

Introduction to monetary policy

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

Student Handbook Economics Units 3 & 4

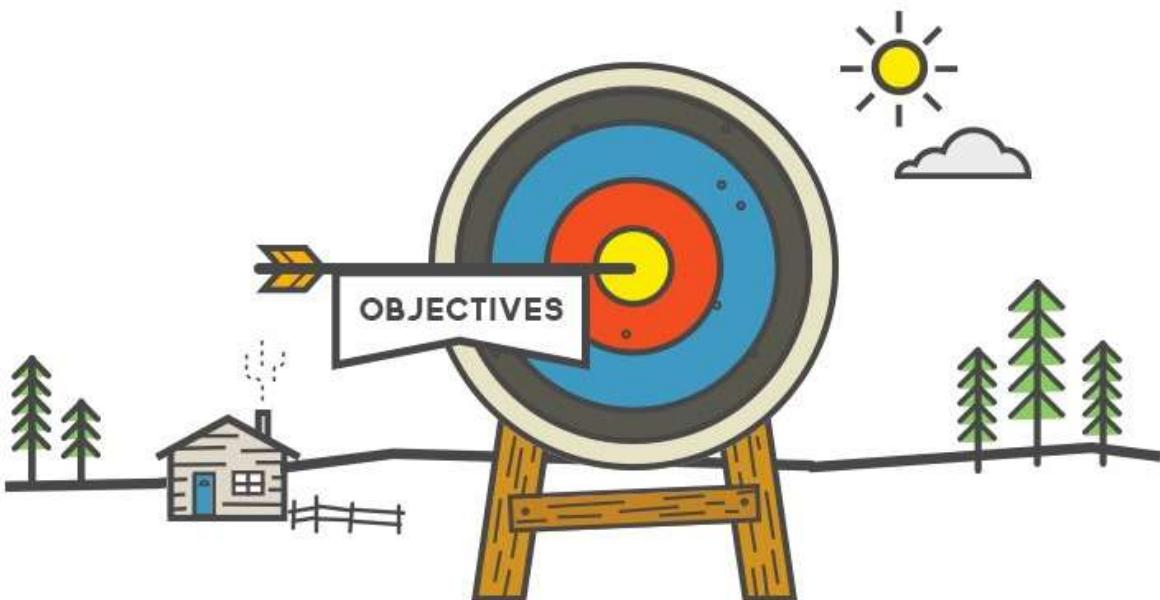


Learning intention

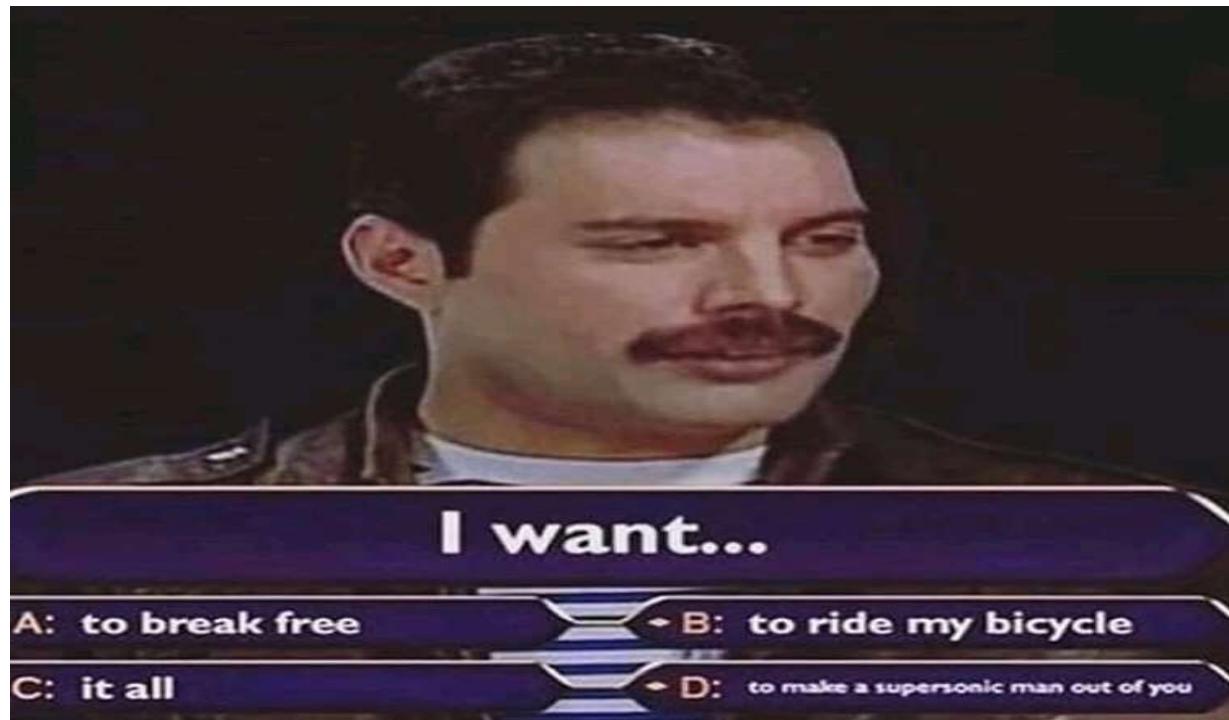
UNIT 4

- We are learning to discuss the concept of monetary policy.

Success criteria...



1. Define the term monetary policy.
2. Explain what is meant by the cash rate.
3. Discuss how the RBA achieves the cash rate.



Let's get started...

- Test your understanding of fiscal policy by completing the multiple-choice questions on pages 252 to 253 of your text.

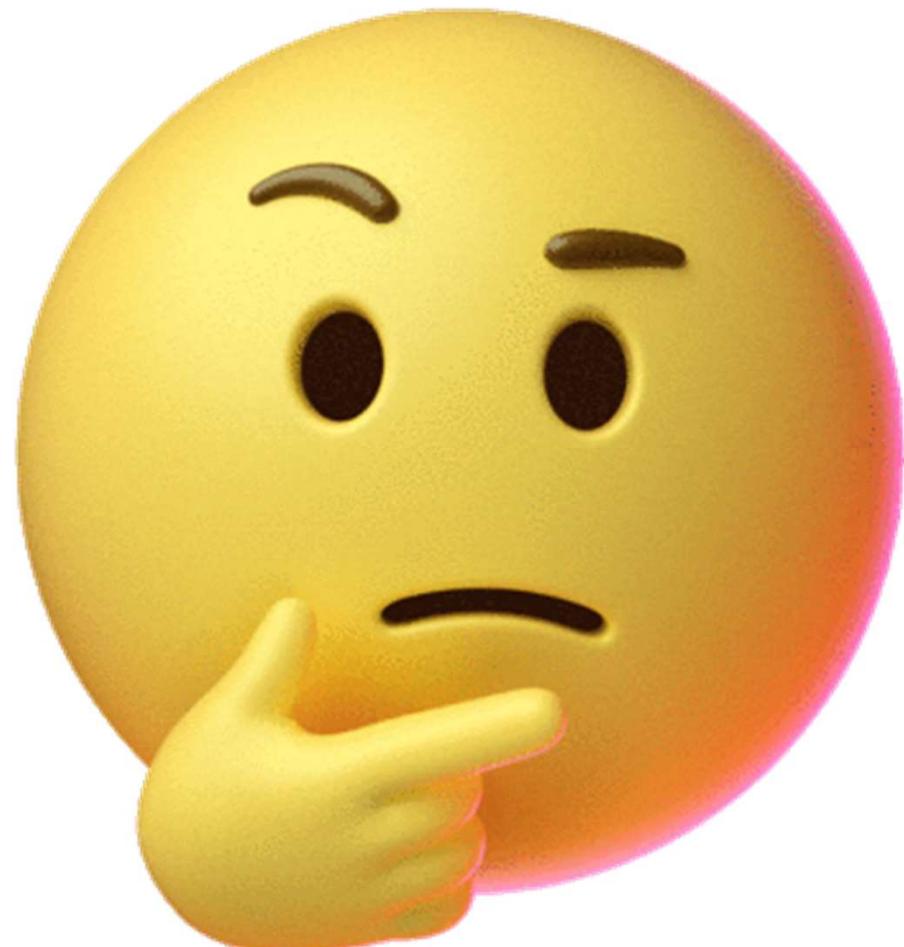


What is meant by monetary policy?

Monetary policy refers to those actions taken by the Reserve Bank of Australia to control monetary policy to achieve the economic objectives of the bank.

Do you
recall?

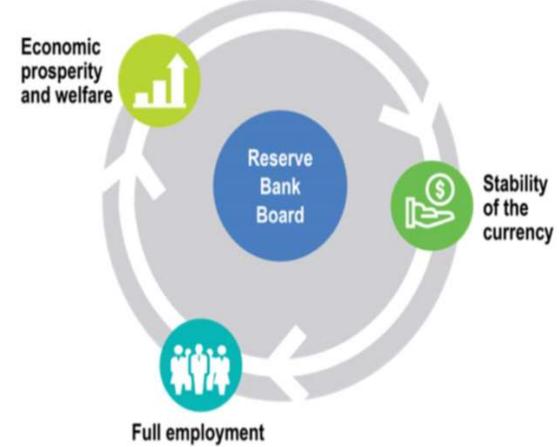
What are the
three main
economic
objectives of
the RBA?



How did you go?

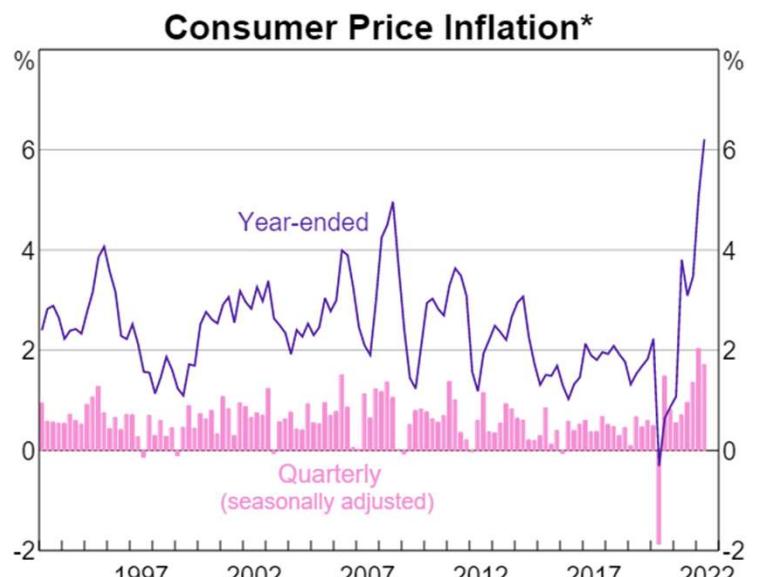
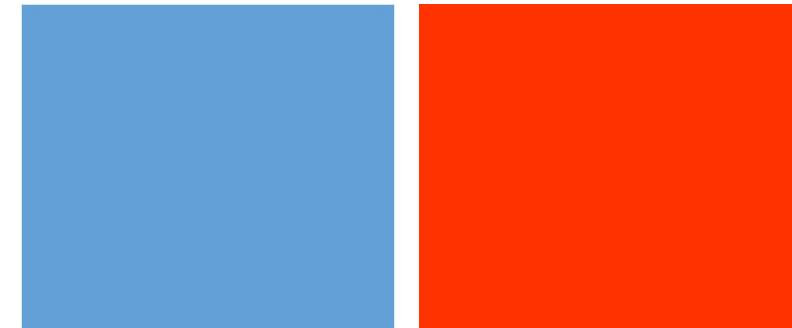
- The Bank is a statutory authority, established by an Act of Parliament, the *Reserve Bank Act 1959*, which gives it specific powers and obligations.
- The Reserve Bank has three key economic aims as shown to the right.

What Is the Role of the Reserve Bank Board?



Key objective – price stability

- A target of 2-3% on average over the cycle was set in 1993.
- It was thought that this level would not materially distort economic decisions in the community.

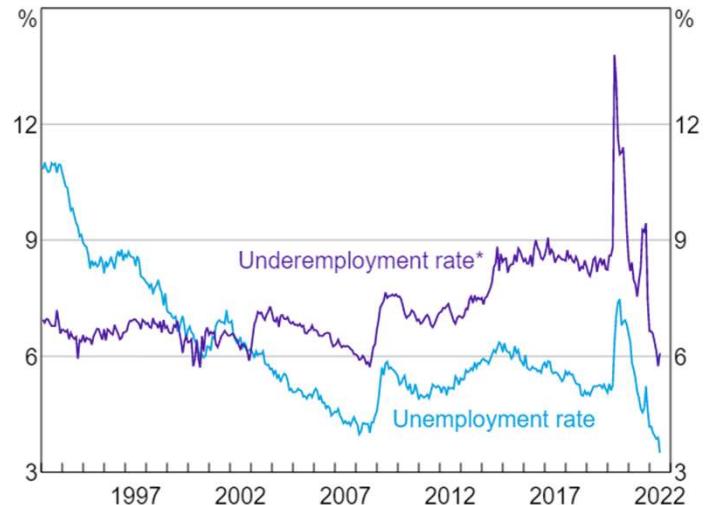


Key objective – full employment

- Price stability is a crucial precondition for sustained growth in economic activity and employment.
- Price stability assist businesses in making sound investment decisions, this underpin the creation of jobs, protects the savings of Australians and preserve the value of the currency.

Labour Underutilisation Rates

Heads-based

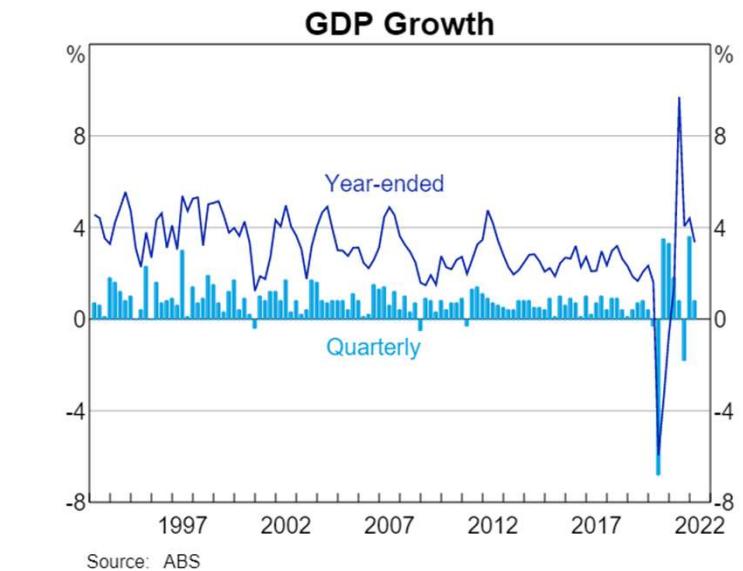


* Full-time workers on reduced hours for economic reasons and part-time workers who would like, and are available, to work more hours.

Source: ABS

Key objective – economic welfare

- A third objective of monetary policy is the economic prosperity and welfare of the people of Australia.
- The first two objectives lead to this third, and ultimate, objective of monetary policy and indeed of economic policy.



What are the main tools of monetary policy?

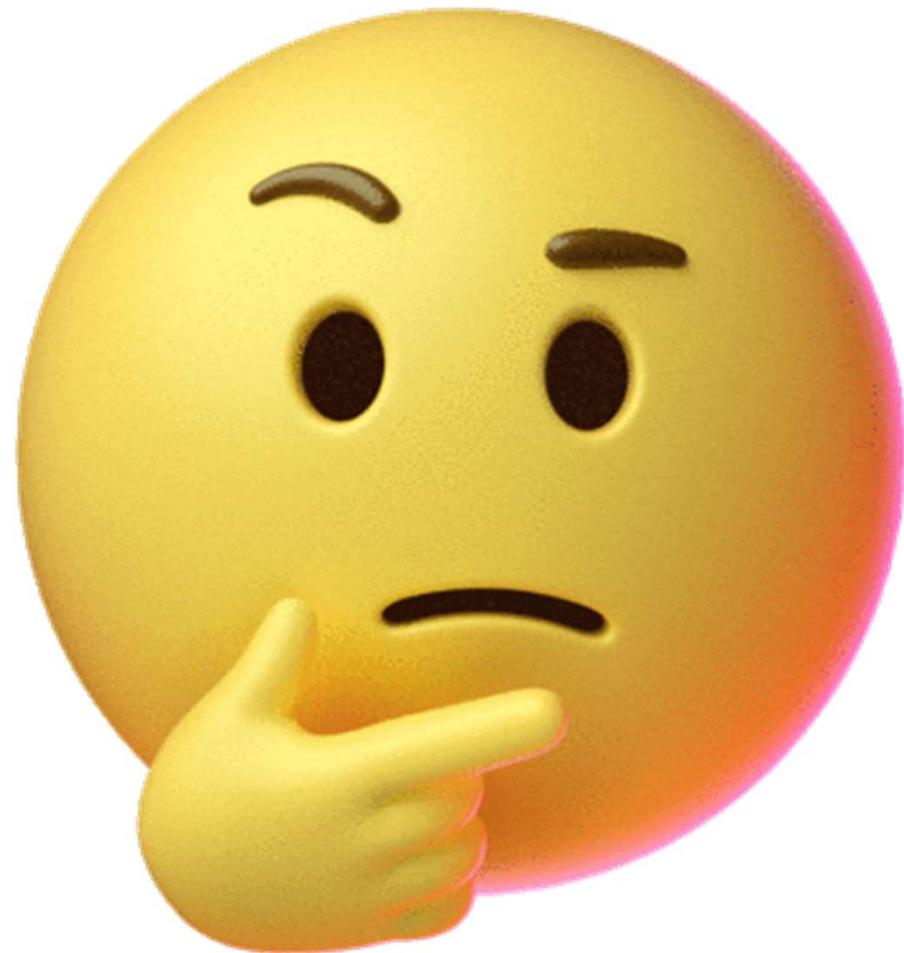


Monetary policy attempts to influence the level of economic activity (the amount of buying and selling in the economy) through:

- i. the price of money by using the official **cash rate** to influence short-term interest rates;
- ii. changes to the amount of money in circulation (quantitative easing/tightening).

Time to
think...

What is
meant by the
cash rate?



How did you go?

- The official cash rate is the target set by the RBA for the interest rate which banks pay to borrow funds from other banks in the money market on an overnight basis.

Let's find out some more...

View the video found at <https://youtu.be/eTNUh8NW7QI> in order to find out more about the cash rate.



Time to
think...

What was
official cash
rate through
to May, 2022?



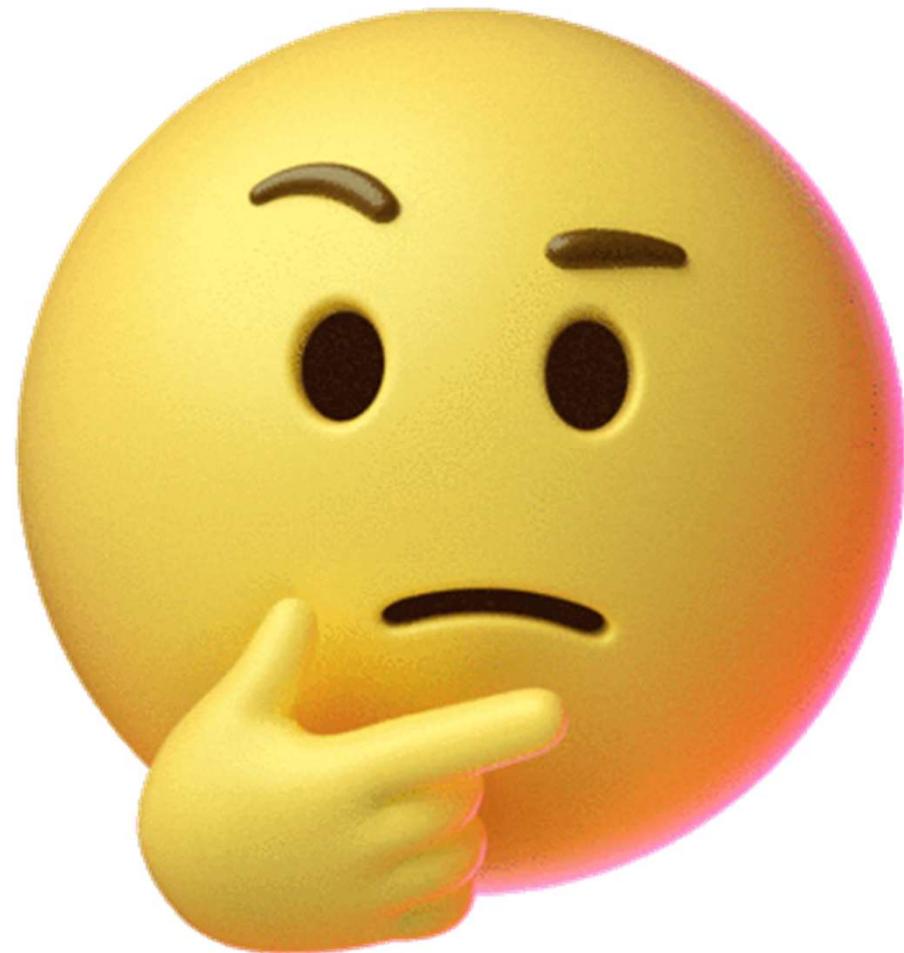
How did
you go?

The official cash
rate has been set
at 0.1% since 4
November 2020.

0.1%

Time to
think...

What is the
current cash
rate?



How did
you go?

The cash rate
has increased
4 times since
May, 2020.

1.85%

How does the RBA set about achieving the target cash rate?

The Reserve Bank implements monetary policy by keeping the cash rate as close as possible to the target.



It does this by conducting money market transactions. These 'open market operations' are typically conducted as auctions.



Open market operations increase or decrease the amount of cash held by banks.



The Reserve Bank also helps banks manage cash under terms where lending and deposit rates form a corridor of 0.25 percentage points above and below the cash rate target. The corridor helps keep the cash rate close to target.



The Reserve Bank lends cash to banks at an interest rate 0.25 percentage points above the cash rate target. Banks would not borrow cash at a higher rate, so there is no market above this lending rate.



Banks deposit cash with the Reserve Bank at 0.25 percentage points below the cash rate target. Banks do not lend cash at a lower rate, so there is no market below this deposit rate.





Philip Lowe
Governor



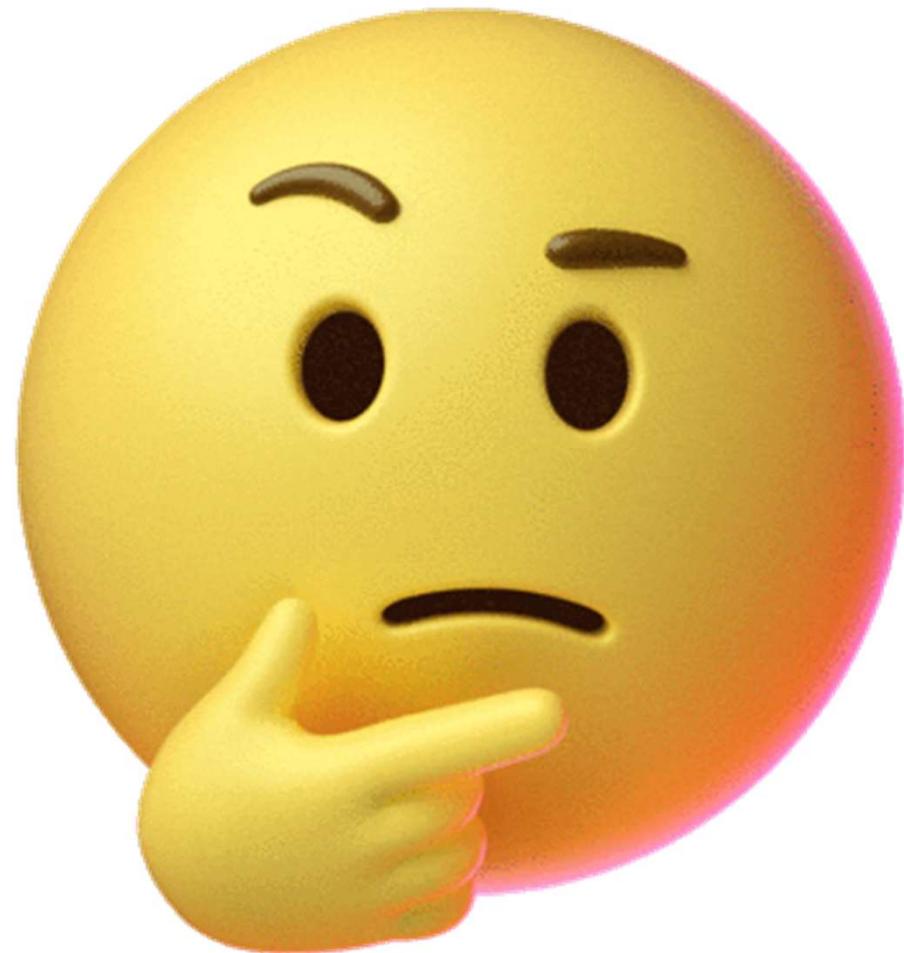
Guy Debelle
Deputy Governor

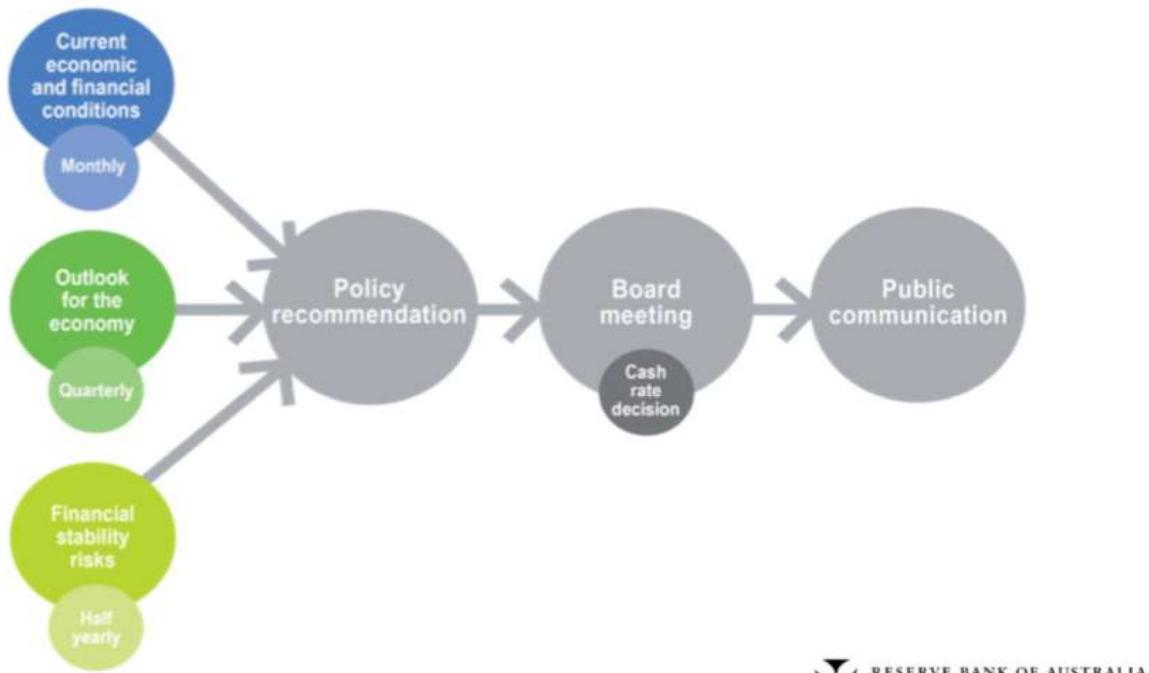
Who makes decisions about the cash rate?

- The Reserve Bank Board makes the decisions about Australia's monetary policy. The Board has nine members, of which at least five (including the Governor as Chair or Deputy Governor as Deputy Chair) must be present to conduct a meeting. The Board **meets on the first Tuesday of every month** (except in January).
- The Board discusses a broad range of issues that help it assess whether the stance of monetary policy is consistent with its objectives. Each month, Reserve Bank staff prepare detailed papers on developments in the Australian and international economies and financial markets. These papers include a recommendation for the monetary policy decision.
- The monetary policy decision is made by a majority vote (with the Chair having an additional casting vote if required). The Board's decision is announced to the public at 2.30 pm on the day of the meeting. Minutes of the Board meeting are published two weeks later, providing transparency to the public about the factors that influenced the decision.

Time to
think...

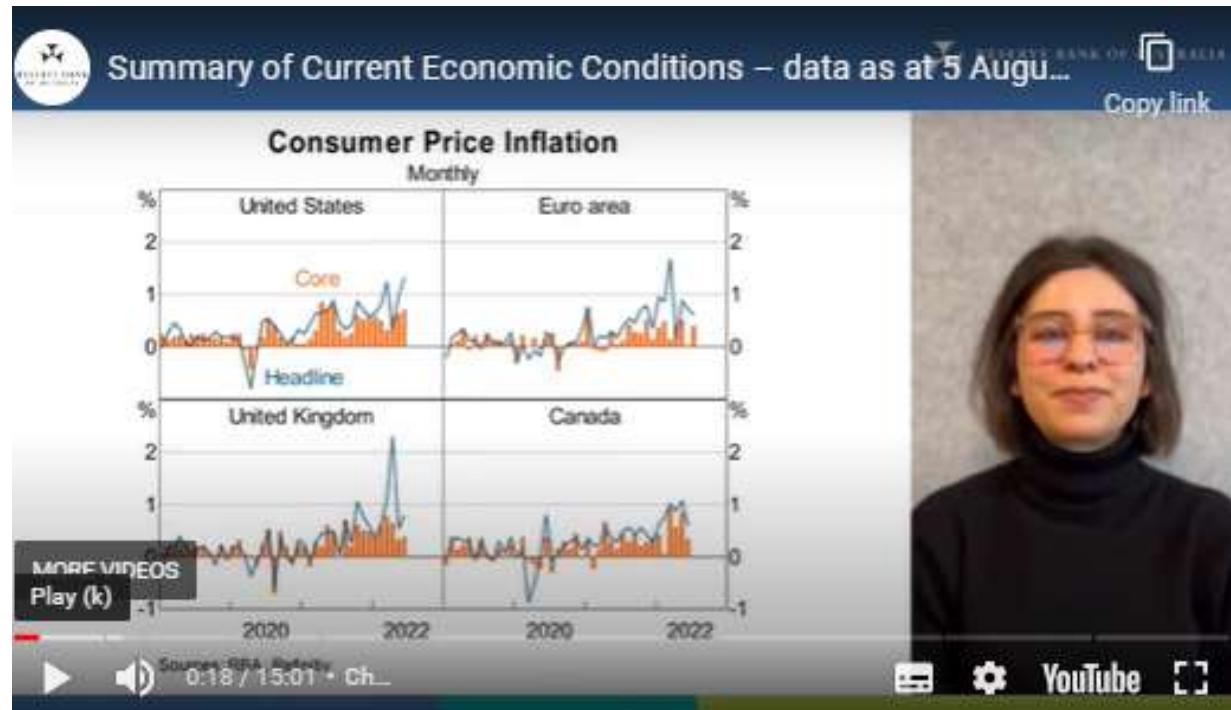
What is the
primary goal
of the RBA?





Why might the Reserve Bank Board change the cash rate?

- Remember the key aim of the Reserve Bank is to maintain the level of inflation between 2-3% over the course of the business cycle.
- The Reserve Bank Board may choose to increase the cash rate when inflation is too high (usually at the peak of a boom). In these cases, the Reserve Bank must carefully consider the trade-off between smoothing the business cycle (in particular economic growth and unemployment) in the short run and achieving its inflation target.
- Alternately, if the level of inflation is too low the Reserve Bank Board may choose to decrease the cash rate. This is most likely to occur during an economic trough.



What are the sorts of things
that the Board considers?

View the video on current economic conditions (published by the RBA on 5 August, 2021) found at <https://www.rba.gov.au/education/resources/videos.html> to get a feel for the types of considerations the RBA has when setting the target for the cash rate.

What does the Reserve Bank Board base their decisions on?



what are other
words for
jawboning?



schmoozing, shmoozing,
shmoosring, blandishment,
cajolery, wheedling, sweet talk,
soft soap, cajolement, snow job



Let's dig a little
deeper...

- Read the statement by the RBA Governor Phillip Lowe from 2 August, 2022 found at <https://www.rba.gov.au/media-releases/2022/mr-22-21.html>.
- Explain what was decided at the meeting of the RBA Board and the reasons for this decision.

Before you go...

- Complete the true/false questions on the following slide.



Monetary Policy – True or False?

Statement	True/False
Monetary policy refers to those actions taken by the Reserve Bank of Australia to control monetary policy to achieve the economic objectives of the bank.	
The Reserve Bank is a statutory authority.	
The key economic objective of the RBA is economic growth.	
The target for inflation is 2-3% on average over the cycle.	
The cash rate is currently 0.25%.	
There are 10 members on the Reserve Bank Board.	
The Reserve Bank Board meets on the first Tuesday of every month except January.	
When determining the cash rate the RBA considers a broad range of economic indicators.	
An important component of the process of changing the cash rate is jawboning about the decision.	
The current rate of inflation in Australia is 0.3%.	