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AUSTRALIA’S ECONOMIC OUTLOOK

By Ted Kramer, Editor

At this time of the year economists try to make some predictions about how the Australian economy will perform over the next year. Their interest at this time is influenced by how economic conditions will affect the federal budget and how the federal budget will affect future economic conditions.

To guide these decisions, they tend to reflect on:

• the latest Statement on Monetary Policy produced by the RBA
• the latest Mid-Year Economic and Fiscal Outlook produced by the Federal Treasury
• recent economic data, generally produced by the Australian Bureau of Statistics and the major banks.

Both the RBA and the Treasury have developed models of the economy which assist them to make forecasts and predictions. The forecasts are made with greater certainty than predictions but, given the level of uncertainty that exists about future economic performance both internationally and domestically, the official forecasts are often specified as being within a band of possible results. In this article, you should assume that any forecast data, that is not expressed as a band of possible outcomes, is the mid-point of the range of possible results.

Uncertainty

The Global Financial Crisis (GFC) of 2008 taught us to be more aware of risk. In this case, the risk was basically in the housing market in the United States. But as the crisis unfolded unexpected consequences occurred right throughout our globalised financial system. Even your local council probably lost millions that it thought was in safe assets – at least according to the experts at assessing risk; the ratings agencies.

Economic stimulus programs were devised to keep individual economies out of a major recession. But the programs have left the world with a lot of debt, especially in those countries that had a lot of debt to begin with eg Greece. That country was like a bankrupt business and still has to be bailed out.

The debt threatens to upset the running of the global financial system again because, for many countries, it would be impossible to undertake another major stimulus program. There are simply not the funds available.

Despite the stimulus programs, GDP growth forecasts for Japan, the Euro area and the United States are still quite low, refer to Table 1.

Table 1: International GDP growth forecasts

<table>
<thead>
<tr>
<th>Country</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>6.9</td>
<td>6.5</td>
<td>6.2</td>
<td>6</td>
</tr>
<tr>
<td>India</td>
<td>7.2</td>
<td>7.5</td>
<td>7.5</td>
<td>7.3</td>
</tr>
<tr>
<td>Japan</td>
<td>1.2</td>
<td>1</td>
<td>1/2</td>
<td>1/2</td>
</tr>
<tr>
<td>United States</td>
<td>2.5</td>
<td>1/2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Euro area</td>
<td>1.9</td>
<td>1/2</td>
<td>1/2</td>
<td>1/4</td>
</tr>
<tr>
<td>Other East Asia</td>
<td>3.7</td>
<td>3/4</td>
<td>4</td>
<td>4/4</td>
</tr>
<tr>
<td>Major trading partners</td>
<td>4.2</td>
<td>4.2</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>World</td>
<td>3.2</td>
<td>3</td>
<td>3/4</td>
<td>3/2</td>
</tr>
</tbody>
</table>

Note: Other East Asia comprises the newly industrialised economies of Hong Kong, South Korea, Singapore and Taiwan and the Association of Southeast Asian Nations group of five (ASEAN 5), comprising Indonesia, Malaysia, the Philippines, Thailand and Vietnam. World GDP growth rates are calculated using GDP weights based on purchasing power parity (PPP). Trade weights for major trading partners are calculated using export trade weights.


Source: MYEFO, December 2016, page 8

In Australia, we are an exception. Our outlook is good because our government debt is still relatively low and our economy has survived 25 years without a recession. However, much of our success could be attributed to our trading relationship with China. While we are being helped by China’s stimulus programs they may not last long enough for our economy to complete its transition from the mining boom. And as for our housing price growth in Sydney and Melbourne – it is like the situation in the USA prior to the GFC; Spain prior to its recession and Japan prior to its long period of stagnation. At least we have the Australian Prudential Regulation Authority (APRA) and the Reserve Bank of Australia (RBA) to monitor the financial stability of our banks. But any major fall in housing prices could have substantial adverse effects on our economy.
The main sources of economic uncertainty internationally appear to be:

- the high levels of debt held by many countries and households. This could stifle future stimulus programs and lead to major fluctuations in the currency and asset markets.
- the intention of some countries to change their international economic relationships. Both Britain and the USA are intending to disrupt the current pattern of world trade and perhaps lead others to do so. This may not only put an end to many of the beneficial effects of globalisation but also leave many of those who voted for these policies worse off.
- the inability of international institutions to get agreement on problems that affect the world e.g. multilateral trading agreements, taxation policies for individuals and businesses that earn incomes in several of countries, asylum seekers, foreign aid and environmental policy.

In the Australian economy uncertainties arise from:

- the lack of growth in non-mining business investment after the mining investment boom. It appears that in the boom the high levels of mining investment crowded out other private investment in the economy and now, with the level of mining investment continuing to fall, the private investment that once existed has not returned.
- any adverse falls in the returns that we get from our mining and energy exports. Fortunately, there has been some recovery in commodity prices – iron ore, coking coal, thermal coal, and Liquefied Natural Gas (LNG) since the trough in 2015-16. But, if the situation in China changes, then they may drop again.
- levels of household debt and the growth in house prices in Sydney and Melbourne. This could lead to an Australian financial crisis if at some stage sellers cannot sell their houses for the price that they paid for them and panic selling starts. (While this might sound good for the many people who cannot afford a house, panic selling could lead to a recession and lower income and employment levels).
- any future growth in the value of the Australian dollar (AUD) could not only hurt exports and the inflow of foreign investment into Australia, but also could reduce the price of imports and reduce the production of Australian-made goods and services.
- growing levels of government debt. While governments which cut taxes can stimulate incomes and employment it is not a strategy that can definitely lead to greater tax receipts and a lower budget deficit. Eventually, as a result of attempts to fix the budget deficit, people’s disposable income may drop and adversely affect economic activity.
- the level of interest rates. While an increase in interest rates would reduce the growth rate in house prices, if it is large enough, it may lead to many buyers being unable to meet their mortgage repayments. This could restrict household consumption and private investment.
- the rate of growth in wages. This is at a record low. While too much wages growth leads to a cost price spiral and inflation, too little growth constrains the growth in household consumption, business investment and government spending. Clearly, wages growth arising from increased labour productivity would be ideal. Even a more equal distribution of income could help.
- major weather events – droughts, floods and winds. Cyclones in Queensland can virtually halt normal economic activity for months and affect the whole of the economy.

**Student activities**

1. Why does the Reserve Bank produce the quarterly Statement on Monetary Policy and the Treasury produce the Mid-Year Economic and Fiscal Outlook? In your answer refer to Australia’s main macroeconomic policy instruments.
2. How can uncertainties and risk affect the stability of our financial system?
3. Why are economic forecasts often ‘wrong’?
4. Examine Table 1 and compare the growth forecasts for the developed economies and the emerging economies.
5. List Australia’s main sources of uncertainty that are arising in the international economy.
The outlook for economic growth

Variations in Australia’s key economic indicators, such as inflation and unemployment, are associated very closely with the rate of economic growth. Australians faced a scare with the release of the economic growth figure for the September Quarter 2016. Gross Domestic Product (GDP) fell by 0.5 percent. Some predicted that there would be a fall in the next quarter and that Australia’s record growth path would end in a technical recession. But the panic stopped when it was realised that seasonal factors, such as bad weather, had caused the slow-down. The growth rate for the next quarter, the December quarter, was a well above the short-term average at 1.1 percent. And Australia’s record period of economic growth stayed intact.

So, given that quarterly growth figures can be quite volatile, what is the outlook for economic growth?

Well we now know that cyclone Debbie might cause some seasonal fluctuations. But the RBA prepared its forecast before the cyclone, and forecast growth in the range:

- 1.5 to 2.5% for 2016-17
- 2.5 to 3.5% for 2017-18
- 2.75 to 3.75% for 2018-19,

refer to Table 2.

Table 2: Output, Growth and Inflation Forecasts

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP growth</td>
<td>2%</td>
<td>1.1%</td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>5.8%</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>CPI inflation</td>
<td>1.5%</td>
<td>2%</td>
<td>1.1%</td>
<td>1.1%</td>
<td>2%</td>
<td>2%</td>
</tr>
<tr>
<td>Underlying inflation</td>
<td>1.6%</td>
<td>1.1%</td>
<td>1.1%</td>
<td>1.1%</td>
<td>2%</td>
<td>2%</td>
</tr>
</tbody>
</table>

The forecasts prepared for the MYEFO in December 2016 are in the same range as the RBA but slightly lower, refer to Table 3. However, the forecasts in the Pre-Election Economic and Fiscal Outlook (May 2016) were slightly higher than the MYEFO.

Table 3: Domestic Economy Forecasts

<table>
<thead>
<tr>
<th>Outcome(s)</th>
<th>2016-17</th>
<th>2017-18</th>
<th>2018-19</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP growth</td>
<td>2%</td>
<td>2.5%</td>
<td>3%</td>
</tr>
<tr>
<td>CPI inflation</td>
<td>1.5%</td>
<td>2%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Underlying inflation</td>
<td>1.6%</td>
<td>1.1%</td>
<td>1.1%</td>
</tr>
</tbody>
</table>

The forecasts prepared for the MYEFO in December 2016 are in the same range as the RBA but slightly lower, refer to Table 3. However, the forecasts in the Pre-Election Economic and Fiscal Outlook (May 2016) were slightly higher than the MYEFO.

Given that the average economic growth rate from 1960 to 2016 was 3.5% the forecasts suggest that the economic growth rate will be below average for some time. And this is likely to occur with large budget deficits and record low interest rates. Even wages growth is at a record low.

So why such low growth forecasts?

In terms of the main aggregates in GDP the MYEFO sees the main variables as being:

- household consumption growing at 2.75% in 2016-17 and 3% in 2017-18. The current rate of growth is probably lower than that but the MYEFO expects household debt to continue to rise as consumption spending outpaces the growth in disposable incomes. In other words, the growth rate in household consumption will not be achieved unless households go further into debt.
- non-mining business investment is forecast to grow at only 1.5% for 2016-17 but 4.5% for 2017-18. The Treasury sees much of this growth occurring in the non-mining states. But since inventories are not expected to fall and household consumption is not expected to take off then...
it must be the low interest rate and low cost environment that is encouraging greater business investment.

- mining investment is forecast to continue to fall, but at a slower rate ie from 21% for 2016-17 to 12% for 2017-18. It is expected that the effect on the economy of the fall in mining investment will continue to diminish. However, the impact of these falls are incurred mainly by Western Australia, Queensland and South Australia, which have a relatively high proportion of their total output from mining.
- business investment, overall, is expected to fall by 6% in 2016-17 and to be flat in 2017-18. In other words, autonomous business investment will not produce those multiplier effects that the economy needs.
- growth in investment in dwellings (homes) is forecast to drop – from a rise of 10.8% in 2015-16 to 4.5% in 2016-17 and 0.5% in 2017-18. This component of GDP has been very important in assisting the transition of the economy from the mining investment boom. In 2015-16 it more than covered the relative decline in business investment.
- exports are forecast to rise by 5% or more, with the main growth being in LNG, iron ore and services, such as tourism and education.
- imports detract from GDP and are forecast to only grow by 2% in 2016-17 and 3% in 2017-18. This reflects the fact that the mining companies are not importing as much capital equipment as they did in the mining investment boom.

Most of the other components of GDP are forecast to provide much the same contribution to GDP as they do now, such as public capital formation and government recurrent spending.

In terms of the range of possible outcomes for GDP growth the RBA has produced Graph 1. It is expressed in terms of confidence intervals based on historical forecast errors. It is a way of incorporating the possible effect of uncertainty on the growth forecast.

The outlook for inflation and unemployment

With economic growth being forecast to be at below average rates then there is not much pressure on consumer prices or wage rates. In fact, in several parts of the western world the disruption of the GFC caused major recessions to develop with sustained periods of deflation, very high unemployment and even negative interest rates.

By sustaining positive economic growth Australia has been able to avoid high unemployment rates, price stagnation and extremely low interest rates. But inflation, when measured using the Consumer Price Index (CPI), has been subdued, currently at 1.5%. It is asset price inflation that is causing the problems, especially the housing bubble in Sydney and Melbourne.

The CPI inflation forecasts by the RBA and the MYEFO tend to be consistent, with the MYEFO generally close to the mid-point of the range forecast by the RBA. Both expect inflation to be about 2% per year for 2016-17 and 2017-18. This is at the lower end of the RBA’s target range so there appears to be room for both monetary and fiscal policy to stimulate economic activity.

In terms of the range of possible outcomes, however, the RBA has produced Graph 2.
Often rising wage rates are seen as a constraint to stimulatory macroeconomic policies, but at the moment wage inflation is only 1.9% and the MYEFO expects it to be 2.25% for 2016-17 and 2.5% for 2017-18. As a result, inflationary expectations are very low.

With the level of unemployment currently at 5.9% (Feb 2017) and a drift from full-time to part-time employment, then normally additional stimulatory policies would be appropriate. Even the RBA expects unemployment to remain in the 5% to 6% range until 2018-19, while the MYEFO forecasts it to be 5.5% until 2017-18. However, its range of possible outcomes is expressed in Graph 3.

The need for stimulatory policies is also evident in the underemployment rate. Graph 4, below, shows that since February 2015 the unemployment rate has fallen while the underemployment has remained at about 8.5%.

Underemployment occurs when:

- people employed part-time want to work more hours and are available to start work
- people who are usually employed full-time are working part-time for economic reasons.

The second type of underemployment is usually at very low levels, except in times of a temporary collapse in economic activity, such as in the GFC. It is the first type that is of concern. In terms of a long-term trend it has led the underemployment rate upwards since 1980, refer to Graph 5.
One would have to be very brave to forecast that this trend will not continue. With the average underemployed person wanting to work an extra 14 hours per week then that is a lot of spare capacity in the labour force, even if unemployment fell back to 4% as it did prior to the GFC. Those affected are mainly females, younger workers and older workers. All low skilled workers can be affected.

**Historical perspective**

This economic outlook is very different from the forecasts prepared for the Australian economy from the 1970s up until the GFC in 2008. Then the western world was characterised by strong economic growth, the need to constantly keep CPI and wage inflation under control, relatively high inflationary expectations, periods of high unemployment and greater free trade. The emerging economies are now the growth engines for the world and are major exporters of manufactured goods. China is the recent success story and it has followed South Korea and Japan. Many other countries are following their path.

The failure of multilateral trade negotiations and the success of Brexit and Donald Trump help the problems of the past appear very predictable. Uncertainty now prevails.

**Outlook for the Australian Dollar**

In recent years, the value of the AUD has fluctuated fairly much in line with the terms of trade (TOT). In turn, the TOT has been fluctuating in line with the RBA’s index of commodity prices, refer to Graphs 6, 7 and 8.

**Graph 6: Australian Dollar – trade weighted index**

*Source: Reserve Bank of Australia, Chart Pack*

**Graph 7: Terms of Trade**

*Source: ABS, RBA, Thomson Reuters, VMReuters*

**Student activities**

7. What factors are currently holding back Australia’s economic growth rate?

8. What is Australia’s current outlook for inflation? Why is it important to avoid deflation?

9. What is the difference between unemployment and underemployment?

10. What is Australia’s current outlook for unemployment and underemployment?

11. Why is underemployment becoming such an important measure of the underutilisation of labour?

12. From an historical perspective, what sections of the Economics textbooks are less relevant in today’s economic conditions than they were prior to 2008?
Unfortunately, for Australia, the prices of the key export commodities – iron ore, thermal coal and coking coal, Graph 9, (as well as liquefied natural gas), have been quite volatile causing the TOT and AUD to be volatile. Its recent range relative to the US dollar has been between 77 cents and 72 cents.

The outlook for the dollar, however, is not optimistic. After a big fall in the TOT in 2015-16 it rose to close to the 2014-15 level in 2016-17. But, according to the MYEFO the TOT will start falling again leading to a decline in the AUD. The economic forecast prepared by Trading Economics in April 2017 has the AUD falling to 73 cents by the end of the year and 61 cents in 2020.

However, while a fall in commodity prices is not good for Australia now that so much has been invested in new and expanded mines, a fall in the AUD could have some beneficial effects. It could assist the transition of the economy from the declining mining investment boom by:

- reducing the cost of our exports of goods and services to foreign buyers. This could assist the recovery of those industries that suffered the adverse effects of the high AUD during the mining boom, such as manufacturing, education, tourism, and agriculture. In fact, many manufacturers closed their Australian manufacturing operations eg Ford, General Motors Holden and Toyota. Even our main steel producers at Port Kembla and Whyalla cut back production and threatened closure.
- encouraging greater foreign investment by making it cheaper to invest in Australia. This could help our waning levels of business investment.

Each of these effects should lead to increases in GDP and, as a result, increases in employment, incomes, household consumption and eventually business investment. The increased revenues from taxation could also lead to greater government spending on items that improve the efficiency of the economy, such as education, transport, health, national broadband network and (clean) electricity generation and distribution.

A lower AUD, however, makes:
- imports more expensive
- Australian investment abroad more expensive.

While it can have a detrimental effect on Australian businesses buying inputs from abroad and slow the rate at which Australian businesses are expanding abroad, a lower AUD should benefit the import competing industries and have an overall effect of improving economic activity.

Indeed, the RBA has been facilitating the fall in the AUD for at least the last 5 years and would probably like it to drop in value in the short-term. To do that it could lower the cash rate again. This would lower the interest rate differential between Australia and other countries and slow the inflow of portfolio investment and hence could reduce the value of the AUD. Our cash rate is 1.5% whereas the policy interest rate in Japan has been -0.10% since January 2016 and the rate has been -0.40% in the Euro area. Even the rising US rate is only about 0.625%. There is a great incentive for foreigners to invest in Australia.
So, if a fall in the AUD could increase both aggregate demand and supply at a time when both are needed, why has the RBA chosen not to do so?

Well the answer lies in housing. The low interest rate environment has stimulated housing construction and the demand for housing. New dwelling investment has been rising by about 10% recently and housing construction has partially 'filled the hole' left by the decline in mining investment. However, the MYEFO only forecasts new dwelling investment to rise by 0.5% in 2017-18. So why not reduce rates again?

Well, the housing price bubble in Melbourne and Sydney would just be inflated by a lower cash rate. The prices of existing dwellings and new dwellings in Sydney and Melbourne have been growing rapidly, far more than wages and causing further increases in household debt. The CoreLogic Index of prices of all dwellings for the year to the end of March 2017 was 18.88% for Sydney and 15.93% for Melbourne. In both cities the price of houses rose faster than the price of units. In fact, in Sydney since June 2012 prices have risen a cumulative 70%.

You might think, what has this got to do with the forecast value of the AUD? The answer being that were it not for the housing bubble, interest rates could be lowered and the AUD would be able to fall and produce some of the benefits that are listed above. On the other hand, raising interest rates could stifle the bubble but would probably be detrimental to the economy because it would lead to an increase in the value of the AUD, reduce consumer spending and perhaps cause many new home owners to default on their mortgage repayments.

Clearly the government needs a way to deflate the bubble without increasing interest rates. Thankfully, the Australian Prudential Regulation Authority (APRA), which is responsible for the financial stability of the banks, has implemented measures to improve the selection process for people seeking new mortgages, such as restricting the proportion of interest only housing loans. And the federal government is expected to take action in this year’s budget to reduce the tax advantages of investment properties, as it did with superannuation last year. (Unfortunately, people just seem to have switched their savings from super to property.)

If the bubble can be controlled without the use of higher interest rates then the value of the AUD relative to the trade-weighted index should drop slowly over the next couple of years. Economic recovery and rising interest rates in the USA should ensure that the value of the AUD falls against the US dollar for at least a couple of years.

The value of the AUD can also be affected by factors which affect Australia’s external stability. These include:

- items in the Balance of Payments, such as
  - the balance of goods and services
  - the primary income deficit
  - the current account deficit

- the net international investment position, such as
  - net foreign debt
  - net foreign equity.

The key to all of these variables is the value of exports. When the value of exports is high we can service the payments that arise from buying imports, having too much capital inflow and building up too much foreign debt. But, for the value of exports to be high Australia needs:

- world market prices for its products to be high
- to be able to supply the volumes required
- be the recipient of orders from our key export destinations.

It is good for us to have trading partners with high rates of economic growth. The following Graph 9 shows that Australia has chosen trading partners which have excellent growth records. The mining investment boom has helped us to satisfy the orders from these economies. The main factor that could affect the value of exports is world market prices. As noted earlier in this article, they can be quite volatile.
In terms of Australia’s external stability, we are in an excellent position, as indicated by Graphs 11 and 12. Therefore it would be expected that the AUD should just fall as the terms of trade falls slowly over time. Currently, we are not a ‘banana republic’, and should not see for quite some time the AUD falling to anywhere its record lows of around 50 cents for a US dollar.

Student activities

13. Explain why the prices of Australia’s key mining and energy resources are currently closely linked to the value of the Australian dollar.

14. Explain why a fall in the value of the Australian dollar could benefit Australia’s outlook for employment and economic growth.

15. How has the Reserve Bank been influencing the value of the Australian dollar?

16. Why can’t the Reserve Bank achieve a further reduction in the value of the dollar?

17. What are the key factors that affect Australia’s external stability?

18. Assess the likelihood of a rapid fall in the value of the dollar. In your answer refer to each of the main factors affecting Australia’s external stability.
Conclusion

What could governments be doing to improve our economic outlook? From the text above it appears that governments should be:

- facilitating the transition of the economy from the massive mining investment boom by a range of measures, including stimulating business investment
- deflating the housing price bubble to enable lower interest rates and a lower AUD
- doing whatever is possible to maintain the prices of iron ore, thermal coal, coking coal and liquefied natural gas at their current levels or higher.

Firstly, with the benefit of hindsight it appears that the governments of the time thought that the mining boom would never end. They were happy for mining investment to displace non-mining investment without giving a thought to the uncertainties that were likely to arise after the boom. New dwelling investment has been our saviour so far but taxing the miners and subsidising some of the non-mining industries so that they did not have to close might have avoided some of the difficulties of this transition period.

Many economists have advocated infrastructure projects to fill the vacuum. In New South Wales, there are so many new infrastructure projects taking place that it is not surprising that it is the fastest growing state. Meanwhile the federal government has focussed its attention on implementing deflationary measures to reduce the size of the budget deficit to protect its triple A credit rating. Some well-chosen infrastructure projects from it could be useful to stimulate growth.

Unfortunately, during the mining boom governments spent the windfall that they gained in extra revenue without the thought of what might happen when the boom subsided. As a result, all governments have been faced with budget deficits and are therefore limited in their capacity to stimulate economic activity.

Secondly, governments need to act quickly to reduce house prices before they inflate so much that any adverse change in the economy could cause buyers to default on their loans. This effect could be magnified if house prices fell substantially for new borrowers. Lower interest rates could lead to a lower AUD and better outcomes for economic growth and employment.

Finally, Australia should not do anything to jeopardise its trading relationships with our major trading partners. Both China and Japan buy much of our main commodity exports. Any change in their policies eg their stimulus programs, could lead to lower commodity prices and jeopardise our economic outlook.

Student activities

19. Essay: Evaluate Australia’s current macro and micro economic policy management from the viewpoint of sustaining economic growth while the mining investment boom is subsiding. (If you were both the Treasurer and the Governor of the Reserve Bank how might you produce a better growth path for Australia for the next few years?)

References:

