The tools of macroeconomic policy—a short primer

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Key issue
Macroeconomic policy aims to provide a stable economic environment that is conducive to fostering strong and sustainable economic growth. The key pillars of macroeconomic policy are fiscal policy, monetary policy and exchange rate policy.

Macroeconomic policy is concerned with the operation of the economy as a whole. In broad terms, the goal of macroeconomic policy is to provide a stable economic environment that is conducive to fostering strong and sustainable economic growth, on which the creation of jobs, wealth and improved living standards depend. The key pillars of macroeconomic policy are: fiscal policy, monetary policy and exchange rate policy. This brief outlines the nature of each of these policy instruments and the different ways they can help promote stable and sustainable growth.

Fiscal policy

Fiscal policy operates through changes in the level and composition of government spending, the level and types of taxes levied and the level and form of government borrowing. Governments can directly influence economic activity through recurrent and capital expenditure, and indirectly, through the effects of spending, taxes and transfers on private consumption, investment and net exports.

Under current institutional arrangements, fiscal policy is the only arm of macroeconomic policy directly controlled by government.

As an instrument for stabilising fluctuations in economic activity, fiscal policy can reflect discretionary actions by government or the influence of the ‘automatic stabilisers’. A fiscal stimulus package is an example of discretionary action by government intended to support aggregate demand by increasing public spending and/or cutting taxes.

The ‘automatic stabilisers’ refers to certain types of government spending and revenue that are sensitive to changes in economic activity, and to the size and inertia of government more generally. They have a stabilising effect on fluctuations in...
aggregate demand and operate without requiring any specific actions by
government. For example, if the economy slows, on the revenue side of the budget
the amount of tax collected declines because corporate profits and taxpayers’
incomes fall; on the expenditure side, unemployment benefits and other social
spending increases. The effects of these changes tend to offset part of the decline in
aggregate demand that would otherwise occur. This cyclical sensitivity makes fiscal
policy automatically expansionary during downturns and contractionary during
upturns in economic activity.

At least conceptually, the operation of the automatic stabilisers over the economic
cycle should have no effect on the underlying structural position of the budget. A
short-term cyclical deterioration in the budget bottom line should be reversed as
economic conditions improve.

As well as having a short-term stabilisation role, fiscal policy can also be framed
against longer-term objectives. This can include ensuring the long-term
sustainability of the budget and its capacity to meet future challenges, such as
population ageing, and seeking to increase the long-term growth potential of the
economy, through investments in areas such as infrastructure and education.

In Australia the conduct of fiscal policy is subject to the Charter of Budget Honesty
Act 1998 which imposes a formal requirement on the Australian Government to set
out and report against a medium-term fiscal strategy. This framework is required to
be based on ‘principles of sound fiscal management’ including: having regard for
government debt and the management of fiscal risks, the state of the economic
cycle, the adequacy of national saving, the stability and integrity of the tax base and
equity between generations. The medium term focus of the Charter does not
preclude a role for either discretionary action by government intended to stabilise
fluctuations in economic activity, or the automatic stabilisers.

Monetary policy

In Australia, the Reserve Bank of Australia (RBA) Board is responsible for setting
monetary policy. Monetary policy decisions are implemented by changing the cash
rate (the interest rate on overnight loans in the money market). The cash rate is
determined in the money market by the forces of supply and demand for overnight
funds. Through open market operations the RBA can target the cash rate by
increasing or decreasing the supply of funds that banks use to settle transactions
among themselves. For example, if the RBA wants to lower the cash rate it can
supply more exchange settlement funds than the commercial banks want to hold. In
this case, banks will respond by offloading funds, which pushes the cash rate lower.
By changing the cash rate the RBA is able to influence interest rates across the financial system. Changes in interest rates in turn can influence economic activity by affecting savings and investment behaviour, household expenditure, the supply of credit, asset prices and the exchange rate.

If demand pressures are building up in the economy, reflected in rising prices, the RBA can tighten monetary policy, thereby dampening demand. Conversely, in the face of weak demand, reflected in deflationary pressures, the RBA can loosen monetary policy to support economic activity.

However, it is important to remember that monetary policy can exert an influence on the macro-economy even when interest rates are left unchanged. What matters is the level of interest rates. It is possible the cash rate may not have changed for some time but the level of interest rates is nonetheless exerting a strong expansionary or contractionary effect on the economy.

The RBA Board sets the cash rate with a view to achieving the objectives set out in the Reserve Bank Act 1959, namely: the stability of the currency of Australia, the maintenance of full employment and the economic prosperity and welfare of the Australian community. In pursuit of these objectives, the RBA aims to maintain inflation between 2% and 3%, on average, over the economic cycle, thereby anchoring inflationary expectations. By targeting low and stable inflation the RBA seeks to encourage strong and stable economic growth.

Exchange rate policy

Exchange rate policy is concerned with how the value of the domestic currency, relative to other currencies, is determined. Australia has had a floating exchange rate since December 1983. The value of the Australian dollar is determined by market forces.

In response to the mining boom, the Australian dollar appreciated, which helped moderate inflationary pressures and ensure the economy received the price signals needed to facilitate the flow of resources to the mining sector. The appreciation of the dollar also helped spread the benefits of the mining boom by increasing the purchasing power of Australian households. However, the high exchange rate had a contractionary effect on a number of sectors of the economy (such as manufacturing).

The Australian dollar has recently depreciated. This should improve the international competitiveness of Australia’s export and import–competing industries.
Further reading


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