4d Monetary policy

Information, content, and concepts
- What is meant by monetary policy, and how is it implemented?
- What is the purpose of monetary policy?
- Recent monetary policy settings.
- What factors determine interest rates?

Impact of changes in interest rates on economic activity and the Australian dollar

The GFC and monetary policy

Unlocking the mysteries of the unit - monetary policy:

Turning Economics into simple English!

- Simplifying MP: Use of interest rates to change aggregate demand
- Other expressions: Interest rate strategy
- Alternative macro policy: Fiscal policy
- View held by economists: Monetary policy is the key strategy to alter short-term demand

The skills that you need to develop:

- Knowledge skills: Learn key concepts and definitions - monetary policy, Reserve Bank
- Abbreviations: RBA = Reserve Bank, CGS = Commonwealth government securities
  STMM = Short-term money market
- Writing skills: Prepare six lines on each of the syllabus dot points - Objectives of monetary policy, monetary policy implementation, impact of changes in interest rates on economic growth, impact of changes in interest rates on the Australian dollar
- Research skills: Obtain current figures on official interest rates
- Calculation skills: Learn the steps involved in calculating real interest rates

How does this unit overlap with the other units in the course?

UNIT OF ECONOMICS	LINKAGE BETWEEN THESE UNITS
1i Case study	Information: Many countries use monetary policy to achieve economic growth targets
4c Fiscal policy	Effects: Financing of the budget deficit can impact monetary policy
4h Policy responses	Policies: Monetary policy is a significant policy response to improve economic objectives, especially price stability

Revision - prior to commencing this unit:

Order	UNIT OF WORK	REVISE THE FOLLOWING ASPECTS OF THESE UNITS
1	3c Inflation	Content - cause of inflation
2	4b Macroeconomic policies	Content - diagrams

What is meant by monetary policy, and how is it

Definition of 'Monetary Policy':

- Monetary policy is administered by the Reserve Bank. It takes actions to influence the cost (interest rate) and supply (money supply) of loanable funds.
- When the Reserve Bank changes official cash rates this has a flow-on effect for short-term interest rates.

Monetary policy refers to the use of interest rates to affect aggregate demand and stabilise the economy. It is administered by the Reserve Bank (RBA), which is an independent statutory body. Monetary policy is thus controlled by bureaucrats, not politicians. Monetary policy is usually described in terms of interest rates, but in fact the RBA does not have direct control over rates. Rather, it interacts in the short-term money market with banks and financial institutions to implement monetary policy through **domestic market operations**. The cash rate has flow-on effects by changing the overall cost of borrowing for banks. As a result, a change in the cash rate eventually leads to changes in other interest rates operating in the economy, such as the rate on mortgages and business borrowings.

Information overload: If you are not a purist of Economics, ignore!

Short-term interest rates and the cash rate move in the same direction. If the RBA sells second-hand Commonwealth Government Securities (CGS), the cash rate and general interest rates rise. When the RBA increases interest rates this is called tightening monetary policy. If the RBA buys CGS, the cash rate and general short-term interest rates fall. When it lowers interest rates, it is said to loosen the monetary policy stance. As Australia is in a competitive finance market, other short-term rates follow this trend, although the change in rates by financial institutions might not be immediate or directly proportional to changes in the RBA's rate.

The 'announcement effect' of a change in rates is generally sufficient and private banks tend to shift their borrowing/lending rates automatically.

The RBA Board meets on the first Tuesday of every month. It decides the monetary policy stance, by setting an official target cash rate. It can raise the target cash rate, lower it, or maintain the current target. It announces its monetary policy intentions that day at 2.30 pm.

Overload!

Ignore this section if you are still coming to grips with the basics

What is the purpose of monetary policy?

Definition of 'Purpose of Monetary Policy':

- Monetary policy is intended to regulate economic activity.
- The monetary policy stance reflects its current purpose, which is to expand the economy during times of low activity and to contract the economy when there are inflationary pressures.

Monetary policy is a macroeconomic policy, whose main purpose is to **stabilise the economy** by altering aggregate demand. Its stated goals are price stability, economic growth, and full employment. In practice, controlling inflation is by far the major focus. **Since 1996, the RBA has had a formal target to maintain inflation within a band of 2-3% on average over the course of the economic cycle**. When inflationary pressures are high, monetary policy aims to dampen economic activity. If there are signs of inflationary pressures, it swiftly moves to dampen demand to defend the 2-3% target band. When the economy is in a downswing, it is unlikely there are strong inflationary pressures and so the RBA's focus shifts to stimulating economic activity. The purpose in this case is to **expand** the economy. The resulting **higher growth** will cause increased demand for labour.

Information overload: If you are not a purist of Economics, ignore!

The RBA acts to dampen inflation pre-emptively to minimise any inflationary expectations and to convince the market that inflation is under control. Low inflation is important for many economic reasons. It helps to stabilise consumer spending and business investment. However, the RBA is wary not to raise interest rates too dramatically, because the resulting fall in business investment could reduce productive capacity in the medium term. The RBA must also focus intently on inflation because no other policy is able to control it in the short term. Fiscal policy is not good at dampening economic activity, and micro policies only take effect in the long term.

Key points to memorise for exam success:

The processes of monetary policy:

i. The Reserve Bank
ii. Buys and sells
iii Treasury notes and government bonds
iv. In the short-term money market
v. Using the Reserve Bank's Information and Transfer System (RITS)
vi. Altering money supply in the exchange settlement accounts
vii. Causing the overnight cash rate to change
viii. This has flow-on effects to change all other short-term interest rates

Turning key points into paragraphs for the exams:

"The RBA implements its monetary policy through domestic market operations. This involves the buying and selling of second-hand Treasury notes in the short-term money market. The Reserve Bank's Information and Transfer System (RITS) is used to make the process easy and efficient. These RBA actions alter the level of funds in exchange settlement accounts, which influences the overnight cash rate. This has a flow-on effect to change short-term interest rates in the economy. For instance, if the RBA sells Treasury notes, the level of funds in the ESAs is decreased, as banks must withdraw money to buy the notes their customers have purchased from the RBA. They must replenish their ESAs by borrowing on the STMM. This increases demand for money, which increases interest rates. In addition, as the supply of money has decreased, the overnight cash rate rises.

Recent monetary policy settings:

Exam focus:
Learn key points -
Vital for short answers

Australia recovered from the GFC quite quickly. The consequence of this recovery, however, was rising inflationary pressures, particularly from the housing sector. House prices rose very quickly, compounded by fiscal stimuli such as first-time home buyers' grants and stamp duty discounts.

From October 2009 to November 2010, the RBA tightened monetary policy, raising the official cash rate from 3% to 4.75% .

From November 2010 to July 2011 the rate remained steady at 4.75%. Interest rates had been expected to rise more quickly, but in late 2010 and throughout 2011 growth in employment and lending was more moderate than expected, and natural disasters (such as floods and cyclones) meant that GDP growth was likely to be lower than expected. As production increases with recovery from these disasters, inflationary pressures will likely become more serious again.

Key points to memorise for exam success:

The effects of selling bonds (tight monetary stance):
i. The cash rate and all other short-term interest rates go up
ii. Money supply falls

The effects of buying bonds (loose monetary stance):
i. The cash rate and all other interest rates go down
ii. Money supply increases

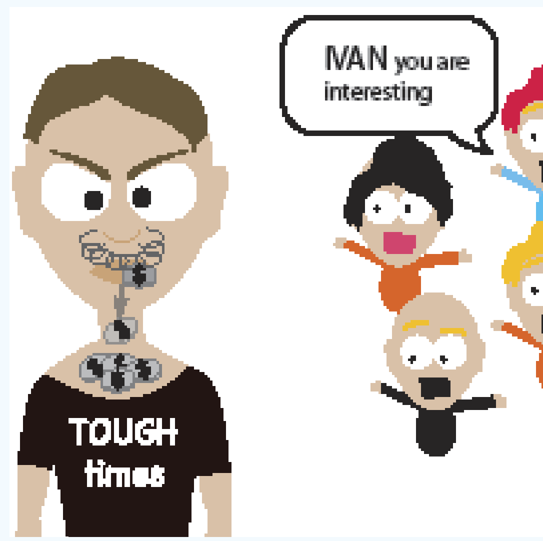
Memory techniques:

Aim of the story: Monetary policy stance

To visualise and understand in detail how the RBA's domestic market operations influence interest rates.

The structure: Barry and Ivan Show

This story takes place over two scenes.



Scene 1: **Ivan** is standing in the middle of the road, **eating money**.
People say "wow, that's **interesting**!".
Ivan has a **bicycle chain** through his nose.

Explanation:
Ivan = RBA increasing interest rates (selling bonds)
Eating money = **Money supply down**
Interesting = **Interest rates go up**
Bicycle chain = **Tough** times (economy contracts)

Scene 2: **Barry** arrives on the scene.
He has a **boom box** that goes "boom, boom, boom".
He's got **big bucks** but he is really **boring** (uninteresting).

Explanation:
Barry = RBA buying bonds
Big bucks = **Money supply goes up**
Boring (uninteresting) = **Interest rates** go **down**
Boom box = **Booming** times

Turning key points into paragraphs for the exams:

"The RBA sells bonds to tighten monetary policy. By selling bonds, it decreases money supply. Interest rates are effectively the 'cost' of money, and the cash rate therefore rises. This has flow-on effects to increase all short-term interest rates. Because money is more 'expensive', the level of economic activity within the economy falls, and the economy contracts."

Impact of changes in interest rates on economic activity and the $A:

What factors determine interest rates?

The factors determining **short-term rates** all relate to the RBA's monetary policy stance. When inflationary pressures are high, higher interest rates are used by the RBA to dampen economic activity. When unemployment is rising, lower interest rates are used to increase economic activity. **Long-term rates** are determined by market forces, with inflationary expectations driving these decisions. If institutions expect inflation and interest rates to rise, they take actions which essentially make this a self-fulfilling prophecy, selling bonds in the bond market, which drives down prices of old securities and effectively increases interest rates. This rate increase is independent of the RBA. **International factors** could also influence the short-term rates set by the RBA and long-term rates determined by market forces. The RBA might feel pressured to lower interest rates during a world financial economic crisis.

Key points to memorise for exam success:

Factors that determine interest rates:
i. Short-term – monetary policy stance
ii. Long-term – inflationary expectations, demand and supply of funds
iii. Overseas interest rates

Turning key points into paragraphs for the exams:

"Interest rates are determined by the monetary policy decisions of the RBA. It conducts domestic market operations to influence interest rates, which involves trading second-hand Commonwealth government securities (CGS) in the short-term money market. If the RBA loosens monetary policy, by buying CGS, short-term interest rates will decrease. If it tightens policy, by selling CGS, interest rates will increase. Accumulating inflationary pressures and expectations within the economy will cause long-term interest rates to rise due to market forces. Additionally, the macroeconomic decisions of global economic powers, such as the US and the G8, influence Australian interest rates."

Where to use these paragraphs?:

Use them early in the answer, or as a skeleton structure, depending on the question, and pad out with extra detail and figures as necessary.

Impact on economic activity:

The RBA uses interest rates to manipulate economic activity. Specifically, it affects aggregate demand, effectively controlling inflation, employment and economic growth. The interest rate works through a **transmission mechanism**, which means it operates through flow-on effects to achieve its objectives. Interest rates are effectively the cost of borrowing money. If interest rates rise, it is more expensive for individuals to borrow money.

Recounting a question to clarify an Economics issue!

Question to: **Bernie Fraser, Governor of the Reserve Bank**
Question: 'When you increase rates to lower inflation, in effect is the RBA causing misery to firms and household to achieve its objective of lower inflation? Is there not a more humane approach? '
Asked by: Matthew Tyson - 2nd in the State in 3 Unit Economics, 1991

Information overload: If you are not a purist of Economics, ignore!

As a result of higher interest rates, there is a fall in consumer spending (one of the components of aggregate demand), particularly for big purchases such as cars and houses which normally require loans.

Higher interest rates are often linked with a decline in the property sector. Higher rates also affect people with existing loans, causing them to have less disposable income.

Moreover, interest rates also affect the return on savings as they translate to higher incomes. There is added incentive, therefore, for households to save rather than spend, further reducing household spending. The fall in consumer expenditure has flow-on effects. Demand for goods and services falls, so businesses experience declining sales. In an attempt to maintain sales, businesses lower prices, effectively lowering inflation.

This is one example of how the transmission mechanism operates. Moreover, firms encounter similar considerations to individuals in terms of borrowing. It is more expensive for them to take out loans for capital equipment, and the fall in consumer demand means there is less reason to invest in expanding capacity. As a result, business investment (another component of aggregate demand) falls. For these reasons, higher interest rates very **effectively dampen economic activity**.

Lowering interest rates has the opposite effect. Economic activity is boosted as it becomes more affordable for individuals and businesses to borrow for large purchases or business investments and saving becomes less attractive.

However, interest rates are generally **less effective at speeding up** the economy than dampening economic activity. Even if interest rates are lower, people may choose to be cautious and save some of the benefits rather than spend them immediately. Banks tend to be slower to pass on the RBA's interest rate cuts than they are to raise market interest rates.

Overload!

Ignore this section if you are still coming to grips with the basics

Impact on exchange rates:

Monetary policy is firmly focused on **'internal balance'**, referring to the domestic goals of low inflation and sustainable growth. However, interest rates inevitably affect exchange rates, and so also impact Australia's external balance. **As interest rates rise, there is a greater incentive for individuals to save more money**. The same logic applies to foreign investors who benefit from obtaining higher returns on their investments.

The most important factor is the **interest rate differential**. If Australian interest rates are relatively high compared to interest rates around the world, foreign investors prefer to invest in Australia and capital inflow increases. As investments in Australia are made in Australian dollars, demand for the Australian currency rises, causing an **appreciation**. This has mixed impacts on Australia's external stability. On the one hand, capital inflows are necessary to fund the Current account deficit. On the other hand, an appreciation reduces international competitiveness because Australian exports effectively become more expensive, worsening the CAD. Tourism in particular suffers greatly.

The RBA does **not generally use monetary policy for external goals**. Indeed, if it had to do so regularly, it would be a case of external instability, whereby the external accounts would be constraining domestic policy-making. April 2000, however, was a rare occasion when one of the stated reasons for an interest rate rise was to attract capital inflow.

Overload!

Ignore this section if you are still coming to grips with the basics

Recounting a question to clarify an Economics issue! Q & A

Question to: Peter Costello, Treasurer

Question: 'My mum has a plea to you as Federal Treasurer. She believes you can influence the Governor of the Reserve Bank. Can you have a quiet word in his ear not to lift interest rates?'

Effects module - Impact of higher interest rates

Key points to memorise:

The effects of higher interest rates on the economy:

i. Fixed investment falls (expenditure by firms)
ii. Savings rise, consumption falls
iii. Capital inflow increases, leading to an appreciation of the Australian dollar
iv. Inflation falls
v. Housing sector contracts

Tip: Don't confuse higher speculative capital inflows with lower domestic investment!

Aim of the story: Effects of higher interest rates

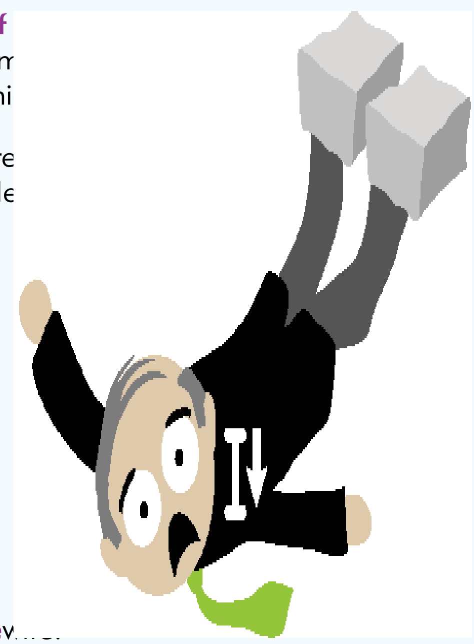
This story will help you to visualise and remember the effects of higher interest rates.

The story: Ivan the Terrible

Overview: **Ivan** the **Terrible** has his own chat show.
Today he has a fascinating roster of **guests** lined up to have a Q&A session with him!

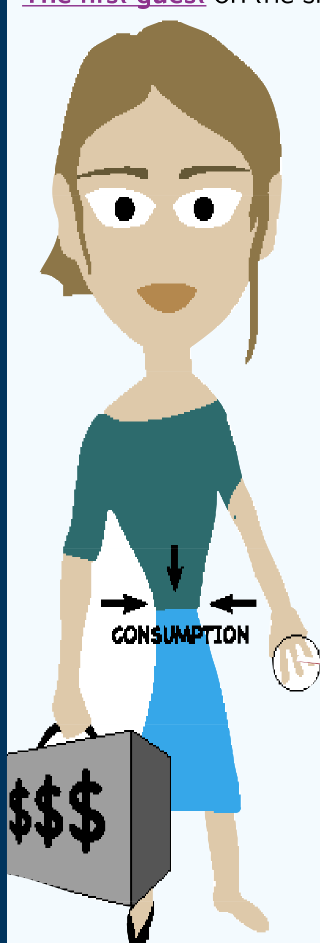
Explanation:

Ivan = Interest rates **(Focus of the story - the effects of**
Terrible = He has **increased** interest rates - the econom
Guests = Each guest or event relates to an **effect** of hi



The first guest on the show is a businessman. He wears a gre
and his feet are **fixed** in concrete. He

Explanation:
There is a fall in
fixed investment by firms



The second guest is Susan, a **housew**...
She shows her **bank statement** and says "I'm **saving** a lot more now!"
Ivan comments, "why Susan, you've lost weight!"
She smiles and says, "yes, I've stopped **consuming** food!"

She normally has fully **imported** rings on her fingers, but she's stopped buying them.

Explanation:

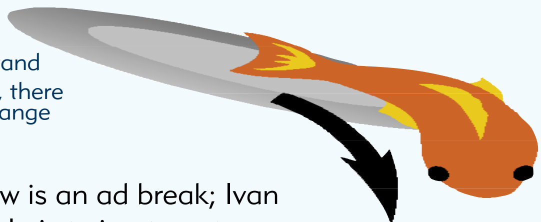
Housewife/husband	=	**House**hold/consumer sector
Bank statement	=	Household **savings** rise
Stopped consuming	=	Household **consumption falls**
No imported (M) rings	=	**Imports (M) decrease**

The third guest is Ronnie, a clown. He's not from here; he's a foreigner. He's brought bags of **foreign currency** with him. Every good clown, of course, has a **balloon**. They call him Helium Breath. He has a balloon with **$A** written on it. He blows up the balloon.

Explanation:

Bags of currencies	=	Capital **inflows** rise
Balloon **inflated**	=	Australian dollar **appreciates**

Don't confuse the higher speculative capital inflows with the lower investment (expenditure by firms)!



(If you are trying to understand why a fish is used for inflation, there is no link. It is one of those strange Creative,symbols.)

The fourth part of the show is an ad break; Ivan is trying to have a snack. He is trying to eat a **fish**, but it keeps **falling** off the table!

Explanation:

Fish	=	Symbol for **inflation**
Falling	=	**Lower** inflation

The fifth guest

Ivan then turns to his audience and growls, in a deep, threatening voice, "You' all happy, aren't you?" There is one voice from the back of the crowd that yel out, "Not happy, Ivan, not happy!" Ivan gets him up on the stage to talk to hir He used to be called Harry Double Storey House, but now his name is **Har Houseless**.

Explanation:

Harry **Houseless**	=	Decline in **housing** sector

Examination questions:

What are the effects of higher interest rates?
How does monetary policy control inflation?

Turning this structure into paragraphs:

"Interest rates are a blunt instrument used by the RBA to dampen economic activity across the entire economy, acting, in this way, as a transmission mechanism. Firstly, interest rates affect firms. There is a fall in fixed investment, because it is more expensive to borrow money. Fixed investment is capital investment, so this lowers potential future output. The disposable income of consumers declines because interest payments on existing debts rise. It is also more expensive for individuals to borrow money to finance large purchases. People are also more likely to increase savings, rather than consumption. Moreover, business suffers a decline in profits on account of higher loan repayment costs. This is compounded by declining sales caused by lowered consumption. Firms respond by **lowering prices** to maintain sales. This translates into lower inflation. Related to this, there is a rise in cyclical unemployment, which further reduces consumption. There is a rise in speculative capital inflow as foreign investors are attracted by higher interest rates, particularly if they are higher than in other nations. This creates

higher levels of foreign liabilities which worsen the Primary Incomes account in future years.
Due to this heightened demand for Australian currency, there is an appreciation of the dollar. This has some benefits for the economy. As import prices fall, imported inflation decreases. This benefits consumers and firms who use imports in the production process. Most importantly, Australian firms become less internationally competitive, causing a decline in exports. This is particularly harmful for export-oriented sectors such as tourism and agriculture.
As long as there is a rise in real interest rates, inflation falls. This is the main reason for increasing interest rates. Imported inflation decreases and, most importantly, demand inflation falls. Interest rates dampen economic activity across all sectors, reducing aggregate demand, and the corresponding upward pressure on prices. As monetary policy is a blunt instrument, it has varying impacts on different sectors. The housing sector is particularly affected by the level of interest rates. As rates rise, fewer people are prepared to buy homes. Those with existing mortgages find it harder to satisfy their obligations and may have to sell. The reduced demand for housing has a flow-on effect to other sectors including tradesmen and retailers who furnish homes."

The GFC and monetary policy:

In 2008, the world entered a financial crisis. Economic growth in all countries slowed, with many entering recession. To revive Australia's growth, the RBA implemented emergency settings and quickly loosened monetary policy. In March 2008 the cash rate target was 7.25%, but by April 2009 it had been lowered to 3%, including three cuts of one full percentage point (changes are most commonly made in 0.25% increments). This evidence suggests this strategy was largely successful, as Australia was one of the few advanced economies to avoid recession, and on the whole fared much better than most. Expansionary monetary policy helped because it made it easier for firms and households to borrow, boosting consumer spending and business investment. It also eased the debt burden for families and business, which helped revive economic activity. Another strategy that was available to the RBA was **quantitative easing**, which involves boosting money supply by essentially printing money. This can quickly increase spending and avoid deflation. Australia resisted using this method. Larger, more adversely affected economies such as the US and UK took this additional route (along with slashing interest rates). The increased money supply caused by quantitative easing may create inflationary pressures once recovery commences. In October 2009, Australia became the **first country to raise interest rates** post-GFC.

Exam focus:
Learn key points - Useful inputs for constructing conclusions

The RBA's post-GFC monetary policy actions illustrate some of the policy's limitations:
Firstly, monetary policy is impacted by fiscal policy. **The primary reason for the increase in interest rates in 2010 was the inflationary pressures** caused by the fiscal stimulus undertaken to expand the economy, such as infrastructure spending, guarantees on bank loans, tax breaks, and grants to first home buyers. Excessive fiscal expansion can stimulate aggregate demand, causing inflationary expectations. While the stimulus was necessary to counter the GFC, some argue fiscal expansion such as the first home buyer grants continued for too long and gave monetary policy too much to do. Many stimulatory fiscal policies were still in place in early 2010 as demand was rising. This demonstrates that the effectiveness of monetary policy is threatened by the operation of other policies.

Overload!
Ignore this section if you are still coming to grips with the basics

Secondly, monetary policy is a **blunt instrument which affects the entire economy**. The RBA cannot pick and choose, increasing rates for some sectors and loosening rates for others. In late-2009 and early-2010, a new real estate bubble was forming, partly fuelled by concessions to first home buyers. At the same time there was a stimulus in growth coming from the terms of trade. This stimulus is identified in the minutes of the RBA in April 2010; 'the fact that the prospective rise in the terms of trade was now likely to be noticeably stronger than had been expected was a factor suggesting that it might be prudent not to delay adjustment'.

From October to November 2010, the Reserve Bank raised its cash rate from 3% to 4.75%. However, many non-mining sectors continued to struggle. The retail sector reported only mediocre sales. Some parts of the economy needed stimulation, while others required dampening. Monetary policy cannot do both at once. By mid-2011, the rate had remained at 4.75% natural disasters dampened economic growth and growth in employment was more moderate than expected. However, given that ToT continued to rise to record levels, as the economy rebounds from natural disasters the RBA will again be faced with the problem that some parts of the economy remain sluggish, while others will be growing quickly.

Thirdly, banks tend to increase their market interest rates more than any increase in the official cash rate. It is not uncommon for banks to raise rates by at least 0.4% in response to the RBA raising the official rate by 0.25%. This means the RBA is not fully in control of interest rates. The RBA has begun to factor in higher rates charged by banks in addition to official rate rises. This threatens the effectiveness of monetary policy.

Real interest rate:

The real interest rate adjusts the nominal interest rate for the impact of inflation. The approximate real interest rate is calculated by: **nominal interest rate - inflation rate**. If the nominal interest rate is 5.5% and inflation is at 2.5%, the real interest rate is 3%.

A technical analysis of MP

The '**announcement effect**' of a change in rates is generally sufficient. Private banks tend to shift their borrowing/lending rates automatically after the RBA announces a change in its target cash rate. Every bank has an exchange settlement account (ESA) with the RBA. These are used for inter-bank transactions (such as clearing cheques) and transactions with the RBA. Banks must ensure there are always sufficient funds in their ESAs for these transactions. However, these accounts earn a very low rate of interest, so banks keep them as low as possible.

A market transaction involves the RBA buying and selling second-hand Commonwealth Government Securities (CGS). These were originally issued by the Treasury to finance budget deficits or other governmental borrowing. If the RBA buys second-hand securities, they pay the agreed price to bond holders. These holders then deposit the proceeds with their individual bank, which increases that bank's ESA. As banks do not want excessive amounts in their low interest ESA, they place these funds on the overnight/short-term money market. This increases the money supply, which means the supply curve of funds in the market shifts to the right. This then lowers the interest rate, which is the price of borrowing money. Therefore, buying bonds decreases the official interest rate, which is the rate on the overnight/short-term money market.

The reverse applies if the RBA sells second-hand Commonwealth government securities. When the RBA changes the official interest rate it is required to engage in market operations to ensure the rate adjusts to the new official rate. The process is automated through the Reserve Bank Information and Transfer System (RITS). In theory it seems difficult to reach the desired rate by ongoing buying and selling of government securities. However, in practice the RBA is remarkably successful. This process is known as domestic market operations.

Overload!

Ignore this section if you are still coming to grips with the basics

Effectiveness monetary policy:

As the adoption of the 2-3% target band in 1996 shows, **price stability is the dominant purpose of monetary policy**, and therefore it should be judged on how effective it is at keeping inflation within this gap. It is very effective at dampening economic activity. Interest rates act as a **transmission mechanism**, so tighter monetary policy leads to lower activity throughout the whole economy; it is thus very well-suited to dampening inflationary pressures. It is less effective at meeting secondary goals. It is not nearly as good at boosting economic activity as it is at slowing growth.

Exam focus:
Learn key points - Useful inputs for constructing conclusions

One of the major benefits of monetary policy is that it is quick to formulate and implement. Because the RBA is independent, it is not subject to drawn-out political debate like fiscal policy. Monetary policy can be changed monthly in response to inflationary pressures. The RBA has a pre-emptive approach, taking action to prevent an anticipated increase in inflation. This is necessary due to the significant time lag, as it takes 6-18 months for the effects of interest rate changes to become fully apparent. Monetary policy is a 'blunt instrument', which means it cannot directly target individual causes of inflation, but can only affect the whole economy. Statistical evidence suggests that monetary policy is generally effective. Since 1996, the RBA has succeeded in keeping inflation within the 2-3% target band, with the only major exception occurring in 2000 following the introduction of the GST. It is therefore clear that monetary policy is an important and effective part of the policy mix.

The revision process prior to the examinations:

Order	UNIT OF WORK / KEY STRUCTURE	FOCUS ON REVISING THESE KEY INPUTS FOR EXAMS
1	4b Macro and micro policies	Diagrams
2	4d Monetary policy	Content, key structures, calculations, diagrams, essay plans
3	4i Policy responses	Using monetary policy in essays
4	Research current figures (1month prior to the exams is recommended)	The latest official cash rate figure

Resources, references, and internet sites used in this unit:

- RBA - Cash rate target - http://www.rba.gov.au/statistics/cash-rate.html. History of monetary policy decisions.

Recounting a question to clarify an Economics issue!

Question to: **Bernie Fraser, Governor of the Reserve Bank** .
Question: 'If the Reserve Bank is independent of the Government, why did Treasurer Costello say "Don't worry about interest rates, I have the Governor in my pocket"?'
Asked by: Ben Hor - 2nd in the State in 3 Unit Economics, 1996

Recounting a question to clarify an Economics issue!

Q & A

Question to: **John McGrath, CEO of McGrath Partners**
Question: 'Governments around the world are encouraging high levels of loans to people who are in a position whereby they cannot pay back these loans. Is this not creating a housing bubble for the future?'
Asked by: Justin Wong - Equal 1st in the State in 2 Unit Business Studies, 2001

Essay: Critically evaluate the effectiveness of monetary policy.

Introduction

Paragraph 1 – Overview of monetary policy.
Paragraph 2 – Introduction to the process of assessing the policy.

Part 1: Criteria

Paragraph 3 – Government objectives.
Paragraph 4 – Low inflation.
Paragraph 5 – Flow-on. Inflation targeting in the last 15 years.

Part 2: Mechanics of the policy

Paragraph 6 – Domestic market operations.
Paragraph 7 – Aggregate Demand / Aggregate Supply diagram.
Paragraph 8 – Interest rates as a transmission mechanism.
Paragraph 9 – Recent developments.
Paragraph 10 – Other objectives.

Part 3: Limitations / Judgement

Paragraph 11 – Overview of limitations. (Refer to page 349 for details.)
Paragraph 12 – Time lags.
Paragraph 13 – Political constraints.
Paragraph 14 – Global constraints.
Paragraph 15 – The policy must ultimately be judged on its results.
Paragraph 16 – History of low inflation.
Paragraph 17 – Other objectives.
Paragraph 18 – Policy mix.
Paragraph 19 – Importance of prudent fiscal policy.

Conclusion

Paragraph 20 – Summary of the answer.

Introduction

Writing technique: Introducing the answer - give an overview of the response

Monetary policy, administered by the Reserve Bank, is one of the primary instruments used to address the government's economic objectives. Its effectiveness must be judged on its capacity and success in fulfilling its aims. It has been used aggressively in the last 15 years to fight inflation. Its effectiveness must therefore be judged primarily against this purpose, not the broad range of outcomes it targeted prior to that. Although it officially also addresses issues like growth and employment, the RBA's focus is firmly on targeting inflation between 2-3%. In this respect, it has been remarkably successful.

Section 1: Criteria

Writing technique: Explanation of criteria for judging the policy

The government has six core objectives. Monetary policy is expressly used to target only three or four of these. Price stability is the primary aim, while sustainable economic growth and strong employment are also stated policy objectives. It may also to some extent address external stability. Monetary policy has no role in distribution of income or environmental management.
Low inflation is undoubtedly the key aim. Monetary policy has been expressly used to contain inflation within a 2-3% target band over the economic cycle since 1996, when the target band was introduced. This level of inflation is considered appropriate for maintaining sustainable growth. Monetary policy should be judged on its effectiveness in controlling inflation. However, it is also permissible to evaluate its operation in achieving its secondary purposes.

Section 2: Mechanics

Monetary policy is implemented though market operations conducted by the Reserve Bank. It buys and sells treasury notes and Commonwealth government securities (CGS) to alter the supply of money in exchange

Writing technique: Explanation of how the policy functions

Memory technique: Refer to this chapter for revision notes outlining the mechanics of monetary policy

Writing technique: Figures to support this argument

settlement accounts held by banks with the RBA. If the RBA sells CGS, money supply will decrease. To make up the shortfall in their ESAs, banks will borrow funds from the STMM, which increases short-term interest rates in the economy.

Interest rates act as a transmission mechanism. Higher interest rates dampen economic activity by reducing investment and consumer spending. When rates are high, individuals and firms find it harder to borrow to finance consumption and investment. They have less money anyway, as existing loan repayments have increased. Reduced spending increases unemployment, which further reduces income and consumption. This lower aggregate demand puts downward pressure on price levels. During the GFC of 2008-2010 interest rates were lowered to stimulate aggregate demand and therefore boost economic growth. This also increases employment, which is a derived demand of growth. From March 2008 to April 2009 the cash rate was slashed from 7.25% to 3%. Even though monetary policy is more successful at contracting growth than expanding it, this strategy helped Australia avoid recession and start growing again more quickly than other economies.

Section 3: Limitations and Judgement

Writing technique: Describing policy limitations

Memory technique: Refer to chapter 4h Limitations of economic policies for revision notes on this issue

Creative technique: The Lindsay Lim story helps you remember policy limitations

(Refer to page 356 for details)

Writing technique: Statistics to support your argument

Monetary policy has a number of significant limitations. There are considerable time lags and political implications. While it can be quickly implemented, there is a lag of 6-18 months before the effect of an interest rate change becomes apparent in the economy. This means the potency of the policy is unknown, which causes problems for economic planning.

Moreover, as monetary policy is almost solely focused on price stability this creates conflicts with other objectives. As the Phillips Curve indicates, low inflation is generally linked with high unemployment. It is also linked with dampened economic growth. A balance must be struck between political aims. In 2010-2011, the RBA raised the cash rate from 3% to 4.75% as some sectors grew very quickly after the GFC, even though growth in other sectors (like retail) remained very slow.

It is also limited by global conditions. Cheap global credit may constrain the RBA's instinct to raise interest rates to reduce inflation, as this could simply drive Australians to borrow from overseas.

Ultimately, monetary policy should be judged on how well it has fulfilled its objectives. The data suggest it has been very effective. Inflation has remained relatively low.

Since 1996, when the inflation target was introduced, it has only exceeded the band on two occasions, both of which can be explained by extenuating circumstances.

Australia has enjoyed more than a decade of consistent economic growth. Unemployment is approximately at its lowest level for thirty years. External stability remains a problem though, with persistently high CADs

However, it must be acknowledged that monetary policy is one part of a policy mix which has achieved these strong results. Monetary policy has certainly had a significant role, but so have fiscal and micro policies.

Indeed, monetary policy relies on the policy mix, particularly fiscal policy, to complement it. Fiscal policy must be counter-cyclical, which means contractionary during economic booms. Otherwise, fiscal stimulation would cancel out the effects of tightened monetary policy.

Conclusion

Writing technique: Concluding the answer - summarise your main arguments

Monetary policy has nevertheless been very effective at fulfilling its primary objective of price stability. It has helped keep inflation low over the last 15 years. It can also address other economic objectives, but is less suited for these roles. It has been successfully used during and after the Global Financial Crisis.

Section 2: Examining Economics

Testing key concepts:

Answer the following questions in point form.

What factors determine interest rates?

i. ______________________________

ii. ______________________________

iii. ______________________________

Multiple choice:

Select the alternative that best answers the question.

1. Which of the following applies to monetary policy?

a. The Australian government sells bonds which pushes up interest rates
b. Monetary policy is currently the major swing instrument used to regulate economic activity
c. Monetary policy takes longer to implement than fiscal policy
d. The Reserve Bank meets every fortnight to consider the monetary policy stance

2. What monetary policy action can be used to counter inflationary pressures?

a. Increase income tax to contract the economy
b. Boost aggregate supply, because inflation is caused by demand rising faster than supply
c. Sell bonds to cause the cash rate to rise
d. Sell bonds to push up the tax rate

3. Which of the following are likely outcomes of the Reserve Bank raising interest rates?

a. Aggregate demand falls and the Australian dollar rises
b. National income falls and the Australian dollar depreciates
c. Economic growth accelerates and the Australian dollar appreciates
d. National income rises and the Australian dollar depreciates

4. If the Reserve Bank sells government securities to banks and non-bank financial institutions, which of the following occurs?

a. A decrease in cash
b. An increase in money supply and a fall in yields
c. A decrease in liquidity and a decrease in the cash rate
d. A fall in cash and an increase in interest rates

Prepare a conclusion for exams:

Fill in the missing words to prepare a conclusion on monetary policy.

The words needed to complete this conclusion are - (blunt instrument, domestic market operations, inflation, exchange rates, macroeconomic management)

Monetary policy, administered by the RBA, is the foremost policy for ______________. It consists of the ______________ of the RBA, which alter the cash rate. This affects the rate of interest. Changes in interest rates impact the entire economy, such as altering levels of saving, investment and spending, and ______________. Despite being a ______________ with considerable time lags, it has proved very effective at achieving price stability, particularly because of its pre-emptive use and the RBA's political independence. It is the best policy for fighting ______________, although is very limited in terms of other objectives.

Answers to the multiple choice questions:

1b, 2c, 3a, 4d.

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