MONETARY POLICY 15

MULTIPLE CHOICE

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

SHORT ANSWER QUESTIONS

Question 1

(a) The cash rate is the interest rate in the short-term money market.

(b) An answer to this question will include any one of the following:

- Price stability or minimising inflation
- Maintenance of full employment
- A sustainable level of economic growth

(c) When the RBA wants to increase the cash rate, it will sell second-hand Commonwelath Government Securities (CGS) in the short term money market. Banks pay for the CGS out of their exchange settlement accounts, reducing liquidity in the short-term money market which raises the cash rate, with a reduced supply of funds in the short term money market, the cash rate will rise. When the RBA wants to decrease the cash rate, it will buy CGS from the banks, increasing liquidity in the market and lowering the cash rate.

(d) An increase in the cash rate will be passed on by banks as an increase in interest rates (in order to maintain their profit margins). Higher interest rates will increase the cost of credit, reducing consumption, and increase the cost of borrowing to finance investment projects, reducing investment. Servicing costs on extisting loans will rise. As mortgage repayments rise, household disposable income will fall, reducing consumption. Increase servicing costs on loans will reduce funds available for investment by firms. Higher interest rates will encourage financial inflows into Australia, causing an appreciation. This will worsen export competitiveness (and increase import consumption). Overall, aggregate demand and economic growth will fall.

Question 2

(a) Inflation targeting is where a central bank implements monetary policy for the purpose of achieving a particular level of inflation.

(b) Australia's inflation target band is 2-3%.

(c) In attempting to reduce an anticipated rise in inflation, the RBA will increase the cash rate. This will increase interest rates, slowing consumption and investment and decreasing aggregate demand. When aggregate demand falls, the economy is less likely to experience demand-pull inflation. The use of pre-emptive monetary policy to achieve an inflation target keeps inflationary expectations low; workers will not ask for exccessive wage increases in the expectation of higher inflation, and consumers will not bring forward their consumption plans unnecessarily.

(d) Monetary policy is a blunt instrument which produces conflicting changes in components of the CAD. If the RBA were to raise interest rates, economic growth would fall and incomes would fall, lowering import consumption, improving the balance on goods and services (BOGS). However higher interest rates would increase financial inflows into Australia, which increase demand for the dollar causing an appreciation. This would worsen export competitiveness, worsening the BOGS. In addition, the increased financial inflows will add to foreign liabilities, creating additional servicing costs, worsening the net income deficit. However the higher dollar will reduce the Australian dollar value of foreign debt denominated in foreign currencies, lowering the value of their income payments, improving the net income account. Overall there is no clear impact on the CAD from a change in interest rates.

Question 3

(a) An answer to this question may include any two of the following:

- Australia's cash rate adjustments occur in cycles, with a period of sustained cash rate increases in 2002-03 following successive decreases in 2001.
- The cash rate increases tend to cluster in successive months, such as May-June 2002 and November-December 2003, with months without change in between.
- The cash rate tends to increase in 0.25 percentage point increments, with occasional increases of higher value.

(b) An answer to this question may include any two of the following:

- Interest rates
- Economic Growth
- The unemployment rate
- The exchange rate
- Consumer spending
- Wage levels
- Productivity
- Interest rates in other economies

(c) Pre-emptive changes to the cash rate allow the RBA to manage inflationary expectations. A small change in the cash rate before inflation increases will create confidence that inflation is under control, encouraging businesses and consumers to adjust their economic activities accordingly. Furthermore, the RBA may pre-emptively increase the cash rate because it takes 6-18 months for monetary policy changes to impact on the economy, and any future increases in consumption must be reduced before they occur.

(d) Lower interest rates would increase the rate of economic growth in Australia, increasing domestic incomes. This will increase the rate of consumption, causing demand-pull inflation where consumers bid up prices for limited goods and services. As production increases, workers may demand higher wages as their share in the increased revenue, increasing cost-push inflation. Also lower interest rates relative to overseas will induce financial outflows, causing a depreciation, which will increase imported inflation.