Challenges the Australian Economy is Facing and How It Confronts Them

1 Current Economic Environment in Australia

Recent years, as at the post-pandemic stage, the Australian economic faces several tough but stable challenges. According to Australia Economic Outlook Q2 2024, the economy grew by only 1.1% in the past 12 months (KPMG, 2024). The unemployment rate increased to 4.2% (Australian Bureau of Statistics, 2024) in July. The inflation slightly eased but is still higher than Reserve Bank of Australia's (RBA) target.

To navigate the economy to a better place, RBA is expected to take a series of action. As announced by RBA in August, the cash rate will be kept at the same level as it was since November 2023, 4.35% (Reserve Bank of Australia, 2024). However, since 2022, this rate had been raised many times. This is one of the aspects RBA is seeking a change to control inflation, hence bringing other economic indexes back to a stable and pleasant level.

2 Reasons for The High Interest Rate

In fact, most of the challenges that make "the Australian economy staggered into 2024" (KPMG, 2024) are related to high inflation e.g. high unemployment rate, low economic growth. Therefore, RBA has prioritized inflation control as its primary objective (Reserve Bank of Australia, 2024) One major tool to ease inflation is to set a higher interest rate. The inversely correlated relationship between interest rate and inflation is central to monetary policy, as higher interest rates reduce consumer and business spending, which in turn helps to reduce the upward pressure on prices. This approach is consistent with the Taylor Rule, a monetary policy guideline that suggests how central banks should set interest rates in response to deviations of inflation from its target and output from its potential level.

3 Impacts Brought by The Interest Rate

3.1 On consumption

With a higher interest rate, consumers tend to keep the money in their saving accounts and are discouraged to spend their money in consuming as the cost of credit increases. This will result in lower demand for goods and services. Therefore, high interest rates bring negative impacts on consumption.

3.2 Impacts on investments

When cost of borrowing increases, businesses are less likely to apply for loans. Instead of interacting between firms and investing in different projects, they tend to use the money and assets they have in a more conservative way. This trend among businesses is a discouragement for individual investors as they will see no potential growth within the market. As a result, investments in the market will be negatively impacted.

3.3 On trade

By affecting currency exchange rates, interest rates will also impact international trade. Although high interest rates may discourage domestic investments, it will attract international investors and lead to an appreciation in the local currency. Domestic businesses relying on manufacturing and exporting will be negatively affected as appreciated local currency can make the exports more expensive and imports cheaper. Terms of trade will decrease.

3.4 On labor market

Shown in Figure 1, unemployment rate and the long-term interest rate have similar trends in the past three years. Higher interest rates lead to higher unemployment rate. When interest rates increase, both consumption and investments are negatively affected. The market tends to lose its vitality under a high-interest rate environment. Fewer jobs are provided or created in the market. This will cause unemployment rate to increase.

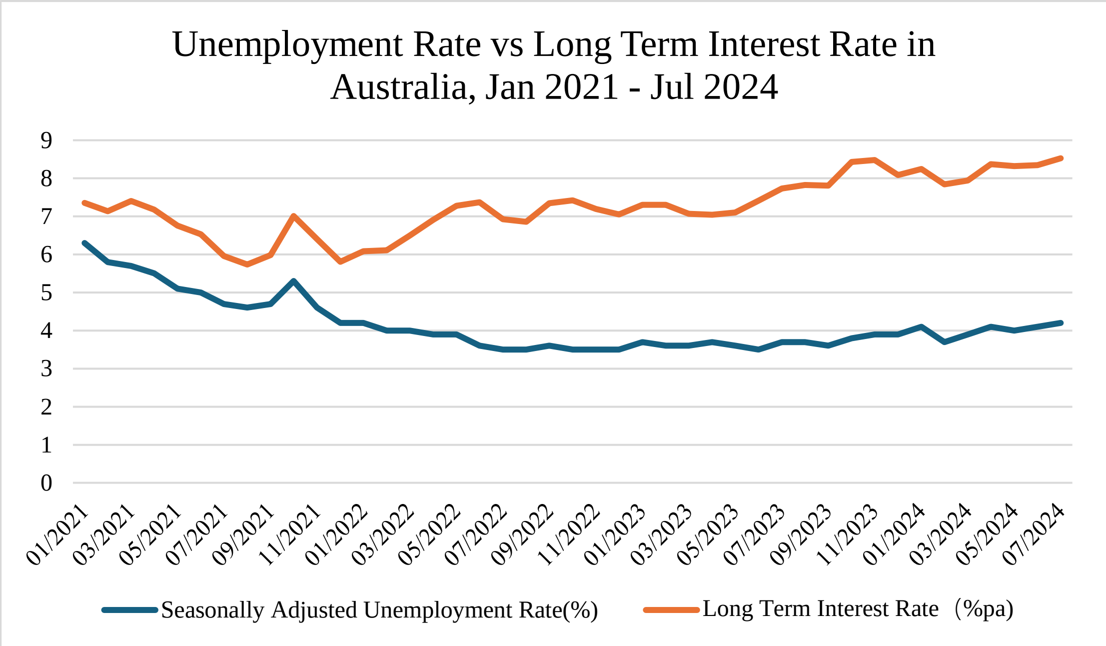

Figure 1 Unemployment Rate vs Long Term Interest Rate in Australia, Jan 2021 - Jul 2024 (CEIC Data n.d.)

4 Inflation in Australia 2021- 2023

4.1 Inflation background

Inflation in Australia was shaped not only by its domestic disruptions. Breaking news that happened worldwide also played a role in it. For example, the Russia-Ukraine conflict, one of the geopolitical tensions, brought a deteriorated impact on global supply chain and pushed prices of energy and commodity to a new level. In 2021, the decreasing trend in inflation was turned into a significant growth trend. As it got to 2022, inflation reached its highest level in the 21st century as shown in Figure 2. By the end of 2023, inflation had eased slightly to 5.4%, but it was still higher than the RBA's target range (Reserve Bank of Australia, 2023).

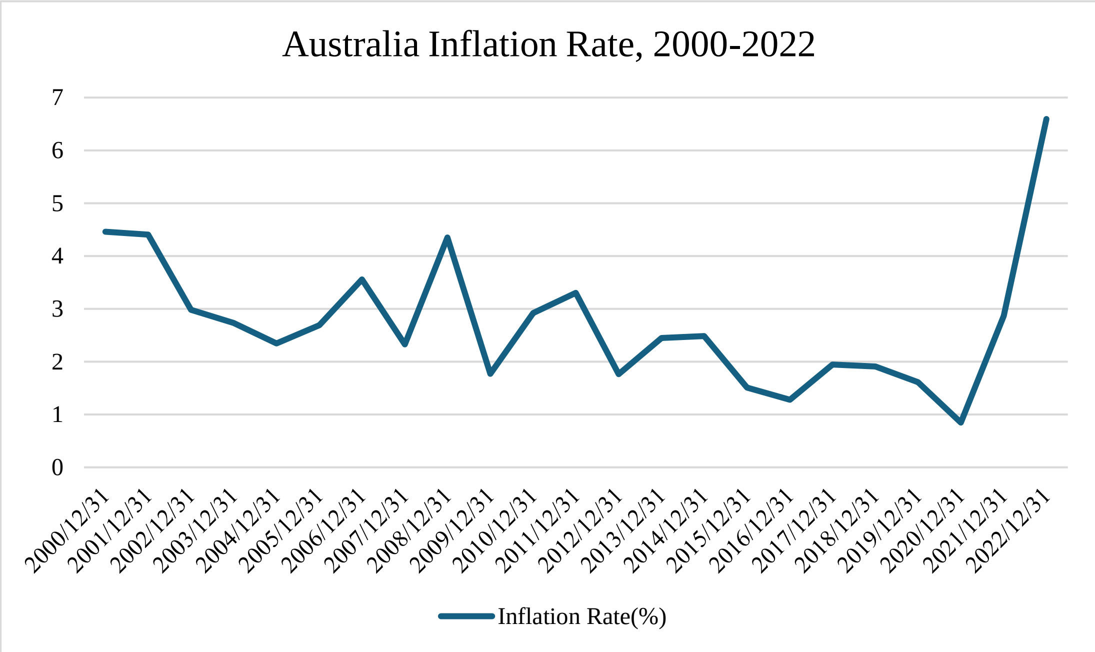

Figure 2 Australia Inflation Rate 2000-2022 (Macrotrends, n.d.)

4.2 Adjustment of assessment

In early 2021, the inflationary pressures were viewed as transitory by RBA, thus RBA maintained a relatively accommodative monetary policy. No adjustment on cash rate was implemented. When it got the middle of 2022, inflation started to be treated as persistent. RBA started to carry out a series of increase in interest rates and cash rate in May 2022. The rise in the cash rate continued until November 2023, when RBA's focus had fully shifted to controlling inflation despite the risk that economic growth may be constrained.

5 Discussion about RBA's action

RBA showed its commitment to controlling inflation and bringing stability back to the economy by conducting a series of actions, especially maintaining a high interest rates. Those approaches did help cool down the inflation, but meanwhile they caused unemployment rate to grow and slowed down economic growth. To continue bringing a stable economy back to Australia, RBA should notice the importance of balancing between the benefits and harms they bring.

6 Expectation of future Australian economy

Easing inflation or even making it back to pre-pandemic stage is a long-term strike worth fighting for. Fortunately, the actions RBA took got initial results. Under the unstable global economic environment, it's important that RBA achieve its goals by measured steps rather than hitting them aggressive approaches. Hope the cash rate will be reduced a year from now, or even within a shorter period. Hence, the negatively affected consumption, investment and labour market can start to recover.

7. Conclusion

The Australian economy is navigating a high-inflation period with slow growth in the post-pandemic era, driven by both internal and external factors. One major action RBA took is maintaining the cash rate at 4.35%. RBA is bringing faith back in dealing with high inflation rate, but those negative effects in consumption, investment and labour market cannot be ignored. RBA need to take those into consideration when making decisions in the future, then the Australian economy can have a stable recovery.

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