



2021 Ateco Assessment 3 Answers

year 11 chem (University of Western Australia)

Statement by Philip Lowe, Governor: Monetary Policy Decision

Number 2021-03

Date 2 March 2021

Excerpts from the Media Release

At its meeting today, the Board decided to maintain the current policy settings, including the targets of 10 basis points for the cash rate...

In Australia, the economic recovery is well under way and has been stronger than was earlier expected. There has been strong growth in employment and a welcome decline in the unemployment rate to 6.4 per cent. Retail spending has been strong and most of the households and businesses that had deferred loan repayments have now recommenced repayments. The recovery is expected to continue, with the central scenario being for GDP to grow by 3½ per cent over both 2021 and 2022. GDP is expected to return to its end-2019 level by the middle of this year.

The economy is still operating with considerable spare capacity and the unemployment rate remains higher than it has been for some years. Further progress in reducing spare capacity is expected, but it will be some time before the labour market is tight enough to generate wage increases that are consistent with achieving the inflation target. In the central scenario, the unemployment rate will still be around 6 per cent at the end of this year and 5½ per cent at the end of 2022. In underlying terms, inflation is expected to be 1¼ per cent over 2021 and 1½ per cent over 2022. CPI inflation is expected to rise temporarily because of the reversal of some COVID-19-related price reductions.

The current monetary policy settings are continuing to help the economy by keeping financing costs very low, contributing to a lower exchange rate than otherwise, and supporting the supply of credit and household and business balance sheets. Together, monetary and fiscal policy are supporting the recovery in aggregate demand and the pick-up in employment.

a) Outline the main objectives of monetary policy and the RBA's current monetary stance and its reasoning for it given Australia's economic conditions. (7 marks)

Define Monetary Policy (1/2) - the responsibility of the RBA (1/2)

3 objectives low inflation, low unemployment and sustainable growth. (1 1/2)

Most important objective – inflation with a target of 2-3%. (1)

Current stance – expansionary (1/2) – it's maintaining an historically low cash rate at ten basis point (1/2)

Australia is still recovering from the 2020 recession (1/2)

Australia has considerable spare capacity (1/2) and high unemployment (1/2) and low inflation rate (1/2)

Lower cash rate is supporting AD- through low borrowing costs and supply of credit. (1/2)

b) With the aid of a diagram, explain the likely impact of the RBA's current monetary policy stance on the level of economic activity. (13 marks)

Explain the flow on effect of the cash rate on other interest rates (1)

Define Transmission mechanism (1)

Discuss fully the impact of low interest rates on

- Savings/cost of borrowing – low incentive to save, high incentive to borrow and invest – increase in AD. (1-2)
- Cashflow of households and firms - lower mortgage /loan repayments for households and firms increase cash flow resulting in increased C and I. (1-2)
- Wealth and asset prices- increased demand for higher yielding assets (because bank interest is too low) led to higher assets prices and share prices. (1-2)
- Exchange rate and the trade sector – low interest rates reduce capital inflows and the demand for AUD. This results in the lower AUD and increased net exports. (1-2)

Fully labelled diagram – AD shifts to the right OR AE shifts upwards (1)

Explanation of diagram – Output rises – contractionary gap closes and price rises (1)

Potential Issues – liquidity trap and need for fiscal stimulus (1)