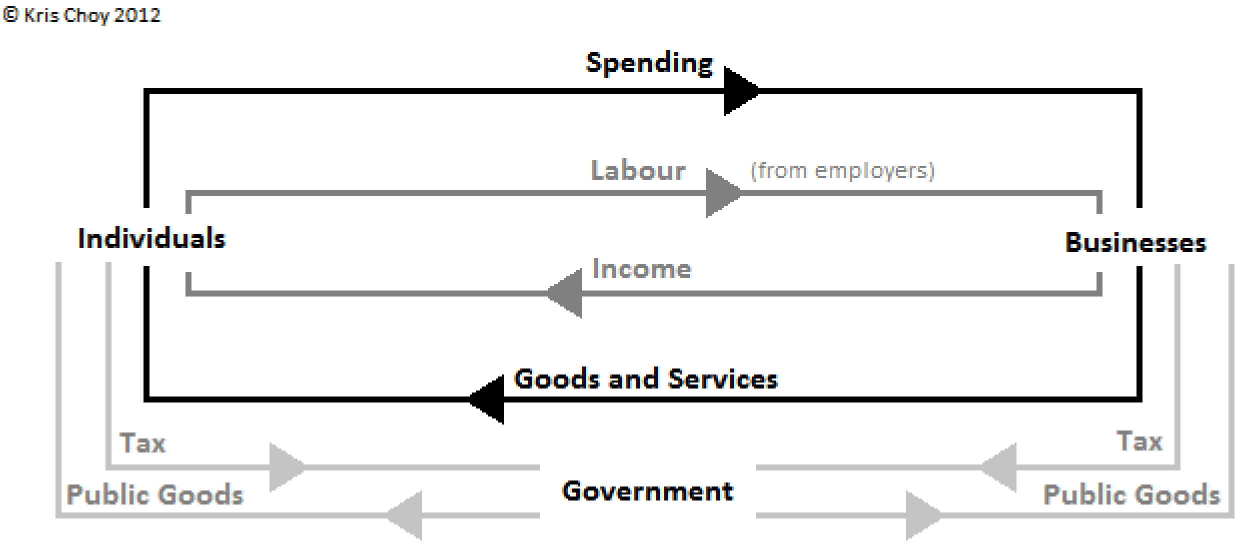
3.9 OUR ECONOMY

ECONOMIC CHANGE

Economic links between Australian consumers, employers, businesses and governments

CIRCULAR FLOW MODEL

- The **circular flow model** shows the economic links between individuals and businesses.



- If all income is spent and all goods are sold, it is a **stable economy**. (**Spending = Goods and Services**)
- There can also be losses and gains of money, and if **leakages = injections**, it is still stable.
    - **Leakages** – income received but not spent (savings and taxes)
    - **Injections** – added spending (investments and government spending)
- A **contracting economy** is one that has **more leakages** than injections.
    - Too much stock (inventory accumulation), little spending, drop in prices
- An **expanding economy** is one that has **more injections** than leakages.
    - More goods and services produced, higher prices

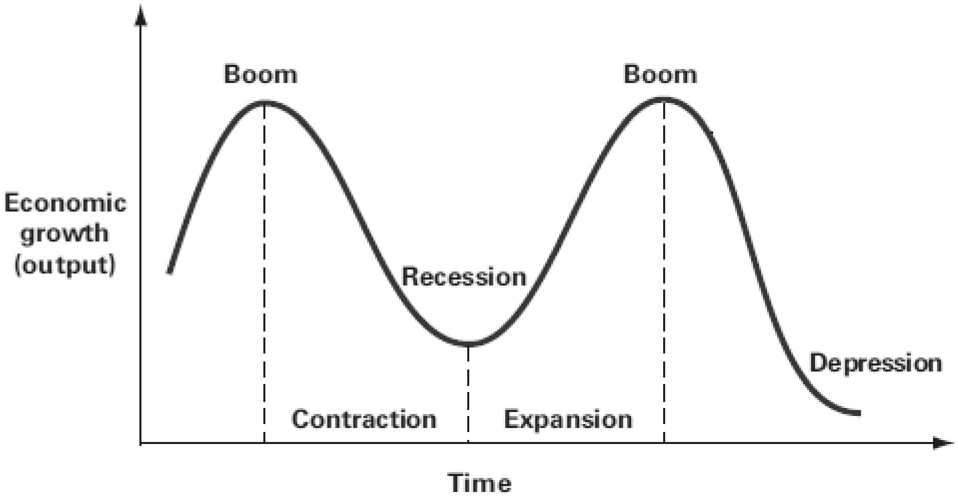
GLOBAL TRADE LINKS

- **Imports are a leakage**, as they are **not produced in Australia** and money is spent.
- **Exports are an injection**, as they provide more money.
- If imports = exports, then it **is balanced**, however, if imports > exports, it is a **trade deficit**
    - This negative balance of trade can lead to foreign debt

The business cycle and changes in total output, consumer spending, inflation, wage rates, interest rates and unemployment

THE BUSINESS CYCLE

- The **business cycle** is the **fluctuations** in the level of economic activity that an economy goes through over time.
- These cycles are **high and low economic activities** – 'booms' and 'busts'.



- A **contraction** (recession or depression) is caused by lack of spending (not inability to produce goods)
    - If customers **stop spending**, business will **cut back on production** and **loss of jobs and incomes**.
- An **expansion** (boom) causes production, spending and employment to rise.
    - High business and consumer confidence, increased total spending
- The following table shows the **changes to an economy** during contraction and expansion of an economy.

Change to:	Contraction	Expansion
Total Output	↓ production (output)	↑ production (output)
Consumer Spending	↓ consumer spending	↑ consumer spending
Inflation	↓ inflation rate (prices go down)	↗ inflation rate (prices go up later)
Wage rates	↓ wage rates or grow very slowly	↑ wage rates – competing for labour resources
Interest rates	↓ – few investment opportunities	↑ – loanable funds are in short supply
Unemployment	↑, as businesses require less jobs	↓, as more production, more jobs required

Interest rates

SAVING AND BORROWING

- People with **surplus funds** (spare money) save through a **financial institution**. They receive **interest** on the money deposited, as the institutions **use the money.**
- People with **deficit funds** (not enough money) borrow, and must also pay money for the **use of the money**.
- Financial institutions make a **profit** by charging a **higher rate to borrowers** than depositors.

SHORT-TERM AND LONG-TERM

- Interest rates can be classified as either **short-term or long-term**.
- When **borrowing**, interest rates are **lower long-term**, and **higher short-term**.
- When **saving**, interest rates are **higher long-term**, and **lower short-term**.

FIXED AND VARIABLE

- **Fixed interest rates** are **set for the entire 'term'** (length of time to repay) of the loan.

Advantages	Disadvantages
- Protects from unexpected interest rate rises - Predictable payments → easier to budget	- Cannot take advantage of a fall in interest rates - Early payout penalty if you want to clear loan

- **Variable interest rates** can **move up or down** during the term of the loan.

Advantages	Disadvantages
- If interest rates fall, repayments reduced - Shorten term of loan if you maintain the higher repayment - Additional repayments made without penalty	- If interest rates rise, repayments rise - May be forced to increase repayments if loan cannot be paid within term

- Financial institutions also offer:
    - **Combination loan** – fixed initially (10 years), then changes to variable
    - **Split loan** – part of loan is fixed, remaining portion is variable
- These loans allow you to **protect against rising interest rates**.

Effect of rising and falling interest rates on consumer and personal financial decision-making

- **Rising interest rates** makes **saving more attractive** and **borrowing more expensive**.
    - Opposite effect for falling interest rates
- When interest rates are **high**, consumers may **find it hard** to repay loans.
    - Consumers may need to **default** (unable to pay borrowed money) on their loan.
- When interest rates are **low**, consumers are **willing** to borrow money.

CHOICE OF FIXED OR VARIABLE INTEREST RATES

- When interest rates **rise**, **fixed loan** prevents larger repayments.
- When interest rates **falls**, **variable loan** allows lower repayments.

MANAGING INTEREST RATE RISE

- **Reserve Bank of Australia** increases **government bond rates** by repurchasing government bonds.
    - Reduces amount of loanable funds and increases price of money
- Debtors have to spend more to repay debt, so they **reduce spending**
    - This **slows down economy** to a sustainable rate (around 3% to 4%)

PRICE CHANGES

Inflation

- Inflation is a general **increase in prices** and **fall in the purchasing value of money**.
    - Thus, the **cost of living** becomes **higher**.

CONSUMER PRICES

- Inflation is measured using the **Consumer Price Index** (CPI).
- The figure released quarterly, **measured by prices of 80 000 goods** and services purchased by people.
    - Calculates the average increases in prices

WAGE RATES

- The **Wage Cost Index** (WCI) measures change in wage rates.
    - Similar to the CPI, but uses a **mixed group of jobs** instead of goods and services.
- Inflation can affect wage recievers:
    - When **main incomes don't keep up with rising prices**, workers' real incomes decrease.
    - Although they have higher incomes, living standards do not improve.
    - Very few (wage rates rise faster than prices) can improve standard of living
        - Their jobs may be in high demand or they have strong trade unions
- People on **fixed incomes** (superannuation, welfare recipients) have their **incomes increase slowly**

Effect of changes in the value of the Australian dollar on consumers and businesses

- The **foreign exchange rate** is the **ratio of one currency to another**.
    - Money is converted through the **foreign exchange market** (forex, fx)

FLUCTUATIONS OF EXCHANGE RATES

- Australia's exchange rate was **set by the government** before 1983, but now 'floats'
    - **Market forces of demand and supply** set the value of Australian dollar
- When the Australian dollar **decreases** value **relative to other currencies**, it is called a **depreciation**.
    - Purchase of **imports more expensive**, and **exports cheaper**
    - Thus, improves **international competitiveness** of exporting businesses → **profitability**
- When the Australian dollar **increases** value, it is an **appreciation** and has the opposite effect
    - Reduces international competitiveness, reduces profitability
    - Imported goods, overseas travel and foreign shares and investments **costs less**
        - Good for consumer