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Economics
Teach Yourself Series
Topic 9:Monetary Policy(Units2&4)

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Monetary Policy

As noted previously, an economy will experience fluctuations in the level of economic activity. These fluctuations can cause unemployment, inflation, a lack of economic activity and growth and an imbalance in the external sector.

The government will implement policies in an effort to ‘smooth out’ these fluctuations and help it achieve its economic goals. One such policy is Monetary Policy.

Initial terminology
As it appears in Units 2 & 4

Borrowing money is an important aspect of any economy. Consumers borrow money to finance the purchase of a house (mortgage) and fund purchases of goods and services (credit card, store cards and personal loans). Businesses borrow money to fund expansion of their operations and the government will also borrow money to fund their spending, particularly if they run a budget deficit.

Monetary policy is concerned with the level of borrowing and the cost of borrowing (interest rates).

Monetary policy impacts on the domestic and external economy through:

* Demand- e.g. lowering interest rates
  - encourages buying
  - less interest needs to be paid on loans
  - encourages use of credit
  - reduces prices
* Supply- e.g. lowering interest rates
  - cuts production costs
  - creates confidence
  - reduces repayment costs
  - encourages employment

What is Monetary Policy
As it appears in Units 2 & 4

Monetary policy refers to the actions of the Reserve Bank of Australia (RBA), which are designed to influence monetary conditions such as interest rates and the availability of credit.

The RBA conducts monetary policy using the cash rate in the cash market. The main aim is to keep headline inflation between 2-3% on average during the business cycle (7-10 years). Other targets are a stable currency, full employment and economic prosperity.

The RBA has control over the supply of funds, in the market for cash. It sets the interest rate for cash and this rate flows through to the level of interest rates through the whole economy.

It is important that students understand how the RBA changes the cash rate.

Other ‘weapons’ of monetary policy are:

- ‘Suasion’ –public comments by the RBA that may cause consumers and businesses to act in a manner that the RBA would like.
- Exchange Rate manipulation – as the value of the $A can contribute to economic problems, the RBA can intervene in the foreign exchange market (FEX) to manipulate the value of the $A. This is sometimes referred to as a ‘dirty float’. The RBA purchasing $A in the FEX market will cause an appreciation of the $A. The opposite also applies.

Review Questions

1. Which of the following provides the most accurate definition of monetary policy?
- **A.** A policy that involves the manipulation of the exchange rate to achieve low inflation
- **B.** A policy that involves the manipulation of interest rates to achieve low inflation
- **C.** A policy that involves the manipulation of the currency to achieve low inflation
- **D.** A policy that involves the manipulation of inflation rates to achieve low interest rates

2. Which of the following is not an instrument of monetary policy?
- **A.** Suasion
- **B.** Exchange rate manipulation
- **C.** Inflation rate manipulation
- **D.** Interest rate manipulation

Types of Monetary Policy and its effects
As it appears in Unit 4

There are generally two types of monetary policy:

- Expansionary
  Monetary policy stance designed to increase the level of C and I in the economy to increase AD and lead to:
  - Increased economic growth
  - Increased employment
  - Move business cycle to an 'upswing'

- Contractionary
  Monetary policy stance designed to slow the level of economic activity by slowing C and I in the economy to slow/decrease AD and lead to:
  - Slower economic growth
  - Reduced inflationary pressures
  - Maintain business cycle at a boom stage

By using an expansionary (loose) monetary policy stance the internal economy should be stimulated – economic growth and employment increases (and of course would not be appropriate if there is evidence of inflation).
By using a contractionary (tight) monetary policy stance the internal economy should be slowed- economic growth decreases, employment falls and inflation is reduced. That is, this stance is appropriate to slow a 'booming' economy e.g. 1999-2000, 1989/90.
By using a neutral monetary policy stance the RBA is trying not to either stimulate or slow the level of economic activity. It will probably set a cash rate target around 4.5-5% to maintain a steady rate of growth with low inflation.

Review Questions

3. Which of the following is not a stated objective of the Reserve Bank of Australia (RBA)?
- **A.** Stability of the currency
- **B.** Maintenance of full employment
- **C.** An increase in living standards of the people of Australia
- **D.** The economic prosperity and welfare of the people of Australia

4. Briefly explain the impact of current RBA changes to the cash rate on the achievement of sustainable economic growth.

5. Briefly explain the impact of current RBA changes to the cash rate on the achievement of sustainable economic growth.

Monetary Policy mechanism As it appears in Unit 4

The RBA has control over the supply of funds, in the market for cash. It sets the interest rate for cash and this rate flows through to the level of interest rates through the whole economy.
The mechanism for the operation of monetary policy is Open Market Operations. Open Market Operations operate as follows:

1. Banks are required to keep an amount of their deposits in an account at the Reserve Bank – the Exchange Settlement Account [ESA]
2. These accounts facilitate transfers between banks. The balance in these accounts changes daily depending on which the balance of the transactions between the banks
3. Those banks with a surplus earn interest on the surplus at .25% below the current market interest. Those in deficit pay interest at .25% above the market rate.
4. Banks in surplus will aim to invest that surplus in the cash market – banks in deficit will borrow.
5. The cash rate (the market interest rate) will therefore change according to the demand and supply based on the movements in the ESA surpluses and deficits.
6. As this is an unstable situation, the RBA manipulates the cash rate by buying or selling Commonwealth Government Securities.
7. If there is too much cash in the market and it seems the cash rate will fall, the RBA will sell CGS to decrease the supply of money.
8. This will cause the cash rate to change (rise).
9. The opposite will also apply.

Solutions to Review Questions

1. *Answer:* B

Explanation:
The RBA identifies stability of the currency and low inflation as its main goals. The manipulation of interest rates is the main weapon used by the RBA.

2. *Answer:* C

Explanation:
Inflation is an effect not a cause. The other options are used by the RBA to control inflation.

3. *Answer:*C

Explanation:
Students should make themselves award of the RBA goals by visiting the RBA website. The other 3 options are all expressly stated as objectives.

4. In recent moves the RBA has raised the cash rate (currently 4.75%) as Australia moves out of periods of slow growth resulting from the worldwide economic downturn. As Australia's economy has grown steadily and is predicted to continue to grow, the RBA has monitored the economy to ensure the rate of growth does not lead to inflation – a factor that hinders sustainable growth. Small changes are designed to dampen inflationary pressures.

5. This would be the result of tightening of monetary policy by the Reserve Bank. Higher rates of interest may lead to a slowing of economic activity and aggregate demand due to a number of factors. The increasing cost of finance may result in a decline in discretionary consumption expenditure. The effect of this increase in unemployment is likely to be compounded as those who have recently become unemployed move on to welfare payments and, therefore, a significantly lower disposable income. This may further reduce the level of aggregate demand.

6. *Answer:*D

Explanation:
Higher interest rates will make borrowing more expensive, which is a contractionary policy move.

7. *Answer:*B

Explanation:
A loosening of monetary policy means interest rates will fall increasing spending in the economy. This will spill over into increased spending on imports, leading to a rise in import prices.

8. A rise in the cash rate by the RBA will cause:

- Material living standards to fall. As credit becomes tighter and mortgage repayments rise, the discretionary income of consumers will fall. This will see a decline in spending on goods and services and possibly a decline in savings. This should lead to a decline in material living standards
- Non-material living standards to fall. This increase in the cash rate will see less investment as credit becomes more expensive. Combined with a decrease in consumer demand, firms will possibly reduce their need for labour. A rise in unemployment will cause social problems as stress increases for those who have lost their jobs. Social disharmony can follow and an increase in mortgage foreclosures.

9. An increase in interest rates will act as a supply-side factor on prices as interest is a cost of production for many firms. An increase in interest rates will see costs rise, leading to an increase in prices – suppliers pass on the increase rather than absorb it.

A decrease in interest rates will see an increase in borrowing and credit purchasing. If the economy is close to productive capacity, then this increase in demand will place pressure on prices leading to demand inflation.

10. Lowering the cash rate to 3% would encourage individuals and businesses to borrow money as the cost of repayments is reduced. This makes the cost of expansion for businesses cheaper, allowing expansion without a great increase in costs. Consumers are able to maintain their level of spending and/or increase their spending as it is relatively cheaper.

11. As the economy remained strong and consumer and business confidence high, there was only a small decrease in the level of economic activity. As the world economy improved and domestic confidence returned, spending began to return to pre-GFC levels. As demand rises, if supply is not able to match the increased demand, inflation occurs. The rise in interest rates slowed spending and reduced inflationary pressures..

12. Monetary policy is a more effective policy instrument for slowing demand inflationary pressures than stimulating demand. There is generally an impact lag of between 12 to 18 months. As interest rates fall households may choose to not change their discretionary spendingbut rather reduce their mortgage debt more quickly. Monetary policy provides the incentive, but consumers and businesses have the choice not to spend, which reduces the effectiveness of monetary policy when confidence in the economy is low.