ECONOMICS

Australia's Monetary Policy

Discuss the effectiveness of monetary policy in achieving economic objectives, in particular inflation and employment.

Monetary policy within Australia refers to the most active arm of the government's macroeconomic policy mix which encompasses the management of the economy's internal stability (minimal inflation and full employment) by the Reserve Bank of Australia. The RBA aims to achieve a headline inflation rate of 2 to 3% on average over the economic cycle with this formal inflation target proving to be a successful goal for managing Australia's internal stability. Although monetary policy does not directly impact employment, it can help maintain a sustainable rate of economic growth which in turn will aid the economy as a whole in achieving its economic objectives of internal balance and external balance (stable exchange rate/NFLs/external debt and import expenditure financed by export income).

The implementation of monetary policy is through the use of open market operations in the short term money market. Within this market are exchange settlement accounts (ESA) which provide a mechanism for banks to settle payments between one another when they borrow money and the RBA. The cash rate is the interest rate charged on any borrowings which is directly influenced by the RBA.

If the RBA chooses to raise cash rates, it would sell Commonwealth Government Securities (CGS) and Repurchase Agreements (Repos) in the short term money market and banks would withdraw money from their ESA to pay for them. This equates to a loss in money supply or liquidity in the money market and thus the decrease in borrowable funds increases the cash rate. An increase in cash rate forces banks to pass on the rise in borrowing costs to clients by increasing interest rates. By increasing interest rates, aggregate demand in the economy is lowered as consumers are less likely to use debt to finance consumption and are more inclined to save. This can be seen as Contractionary monetary policy as economic growth is restricted in order to achieve a sustainable level of economic growth that isn't too high causing demand-pull inflation to occur. Demand pull inflation occurs when aggregate demand or aggregate output exceeds aggregate supply and thus remaining output must be rationed amongst consumers thus increasing prices. Mortgage and interest repayments similarly increase and thus household income decreases alongside consumption. However the higher interest rates attract foreign investors, encouraging capital inflows and increasing the demand for the $AUD. This leads to an appreciation which increase import expenditure and lowers export income and international competitiveness.

By using Contractionary monetary policy, i.e. increasing cash rate to increase interest rates, aggregate demand can be controlled. Higher interest rates were implemented by the RBA in 2007 and early 2008 due to high rates of inflation due to the economy experiencing capacity constraints with unemployment at a 34 year low of 3.9%, creating a shortage of skills and driving up wage pressure. As a result demand pull inflation (high AD from high economic activity) and cost push inflation (demands for wage increases due to shortage of skills in labour force – increased price passed onto consumers) with headline inflation reaching 5% in 2008. The RBA thus had to raise interest rates from 6.25% to 7.25%, their highest levels since 1996, in an attempt to lower AD and reduce inflation.

Conversely, expansionary monetary policy applies a decrease in cash rate can be achieved by the RBA buying CGS and Repos where they deposit money into the sellers ESA and thus increase liquidity thereby decreasing the cash rate. To maintain competition between banks, interest rates would decrease across the economy and thus increase aggregate demand as higher expenditure occurs to stimulate economic activity and thus economic growth. Such action was taken at the end

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of 2008 where the RBA cut interest rates to 3% by April 2009 due to the global financial crisis which was causing a severe drop in economic growth due to the lack of credit supply. Therefore to avoid recession, expansionary monetary policy was conducted to encourage expenditure by consumers to increase AD and thus economic growth.

The RBA's employment of an inflation target band of 2-3% also anchors inflationary expectations. With a credible attempt to maintain this target through monetary policy, firms and businesses can expect that inflation will fall within this band and thus have power when negotiating wages or when setting prices for the future. This prevents cost-push inflation where wage increases are demanded without increases in labour productivity due to an expected increase in prices so that they may maintain their real wages.

Monetary policy however is not as effective in reducing the natural rate of unemployment as it is only capable of maintaining sustainable economic growth to decrease cyclical unemployment. Cyclical unemployment occurs when there has been a contraction in economic activity thus AD decreases leading to a decrease in the demand for labour causing job losses. Through the explanation of the short run Phillips Curve however it can be seen that an increase in government expenditure (expansionary fiscal policy), unemployment could be reduced at the expense of higher inflation. This would occur because as full employment is achieved there will be an increase in economic growth with a skill shortage in the economy. Growth may become unsustainable with excess AD caused by EXCESS EXPENDITURE (AD = C+ I + G + X-M) and thus remaining output must be rationed at higher prices thus causing demand-pull inflation. While wage demands may increase with this inflation in an attempt to maintain real wages and thus cause cost-push inflation, leading to a wage-price inflation spiral. The long run Phillips Curve further explains how there is no trade off in the long term as if both cost-push inflation and demand-pull inflation occurs then firms have no choice but to reduce labour in order to save costs to fund higher wages. This means unemployment remains the same and any attempt to reduce it below its natural rate would be inflationary.

Monetary policy can also affect external stability which has three goals: sustainable CAD, stable exchange rate and minimal NFLs. However monetary policy only has an effect on exchange rate. An increase in interest rates lead to positive speculation of the $AUD and thus an increase in capital inflows and a demand for the $AUD occurs. This leads to an appreciation. Conversely if interest rates decrease, a depreciation of the $AUD occurs.

Disadvantages of monetary policy that hinder its effectiveness is its time lag of 6-18 months which is LONGER THAN FP but can be IMPLEMENTED MORE QUICKLY. Because of this the RBA must be pre-emptive about conducting its monetary policy and raises interest rates before inflation is expected to increase so that it can be effectively managed.

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