’ that have been experienced by Australia are:

- Drought and water supply issues – eg. lack of water has reduced the capacity of farmers to produce.

- Climate change and associated severe weather events – eg. the floods and Cyclone Yasi in Queensland in early 2011 both had a negative impact on economic growth.
MEASUREMENT OF ECONOMIC GROWTH

REAL GROSS DOMESTIC PRODUCT (GDP)

The main measure of economic growth in the economy is the Gross Domestic Product (GDP). GDP is defined as the final market value of all goods and services produced in the Australian economy over a given period of time. This is called GDP at market prices. When the value of production is adjusted for inflation then it is called Real GDP or GDP at constant prices. The chain volume measure of GDP involves using prices from the previous period and applying them to current period output. This shows the change in the value of total output due to volume rather than price changes.

LIMITATIONS OF REAL GDP AS A MEASURE OF ECONOMIC GROWTH AND LIVING STANDARDS

- **Excluded production**: Some forms of production are not considered: The value of household production, ‘the cash economy’, the value of voluntary work where there is no exchange of money.

- **Imputed measurement**: The value of some production such as farm produce consumed on the farm and the value of rent paid by homeowners to themselves is imputed (estimated).

- **Quality changes**: Changes in the quality of goods and services produced may not be reflected in price and the value of Real GDP.

- **Distribution**: Real GDP tells us nothing about how the goods and services are distributed and who benefits from any increases in production.

- **Living standards**: Real GDP does not take into account the qualitative aspects of living standards and the possible costs of economic growth such as longer working hours, pollution, environmental damage and other social costs.

- **Maintaining the status quo**: Some spending that is included in the calculation of GDP does not really add to living standards but merely maintains them following some form of event. For example, when the Exxon Valdez spilt barrels of oil into the ocean GDP increased as a result of the clean up. The impact on the standard of living, however, was merely returning the ocean to its original form.
ALTERNATIVE MEASURES OF LIVING STANDARDS

GENUINE PROGRESS INDICATOR (GPI)

The Genuine Progress Indicator (GPI) is a measure of living standards in the economy and is a broader measure than the Gross Domestic Product. It includes a wider range of factors that contribute to the society’s economic welfare or living standards. The Genuine Progress Indicator uses the data for the measurement of the GDP of the economy but makes adjustments to that data to reflect the positive and negative effects on living standards from different types of economic activity.

**Positive adjustments** include benefits such as:

- Ongoing benefits from the spending on public infrastructure and spending on consumer durable goods.
- Benefits to the community from unpaid work ie: housework, voluntary work.

**Negative adjustments** include costs such as:

- Damage to the environment such as air pollution.
- Depletion of non-renewable energy resources.
- Increased hours of work.
- Inequality in the distribution of income.
- Defensive expenditures such as on medical expenditures following road accidents.
- Increased crime rates.

**LIMITATIONS OF THE GPI**

- The subjective problem of identifying what indicators to include in the GPI.
- Determining the relative importance of the different indicators (weighting).
- The problem of the collection of data.
- The accurate measurement of the benefit or the cost to a society’s economic welfare.
MEASURING AUSTRALIA’S PROGRESS (MAP)

Measuring Australia’s Progress (MAP) uses a range of statistical measures compiled by the Australian Bureau of Statistics to build up a picture of changes in Australia’s non-material and material living standards. This broad range of measures is classified under four categories. Unlike the GDP or GPI figure the ABS does not compile a single indicator.

Measuring Australia’s economic progress (MAP)

<table>
<thead>
<tr>
<th>Individuals</th>
<th>The economy and economic resources</th>
<th>The environment</th>
<th>Living together</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health – eg. life expectancy, infant mortality</td>
<td>National income – real GDP per capita, real disposable income per capita</td>
<td>The natural landscape – threatened species, water storage capacity</td>
<td>Family, community and social cohesion – lone parent families, children without employed parent</td>
</tr>
<tr>
<td>Education and training eg. literacy</td>
<td>Economic hardship</td>
<td>Air and atmosphere</td>
<td>Crime</td>
</tr>
<tr>
<td>Work – eg. participation rate, unemployment rate</td>
<td>National wealth</td>
<td>Oceans and estuaries</td>
<td>Communication – eg. internet access</td>
</tr>
<tr>
<td>Culture and leisure</td>
<td>Inflation</td>
<td></td>
<td>Transport</td>
</tr>
</tbody>
</table>


LIMITATIONS OF MAP

- The MAP cannot be condensed into a single statistic or figure to measure living standards.
- If one dimension shows progress i.e. life expectancy increases and another shows regression, i.e. pollution levels, how is the overall change in living standards determined?
- The selection of specific measures is subjective.
- The problem of collecting reliable data.
- The weighting of each indicator.
QUESTION 38 (Sample VCAA examination paper)
Outline one limitation of using changes in real GDP (GDP) as a measure of changes in living
standards.
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THE IMPORTANCE OF PURSUING ECONOMIC GROWTH AND THE IMPACT UPON LIVING STANDARDS

BENEFITS OF ECONOMIC GROWTH

Strong and sustainable growth can improve both material and non-material living standards in the economy.

- **Economic welfare:** More goods and services are produced in the economy which means more needs and wants can be satisfied. Increased production causes per capita incomes to rise which gives individuals access to more goods and services.

- **Full employment:** Increased spending in the economy (aggregate demand) increases production and reduces cyclical unemployment. The increased production generally creates an increased derived demand for labour. Extended periods of economic growth have enabled Australia to reduce its unemployment rate. Low unemployment caused by strong economic growth means higher real incomes (material living standards improve) as well as increased self-esteem and personal health (non-material living standards improve).

- **Lower inflation:** An increase in the productive capacity of the economy can reduce demand inflationary pressures in the economy caused by an increase in aggregate demand.

- **More consumer choice:** An increase in the production of goods and services allows consumers greater choice. The economy has the capacity to export more goods which results in export income to buy imports. A greater quantity and wider range of goods and services is available to help achieve a higher standard living.

- **Current account deficit:** Economic growth that is driven by expansion of productive capacity can assist in meeting domestic demand for goods and services which means that there is less demand for imports. This will reduce the demand for imports which will improve the current account deficit.

- **More equitable distribution of income:** Reduced unemployment resulting from economic growth will help achieve a more equitable distribution of income since more people are earning factor income rather than transfer income.
COSTS OF ECONOMIC GROWTH

Strong and sustained economic growth can also reduce living standards in the economy.

- **Negative externalities:** Strong economic growth may be associated with a range of negative externalities, which may reduce non-material living standards i.e. carbon emissions and pollution. In addition, the increase in rates of economic growth may result in more rapid depletion of natural resources.

  Policies such as the carbon tax, introduced to address negative externalities associated with strong economic growth may lower material living standards in the short term due to expected impact on production costs and increase prices for households.

- **Inflation:** An increase in aggregate demand which increases aggregate supply may cause shortages of goods and services which results in prices in the economy rising. Cost push inflation may occur because of a rise in production costs due to a shortage of labour and materials.

- **Quality of life:** Longer working hours, reduced leisure time and effects on health reduce non-material living standards.

**QUESTION 39**

Explain one economic advantage and one economic disadvantage of economic growth for the living standards of Australians.

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THE IMPACT ON LIVING STANDARDS OF FAILING TO MEET THE GOAL OF STRONG AND SUSTAINABLE ECONOMIC GROWTH

There are costs for the economy in terms of its living standards when it is not experiencing strong and sustained economic growth both in the short term and the long term.

- **Unemployment:** In 2008 the Australian economy experienced a downturn in the level of economic caused by the global financial crisis and the slowdown in world economic growth. The lack of availability of credit and the fall in aggregate demand resulted in a fall in production which caused an increase in cyclical unemployment. Individuals who lose their jobs are affected by their ability to access goods and services and the emotional and social effects associated with being unemployed.

- **Economic welfare:** If the rate of increase in production is not greater than the increase in population then output per capita falls. A decrease in production means that fewer needs and wants can be satisfied. This causes a fall in living standards.

- **Growth in productive capacity:** If the rate of increase in production is slow then investment spending by businesses may slow which impacts on the growth of the productive capacity of the economy which influences the capacity of the economy to produce more goods and services in the longer term.

DEMAND FACTORS AFFECTING ECONOMIC GROWTH

Demand is created by consumers, businesses, governments and from overseas, i.e. those groups represented by the aggregate demand equation C+I+G1+G2+X-M. When demand increases, producers will respond by increasing production. This results in an increase in economic growth. Conversely, a slowing of demand will reduce economic growth.

These include:

- **Interest rates:** Eg. A decrease in interest rates will encourage borrowing by households and business and increase demand (C and I). The increase in AD will be met by increased production, which increases economic growth. For those households who are already indebted the increase in interest rates will reduce the amount of discretionary income they have left over after servicing debt. All transmission mechanisms will be discussed in the monetary policy section of the notes.

- **Disposable Income:** Eg. A rise in income increases consumers’ purchasing power. Increased spending (C) increases AD, which is met by increased production and economic growth, assuming that the economy is operating with some spare capacity or can expand the supply side.
- **Consumer Confidence**: Consumer spending will be influenced by their perceived view of future economic conditions. If consumers feel secure in their job and believe that the “good times” will continue will be more likely to:

  (a) Decrease the propensity to save.

  (b) Increase their willingness to borrow and spend.

  This essentially means they are happy to bring consumption forward rather than adopt a wait and see approach.

- **Business confidence**: Increased business confidence will be associated with a positive view about the firm’s future profitability. This will encourage firms to invest in new capital and technology, research and development and the training of human capital.

- **Overseas economic conditions**: For example, strong rates of economic growth in the economies of our major trading partners will result in higher levels of disposable income and therefore an ability to purchase Australian made goods and services (exports).

  The strong growth rates in China for example (above 10%) have resulted in a strong growth in demand for Australian minerals (coal, iron ore, copper). This additional demand has allowed mining companies to increase the scale of the operations and increased volume of production.
Exchange rate movements

The value of the dollar affects:

(a) The demand for exported goods as it determines the foreign currency price that overseas consumers of the products must pay. For example the recent appreciation of the AUD has made it increasingly difficult for non-mining exports to compete in the world market.

(b) The demand for imported products (and hence for the Australian made substitutes) depends upon the AUD price that Australians must pay. The recent appreciation means that less AUD will be needed for each unit of currency resulting in lower prices for consumers. This may mean consumers will substitute away from the Australian made product and purchase the imported item instead (a leakage).

Government actions:

For example, increased income tax rates will reduce personal disposable income, reducing spending (C), resulting in lower production and economic growth. An increase in government spending (G₁ and G₂) will increase AD and expand the economy leading to increased production and economic growth.

Wealth effects:

When consumers experience an increase in the paper value of their wealth they may be more inclined to increase their propensity to spend and therefore borrow additional money.

In recent months, some consumers have experienced phenomenal decreases in their wealth due to the sharp fall in share prices (August 2011) due to uncertainty in global financial markets and the global economy. This may see a fall in consumer borrowing and spending as consumers feel less wealthy.

QUESTION 40
Which of the following factors would have a different effect on the rate of economic growth from the other three?

A A drought across Australia.
B A world economic recession.
C A decrease in the general level of Australia interest rates.
D A decline in business expectations about the state of the economy.

QUESTION 41
Explain how a slowdown in world economic growth can impact on economic growth in Australia.

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SUPPLY FACTORS AFFECTING ECONOMIC GROWTH

Supply side factors determine the productive capacity or the potential long-term growth rate of economic growth.

These factors influence the willingness and ability of firms and the government to supply goods or services.

Supply side factors that affect the rate of economic growth:

1. Quantity and availability of productive resources.
2. Production costs.
3. Efficiency and productivity.

A closer look at some of these:

Productivity

Productivity is a measure of how efficient resources are being used to convert raw materials (land, labour and capital) to final products (goods and services). An increase in productivity means:

A greater volume of output can be produced using the same number or fewer inputs (resources) or the same volume of production can be produced using fewer inputs.

Increased productivity will therefore result in a decrease in the cost per unit produced. This enables the economy to increase its supply potential and will therefore accommodate a higher level of aggregate demand.

Factors that have contributed to growth in productivity between the mid 1990s and 2002:

- Uptake of new information and communication technology.
- More sophisticated capital such as machinery, computers and robots.
- Microeconomic reforms such as trade liberalisation, deregulation, privatisation, tax reform and labour market reform.

Wage Costs

Wages represent a significant percentage of any business’s costs. Generally speaking a wage increase will increase the cost of production unless workers are able to increase their productivity levels. Greater output per hour will decrease costs per unit which will enable firms to increase wages without decreasing their ability to supply.
Interest Rates

Most firms operate with some debt and an increase in interest rates will therefore result in an increase in their costs of production and reduce profitability and the willingness to produce. Higher interest rates will deter investment spending (which is technically a demand side factor). Lower investment will slow the growth of the country’s productive capacity and hence future rates of economic growth.

Exchange Rates

The cost of imports used as inputs in the production process will be affected by the movement in the exchange rate. A depreciation of the AUD, for example may inhibit the supply potential of the economy because those firms that use imported components in the production process will be faced with higher costs of production. This will shift their supply curves to the left and may restrict their willingness to expand.

Level of profits

If profit levels rise, businesses will be more willing to expand and increase supply. This leads to increased production and AS.

Government taxes

Company tax is a cost of production. If the government lowers the rate of company tax, profits will rise, increasing the willingness of businesses to supply, resulting in an increase in AS.

Production costs

Increased costs of raw materials, electricity fuel, capital equipment, etc. will raise production costs and reduce profits, causing a decline in the willingness of businesses to supply, resulting in a fall in AS.

Infrastructure

Increased spending by the government on infrastructure (eg. roads, railways, ports, communication systems) will improve the efficiency of the production process and avoid bottlenecks, increasing the ability of businesses to supply, lifting AS. For example, the building of new rail and road network will enable freight companies to move their produce in shorter amounts of time. This helps to increase productivity and reduce costs.

Natural disasters

Natural disasters such as droughts and floods will reduce supply of rural products and products that rely on rural products for inputs. This reduces the ability of producers to supply, reducing AS.

With all examples of changes to demand and supply factors provided, a change in the opposite direction will result in an opposite effect.
QUESTION 42
Explain how an increase in productivity can contribute to a strong and sustainable rate of economic growth.

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QUESTION 43
If the Australian Government wanted to increase economic growth, which of the following policies would be the least effective during a period of capacity constraints?

A A lowering of the cash rate.
B Increased subsidies for child care.
C Increased spending on vocational education and training.
D Lowering the company tax rate.


ECONOMIC GROWTH –Y/E June 2008

The economy grew strongly during the 2007/08 financial year recording an growth rate of 3.7%. Consumer and investment spending were strong as were the Terms of Trade, reflecting strong demand from overseas for our commodities.

Demand side factors

- Depreciation of exchange rate by 20% over the year to February 2008 which maintained international competitiveness.
- Consumer confidence strong.
- Strong commodity prices and terms of trade.
- High credit growth.
- Population growth increased.
Supply side factors

- Strong growth in profits (12.4% compared to 7.9% the previous year).
- Appreciation in the exchange rate.
- Higher oil prices in the first half of the year.
- Full employment in the labour market leading to upward pressure on wages and other labour costs.
- Capacity constraints with shortages of skilled labour and lack of infrastructure.

ECONOMIC GROWTH – Y/E June 2009

The rate of economic growth for the year 2008/09 was just 0.6%. The economy slowed dramatically from late 2008 into 2009 due to the impact of the global economic crisis. Australian Government’s implementation of both expansionary monetary and fiscal policies promoted confidence and spending by consumers. The Government’s Economic Security Strategy Package or fiscal stimulus package included a payment of $950 to low and middle income earners to stimulate consumer spending and aggregate demand. Government spending on infrastructure increased. Australia’s stable financial system, the strong fundamentals of the economy and the continued strength of the Asian region, particularly China, all minimised the impact of the world financial crisis and by mid 2009 it became evident that Australia had narrowly avoided a recession. ‘Australia was saved by stimulus and China’. RBA Governor

Demand side factors

- Severe global downturn.
- Fall in commodity prices and the terms of trade.
- Significant fall in consumer confidence from 103 in 07/08 to 87 in 08/09.
- Dramatic slump in business confidence to -16.2.
- Interest rates lowered from 7.25% to 3% (cash rate).
- Fiscal stimulus package.

Supply side factors

- Labour market weakening and slowing of wages growth.
- Depreciation of the exchange rate.
- Growth in profits slowed.
- Labour productivity slowed.
ECONOMIC GROWTH – Y/E June 2010

Economic growth picked up as the economy recovered from the GFC. Annual growth for the year ending June 2010 was 3.3%. Particularly strong growth was recorded in the June quarter which was fuelled by strong private consumption spending. Fiscal stimulus and lower interest rates resulted in higher levels of aggregate demand and production. Strong growth in Asia helped exports to pick up, commodity prices started to rise again as did the Terms of Trade. By mid 2010 it was back around the historically high levels they reached in 2008, prior to the GFC.

Demand factors:

- Improvement in both consumer and business confidence.
- Growth in disposable income fell.
- Strong growth in Asia, particularly China, which saw exports pick up.
- Higher commodity prices and Terms of Trade.
- Large budget deficit and fiscal stimulus (G2 increased by 25.3%).

Supply factors:

- Labour productivity grew (2% compared to 0.1% the previous year).
- Wages growth slowed.
- AUD appreciated slightly.
- Labour force grew, increasing productive capacity.
- Price of materials used in manufacturing fell.

ECONOMIC GROWTH – Y/E June 2011


This sums up the state of the economy in the 2010/11 financial year. Australia’s economic recovery remained patchy throughout the year. The annual growth rate in the September and December quarters was 2.7% (lower than the previous year) but annual growth slumped to just 1% in the March quarter. Growth for the quarter was -1.2% the first negative quarter of growth since the GFC.

GDP growth in the September 2010 quarter was weak due to a drop in net exports and slow household expenditure and both private and public investment. GDP growth then accelerated in the December quarter as rising commodity prices spurred new investment and improved the terms of trade and consumer spending gathered pace.

However, the impact of extreme weather conditions – floods and cyclones in Queensland in late 2010 resulted in the economy recording negative growth in the March quarter – for the first time since the March quarter of 1991. Annual growth slumped to just 1%. The floods
saw significant capacity constraints in particular, coal and iron-ore production fell and which saw around 1 ¾ % subtracted from growth. However, there has been a pick-up in coal production in Queensland albeit slower than expected, but this will boost GDP outcomes over the coming quarters.’

There is also some concern regarding the ‘two-speed’ or patch work economy – conditions are strong in the mining industry and sectors associated with the resources boom but the high exchange rate and subdued retail spending are making the trading environment difficult for other areas of the economy. The main uncertainty relates to the behaviour of the household sector. (From : RBA Statement on MP August 2011).

Note: The June 2011 quarterly figures were not available at the time of writing. They will be released by the ABS on September 7 and reported in the media that day and in the newspapers on September 8. It is important that students are familiar with these details.

Demand factors:

- Household saving ratio at a 24 year high and poor retail sales.
- Strong labour market and low unemployment.
- Higher terms of trade (up 22.2% to a 60 year high).
- Subdued credit growth.

Supply factors:

- Severe weather events – floods and cyclones in Queensland – limited productive capacity.
- Some capacity constraints beginning to emerge.

QUESTION 44

Explain how a rise in commodity prices can impact on influence economic growth.

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