

# Monetary Policy

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## Multiple Choice Answers

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

## Short Answer Questions

### Question 1

- a) The cash rate is the interest rate in the short term money market.
- b) If the cash rate increased, the banks would be forced to pass on the increase in borrowing costs to its clients by raising interest rates. If the cash rate decreased, competition between the banks would force down interest rates across the economy.
- c) Exchange settlement accounts provide a mechanism for banks to settle payments between one another and the Reserve Bank. At the end of a days trade, banks may owe money to one another or be owed money by other banks. Additionally, if a bank runs out of money in its exchange settlement accounts on a particular day, it is able to borrow from the supply of money in other banks' exchange settlement accounts. The interest rate charged on these borrowings is the cash rate determined by the market.
- d) If the Reserve Bank of Australia (RBA) wanted to raise interest rates, it would sell second-hand Commonwealth Government Securities (CGS) or Repurchase Agreements (repos) in the short term money market. The banks would pay for these out of their exchange settlement accounts, which reduces the money supply or liquidity in the short term money market. The shortage of borrowable funds would increase the cash rate. Banks would pass on the increased borrowing costs by raising their interest rates, resulting in an increase in interest rates across the economy.

**Question 2**

- a) In Australia, the Reserve Bank of Australia (RBA) targets a level of inflation between 2-3 per cent on average over the economic cycle. This means that the RBA aims to have inflation within the target band over the short to medium term.
- b) The use of inflation targeting provides an anchor for inflationary expectations. If the RBA sets a target for inflation which is credible, and it consistently conducts monetary policy in a way which achieves the inflation target, then individuals and firms across the economy will be able to expect that inflation will fall within the target band. When individuals negotiate wages or when firms set prices for the future, they will be able to expect that inflation will be within the target band, and this will in turn yield low inflation rates.
- c) An increase in interest rates would decrease the level of aggregate demand in the Australian economy. If interest rates were to increase, the cost of credit would rise, which means that individuals would be less likely to use debt to finance consumption. This would lower consumption levels. Additionally, mortgage repayments and other interest payments on existing loans would increase, decreasing the level of household disposable income, lowering consumption. Firms would face higher borrowing costs when financing investment, which means that firms would be unable to undertake less profitable investment projects. This would lower the level of investment. Firms would also face higher servicing costs on existing loans, decreasing the likelihood that a firm would borrow to finance investment. The increase in interest rates would raise the interest differential between Australia and the rest of the world, encouraging capital inflows, increasing demand for the Australian dollar and causing an appreciation. This would increase the foreign currency price of Australian exports, decreasing overseas demand and lowering exports. At the same time, the Australian currency price of imports would fall, encouraging consumers to switch from domestically produced products to imported substitutes, lowering net exports.

**Question 3**

- a) If inflation were expected to fall 1 per cent, this would indicate that aggregate demand is falling. The RBA would adopt an expansionary monetary policy stance by lowering the cash rate to lower interest rates and boost aggregate demand.
- b) Monetary policy has a time lag of 6-18 months between its implementation and impact. If the RBA were to simply react to changes in the economy as they occurred, the impact of the policy decision would occur too late to affect the economy, by which time economic conditions may have changed significantly. Because of this, the RBA conducts pre-emptive monetary policy and raises interest rates before inflation is expected to increase to ensure that it can be effectively managed.
- c) An increase in interest rates would raise the interest differential between Australia and the rest of the world. This would make Australia a more profitable investment destination for foreign investors, which would increase financial inflows into Australia. This would increase demand for the Australian dollar, causing an appreciation.
- d) An increase in interest rates would have an ambiguous impact upon the current account deficit. An increase in interest rates would lower aggregate demand and disposable incomes across the economy, which would reduce expenditure on imports, improving the current account deficit. However, the increase in interest rates would encourage financial inflow, increasing demand for the Australian dollar and causing an appreciation. This would lower Australia's export competitiveness and reduce export volumes, worsening the current account deficit. The appreciation of the dollar would decrease the Australian dollar value of foreign debt denominated in overseas currencies – known as the valuation effect – which would decrease the value of net income repayments, improving the current account. However, the increase in financial inflows which caused the appreciation would also generate an increase in servicing costs, worsening the current account deficit. Overall, an increase in interest rates has no discernable impact on the overall current account balance, which is why monetary policy is now rarely used to target the current account deficit.