**Applied economic exercise**

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# **Extension activity**

# **Read the edited extract of an article appearing in the Economist on the 23rd of July 2020 and answer the questions that follow.**

# **Governments must beware the lure of free money**

It is sometimes said that governments wasted the global financial crisis of 2007-09 by failing to rethink economic policy after the dust settled. Nobody will say the same about the covid-19 pandemic. It has led to a desperate scramble to enact policies that only a few months ago were either unimaginable or heretical. A profound shift is now taking place in economics as a result, of the sort that happens only once in a generation. Much as in the 1970s when clubby Keynesianism gave way to Milton Friedman’s austere monetarism, and in the 1990s when central banks were given their independence, so the pandemic marks the start of a new era. Its overriding preoccupation will be exploiting the opportunities and containing the enormous risks that stem from a supersized level of government intervention in the economy and financial markets.

This new epoch has a number of defining features. The first is the jaw-dropping scale of today’s government borrowing, and the seemingly limitless potential for yet more. The IMF predicts that rich countries will borrow 17% of their combined GDP in 2020 to fund $4.2trn in spending and tax cuts designed to keep the economy going. In Australia, the massive stimulus packages (in excess of $300 billion) provided by the federal government during 2020 have resulted in a huge increase in the budget deficit (expected to exceed $200 billion in 2021) and an accompanying rise in gross government debt (expected to rise above $850 billion in 2021).

The second feature is the whirring of the printing presses. In America, Britain, the euro zone and Japan central banks have created new reserves of money worth some $3.7trn in 2020, and in Australia, the RBA undertook large scale purchases of government bonds on the secondary market which effectively injected cash into the economy and was tantamount to ‘printing money’. This means that central banks around the world, including the RBA in Australia, were tacitly financing the stimulus programs of the governments. The result is that long-term interest rates stay low even while public-debt issuance soars. …The final feature is the most important: low inflation. The absence of upward pressure on prices means there is no immediate need to slow the growth of central-bank asset/bond purchases or to raise short-term interest rates from close to zero. Low inflation is therefore the fundamental reason not to worry about public/government debt, which, thanks to accommodative monetary policy, now costs so little to service that it looks like free money.

Don’t fool yourself that the role of the government will magically return to normal once the pandemic passes and unemployment falls. Yes, governments and central banks may dial down their spending and bailouts. But the new era of economics reflects the culmination of long-term trends. Even before the pandemic, inflation and interest rates were subdued despite a jobs boom. Today the bond market still shows no sign of worrying about long-term inflation. If it is right, deficits and ‘money printing’ may well become the standard tools of policymaking for decades. …A government with a permanently broader and deeper reach across the economy creates some opportunities. Low rates make it cheaper for it to borrow to build new infrastructure, from research labs to electricity grids, that will boost growth and tackle threats such as pandemics and climate change. As societies age, rising spending on health and pensions is inevitable - if the resulting deficits help provide a necessary stimulus to the economy, all the more reason to embrace them.

Yet the new era also presents grave risks. If inflation jumps unexpectedly the entire edifice of debt will shake, as central banks have to raise their policy rates and in turn pay out vast sums of interest on the new reserves that they have created to buy bonds. And even if inflation stays low, the new machinery is vulnerable to capture by lobbyists, unions and cronies. One of monetarism’s key insights was that sprawling macroeconomic management leads to infinite opportunities for politicians to play favourites. Already they are deciding which firms get tax breaks and which workers should be paid by the state to wait for their old jobs to reappear. Soon some loans to the private sector will turn sour, leaving governments to choose which firms fail. When money is free, why not rescue companies, protect obsolete jobs and save investors?

However, though that would provide a brief stimulus, it is a recipe for distorted markets, moral hazard and low growth. Fear of politicians’ myopia was why many countries delegated power to independent central banks, which wielded a single, simple tool—interest rates—to manage the economic cycle. Yet today interest rates, so close to zero, seem impotent and the monarchs who run the world’s central banks are becoming rather like servants working as the government’s debt-management arm. Each new era of economics confronts a new challenge. After the 1930s the task was to prevent depressions. In the 1970s and early 1980s the holy grail was to end stagflation. Today the task for policymakers is to create a framework that allows the business cycle to be managed and financial crises to be fought without a politicised takeover of the economy.

**Questions**

1. **Distinguish clubby Keynesianism from austere monetarism in terms of how government should or could respond to economic downturns.**
2. **Describe why the health pandemic of 2020 marked the start of a new era of economic policy responses to economic downturns.**
3. **Explain the relationship between Australian government stimulus packages, the budget outcome and gross government debt. Use the statistics provided to support your explanation.**
4. **Explain why the RBA purchases of government bonds on secondary markets was tantamount to printing money.**
5. **Explain the relationship between growth in government debt and long-term interest rates, and outline why it depends heavily on who purchases the debt (i.e. who lends to the government).**
6. **Explain why the existence of low inflation around the world has been a fundamental reason behind the willingness of governments (and their central banks) to stimulate their economies via the ‘printing of money’.**
7. **Assuming that deficits and ‘money printing’ become the standard tools of policy-making for decades, discuss two potential benefits for Australian living standards.**
8. **Explain how ‘money printing’ can lead to higher rates of inflation over time and discuss the implications this might have for economic activity in the long-term.**
9. **Describe why near zero policy rates of interest make it more difficult for the RBA to use monetary policy as a means of economic stabilisation.**
10. **Describe the other (political) risks associated with ‘printing money’ as a means of helping economies to emerge from an economic downturn.**