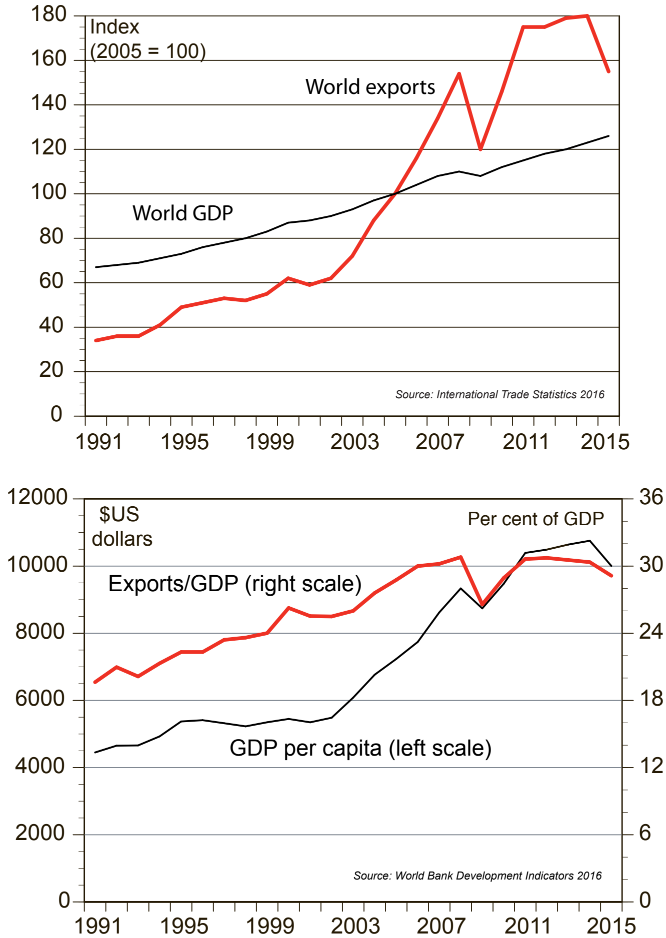

Panel (a) Growth of world exports and GDP 1991 - 2015.

World exports increased by over 350 per cent between 1991 and 2015, while world GDP increased by just 90 per cent.

Panel (b) World GDP per capita and export intensity 1991-2015.

World exports as a percentage of GDP have increased from around 20 per cent in 1991 to 30 per cent by 2015.

Figure 1.2 Global trade and GDP

doubling over this period. Economists believe that increased trade intensity is an important catalyst for higher real incomes and living standards.

Why has world trade grown so fast? It is partly due to the success of world organisations such as the World Trade Organisation (WTO), the International Monetary Fund (IMF) and the World Bank in promoting the liberalisation of world trade. It is also due to improvements in transport and communication which has drastically lowered the costs of international commerce. Trade is seen as an 'engine of growth'. Specialisation and exchange is the cornerstone of all modern economies and is the catalyst for raising living standards. For most economies, including Australia, trade as a proportion of GDP has been increasing. Economies are becoming more open to trade and investment and as a result, economic growth and living standards have accelerated.

International trade can be broadly distinguished between trade in goods (merchandise) and services. The bulk of international trade concerns

Australia's international competitiveness improves if either the real Trade Weighted Index (TWI) falls and/or if real unit labour costs fall.

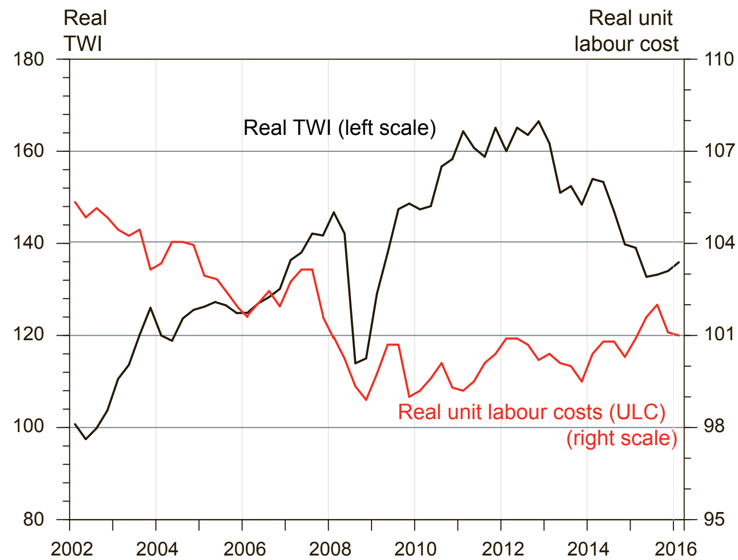

Figure 1.6 Measures of international competitiveness

flat. The real TWI experienced a strong appreciation from 2002 to 2013 - increasing by 65 per cent. This was due to the mining boom and the increased demand for Australian commodities (esp. iron ore and coal) by China. An appreciation reduces the competitiveness of Australia's exports by increasing their price to foreign buyers. In 2009 there was a sharp depreciation in the real TWI due to the global financial crisis. But this was a minor hiccup, with the real TWI increasing again quickly to reach its post float high in 2013. The mining boom came to a sudden end in 2013, commodity prices fell drastically and the real exchange rate fell from its 'dizzy' heights. Between 2013 and 2016, the real TWI depreciated by around 20 per cent, boosting the competitiveness of the traded goods sector.

A number of novel indexes have been developed to help compare the relative cost of goods in different economies. These indexes select a uniform product that is sold in most countries and converts the local price into a standard currency such as the US dollar. Examples include the 'Big Mac' index (McDonalds hamburger), the 'iPad' index (Apple). These indexes are useful in determining whether an exchange rate is under or overvalued. The most famous of these is the Economist Magazine's Big Mac index, which is represented in figure 1.7 (based on prices in July 2016).

PPP - the exchange rate will adjust so that an identical good in two different countries has the same price when expressed in the same currency

According to the Purchasing Power Parity (PPP) theory, the same product should sell for the same price in different countries, once converted to a common exchange rate. The first column of figure 1.7 lists the price of a Big Mac in local currency. Dividing this price by the actual exchange rate in the second column gives the price in US dollars, which is

The business cycle is a regular oscillation of economic activity. The cycle has four phases - boom, contraction, trough and expansion. The vertical axis refers to the level of economic activity. The upward-sloping line is the growth trend, about which there are periods of higher and lower economic activity.

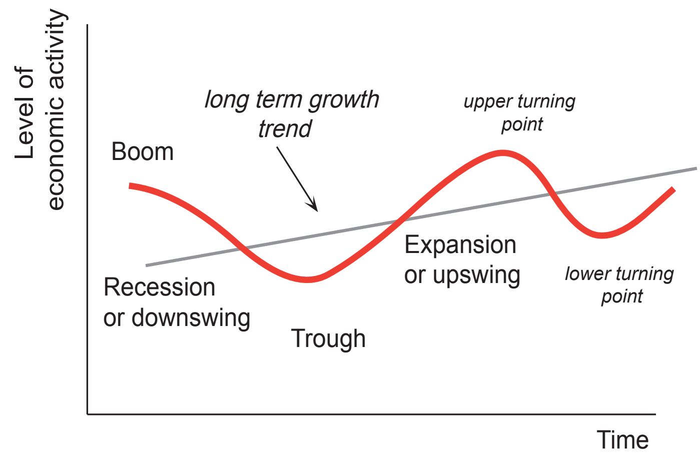

Figure 8.3 The business cycle model

The contraction

Economic booms do not last forever! In the upswing leading to the boom, investment in infrastructure and capital equipment increases productive capacity. That is fine, as long as there is sufficient demand to purchase the goods and services produced. At some point, however, businesses sense that they have enough capacity to meet anticipated demand, which means further investment would carry greater risk. The increased levels of consumer spending that drove investment and output may now result in price increases as the economy reaches capacity. Bottlenecks (shortages of labour or productive capacity) may occur in some industries.

At the peak of the cycle, the increases of income, output and expenditure that characterised the boom start to level off. Slower growth in spending, output and income start to spread throughout the economy, and it feels as if the economic climate has deteriorated. These events give rise to uncertainty as consumers and firms adjust their expectations about the future and change their planned spending as a result.

Government policies designed to restrain the high level of economic activity (see chapters 12-13) may contribute to the changing mood in the economy. If interest rates are increased, for example (tighter monetary policy) this will discourage borrowing and consumer spending on durable goods (because repayments will be increase).

Some time after the peak period of activity, the economy enters the downswing (otherwise called contraction), which may appear dramatic (recession) if accompanied by sharp declines in confidence or falling asset values (as occurred in Australia in 1990 and 2008-09.

On average, consumption spending accounts for 56 per cent of GDP; investment 21.5 per cent; government spending 23 per cent and net exports -1 per cent (figures rounded). Investment shows greatest variability - minimum 16.3 per cent of AE (1992), maximum 26.1 per cent of AE (1961).

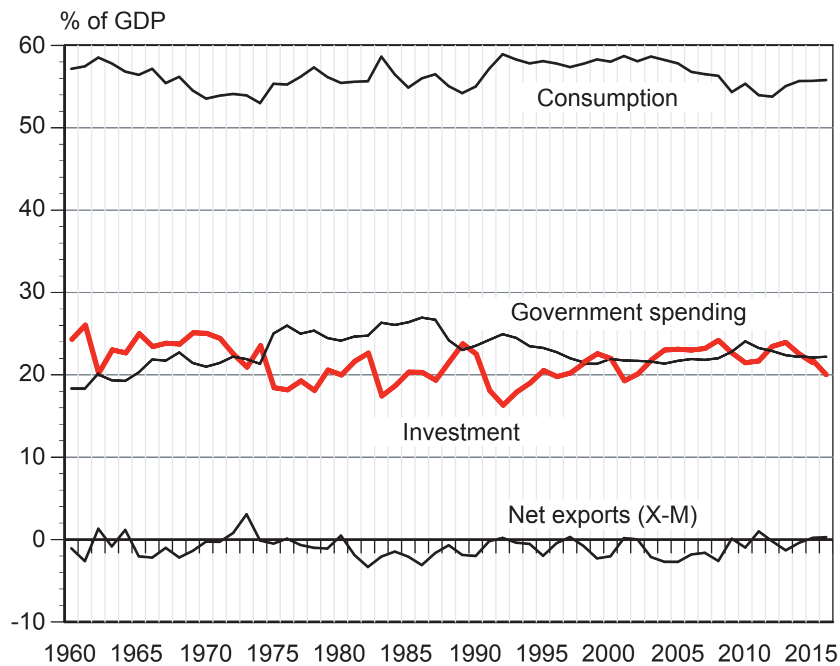

Figure 9.2 Aggregate expenditure proportions

Net exports (exports minus imports) makes up the final element of aggregate expenditure. Exports occur when overseas residents purchase goods and services produced in Australia. Spending on exports adds to aggregate expenditure on goods and services produced in Australia. On the other hand, Australian households, firms, and governments purchase goods and services from overseas. Imports are a withdrawal from the circular flow of income, and thus reduce the aggregate amount of expenditure on Australian goods and services.

In 2015-2016, net exports were $22 billion - representing 0.4 per cent of GDP. In most years, however, the aggregate value of imports exceeds the value of exports. Net exports average about -1 per cent of Australia's GDP over the fifty year period illustrated in figure 9.2.

This completes the brief description of the components of aggregate expenditure (AE). We now want to investigate the factors that affect the components of aggregate expenditure to change - this will give us an insight into the causes of the business cycle.

The determinants of aggregate expenditure

Although economists are interested in how much spending happens in each sector of the macroeconomy, they are more concerned with why that spending changes over the course of the business cycle. Hence we need to explore the factors that influence each of the components of aggregate expenditure.

Note the close link between the cash rate and the rate of inflation. The Reserve Bank's target zone of 2-3 per cent is shaded. The cash rate appears to 'track' the inflation rate.

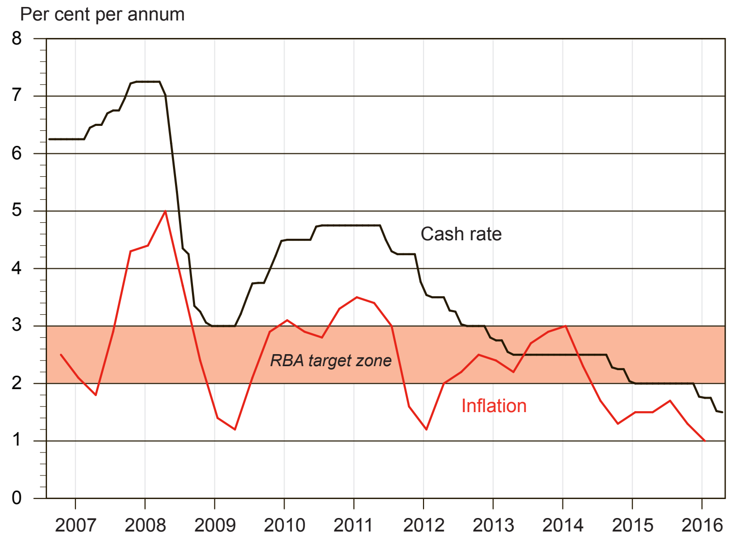

Figure 13.8 Inflation and the cash rate

Australia is not the only country to have adopted inflation targeting as the guiding objective for monetary policy. Other countries such as Canada, the United Kingdom, New Zealand and Sweden have also adopted inflation targets. The results have been very encouraging. Since the adoption of inflation targets, inflation in the group of inflation targeting countries has fallen. The importance of announcing an inflation target and being seen to pursue that target is vital in terms of influencing the expectations of firms and households. The economic growth and inflation data also show that the inflation targeting approach to monetary policy has been successful for the Australian economy in keeping inflation low and in promoting a satisfactory rate of economic growth.

Strengths of monetary policy

Monetary policy is recognised as being an important economic policy tool of the Reserve Bank to influence economic activity because of its flexibility and the speed at which monetary policy decisions can be made and implemented. Changes in interest rates can have a powerful effect on the level of spending in the economy by affecting consumption, investment and net exports.

Arguably the greatest strength of monetary policy is its flexibility. Decisions about whether to raise or cut the cash rate are made every day by the RBA - thus monetary policy can be far more flexible than other types of policy. It does not require specific authorisation by Parliament, which also adds to its flexibility. The Reserve Bank Board meets every month to assess the state of the economy which enables monetary policy decisions to be made and implemented very quickly. In other words, the decision and implementation time lags for monetary policy are relatively short compared with fiscal policy.

Monetary policy is a very flexible policy tool which can be implemented very quickly.