

Objectives of government macro-economic policy

⇒ Keynesian theory: income and expenditure analysis.

$$\text{Aggregate supply} = \text{output} = \text{income}$$

$$\text{Aggregate demand} = \text{Consumption} + \text{Investment} + \text{Government expenditure}$$

- active role for government in changing aggregate demand to correspond with full employment.

⇒ goals of economic macro-economic management - It must establish some order of priority

1. internal balance - full employment without inflation.

- **meaning of full employment** - natural unemployment - seasonal, structural, frictional & hard-core
 - inevitable and unavoidable forms of **unemployment**.
 - **Hysteresis**: increases in natural rate - long-term jobless ratio subject to ratchet effect.
 - **inflationary expectations**: views about future behaviour of prices. If workers expect prices to rise, they will rise - wage increases feed into production costs, & commodity prices rise.
2. **external balance** - equilibrium on current account of balance of payments; confidence in exchange rate
3. **economic growth** - Increasing capacity of a nation to satisfy the material wants of its people over a period of time. Involves an expansion of the nations productive capacity.
- Maximum sustainable economic growth - increasing living standards & real incomes of Australians over long term at highest rate consistent with low inflation & falling foreign debt.

Links and conflicts between economic goals.

⇒ Full employment and external balance: As economy approaches full employment, inflation rises.

- If inflation exceeds that of trading partners, our exports become less competitive → trade imbalance.

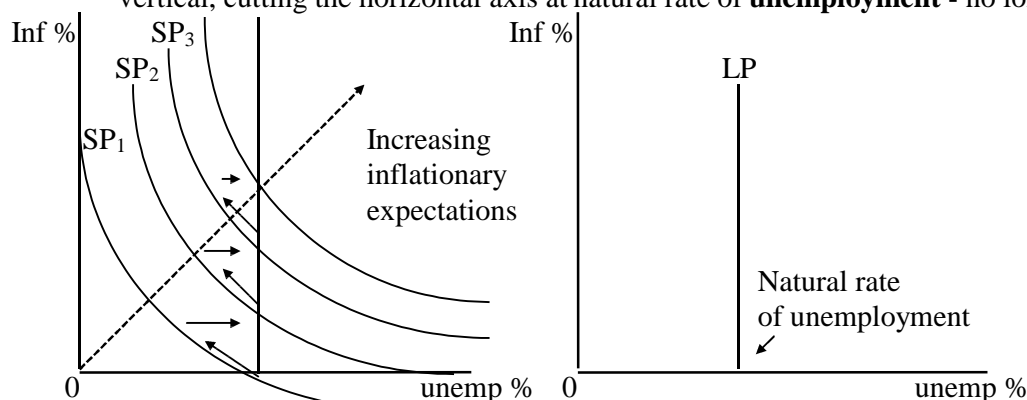
⇒ Full employment and economic growth: growth involves structural change → unemployment

⇒ Economic growth, price stability and external balance: Economic growth accompanied by **inflation**.

- Wage increases → cost-push inf. Higher incomes → excess aggregate spending demand-pull inf.
- If growth financed by foreign borrowing, may increase size of the foreign debt.

⇒ full employment and price stability: As economy approaches full employment, labour becomes relatively scarce, thus employers begin to compete for labour by offering higher wages

- Phillips curve - inverse relationship between unemployment & rate of change of money wages
 - Stagflation and the Phillips curve - 1970s, high **unemployment** & high inflation simultaneously
- Short-run and long-run Phillips curves: Friedman-Phelps expectations-augmented Phillips curve.
 - **Short-run Phillips curves** - Friedman and Phelps attribute shifts in the short-run Phillips curve to changes in people's inflationary expectations.
 - **Long-run Phillips curves** - According to Friedman and Phelps, the long-run Phillips curve is vertical, cutting the horizontal axis at natural rate of **unemployment** - no long term trade-off



NAIRU - Non-accelerating-inflation rate of unemployment: no long-term trade-off between inf & unem.

- Recent work by George Akerlof, William Dickens and George Perry - "The Macroeconomics of Low Inflation" - makes a compelling case that this no-trade-off rule breaks down when inflation is very low.
 - Nominal wage rigidity (wage cuts rare), however, means that trying to get the inflation rate very low impairs real wage flexibility, and therefore increases the unemployment rate even in the long run.
 - Canada: 1% inflation & 10% unemployment compared to US: 3% inflation & 5% unemployment