Monetary Policy

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Multiple Choice

1	D	**6**	A	**11**	C	**16**	C
2	D	**7**	A	**12**	B	**17**	C
3	C	**8**	B	**13**	A	**18**	A
4	B	**9**	A	**14**	A	**19**	D
5	D	**10**	A	**15**	D	**20**	C

Short Answers

Question 1

(a) An account held by commercial banks that is used to settle payments with the Reserve Bank and other banks in the short term money market.

(b) If a commercial bank does not lower its interest rate following a reduction in the cash rate, it may lose some market share if customers move to other banks that have lowered their interest rates. However, this is unlikely to occur in the short term as it is difficult for borrowers to renegotiate existing loans. Nevertheless, over the longer term banks with higher interest rates are likely to lose market share as new borrowers and those renegotiating existing loans shift to other banks with lower rates.

(c) The steep decline in the cash rate at the beginning of the 1990s reflected the early 1990s recession. The Reserve Bank reduced interest rates dramatically as economic growth collapsed, inflation fell and unemployment rose sharply. The reduction in the cash rate in 2008 and 2009 reflected the impact of the global financial crisis, which prompted banks around the world to lower interest rates to avoid a severe global recession.

(d) If the Reserve Bank of Australia (RBA) wants to lower interest rates, it will buy second-hand Commonwealth Government Securities (CGS) or repurchase agreements (repos) in the short term money market. The RBA pays for these into the banks' exchange settlement accounts, which increases the money supply or liquidity in the short term money market. The increased supply of loanable funds will put downward pressure on the cash rate. Banks will pass on the decreased borrowing costs by cutting their interest rates, resulting in a decrease in the general level of interest rates across the economy.

Question 2

(a) Pre-emptive monetary policy refers to how the Reserve Bank adjusts interest rates in anticipation of future changes in the level of inflation, rather than just waiting for those changes in inflation to occur. There is a time lag of between six and eighteen months for monetary policy changes to influence the economy. Thus, in adjusting the cash rate the RBA makes decisions based on its forecasts of economic performance and inflation in 6 to 18 months, rather than relying on past or current economic data.

(b) The Reserve Bank's inflation target requires that headline, or consumer price, inflation is kept between 2 and 3 per cent on average over the cycle. This means that inflation can go above or below the target band in the short-term without it being inconsistent with the target. Secondly, the inflation target is the main guide for monetary policy decisions, and achieving that goal takes priority over other goals (such as reducing cyclical unemployment). Thirdly, while the inflation target is the priority of monetary policy, this is not the same as pursuing a policy of low inflation at any cost. Other goals such as sustainable economic growth and lower unemployment are also pursued by the Reserve Bank so long as they are compatible with the inflation target. Finally, inflation targeting is primarily a short to medium term objective aimed at smoothing the fluctuations of the business cycle.

(c) Monetary policy is not intended to influence external stability directly. However it has a range of influences on the external stability of the Australian economy through its influence on inflation the domestic economy, imports, financial inflows, the current account and the Australian dollar. An increase in interest rates decreases the level of aggregate demand in the Australian economy as the cost of credit rises, discouraging consumption and investment. Over time it should help keep inflation low, which will support longer term foreign investor confidence in Australia and the stability of the exchange rate. Higher interest rates may lead to lower imports (through reducing consumer demand and investment in capital imports), but if those rates cause an appreciation it may make imports more competitive and thus can encourage imports. An increase in interest rates will raise the interest rate differential between Australia and the rest of the world, encouraging financial inflows, increasing demand for the Australian dollar and possibly causing an appreciation of the currency. A higher level of financial inflows will result in increased debt servicing costs in the long term, reflected in a larger deficit on the primary income account of the current account (and a higher current account deficit). The precise impacts depends on a range of other factors in the domestic and global economy.

Question 3

(a) Since the early 1990s inflation in Australia has stayed low, mostly remaining within the 2-3 per cent target band and only occasional moving outside the target range. The largest inflation spike occurred at the introduction of the Goods and Services Tax (in 2000) and there was a mild increase in underlying inflation in the late 2000s due to a combination of inflationary pressures from increased fuel and commodity prices.

(b) Headline inflation is measured by the Consumer Price Index and it can include short-term spikes in inflation caused by large jumps in prices for commodities such as oil, food and energy – for example, a cyclone in northern Queensland damaged Australia's banana crops in 2011 and high banana prices added to headline inflation. Underlying inflation measures the core inflation within the economy by excluding volatile items in its calculation. Thus, headline inflation typically fluctuates more than underlying inflation.

(c) The most likely effect of the introduction of the carbon tax is a short-term increase in headline inflation (the Consumer Price Index). This occurred when the Australian Government last introduced a new indirect tax, the Goods and Services Tax, in 2000. The inflationary effect will however be smaller as the carbon tax applies at a low rate and only has a significant effect on a limited range of items (such as the price of coal-fired electricity). The extent of its inflationary effect depends on the extent to which businesses pass on the tax to consumers through higher prices for goods and services, and whether consumers can switch to alternative goods or services (ie the elasticity of demand for the good or service).

(d) A decrease in interest rates will reduce the differential between Australia and overseas interest rates. This make Australia a less attractive destination for short-term deposits from overseas, which will decrease financial inflows into Australia. This may increase the supply of the Australian dollars as investors sell of Australian dollar denominated financial assets, causing a depreciation of the dollar. On the other hand, if the lower interest rates result in greater confidence in future economic growth in Australia, this increased confidence may have a positive impact on the value of the dollar. The ultimate impact of the decrease in interest rates will depend on the specific conditions applying at the time, but in most circumstances lower interest rates would be expected to contribute to a lower dollar.

Skills Revision

Event	Monetary policy stance	Domestic market operations actions	Change to interest rates	Impact on the economy
Sustained fall in consumer spending	Loosening	RBA buys CGS	Decreased	↑ C, I and X ↑ AD ↑ Demand-pull inflation
Wages growth of 12 per cent in one year	Tightening	RBA sells CGS	Increased	↓ C, I and X ↓ AD ↓ Wages growth
Falling economic growth	Loosening	RBA buys CGS	Decreased	↑ C, I and X ↑ AD ↑ Economic growth
Rapid depreciation of Australia's exchange rate	Tightening	RBA sells CGS	Increased	↓ AD ↑ Financial inflow ↑ Demand for $A Appreciation
Unemployment falls below the natural rate	Tightening (to prevent inflation)	RBA sells CGS	Increased	↓ C, I and X ↓ AD ↑ Unemployment

Domestic Market Operations

	To increase interest rates:	To decrease interest rates:
Buy or sell CGS	Sell	Buy
Change in bank's ESA balances	Decrease	Increase
Change in the money supply in the short term money market	Decrease	Increase
Illustrate the impact of this change	Leftward shift in MS curve	Rightward shift in MS curve
Change in the cash rate	Increase	Decrease
Change in interest rates in the economy	Increase	Decrease