

The Money Supply and Interest Rates

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Multiple Choice

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|--------|---------|---------|
| 1. (B) | 6. (D) | 11. (A) |
| 2. (A) | 7. (C) | 12. (C) |
| 3. (B) | 8. (C) | 13. (A) |
| 4. (A) | 9. (B) | 14. (D) |
| 5. (B) | 10. (A) | 15. (C) |

Short Answers

Question 1

- There has been a trend decrease in M3 money supply growth. It fell from a peak of around 23 per cent in November 2007 to about 12 per cent in July 2009.
- One reason for the trend decrease in M3 growth may have been a slowing in the growth of bank deposits due to the global financial crisis. A second reason may be a slowing in the growth of the deposits that banks hold with the RBA.
- The money base consists of all currency in circulation and all bank deposits with the RBA. This is a measure of the most liquid financial assets. Broad money consists of all currency, bank deposits with the RBA, bank deposits, and deposits in non-bank financial intermediaries minus non-bank financial intermediary holdings of bank deposits. Even though broad money provides a more accurate measure of the total money supply, it takes longer and is more difficult for the RBA to measure broad money and compile the relevant statistics. On the other hand, the money base by itself is not a broad, nor accurate enough measure of money supply. Therefore the RBA uses M3 as its official measure of money supply.
- Firstly, money is a medium of exchange. This means that it can be exchanged for goods, services and resources in the economy. Secondly, money can be used as a measure of value. That is, money can be used to compare the relative value of goods, services and resources. Thirdly, money is also a store of value. It can be used to measure the value of goods, services and resources over time. Finally, money can be used as a method of deferred payment, in the sense that it allows the development of a system of lending and borrowing.

Question 2

- (a). Exchange settlement accounts refer to the accounts that banks and other financial institutions have with the RBA that hold a certain proportion of their funds so that they are able to settle payments with other banks and the RBA.
- (b). A repurchase agreement refers to a transaction in a security where the seller agrees to buy the security back from the initial buyer at a later date.
- (c). One reason why the size of a bank's exchange settlement account may change is expectations of future net inflows or outflows on the account. If a bank expects to have a large net outflow of funds on a particular day, they will increase the size of their exchange settlement accounts. A second reason is transactions paid by cheque occurring between customers of different banks. For example, when a customer of the Commonwealth Bank uses a cheque to buy a good from a business that has a bank account at ANZ, funds will flow from the Commonwealth Bank's exchange settlement account to ANZ's exchange settlement account. The volume of transactions by cheque may vary considerably between banks over different days.
- (d). To lower the cash rate in the short-term money market the RBA would buy securities (such as second hand Commonwealth Government Bonds or Repurchase Agreements) from financial institutions in the overnight money market. The RBA pays for purchased securities by depositing funds into banks' or financial institutions' exchange settlement accounts, creating an excess of borrowable funds and leading to an increase in the supply of settlement funds. This puts downward pressure on the cash rate.
- (e). Provided banks pass on changes in the cash rate, a decrease in the cash rate would lead to a decrease in the general level of market interest rates. This would lead to an increase in the level of economic activity. Lower interest rates stimulate household consumption since the size of existing mortgage repayments on variable mortgages will decrease, and the cost of new borrowing is relatively lower. Business investment will also increase because it means that borrowing is also relatively less expensive.

Question 3

- (a). The interest rate is the cost of borrowing money expressed as a percentage of the total amount borrowed.
- (b). An increase in the level of interest rates this will lead to a decrease in consumer spending. Higher interest rates mean that the cost of new borrowing for consumption is higher. Also, higher interest rates increase the size of mortgage repayments on existing variable mortgages which will then take up a greater proportion of household expenditure leading to lower spending on other consumer items. The opposite is true where interest rates are lowered, which will result in an increase in consumer spending.
- (c). One possible cause of an increase in the general level of interest rates in an economy is a decrease in the level of national savings. A lower supply of loanable funds will see competition for limited funds put upward pressure on interest rates. A second possible cause is an increase in demand for investment by businesses. An increase in demand for borrowing will push up the cost of borrowing leading to higher market interest rates.
- (d). Interest rate differential refers to the difference between the borrowing rate and the lending rate offered by a financial institution. Banks typically charge a lending rate when they make loans to their customers, which is greater than the borrowing rate which they offer on deposits. This is the source of profit earned by financial institutions.
- (e). One difference between financial markets and markets for consumer goods is that financial markets are the market for a factor of production (capital) while markets for consumer goods trade in final (consumption) goods. A second difference is that in financial markets, the price (interest rate) is indirectly influenced by a government authority (the RBA). In markets for consumer goods, the price is usually determined without government intervention by the interaction of supply and demand. A third difference is that financial institutions make a profit

in financial markets by offering a borrowing rate (the interest rate it offers to savers who deposit funds) below the lending rate (the interest rate it charges to other consumers and businesses which require funds). In markets for consumer goods, producers make a profit by earning enough revenue so that it exceeds their costs of production.

Skills Revision (1) – pg 142

	To increase economic activity	To reduce economic activity
Tightening/loosening monetary policy	Loosen	Tighten
Impact on borrowable funds (exchange settlement accounts)	Increase	Decrease
Impact on borrowable funds (ESA)	Increase	Decrease
Cash rate	Decrease	Increase
Market interest rates	Decrease	Increase
Cost of borrowing	Decrease	Increase
Consumption and investment	Increase	Decrease

Skills Revision (2) – pg 143

Tightening

Change to ESA: Decrease

Change to Money Supply: Decrease

Diagram: Show a leftward shift in the vertical money supply (MS) curve and an increase in the cash rate.

Change to the cash rate: Increase

Loosening

Change to ESA: Increase

Change to Money Supply: Increase

Diagram: Show a rightward shift in the vertical money supply (MS) curve and a decrease in the cash rate.

Change to the cash rate: Decrease