

The instruments of macro-economic policy - Monetary policy

è **Monetary policy:** central bank action which seeks to promote the government economic objectives by influencing the cost and availability of money and finance.

è **The goals of monetary policy:** The RBA Act requires the central bank to use its monetary policies and its other banking powers in a manner which will 'best contribute to

- the stability of the currency of Australia' - minimum inflation & stable $x\Delta$ rate.
- 'the maintenance of full employment in Australia
- the economic prosperity and welfare of the people of Australia.' - economic growth

instruments of monetary policy - market operations

è **Market operations:** RBA sales of (previously issued) government securities to, and purchases from, authorised money market dealers for the purpose of influencing interest rates.

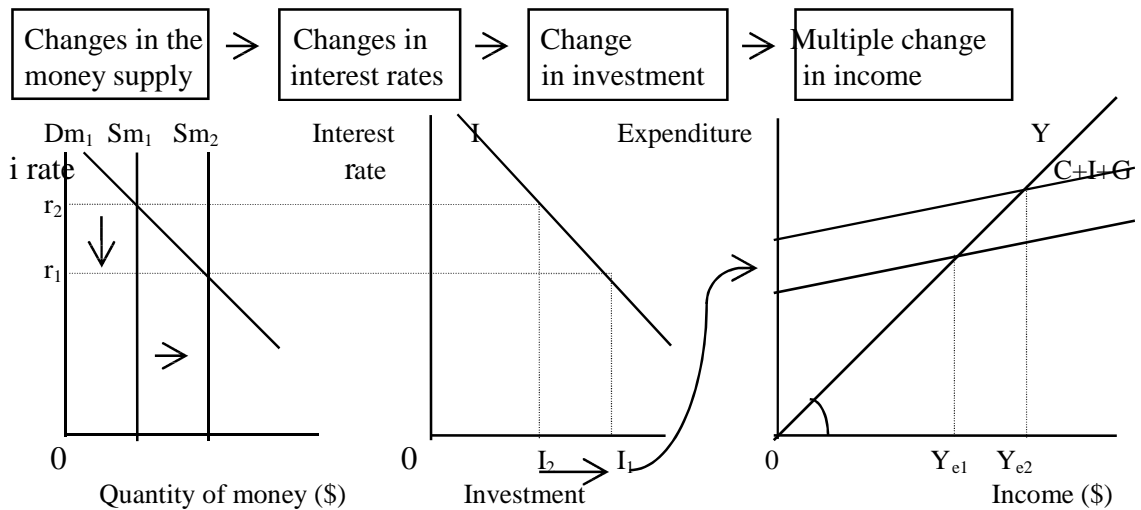
- **official short term money-market:** RBA, authorised dealers & major banks.
 - dealers compete for major banks' Exchange Settlement Funds.
 - By manipulating supply of Government securities so as to control official cash rate (the 24-hour rate in the official market), RBA able to influence interest rates in unofficial money market and subsequently all short-term interest rates in economy.
- Transmission mechanism between OMO changing interest rates, & ultimate impact on money supply: (reverse of Keynesian transition mechanism whilst maintaining indirect nature)
 1. Upward pressure on interest rates through OMO decreases demand for money
 2. decreases level of spending
 3. slows down velocity of circulation of money & reduces money supply.

Impact of interest rate & money supply changes - 2 transition mechanisms

è **Money supply:** is the volume of money which exists in the economy at any point of time.

- **Monetary aggregates:** RBA tended to focus on credit - guide to financial intermediation
 - Credit = Loans & advances by financial intermediaries + bank bills outstanding.
 - relationship between rate of credit growth and demand for G&S by private sector.

è **The Keynesian transmission mechanism:**



- Keynesians believe monetary policy is a relatively weak element of economic management:
 1. Time lags: Changes in income, output and employment are indirect.
 2. Keynesians regard investment expenditures as inelastic- interest rates only one factor

è **Monetarist transmission mechanism** - Friedman & followers' understanding of stagflation

1. inflation is linked to growth in the money supply in excess of growth in output
2. changes in money supply directly alter level of income, output & employment
 - Increase in demand encourages producers to increase supply.

Development of Australia's Monetary policy

è **The demise of monetarism: targeting of money supply 1986 - Jan 1985**

- RBA announced "conditional projections" for the money supply aggregate, M3:
- projections rarely met - RBA had limited control over its own balance sheet
- It was abandoned in Jan 1985 because the relationship between the money supply and GDP had either never existed or had broken down altogether.

Peak/Trough	Date	Unofficial Cash Rate
Peak	January 1987	16.45 %
Trough	February 1988	10.65%
Peak	November 1989	18.15%
Trough	August 1994	4.80%
Peak	August 1996	7.5%

è **Checklist:** Bob Johnson, Governor RBA: "key economic indicators viewed regularly by RBA and an 'on balance' judgement made about appropriate monetary policy"

1. state of the economy: rate of unemployment; rate of economic growth
 2. balance of payments
 3. prices
 4. monetary factors: interest rates, exchange rate, monetary aggregates
- 1980s: attainment of shortrun stabilisation objectives - growth, CAD & $x\Delta$ rate
 - Monetary policy unsuitable for CAD - unreasonable to assume transmission mechanism from interest rates to CAD is through reducing demand for imports.
 - Tight monetary policy, through effect on exchange rate, can increase CAD.
 - Monetary policy a significant factor in precipitating 1991-92 recession.

è **Low inflation: the monetary target of the 1990s.**

- End 1989, move away from checklist towards medium term anti-inflationary focus
 - Federal government committed to underlying inflation rate of 2-3%.
 - Monetary policy has become more transparent
 - changes rates announced immediately since January 1990; changes less volatile

è **The Current stance of monetary policy**

- There are three ways to examine the stance of monetary policy:
 1. Looking at slope of yield curve - difference between 10 year bond rate & 90 day bill rate.
 - Current stance of monetary policy neutral or mildly expansionary
 2. Short-term and long-term nominal interest rates over recent cycles
 - 1994 changes were contractionary, but rates have not achieved levels of recent cycles
 3. Magnitude of short-term and long-term real interest rates
 - while short-term interest rates are low compared to the recent cycle, real interest rates at the longer end of the market have been at exceptionally high levels
- These changed patterns indicate that relationships between interest rates and the economy established over previous cycles are likely no longer to hold true.
- 1995/96: non-inflationary economic growth that will help to reduce unemployment.
- July 30 1996: RBA cut official cash rate from 7.5% to 7% - suggests that inflation is under control, within the 2-3% level aimed at by the RBA.

è Rules versus discretion - an inflation target? Check-list discretionary approach?

- **Inflation target:**
 - advantage: provides a firm anchor for expectations
 - *Role of expectations* (Buckle & Stemp; Blackburn & Christensen) - target reduction in inflation harder to achieve with uncertainty about medium-term monetary policy
 - Uncertainty → tighter monetary policy → lower GDP to achieve inflation target.
 - *Time-inconsistency* (Kydland and Prescott) - monetary authority reneges on initial policy commitment at some later date, undermining its initial policy.
 - Private sector begins to factor in time-inconsistency → loss of credibility
 - disadvantage: RBA cannot intervene to reduce unemployment in a recession
- **Discretion:**
 - Advantage: RBA can intervene as circumstances require
 - *long-run neutrality of money* (vertical long-run Phillips' curve) - monetary policy does have short-run effects but there is not impact on real variables in the long-run.
 - Disadvantage: if RBA not properly informed, could worsen economic outcomes

links between monetary and fiscal policy and relative lags

è Deficit financing

- Government finances its deficit by borrowing from the RBA: money supply will increase
 - If expansion in money supply outstrips growth, inflationary pressures begin to appear.
 - monetary policy can be used to offset effect of deficit financing on money supply
- deficit is financed by borrowing from the public: RBA offset crowding out by buying bonds
- budget surplus used to retire the debt: RBA limited market sales to reduce money supply
- 1996/97 - contractionary fiscal policy government & RBA differ on effect on interest rates

è Comparative effectiveness of fiscal and monetary policy in terms of macro goals

- Time lags:
 - *recognition lag* - recognition lags similar
 - *decision and implementation lag* - Whilst the government's fiscal strategy is put in place only once a year, monetary policy can perform 'swinging instrument' role.
 - *impact lag* - usually very much longer for monetary than fiscal.
 - Contractionary Monetary policy less effective if companies draw on retained profits
 - RBA can push up general level of interest rates but has difficulty in reducing them.
- Recession:
 - Monetary policy less effective because of lengthy & loose transmission mechanism
 - Lower rates may not encourage investment if business expectations pessimistic
 - Direct increases in government expenditure will create expansion in economy.
- Demand inflation:
 - *monetary*: difficult to control quantity of money - high interest rates may work.
 - *Fiscal*: Difficult to reduce government spending in short term.
 - Increases in taxation, especially if considered temporary may not be effective as consumers borrow or draw on past savings to maintain consumption.
- Cost push inflation:
 - *monetary* relatively ineffective - reducing costs by lowering rates increases demand
 - *Fiscal*: tax cuts & investment incentives may have greater demand than cost effects.
- Political Problems:
 - *Fiscal*: spending cuts and taxation increases are very unpopular.
 - *monetary* policy has less problems than fiscal policy except for very high rates