

Glossary

A

absolute convergence the tendency of both the levels and growth rates of output in different countries to approach each other over time, and for their steady-state values to be the same

accelerator model a model that asserts that investment spending is proportional to the change in output, and is not affected by the cost of capital; it describes the behaviour of inventory investment surprisingly well

accommodating policies the use of monetary and fiscal policies in conjunction to offset the effects of a shock on a particular economic variable

action lag the period between the time a policy is decided on and the time it is implemented

active labour market programs programs designed to give the unemployed active help in improving their labour market status (as opposed to the 'passive' help they obtain through the receipt of unemployment benefits)

activist policies policies that respond to the current state of the economy and try to stabilise output

activist rules rules that have countercyclical features

acyclical variables economic variables that tend to display no discernible relationship with business cycle activity at all

adverse supply shock an upward shift in the aggregate supply curve

aggregate demand the sum of the values of all the final goods purchased in an economy

aggregate demand (AD) curve the relationship between the amount of goods and services people wish to purchase and the price level

aggregate demand schedule a synonym for the aggregate demand curve

aggregate supply (AS) curve the relationship between the amount of final goods and services produced in an economy and the price level

aggregate supply–aggregate demand model the model that uniquely determines price level and level of output for which both goods and money market are in equilibrium

anticipated inflation inflation that people expect

anticipatory monetary policy monetary policy adopted in response to inflationary pressures that are expected to arise in the future

arbitrage buying or selling assets in order to take advantage of differences in returns

Asian crisis the financial and goods markets failures in many economies in the Asian region, beginning in 1997 with the depreciation of the Thai baht

Asian Tigers the rapid growth countries of Hong Kong, Singapore, South Korea and Taiwan

automatic adjustment mechanisms mechanisms that automatically act to eliminate balance-of-payments problems

automatic stabiliser a policy that reduces the impact of an economic shock without requiring case-by-case intervention

B

balance of payments a measurement of the net flow of currency into the country from abroad

balance-of-payments surplus a surplus occurring when more money is entering the country than is leaving it

balanced budget multiplier the increase in output that results from equal increases in taxes and government purchases

Barro-Ricardo equivalence proposition (Ricardian equivalence) the proposition that there is no difference between taxes and the accumulation of debt; debt is thought to be the same as future taxes

Basel III Accord the third of the Basel Accords, to be introduced from 2013 until 2018, that provide a global regulatory standard on bank capital adequacy, stress testing and market liquidity risk

beggar-thy-neighbour policy an attempt to increase domestic output at the expense of the output of other countries

Bretton Woods system a system of exchange rates operating between 1946 and 1973, overseen by the IMF, under which most countries fixed their exchange rates in terms of the US dollar by

specifying the rate at which the central bank would buy or sell US dollars

bubble (or speculative bubble) when the value of a variable departs from the level that the factors that determine its value suggest; when an asset price, such as a share price or house price is argued to be over- or under-valued then the suggestion is that such a bubble exists in the market that determines that price

budget constraint the limit to the amount of money an individual, a firm or the government can spend

budget deficit the difference between the amount of money the government spends and the revenue that it receives in the form of taxes

budget surplus the difference between the amount of revenue the government receives in taxes and the money that it spends

buffer stock excess consumer savings used to maintain consumption when income is lower than usual (saving for a rainy day)

business cycle the pattern of expansion and contraction of business activity in the economy

business fixed investment the annual increase in machinery, equipment and structures used in production

business saving saving by firms; profits not paid out to owners/shareholders

C

capital account the net flow of currency into the country resulting from the acquisition of domestic assets by foreigners

capital gains the amount that an asset appreciates in value over time

capital inflow financial flows into a country, appearing in the capital and financial account of a country's balance of payments

capital stock the amount of capital available for use in the economy

capital-labour ratio the amount of capital available for use by each worker; the capital stock divided by the labour supply

cash rate the short-term interest rate targeted by the RBA

central bank a bank that has control over the money supply

certainty-equivalence policy a policy made under the assumption that there is no uncertainty regarding future events

classical adjustment process the process by which the economy automatically moves towards internal and external balance

classical aggregate supply curve a vertical *AS* curve, indicating that output equals potential output

classical case a vertical *LM* curve; the case in which money demand is completely insensitive to changes in the real interest rate

classical quantity theory the proposition that the price level is proportional to the money supply, derived from classical theory and the quantity theory of money

classical recession an extended period in which not only does the economy slow down, but the level of output actually falls

clean floating a flexible exchange rate system in which the central bank does not intervene in foreign exchange markets

Cobb-Douglas production function a production function with constant returns to scale, constant elasticity of output and unit elasticity of substitution between input factors

coincident index an index of economic activity created using variables that closely represent the state of the economy at the present time

cold turkey a policy strategy of moving very quickly (immediately) towards a desired target rather than trying to spread the cost of adjustment over time

competitive depreciation when one country allows its currency to depreciate in order to improve its trade balance, hurting another country; a series of retaliatory depreciations

composite index an index of economic activity, possibly containing leading, lagging and coincident indicator variables

conditional convergence the tendency of growth rates of output in different countries to approach each other over time, and for their steady-state values to be the same

consol (or perpetuity) an asset that pays a fixed amount (coupon) each period forever

consumer price index (CPI) a fixed-weight price index that measures the cost of the goods purchased by the typical urban family

consumption function an equation relating consumption to disposable income

consumption spending spending by consumers

convergence the tendency standards of living in different countries to approach each other over time

convergence club a group of countries or regions exhibiting convergence

coordination approach the theory that price and wage movements are sluggish to react in the face of changes in demand because firms in an economy cannot get together to coordinate their price and wage changes

countercyclical variables economic variables that tend to move in the opposite direction to business activity

coupon a periodic payment made to the holders of a bond

crawling peg an exchange rate policy that devalues the exchange rate at a rate roughly equal to the inflation differential between a country and its trading partners

credibility the degree to which the public believes that the government will implement its announced policies

credibility bonus the extra reduction in inflation due directly to the public's belief in the central bank's commitment to fighting inflation

credible policy a policy that people believe their government will follow

credit short- and long-term loans to firms, households and the government

credit easing unorthodox monetary policy tools focusing on the asset side of the central bank balance sheet used to stimulate credit in a financial crisis

credit rationing limiting the amount of money that individuals can borrow at the prevailing interest rate

crowding out the reduction in some component of aggregate demand—usually investment—that results from an increase in government spending

currency appreciation a currency appreciates when it becomes *more* expensive in terms of foreign currency

currency board the requirement that a specific amount of foreign currency must back up each unit of domestic currency that is printed

currency depreciation a currency depreciates when it becomes *less* expensive in terms of foreign currency

currency union an agreement by two or more countries to share a common currency, for example the European Currency Union

currency–deposit ratio the ratio of the currency to bank deposits; a primary determinant of the money multiplier

current account the net flow of dollars into the country resulting from the sale of domestic goods and services, and from net transfers from abroad

current account deficit a situation in which the current account is negative

cyclical component of GDP fluctuations of output around its trend; the output gap

cyclical unemployment unemployment resulting from business cycle fluctuations

D

debt–income ratio ratio of national debt to GDP

decision lag the period of time required to decide on the proper response to a macroeconomic shock

deep parameters parameters that describe the preferences of individuals and the production of firms, and that can be identified from microeconomic studies

deflation rate at which the price level falls, in percentage terms; opposite of inflation

demand for real balances the quantity of real-money balances people wish to hold

depreciation (of capital) rate at which the capital stock wears out

destiny factors non-economic factors such as poor soil quality and low and unpredictable rainfall, that contribute to sub-Saharan Africa's difficulties in escaping its growth trap

devaluation decrease in the value of the domestic currency relative to the currencies of other countries, used when exchange rates are fixed

difference stationary temporary shocks to a variable that permanently affect its level

diminishing marginal product a characteristic of a production function whereby the marginal product of a factor falls as the amount of the factor increases while all other factors are held constant

diminishing marginal returns when incremental increases in inputs produce less and less extra output as more and more inputs are added

discounted cash flow analysis a method of determining the present value of cash to be received in the future

discouraged workers people who would like to work but have given up looking

discrete lag the time that passes before an effect is felt

disposable income the income available for a household to spend; total income less taxes plus transfers

distributed lag the time that passes while an effect gradually accumulates

divergence the tendency of both the steady-state levels and growth rates of output in different countries not to converge over time, with poorer countries growing more slowly on average over long swings of time than richer countries

dollarisation the replacement of a domestic currency with another country's currency, for example the US dollar

durable goods goods that yield services over a period of time

duration of unemployment the average length of time a person remains unemployed

dynamic behaviour behaviour that takes place over time

dynamic inconsistency the tendency of optimal policy to be different at different points in time

dynamic programming a way of solving a problem by working backwards through time; choices made at one point in time anticipate choices that will need to be made later

E

earned income tax credits a refundable federal tax credit for eligible individuals and families who work and have earned income under a specified threshold

econometric model a model used to make quantitative economic predictions

effective marginal tax rates the amount of every extra dollar earned that is taken away through the tax system or through the withdrawal of social security benefits

efficiency wage theory a theory suggesting that wages might be set above the market clearing

rate in order to motivate workers; a possible explanation for wage rigidity

employment stability a low rate of job lay-off or turnover

endogenous growth steady-state output growth determined by endogenous variables, for example the savings rate

endogenous growth theories theories in which self-sustaining economic growth is fully explained within a theoretical model without the need to postulate some exogenous rate of technological advance as the force to generate sustained growth

equilibrium level of output the level of output at which aggregate supply equals aggregate demand

European Sovereign Debt Crisis the ongoing financial crisis that has made it very difficult for some Eurozone countries to repay or re-finance their government debt

excess sensitivity when one variable's response to changes in another is larger than theory predicts

excess smoothness when one variable's response to changes in another is smaller than theory predicts

exchange rate overshooting the movement of the exchange rate past its target

expectations-augmented Phillips curve Phillips curve that includes inflationary expectations as a determinant of the inflation rate

expectations theory of the term structure the theory that long-term interest rates are equal to the average of current and expected future short-term interest rates, plus a term premium

expected inflation rate the inflation rate expected in the future by workers and firms

expenditure-reducing (increasing) policies policies aimed at offsetting the effects of expenditure-switching policy

expenditure-switching policies policies aimed at increasing purchases of domestic goods and decreasing purchases of imported goods

external balance when the balance of payments is neither in surplus nor in deficit; when the current account and the capital account exactly offset each other; or when the balance-of-payments surplus is equal to zero

F

face value the amount that a bond pays its holder on expiration; the market value of a bond will

equal its face value when the market interest rate is equal to the rate of return on the bond

factor payments payments made to factors of production, such as wages paid to labour

factors of production inputs to production, such as capital, labour and natural resources

Fair Work system system of workplace regulation implemented in January 2010 under the *Fair Work Act* of 2009 that attempts to create a more national system for regulating industrial relations and a return to a stronger emphasis on enterprise based bargaining

final demand the sum of private and public consumption and investment expenditures

final goods goods that are sold to firms, the public or the government for any purpose other than use as an input to production; all goods excluding intermediate ones

finance the sale or purchase of assets

financial crisis when a loss in international confidence in an economy (or group of economies) leads to increased risk premiums, rising interest rates, falling asset prices, increased default rates on loans and disruption of the banking system, and a collapse in the value of the currency

fine-tuning continual attempts to stabilise the economy in the face of small disturbances

fiscal austerity measures taken by governments to increase revenues to reduce expenditures and decrease budget deficits and debt

fiscal policy government policy with respect to government purchases, transfer payments and the tax structure

fiscal policy multiplier the increase in aggregate demand for a \$1 increase in government purchases

Fisher effect the tendency of inflation and nominal interest rates to move together

five economists' plan a detailed proposal on how to create more jobs and cut unemployment

fixed exchange rate (or pegged) system a system in which exchange rates are determined by governments and central banks rather than the free market, and maintained through foreign exchange market intervention

flexible accelerator model a model that asserts that firms plan their investment to close a fraction of the gap between their actual capital stock and their desired capital stock

flexible (floating) exchange rate a system in which exchange rates are allowed to fluctuate with the forces of supply and demand

flow of investment the stream of new capital that adds to the current stock of capital to bring that stock to its desired level

foreign exchange market intervention the sale or purchase, by a country's central bank, of currency in foreign exchange markets for the express purpose of increasing or decreasing the value of the domestic currency

fractional reserve banking the requirement that banks must keep a fraction of their deposits in the form of cash or cash equivalents

frequency of unemployment the average number of times per period that workers become unemployed

frictional unemployment the unemployment associated with the movement of workers in and out of jobs in 'normal' times

full-employment budget surplus what the budget surplus would be (hypothetically) with existing fiscal policy if the economy were at full employment

G

GDP deflator a measure of the price level, obtained by dividing nominal GDP by real GDP

GDP per capita GDP per person

generational accounting evaluates the costs and benefits of the entire fiscal system for various age groups in society

Global Financial Crisis (GFC) the financial crisis of 2007–2008, considered by many economists to be the worst financial crisis since the Great Depression

globalisation the notion that the world is moving towards a single global economy

golden-rule capital stock the steady-state level of capital that provides the most consumption each period

Goods and Services Tax (GST) a type of value-added, consumption-based taxation system introduced in Australia in 2000

goods market equilibrium schedule the relationship investment (I) equals saving (S)—the IS curve

government budget constraint a limit that says the government can finance its deficits only by selling bonds (accumulating debt) or by increasing the monetary base

government budget deficit the excess of government expenditure over government revenue

government expenditure total government spending, including both government purchases and transfers

government purchases government spending on goods and services

government saving all public sector saving net of the savings of public sector enterprises and financial institutions

gradualism a policy strategy of moving slowly towards a desired target

Great Depression a historical period of very low output, deflation and very high unemployment that occurred during the years 1929–1941 in Australia. A number of other countries also experienced severe depressions during this period, particularly the United States

Great Moderation the period of decreased macroeconomic volatility experienced in the United States in particular, but also other several OECD countries including Australia, between the mid-1980s and mid-2000s

Great Recession the classical recession period of 2007–2009 in the United States, as dated by the US National Bureau of Economic Research

gross domestic product (GDP) the measure of all goods and services produced within a country in a given period (usually a quarter or a year)

gross investment total investment; flow into the capital stock

gross national expenditure (GNE) the level of final demand plus the change in inventories (increase or decrease in stocks) in the economy

gross national income (GNI) the measure of the value of all final goods and services produced by domestically owned factors of production

gross private domestic investment total additions to the capital stock by the business sector, not accounting for capital depreciation

growth accounting the theory of measurement of the sources of economic growth

growth cycle the definition of business cycles that focuses on fluctuations in the rate of the growth

of the economy (the detrended level of economic activity) relative to the long-run trend rate of growth

growth disasters where countries have experienced large declines in relative incomes after showing signs of a take-off of growth and development

growth rate the rate at which a variable increases in value; the percentage change in the level of a variable

growth theory a theory that tries to explain why output grows over time and identify the factors that affect the growth rate

growth trap a situation in which neoclassical forces imply that a country is unable to escape a no-growth, low income steady state

H

Heavily Indebted Poor Countries (HIPC)

Initiative a joint project between the World Bank and the International Monetary Fund (IMF) that offers debt relief to those of the world's poorest nations

heterodox approach to stabilisation temporary use of various sorts of income policies—price and wage controls—to support orthodox policy approaches to stabilise inflation

human capital the education and training of individuals

hyperinflation a period of very rapid price increase, usually defined as over 1000 per cent per annum

hysteresis effects the permanent effects that temporary fluctuations in one variable have on another variable

I

imperfect competition a form of competition in which firms have market power—they can choose, to some extent, the price at which they will sell the goods they produce

imperfect information incomplete information, which will result in forecasts that are less than fully accurate, though not necessarily biased

imperfect-information model a model of the aggregate supply curve that is based on the assumption that firms usually observe prices only in their own market and, as such, have only imperfect information over the causes of price movements

impulse propagation when economic mechanisms prevent the economy from adjusting back to its long-run position immediately after a shock has hit the economy

income elasticity the amount that demand for real money balances changes, in percentage terms, when income increases by 1 per cent

income velocity of money the ratio of nominal income to the supply money

increasing returns to scale when, in a production function, doubling all of the inputs to the production process more than doubles output

independence of the central bank the degree to which the central bank has operational and management independence from the government, including from political pressures in setting and achieving its goals

indexation automatic adjustment of prices and wages according to the inflation rate

indicators economic variables that signal whether we are getting close to our desired targets

inflation the percentage rate of increase in the general price level

inflationary inertia the tendency for inflation rates to decrease only slowly over time

inflation targeting using monetary and fiscal policy to achieve a particular rate of real GDP growth

inflation tax the revenue gained by the government because of inflation's devaluation of money holdings

inside lag the period between the time a disturbance occurs and the time action is taken

insider–outsider theory a theory that argues that wages remain above the market-clearing level because those who are unemployed do not sit at the bargaining table

instruments the 'tools' that policy makers manipulate directly to affect the economy

interest differential the difference between rates of interest paid in different countries for the same asset, or in the same country for different assets

interest elasticity the percentage change in the demand for real money balances resulting from a 1 per cent increase in the interest rate

intermediate goods goods used to produce other goods or services

internal balance when output equals potential output

International Monetary Fund (IMF) an international organisation created to promote international monetary cooperation

intertemporal substitution of leisure the extent to which temporarily high real wages cause workers to work harder today and enjoy more leisure tomorrow

intervention sales or purchases of foreign exchange by the central bank in order to stabilise exchange rates

inventory cycle the response of inventory investment to changes in sales that causes further changes in aggregate demand

inventory investment an increase in the stock of goods on hand

investment the purchase of new capital, principally by the business sector

investment subsidy a government payment of part of the cost of private investment

involuntary unemployment when individuals would like to work in the marketplace at the going wage rate, but cannot find a job

IS curve a schedule showing all the combinations of the interest rate and the level of output for which the goods market is in equilibrium

IS–LM model a model showing that the interaction of IS and LM curves determines the interest rate and the level of income for a given price level, for which both goods and money markets are in equilibrium

J

J-curve effect the observation that when a currency depreciates, the value of net exports falls temporarily, and then rises

Job Network the nationwide institutional framework formed by contracting over 300 private, community-based and government organisations to provide outcome-oriented employment services to jobseekers and employers on a competitive basis

Job Services Australia the new name for the Job Network since 2009

just-in-time inventory management an inventory management strategy, where firms hold inventories for as short a time as possible by sending goods out as soon as they are produced, and ordering parts only as they are needed

K

Keynesian aggregate supply curve a horizontal aggregate supply curve, indicating that firms will supply whatever amount of goods is demanded at the existing price level

Keynesian revolution the idea that a reworking of economic theory and macroeconomic policy making, based largely on Keynes writings in his *General Theory* (1936), overthrew the classical mainstream orthodoxy. The intellectual shift involved a critique of the assumption of rational behaviour and a much greater focus on demand, not supply, as the driver of employment outcomes

L

labour force the collective term for people who are working and people who are actively looking for work

labour force underutilisation rate the sum of the number of persons unemployed and the number of persons in underemployment, expressed as a proportion of the labour force

lagging indicators variables that tend to change their behaviour after a peak in general activity, such as employment and unemployment

Laspeyres price index a base-weighted price index such as the CPI—the ratio of today's cost of a fixed basket of goods to the base year cost of that basket

leading indicators variables that tend to change their behaviour before a peak in general activity

life-cycle hypothesis a consumption theory emphasising that consumers consume and save out of total life income, and plan to provide for retirement

lifetime budget constraint the limit to the amount of money we can spend over our lifetime imposed by the total amount of money that we earn/inherit/find/win over our lifetime

lifetime utility the total benefit we derive from consumption (and whatever other activities we value) over our lifetime

liquidity a measure of the ability to make funds available on short notice

liquidity constraints a limitations on the ability to borrow in order to finance consumption plans

liquidity trap a horizontal *LM* curve due to the extreme interest sensitivity of money demand

***LM* curve** a schedule showing all the combinations of the interest rate and the level of output, for a

given price level, for which the demand for real money balances equals the supply of real-money balances

long run a period of one or two decades, over which potential output is achieved on average

loss function a functional representation measuring the loss (or damage) suffered due to any gap between actual and target outcomes

Lucas critique econometric policy evaluation critique that points out that many macroeconomic models assume that expectations are given by a particular function, when that function can change

M

M1 currency plus current deposits

M3 *M1* plus all deposits with banks

macroprudential policy an approach to financial regulation aimed at mitigating the risks to the financial system as a whole (or 'systemic risk')

managed (dirty) floating a flexible exchange rate system in which central banks intervene in exchange markets to moderate short-run fluctuations in exchange rates

marginal loss function a functional representation measuring the incremental loss (or gain) suffered due to a change in a policy instrument

marginal product of capital (MPK) an increment to output obtained by adding one unit of capital, with other factor inputs held constant

marginal product of labour (MPN) an increment to output obtained by adding one unit of labour, with other factor inputs held constant

marginal propensity to consume the increase in consumption for each \$1 increase in disposable income

marginal propensity to import the increase in the demand for imports that results from a one-unit increase in domestic income

marginal propensity to save the increase in savings for each \$1 increase in disposable income; 1 minus the marginal propensity to consume

marginal utility of consumption the increase in utility from consuming an additional unit of some good or service

maturity (or term) of a bond the length of time until a bond expires

medium of exchange one of the roles of money; an asset used to make payments

medium run the period of transition (dynamic adjustment) between the short run and the long run

menu cost a small cost incurred when the nominal price of a good is altered

merchandise trade balance the net exports of goods alone (does not include services or transfers)

microprudential policy an approach to financial regulation aimed at enhancing the safety and soundness of individual financial institutions

monetary accommodation the use of monetary policy to stabilise interest rates during active fiscal policy operations; also, the use of monetary policy to prevent a supply shock from affecting output

monetary approach to the balance of payments emphasises monetary causes of balance-of-payments problems

monetary policy multiplier the increase in aggregate demand per \$1 increase in the money supply

monetisation when the RBA purchases government debt, thus funding budget deficits by printing money

monetising budget deficits a synonym for monetary accommodation

money assets that can be used for making immediate payment

money base currency (notes and coins) and banks' deposits at the RBA; also called monetary base or high-powered money

money-base targeting using monetary policy to keep the money base at a particular level

money illusion the belief that the numbers used to express prices have significance

money market equilibrium schedule the relationship money demand (L) equals money supply (M)—the LM curve

money multiplier the ratio of money stock to the money base

multiplier the increase in endogenous variable for each \$1 increase in exogenous variable; particularly, the increase in GDP for each \$1 increase in government purchases

multiplier uncertainty uncertainty about the effects of policy changes due to uncertainty about the value of the fiscal policy multiplier, monetary policy multiplier and so on

Mundell–Fleming model a model first proposed by Robert Mundell and Marcus Fleming that explores an economy with flexible exchange rates and perfect capital mobility

myopia short-sightedness by households regarding future income streams

N

NAIRU (the non-accelerating inflation rate of unemployment) an estimate of the natural rate of unemployment derived by looking for the unemployment rate at which inflation is neither increasing nor decreasing

naive expectations the assumption that people expect the future value of an economic variable (such as inflation) to equal whatever the value of that economic variable is today

national income accounting identity

$$Y \equiv C + I + G + NX$$

national savings that part of GDP that is not used up as consumption by either households or the government

natural rate of unemployment the rate of unemployment at which the flows into and out of the unemployment pool balance

neoclassical growth theory a theory that asserts that the growth rate of output is determined by exogenous (unexplained within the model) technological growth

neoclassical labour market the model of the labour market underlying the classical supply curve, in which unemployment is seen as largely voluntary

net domestic product (NDP) GDP minus allowance for depreciation of capital

net exports exports minus imports

net investment total (or gross) investment less depreciation; increase in capital stock

net investment income the interest and profits that result from foreign assets held by domestic residents less the income foreigners earn on the domestic assets they own

net present value (NPV) the same as present value: the amount today that is equivalent to a future payment

neutrality of money the proposition that equiproportional changes in the money stock and prices leave the real economy unaffected

New Classical a school of economic thought that sees the world as one in which economic agents maximise and act rationally in their self-interest; in which markets adjust rapidly to changing conditions; and in which the government is likely only to make things worse by intervening

New Classical economics the belief that the private economy is inherently efficient and that the government ought not to attempt to stabilise output and unemployment

New Deal a series of economic reforms enacted in the United States between 1933 and 1936 to combat the effects of the Great Depression

New Keynesian a school of economic thought that does not believe that markets clear all of the time, even when behaviour is rational and economic agents maximise utility or profits

nominal GDP the value of all final goods and services produced in the economy; GDP not adjusted for inflation

nominal GDP targeting using monetary policy to achieve a certain level, or a particular rate of growth, of GDP

nominal money supply the nominal value of bills and coins in circulation; says nothing about the amount that these bills and coins can purchase

non-sterilised intervention intervention in the foreign exchange market that is not sterilised

normative economic analysis theoretical and empirical analysis regarding the government's ability to intervene in the macroeconomy to improve economic welfare

O

Okun's law an empirical law relating GDP growth to changes in unemployment; named for its discoverer, the late Arthur Okun

open economy an economy that trades goods, services and assets with other countries; a closed economy, on the other hand, is an economy that does not trade

open market operation central bank purchase or sale of bonds in exchange for money

operational bequest motive a reason for saving; the desire to leave some of our money behind for descendants/friends/charity

opportunity cost what is forgone to take an action

output gap the difference between actual GDP and potential GDP

outside lag the time required for a policy change to take effect

P

Paasche price index a current-weighted price index such as the GDP—the ratio of the cost of today's output to the cost of that output at a previous period's prices

parameter a type of exogenous variable that gives a function its specific form

peak oil the time at which the maximum rate of oil extraction is reached, after which the rate enters terminal decline

perfect capital mobility when capital has the ability to move instantly, and with a minimum of transactions costs, across national borders in search of the highest return

perfect foresight the assumption that people know the future value of all relevant variables, or that their expectations are always correct

perfectly anticipated inflation the extent to which people have perfect foresight with regard to the inflation rate

permanent income the steady rate of consumption a person could maintain for the rest of his or her life, given the present level of wealth and the income earned now and in the future

personal (household) saving saving by individuals and families

Phillips curve the relation between inflation and unemployment; in a sense, a dynamic version of the aggregate supply curve

policy instruments identified variables that policy makers, such as the RBA and the federal Treasury, can manipulate to achieve their ultimate economic targets

policy irrelevance the inability of monetary or fiscal policy to affect output in rational expectations equilibrium models

policy mix a combination of fiscal and monetary policies to achieve both internal and external balance

policy neutrality when the manipulation of policy instruments has no effect on real economic variables

political business cycle theory the interactions between economic policy decisions, economic outcomes and political considerations

portfolio the mix of assets someone owns

portfolio disequilibrium when people are holding more of some asset (money) at the prevailing interest rate than they wish to

portfolio of policy instruments the range of policy instruments available to policy makers

positive theory of policy making theoretical and empirical analysis of how, and why, policy makers actually behave in practice, as opposed to how economic theory alone suggests they *ought* to act

potential output output that is produced when all factors are fully employed

poverty trap when a country remains in a no-growth, low income steady state due to excessive population growth

precautionary motive people hold money because they do not know how much they'll need to spend

price adjustment mechanism the price–output relation, described by the aggregate supply curve, built up from the links among wages, prices, employment and output

price stickiness when prices (and/or wages) fail to change, or change only slowly, in response to changed macroeconomic conditions

Prices and Incomes Accord a very centralised form of prices and incomes policy, representing an agreement between the Labor government and the ACTU, under which Australia operated between 1983 and 1993

private savings savings by individuals, families and firms; savings by everyone other than the government

procyclical variables economic variables that tend to rise during the expansion in business activity and fall during contractions

producer price index (PPI) a price index based on a market basket of goods used in production

production function a technological relation showing how much output can be produced for a given combination of inputs

productivity shock a change in technology that affects workers' productivity

propagation mechanism a mechanism by which current economic shocks cause fluctuations in the future

public sector saving saving that includes total government saving and savings of public sector enterprises and financial institutions

purchasing power parity (PPP) a theory of exchange rate determination arguing that the exchange rate adjusts to maintain equal purchasing power of foreign and domestic currency

Q

q theory of investment an investment theory emphasising that investment will be high when assets are valuable relative to their reproduction cost (the ratio of asset value to cost is called q)

quantity equation money times velocity equals price times quantity ($M \times V = P \times Y$)

quantity theory of money a theory of money demand emphasising the relation of nominal income to nominal money (sometimes used to mean a vertical LM curve)

R

random walk a variable in which changes over time are unpredictable

random walk model of consumption a model that suggests that changes in consumption should not be predictable

rational expectations a theory of expectations formation in which expectations are based on all available information about the underlying economic variable

rational expectations equilibrium a model in which expectations are formed rationally, and markets are always in equilibrium

real balances the real value of the money stock (the number of dollars divided by the price level)

real business cycle (RBC) theory the theory that recessions and booms are due primarily to shocks in real activity, such as supply shocks, rather than to changes in monetary factors

real devaluation a decline in the purchasing power of the dollar relative to other currencies

real exchange rate the purchasing power of foreign currency relative to the Australian dollar

real GDP a measure of output that adjusts the value of final goods and services to reflect changes in the price level

real GDP targeting using monetary and fiscal policies to achieve a particular rate of real GDP growth

real interest rate return on an investment measured in dollars of constant value; roughly equal to the difference between the nominal interest rate and the rate of inflation

real-money balances the number of units of goods that a given stock of money will buy—that is, the nominal money supply divided by the price level

real money supply the real value of the money supply in circulation; equal to the nominal money supply divided by the price level

real wage restraint the limitation or prevention of real wage increases, either by negotiation or direct control

recognition lag the period between the time a disturbance occurs and the time policy makers discover the disturbance

relative price the price of one commodity in terms of another commodity

rental (user) cost of capital the cost of using a dollar's worth of capital for a given unit of time, usually a year

replacement ratio the ratio of after-tax income while unemployed to after-tax income while employed

reporting effects changes in the measurement of some variable due to a change in the number of people who claim to be in a certain group

reservation wage the lowest wage an individual is willing to accept

Reserve Bank of Australia (RBA) the central bank of Australia

reserve–deposit ratio the ratio of bank reserves to bank deposits; a primary determinant of the money multiplier

reserves part of a bank's deposit kept at the RBA, or in its vaults; money that a bank keeps on hand instead of lending out

residential investment investment in housing

reevaluation increase in the value of the domestic currency relative to the currencies of other countries, used when exchange rates are fixed

risky asset an asset whose future pay-off is uncertain

rules versus discretion the issue of whether the monetary and fiscal authorities should act

in accordance with pre-announced rules, or alternatively have active discretion in determining the values of the policy variables at different times

S

sacrifice ratio the ratio of cumulative GDP lost to reduction in the inflation rate during a period of anti-inflation policy

saving income that is not spent

search unemployment unemployment that exists because people have quit one job in order to search for another

self-fulfilling expectation expectation that causes a variable to change in the expected manner; for example, if enough people expect a currency to depreciate, capital flows generated by their expectations will cause it to do so

short run a period of time short enough that markets are unable to clear, so that output can deviate from potential output

social infrastructure all the institutions and government policies that determine the economic environment

Solow residual a measure of total factor productivity; change in the level of production that cannot be accounted for by changes in factor inputs

speculative motive although the return on holding money is small, people hold it because it reduces the risk associated with their portfolio of assets

speed of price adjustment the amount of time that it takes prices to fully adjust so that all markets are in equilibrium and output equals potential output

spell of unemployment a period in which a person remains continuously unemployed

spillover (interdependence) effects effects that occur when policy changes or supply/demand shocks in one country affect output in another

stable equilibrium an equilibrium that draws nearby variables into itself; if a variable is moved slightly away from a stable equilibrium, it will return

stagflation simultaneous inflation and recession

staggered price adjustment the process that occurs when firms set their prices or negotiate their contracts at different times

standard of deferred payment an asset normally used for making payments due at a later date

steady-state equilibrium the state in which real (per capita) economic variables are constant

sterilised intervention when the central bank (RBA) uses monetary policy to offset the effect of foreign exchange market intervention on the domestic money supply

sticky real wages when real wages fail to change, or only change slowly, in response to changed macroeconomic conditions

stock of capital the total amount of physical capital in an economy at a given point in time; the cumulation of past net investment

store of value an asset that maintains its value over time

structural unemployment the unemployment attributable to the mismatch between the skills available in the work force and the skills required by firms attempting to create employment

supply shock an economic disturbance whose first impact is a shift in the aggregate supply curve

supply-side economics school of economic thought whose proponents focus on the incentive effects of taxation, regulation and social policy affecting the supply side of the economy

T

target zone a specified range to which central banks limit exchange rate fluctuations

targets identified goals of policy

tariff a tax imposed on imported goods

Taylor rule summarises how the monetary authority sets interest rates in response to economic activity

term premium a premium paid to holders of bonds for the risk associated with a particular maturity

term structure of interest the relationship between interest rates on bonds of different maturities

terms of trade the ratio of export prices to import prices

total factor productivity (TFP) the rate at which productivity of inputs increases; measure of technological progress

trade the exchange of goods and services between countries

trade-weighted index (TWI) the exchange rate defined as the relative price of the Australian dollar in terms of a 'basket' of currencies composed of the weighted exchange rates of Australia's main trading partners

transactions motive people hold money in order to purchase goods and services

transfer payments money (such as welfare payments) given by the government to individuals *not* in exchange for goods or services

transmission mechanism the process by which monetary policy affects aggregate demand

trend path of output the path followed by potential output over time

trend (secular) component of GDP potential output

trend stationary temporary shocks to a variable that do not permanently affect its level

trend stationary with breaks trend stationary, but with a trend that sometimes changes

twin deficits the hypothesis that changes in the government's budget deficit (surplus) are reflected in similar (or equal) changes in the external deficit (surplus)

two-sector model a model of economic growth that combines elements of both neoclassical and endogenous growth theories

U

ultimate target a policy target of inherent interest

unanticipated inflation increases in the rate of change of the price level that were not expected

uncovered interest parity the relationship between interest differentials and expected currency appreciation

underemployment employed persons aged 15 years and over who want, and are available for, more hours of work than they currently have

underground (or black) economy defined by the Australian Treasury as 'the aggregate of unrecorded economic activity that escapes measurement and tax assessment due generally to its reliance on cash transactions but also for reasons such as an illegality'

unemployed person a person who does not have a job but is actively seeking one

unemployment hysteresis a theory that argues that recessions may permanently affect the natural rate of unemployment

unemployment pool a group of individuals in transition between jobs

unhedged foreign currency debt borrowing that is taken out in a foreign currency without using the futures market to offset exchange rate risk

unit of account an asset in which prices are denoted

unstable equilibrium an equilibrium that pushes nearby variables away from itself; if a variable is moved slightly away from an unstable equilibrium, forces will push it even further away

V

value added the increase in the value of output at a given stage of production; the value of output minus the cost of inputs

velocity of money the number of times the typical dollar changes hands during the year

very long run a period of decades or more, over which potential output is expected to grow

volatility a measure of how much economic activity changes on average over a given time period

voluntary unemployment when individuals choose to be unemployed during times when wages are temporarily low

W

wage stickiness when wages (real or nominal) fail to change, or only change slowly, in response to changed macroeconomic conditions

wage–price spiral a process in which changes in prices feed back into wages, and from there again into prices

Working Nation the May 1994 White Paper policy statement on unemployment and industry policy

World Trade Organization (WTO) an international organisation that works out rules of trade between its member nations

Y

yield curve a curve that shows how interest rates change as bond maturities increase