MONETARY POLICY

CHAPTER 15

FISCAL POLICY

Multiple choice

1. **D**
2. **A**
3. **A**
4. **B**
5. **D**
6. **B**
7. **B**
8. **C**
9. **A**
10. **C**
11. **B**
12. **A**
13. **D**
14. **B**
15. **A**
16. **C**
17. **B**
18. **D**
19. **A**
20. **A**

Short answer questions

Write your answer in the space provided.

Question 1

(a) **Domestic Market Operations (DMO) is the process by which the Reserve Bank of Australia (RBA) implements monetary policy. It involves the buying and selling of buying and selling of commonwealth government securities (CGS) in the short term money market in order to influence the liquidity in the market and the interest rate on these funds – the cash rate.**

(b) **The RBA uses DMO to influence the official rate of interest in the economy, the cash rate. The cash rate forms the basis of all interest rate levels in the economy. By influencing the cash rate, the RBA can influence the general level of interest rates in the economic which will impact on economy activity. If the RBA were to increase the cash rate through the sale of CGS in the short term money market, interest rates across the economy would rise. Increased interest rates will decrease consumption by increasing servicing costs on existing loans and will also decrease investment by increasing the cost of borrowing funds – causing aggregate demand to fall and lowering the level of economic activity. Conversely, lower interest rates will increase consumption, investment, aggregate demand and thus economic activity.**

(c) **Monetary policy plays a central role in the government's policy mix. Over the last decade, monetary policy has taken the lead role in demand management and controlling inflation in the economy. The 1996 Statement on the Conduct of Monetary Policy outlined the primary goal of monetary policy in the economy - achieving an inflation target of 2-3% over the economic cycle – allowing for an increase in Australia's sustainable economic growth rate. Once the RBA feels that inflationary pressures are under control, it concentrates on ensuring adequate economic growth (3.5-4.0% on average over the course of the economic cycle). In the absence of a formal wages policy, monetary policy can also be used to indirectly control wage levels in the economy, through controlling inflation and stating its policy of ensuring moderate wage growth for fear of increased interest rates.**

Question 2

(a) **A low level of inflation is one of Australia's most stellar economic performances over the last decade. The RBA's strong commitment to its 2-3% inflation target has given Australia's low inflation throughout the last decade allowing for sustainable economic growth and making the economy somewhat of an economic "world beater".**

Australia's inflation rate remained within the RBA's target band throughout the 1990s with only two major exceptions. Strong economic growth in 1995 pushed inflation up to 5.1%, however this jump was only short lived and as the economy settled inflation once again returned to the target band. The other, more recent spike occurred following the introduction of the GST in 2000. The GST lead to a one-off inflation spike to 6.1%. Again however, this did not last more than a year, and as the economy adjusted to the new tax inflation fell. Inflation is currently above the RBA's target at 3.4%. However, this is largely a reflection of one-off and seasonal factors such as the recent drought and higher oil prices. Inflation is expected to return to within the RBA's target band over the coming year.

(b) **The RBA uses monetary policy to influence the official rate of interest in the economy, the cash rate, and to ultimately impact on the level of economic activity and inflation in Australia. The RBA uses Domestic Market Operations – the buying and selling of second-hand Commonwealth Government Securities – to influence the general level of interest rates in the economy. Higher interest rates for example, make it more expensive for investors and consumers to borrow funds, as well as increase the cost of servicing existing debts. As a result, people will consume and invest less, which decreases the level of aggregate demand in the economy. Lower levels of aggregate demand decrease economic activity in the economy, which puts downward pressure on the level of demand-pull inflation. Additionally, lower economic activity is likely to lead to reduced demand for labour which will reduce the pressures for wage rises in the economy – a key course of cost-push inflation. Additionally, the RBA's steadfast resolve to maintain low inflation helps to control inflationary expectations in the economy. Thus the RBA can use monetary policy to maintain inflation within the 2–3% target over the course of the economic cycle.**

Question 3

(a) **An interest rate differential is the difference between the two economies' interest rates in the global economy. For example, if Australia is said to have a positive interest rate differential with respect to the US, this means that the interest rates in Australia are higher than those in the US.**

(b) **An interest rate differential will have an impact on a country's exchange rate because of the effect it will have in attracting foreign capital. For example, if Australia has higher interest rates than in the US (a positive interest rate differential) then this will attract higher levels of foreign capital inflow into Australia, as foreign investors seeks to maximise the returns on their investments. These inflows will increase the demand for Australian dollars, thus causing an appreciation of the AUD.**

Question 3 continued

(c) **One of the major impacts of globalisation has been the increasing influence of the international business cycle on domestic economies. The increased integration of countries thanks to increased trade, investment and financial flows has ensured that swings in the international business cycle have a greater impact than ever before on global economies. Domestic governments can use macroeconomic policies such as fiscal policy and macroeconomic policy to stabilise the level of economic growth when a downturn occurs in the international business cycle. For example, if the international business cycle is experiencing a downturn caused by a synchronised downturn in a number of the world's major economies, a domestic government can offset this by employing expansionary macro policy. Thus, the government would decrease interest rates and increase government expenditure, resulting in increased aggregate demand in the domestic economy, offsetting the negative impact of the downturn on domestic growth. Additionally, governments such as Australia have achieved success in recent years by encouraging export markets which are highly sensitive to global economic movements to increased their dynamic efficiency. In Australia for example, our export market managed to counteract the negative impact of the Asian crisis in the mid to late 1990s by finding new export markets in Europe and South America.**