ECONOMICS

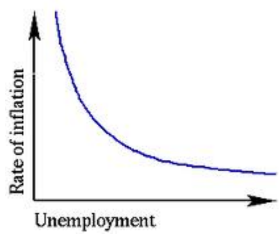
Monetary Policy

Monetary Policy (mp) is the Reserve Bank's main macroeconomic policy used to influence the cost and availability of money in the Australian economy. Through Domestic Market Operations (DMO), economic (eco) objectives are achieved via mp, including sustainable economic growth and internal and external balance, whereby higher employment and lower inflationary pressures ensue from countercyclical initiatives. However, mp has limitations of medium time lag and ineffectiveness of addressing structural problems, whereby stabilisation mechanisms are only effective in curbing eco fluctuations. Thus, through implementing tightening and loosening policies, mp is an effective short to medium term demand management weapon for eco stabilisation.

The federal government has three major economic goals: price stability, full employment and sustainable economic growth. Price stability involves maintaining low inflation, and to a lesser extent the stabilisation of the Australian dollar. In the 1990s, the inflation targeting regime was adopted in aim to sustain an inflation rate of 2-3% on average over the business cycle, that was crucial to 'assist business in making sound investment decisions, creation of jobs, protect savings of Australians and preserve the value of the currency' (conduct of mp 2007). Yet, the inflationary target has allowed for greater control over cost-push inflation, in which excess wages growth to labour productivity threatens inflation as costs flow through increased prices. Moreover, RBA sometimes intervenes in the exchange rate using mp to lower import inflation and stimulate appreciation enabling lower input and production costs. However, the mp is largely utilised for its ability to curb fluctuations for a sustainable rate of growth (3-4% p.a.) in the economy. As such, quality of life is preserved with its stabilising contractionary or expansionary stances. Hence, the mp is important to the economic welfare of consumers and businesses as price stability, full employment and sustained economic growth are managed.

The mp can stimulate or dampen aggregate demand through its influence on the cash rate, the interest rate in the short term money market. Banks are required to hold Exchange Settlement Accounts (ESA) with the RBA, in order to settle payments with other banks and the RBA. However, through DMO, ESA serve another purpose of enabling the RBA to affect the amount of money in it by selling or buying Commonwealth Government Securities (CGS). For instance, during strong economic growth, a contractionary tightening policy is exercised where the RBA sells CGS to drain supply of loanable funds, effectively putting upward pressure on the cash rate. As a result, access to funds for financial institutions become harder as expenses increase, leading to extra costs spilling into longer term and mortgage interest rates as banks maintain profit margins.

This has numerous impacts upon economic activity by the transmission mechanism. A raise in general interest rate levels discourages borrowing by businesses and consumers because loans (for major purchases like houses) account for lower disposable income and tightened budget, hence, consumption, and due to lower AD, businesses have no incentive to invest in capital expansion to increase output. In addition, reduced AD constitutes decreased employment levels since labour is derived demand, but beneficially lessens demand-pull and cost-push inflation. This can be illustrated by the Phillips curve on the right in which a lower inflation corresponds to higher unemployment. Further, an appreciation is promoted as a relatively high inflation rate attracts financial inflow (more returns) or demand for the $A, leaving Australian goods less internationally competitive and decreased export receipts, deteriorating CAD. Yet, in the longer term lower investment is likely to result in slower growth and greater reliance on imports further increasing our CAD. Overall, a monetary contraction is designed to decelerate economic growth with a shortage of borrowable funds, indirectly creating economic leakages, as evident in 1994, where three large rises in interest rates, reduced growth to a manageable 3-4%.



Conversely, to boost a stagnant economy, a loosening mp is employed. An expansionary stance operates with the RBA purchasing CGS to raise the quantity of loanable funds in ESA, putting downward pressure on the cash rate. In effect, access to borrowable funds is easier making returns cheaper so banks are able to pass on savings in the form of reduced interest rates for reasons of competition. Subsequently, the transmission mechanism triggers incentives to borrow by businesses and consumers with costs of servicing existing loans become cheaper (in turn encouraging further spending) and recovered AD fuelling capital investment to meet demands. Additionally, higher AD contributes to higher employment levels but also may come to conflict with inflation (demand-pull and cost-push) if supply capacity is exceeded. Yet, a drop in interest rates leads to more investors withdrawing funds (less returns) causing a depreciation in the $A, which improves international competitiveness and CAD, since export volumes multiply. Hence, a surplus of ESA funds engendered by monetary expansion facilitates positive economic growth, representing injections of consumption and investment demands, and leading to better quality of life (need GFC stats).

The effectiveness of monetary policy can be seen through the degree of success economic objectives have been achieved overtime. Inflation has averaged 2.5% since 1990, compared to previous rates of 8% in the 1980s, indicating the mp's appropriateness in managing inflation within its target range that has contributed to an uninterrupted growth average of 4% per year. In addition, mp is implemented within a relatively quick period with the RBA board discussing (and adjusting) suitable stances each month. As such, mp is essential to maintain business and consumer confidence as inflation kept within the 2-3% target band ensures inflationary expectations are low. However, a time lag of 6-18 months exists between its implementation and visible effects due to changes in interest rates requiring time to feed through borrowing and savings behaviours. Thus, the RBA looks at several indicators of financial conditions and economic performance in making decisions about future movements in interest rates. These include: inflation rate, wages growth, unemployment level, economic growth rate, exchange rate and more.

Whilst the mp is very effective for demand management, it does not deal with structural problems which are the sources of high inflation and low productivity. For example, during the commodity boom of the mid 2000s, capacity constraints were blamed for rising inflationary pressures attributed to limited supply for burgeoning demands. A lack of structural improvement in international competitiveness or national savings, also accounts for the mp's ineffectiveness in addressing the high CAD problem-in contractionary stance, even worsening it. Moreover, successful (loosening) mp is complemented with other economic policies. For example, during the gfc, industrialised nations engaged in both expansion monetary and fiscal policy to restore economic confidence whereby fiscal policy provided a 'kick start.' Therefore, the mp has worked well for managing the growth cycle and level of inflation in the short to medium term, but has been very ineffective for addressing supply side causes that are the core of adverse economic issues.

Overall, monetary policy is essential to an economy's domestic stability as full employment; sustained economic growth and price stability are achieved simultaneously. By changes the cash rate and general interest rates carried out by DMO of CGS transactions, the RBA seeks to smooth out economic fluctuations by lowering spending potentials (with higher interest rates) or improving confidence (with lower interest rates). Nevertheless, despite weaknesses of mp in its time lags and inability to cater for structural factors, monetary policy is crucial to the economic prospects of consumers and businesses in the short to medium term.