Monetary policy stances

What does the syllabus say?

Monetary policy

- the concepts of monetary policy and the cash rate
- circumstances under which the RBA may change the cash rate
- how monetary policy affects the level of economic activity i.e. the transmission mechanism
- **the concepts of expansionary, contractionary and neutral monetary policy stances**
- **the impact of different monetary policy stances on the level of economic activity**
- strengths and weaknesses of monetary policy
- contemporary (the last three years) monetary policy stances in Australia

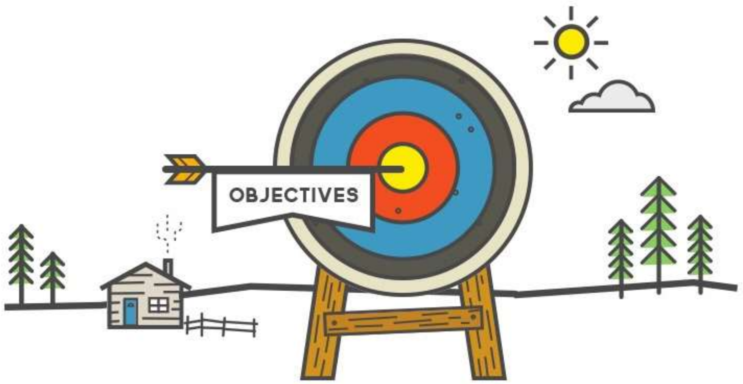
Learning intention

UNIT 4

- We are learning to discuss monetary policy.

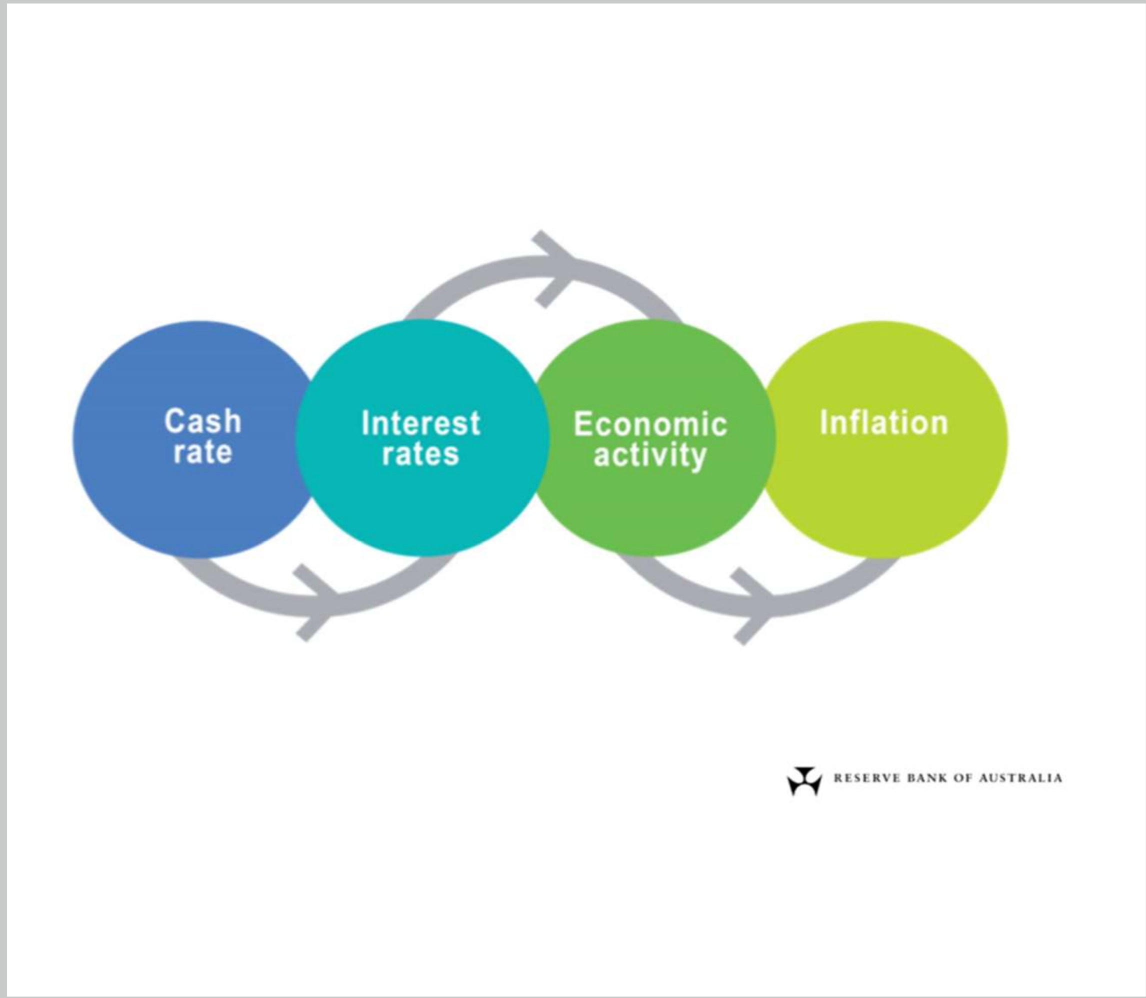
Success criteria…

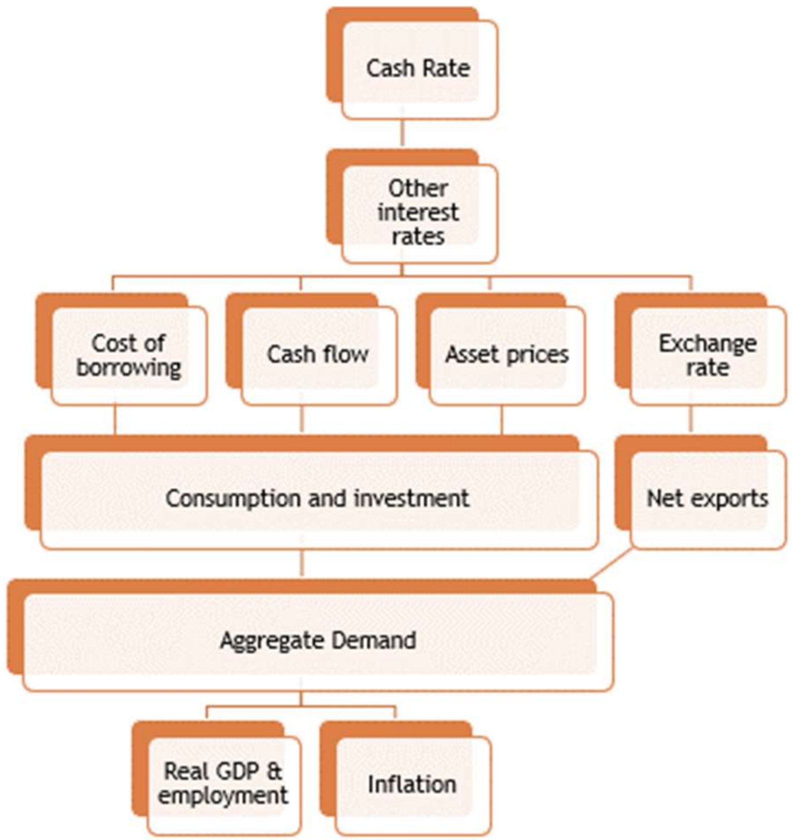
i. IDENTIFY the three different monetary policy stances.
ii. DISCUSS the concept of the three different monetary policy stances.
iii. Using a model, EXPLAIN the intended effect of the three different monetary policy stances.



Let's get started…

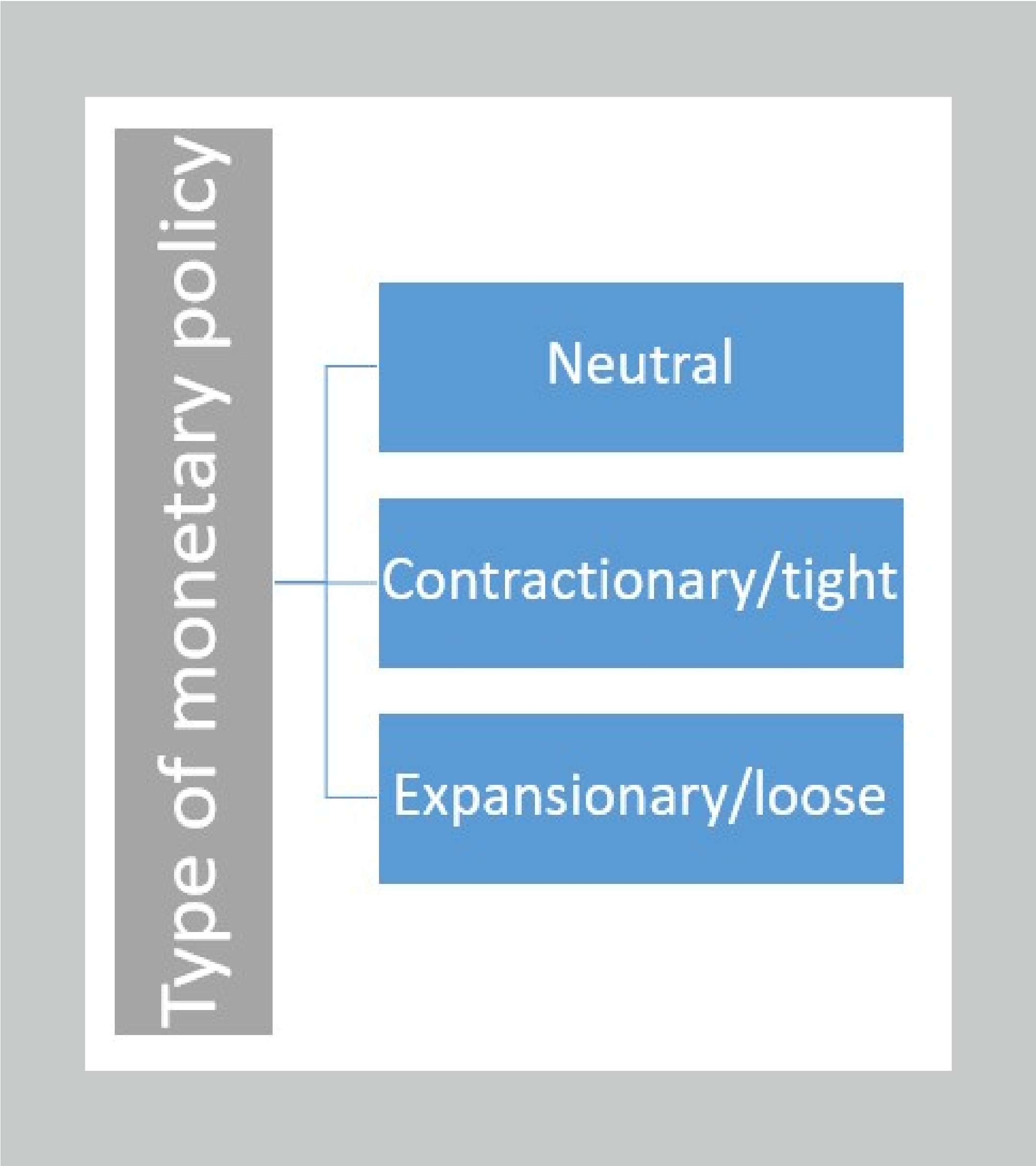
- The image to the right is a simple diagram of how changes to the cash rate flow through the economy.
- Identify and briefly describe the four channels through which the cash rate influences the level of economic activity.





Detailed transmission mechanism diagram

What are the three different types of monetary policy stances?

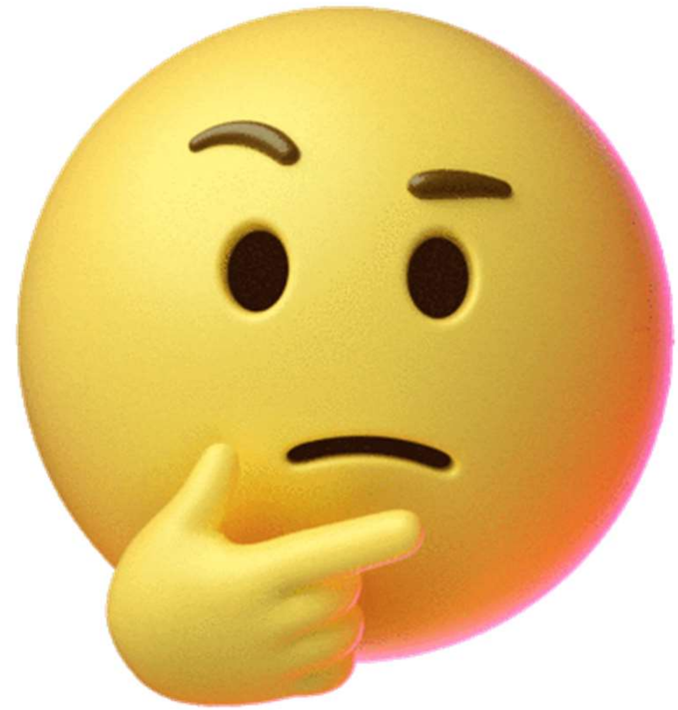


What is neutral monetary policy?

- A neutral rate describes an interest rate at which monetary policy is neither stimulating nor restricting growth.
- In 2022 the Reserve Bank (RBA) stated that the neutral interest rate is probably at least 2.5 per cent.
- The rate at which monetary policy can be considered neutral, can and does vary.

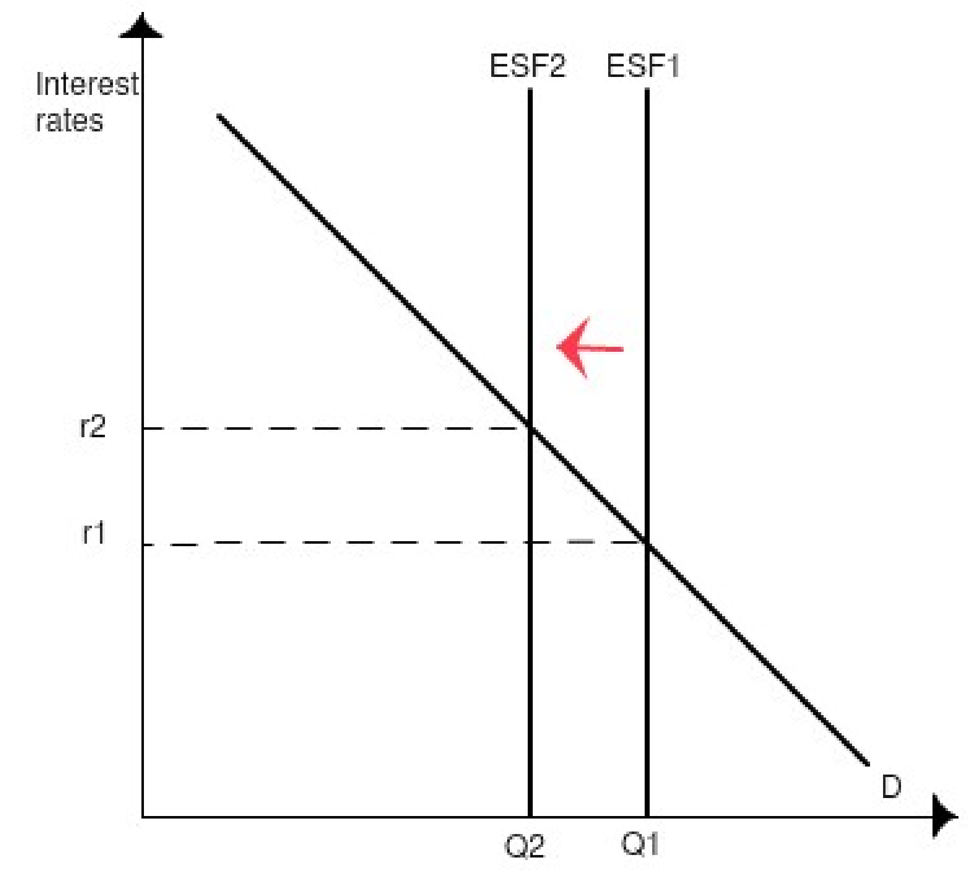
Time to think…

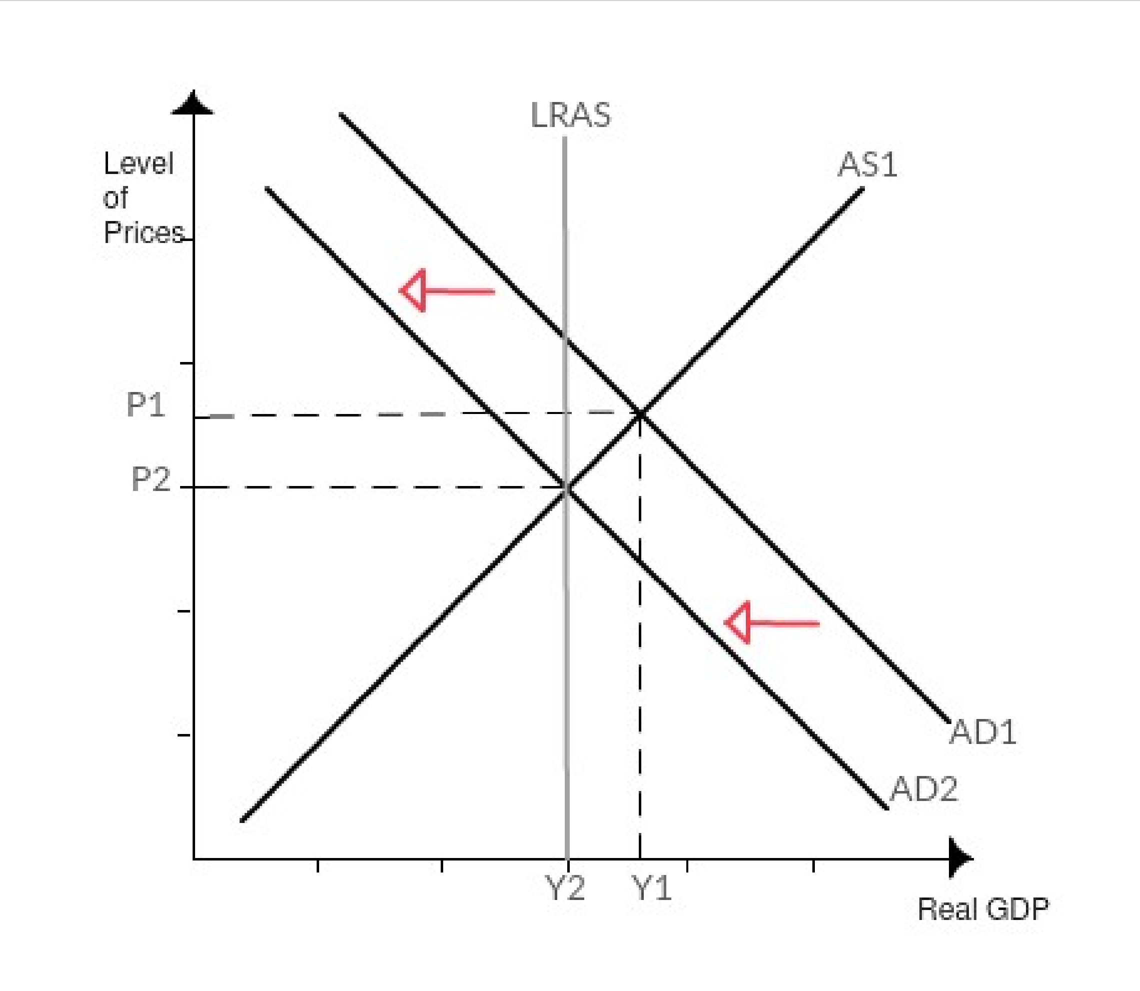
- What do you think is meant by contractionary monetary policy?
- Why would the RBA employ contractionary monetary policy?
- How would you use the AE model and/or the AD/AS model to draw contractionary monetary policy?



What is contractionary policy?

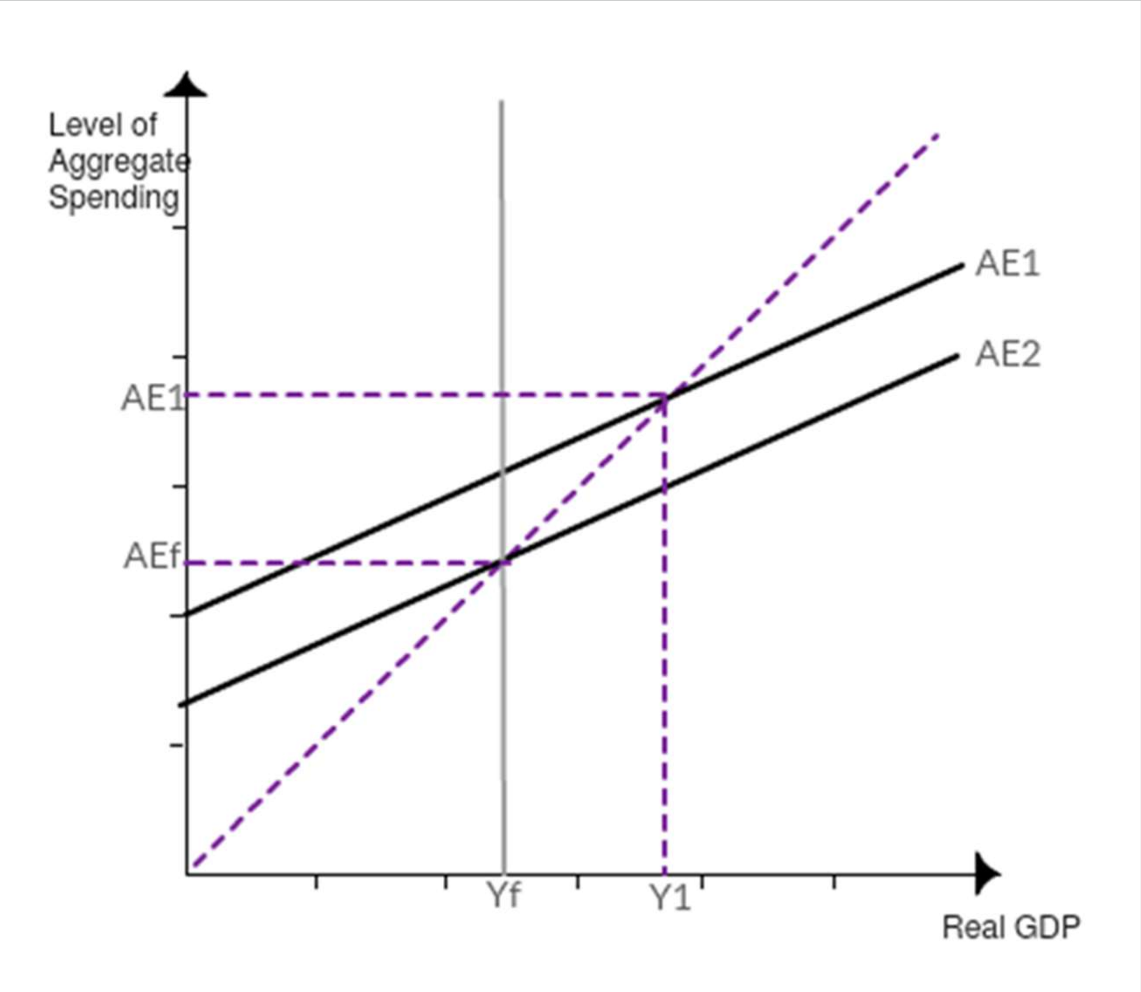
- Is where the RBA wishes to put up the cash rate in order to reduce AE.
- To achieve this goal it sells CGS's in the short-term money market (STMM) moving the supply curve to the left.
- This reduces the liquidity in the STMM from Q1 to Q2.
- Competition between banks to gain these reduced funds in order to facilitate their ESF's forces the cash rate up from r to r2.





How do you model contractionary MP using the AD/AS curve?

- The RBA will implement contractionary MP when the economy is overheating.
- The RBA will increase the cash rate in order to increase interest rates in the economy resulting in a shift in aggregate demand from AD1 to AD2.
- The decrease in AD should reduce the expansionary gap in the economy decreasing prices from P1 to P2.
- Output and income in the economy will fall from Y1 to Y2.

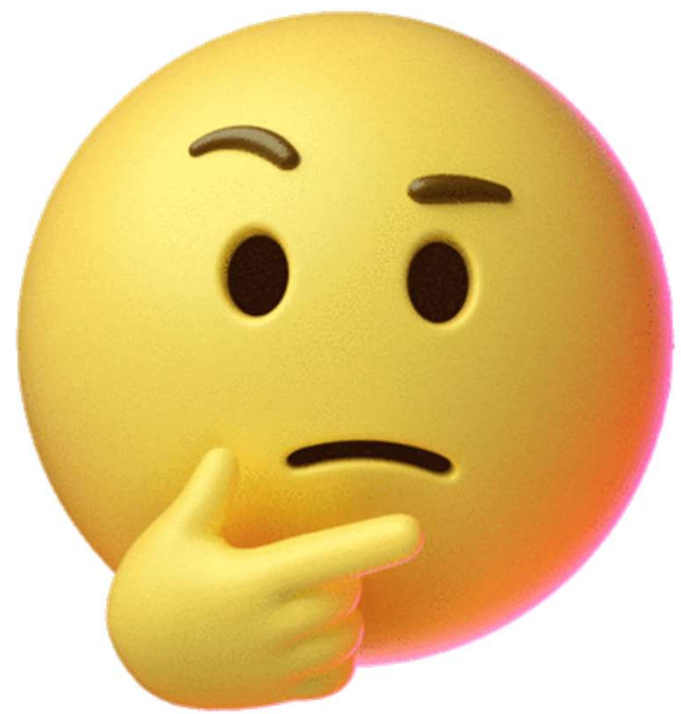


How do you model contractionary MP using an AE curve?

- An increase in the cash rate by the RBA will result in an decrease in spending from AE1 to AE2.
- The resultant decrease in spending will have a negative multiplier effect in the economy decreasing levels of output and income from Y1 to the full employment level Yf.
- This decrease in spending should close the inflationary gap.

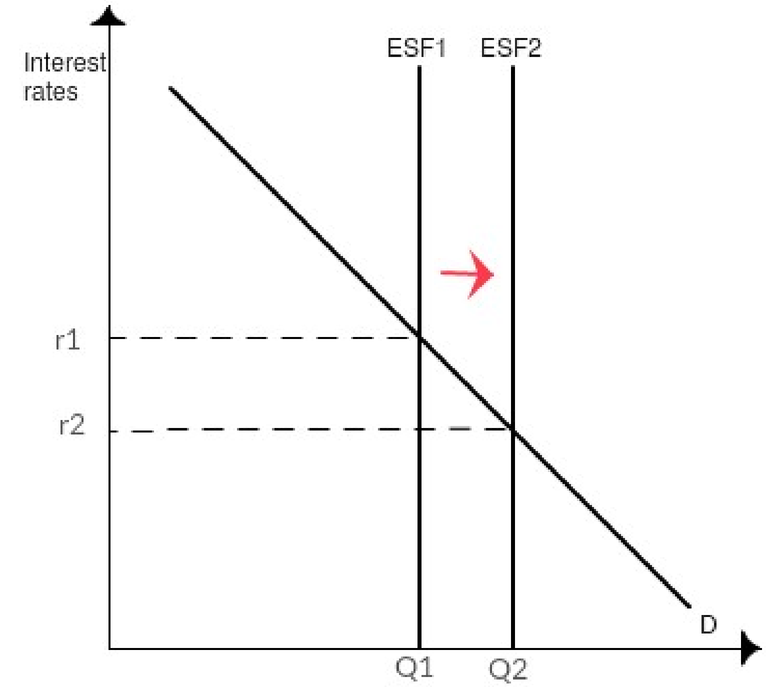
Time to think…

- What do you think is meant by expansionary monetary policy?
- Why would the RBA employ expansionary monetary policy?
- How would you use the AE model and/or the AD/AS model to draw expansionary monetary policy?



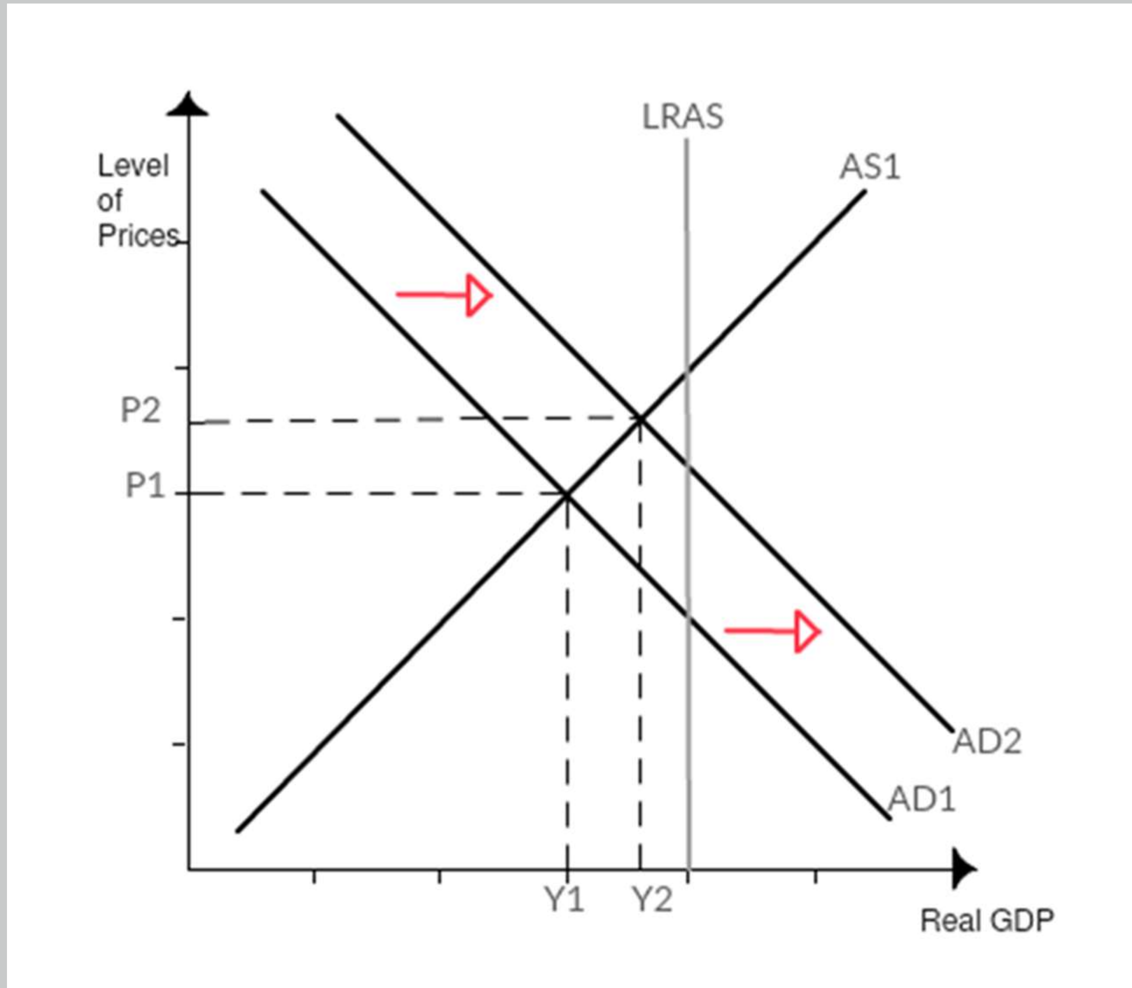
What is expansionary monetary policy?

- Is where the RBA wishes to reduce the cash rate in order to increase AE.
- To achieve this goal it buys Commonwealth Government Securities in the short-term money market (STMM) moving the supply curve to the right.
- This increases the liquidity in the STMM from Q1 to Q2.
- There is little competition between banks to gain these funds to facilitate their ESF's pushing the cash rate down from r1 to r2.



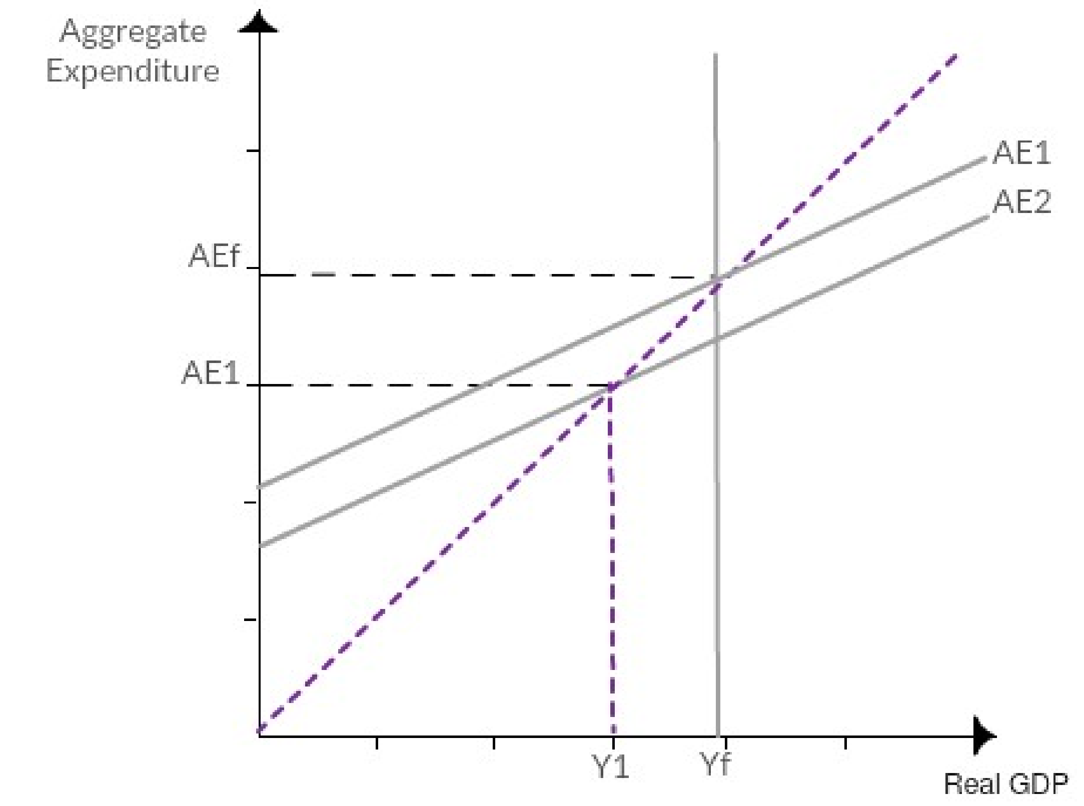
How do you model expansionary MP using the AD/AS curve?

- The RBA will implement expansionary MP when the economy is hit by a negative demand shock.
- The RBA will decrease the cash rate in order to lower interest rates in the economy resulting in a shift in aggregate demand from AD1 to AD2.
- The increase in AD should reduce the expansionary gap in the economy increasing prices from P1 to P2.
- Output and income in the economy will rise from Y1 to Y2.



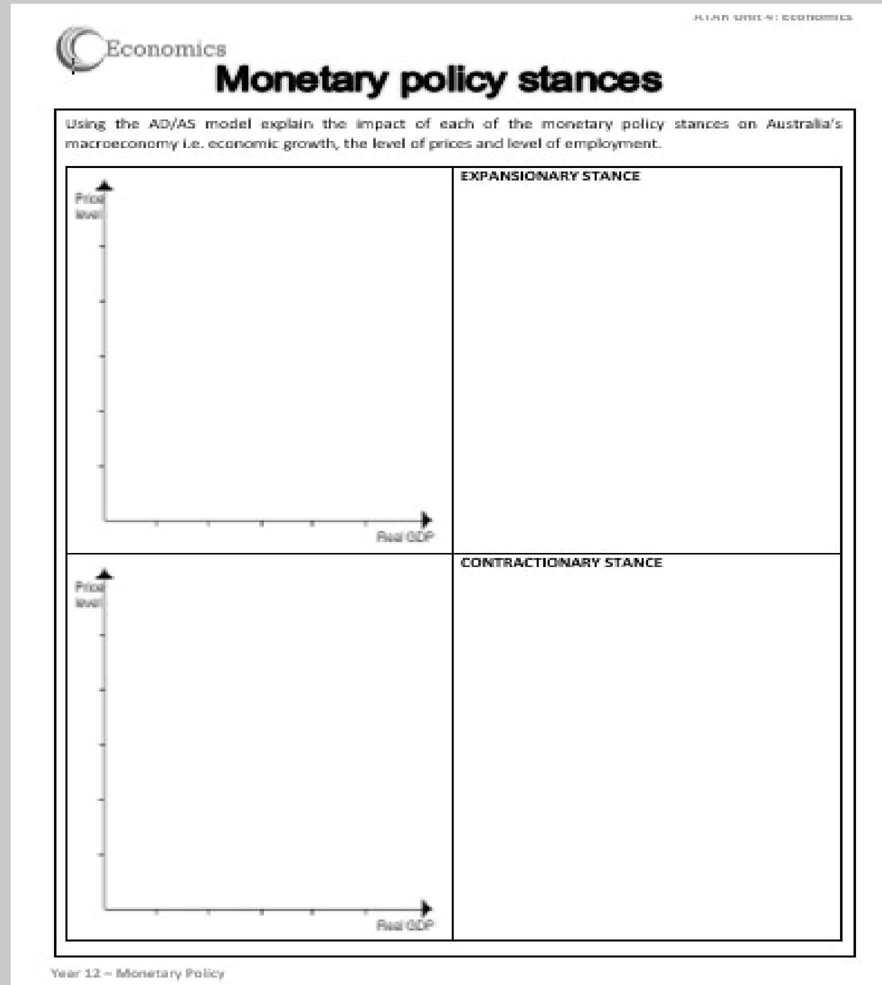
How do you model expansionary MP using an AE curve?

- A fall in the cash rate by the RBA will result in an increase in spending from AE1 to AE2.
- The resultant increase in spending will have a positive multiplier effect in the economy increasing levels of output and income from Y1 to the full employment level Yf.
- This increase in spending should close the deflationary gap.



What impact do MP stances have on the macroeconomy?

- Use the AD/AS curve in order to discuss the impact that different monetary policy stances should have on the macroeconomy.



Economics

Monetary policy stances

Using the AD/AS model explain the impact of each of the monetary policy stances on Australia's macroeconomy i.e. economic growth, the level of prices and level of employment.

Price level / Real GDP	EXPANSIONARY STANCE
Price level / Real GDP	CONTRACTIONARY STANCE

Year 12 – Monetary Policy

Before you go…

- Come up with at least three different reasons why you think monetary policy might not be effective in the current economic environment.