

THE MONEY SUPPLY AND INTEREST RATES



Multiple choice

1. C
2. C
3. B
4. D
5. A

Matching terms

The Reserve Bank of Australia's measure of money supply – it includes all currency and all bank deposits.	M3
Includes all currency and all deposits in banks and non-bank financial intermediaries, minus all NBFIs' holdings of bank deposits.	Broad money
The quantity of money that exists in the economy at any given point in time.	Money supply
Reserve Bank of Australia's purchases and sales of second hand government securities to banks in order to set the cash rate in the short term money market.	Domestic Market Operations
Bank funds held by the Reserve Bank.	Exchange settlement accounts
All currency plus all funds deposited with the Reserve Bank of Australia by the private sector (sometimes referred to as high-powered money).	Money base
Treasury Notes and Treasury Bonds.	Second hand government securities
The cost of borrowing.	Lending rates
The return from savings.	Borrowing rates

True or false

Select the alternative true or false that best answers the question. Place a tick in the space provided.

	True ✓	False ✓
1 Money acts as a means of deferring payments.		✓
2 The monetary base consists of currency plus deposits with banks and non-bank financial intermediaries.		✓
3 The largest component of M3 is bank deposits.	✓	
4 If consumers expect the rate of inflation to increase, nominal interest rates will also increase.	✓	
5 Monetary policy is implemented by the Federal Government.		✓
6 If the Reserve Bank of Australia purchases second-hand Commonwealth Government securities on the short term money market, the level of economic activity should fall.		✓
7 Authorised money market dealers play an important role in the implementation of monetary policy in Australia today.		✓
8 When the Reserve Bank of Australia sells second-hand government securities the result is reduced liquidity in the overnight cash market.	✓	
9 A tightening of monetary policy would lead to reduced investment demand.	✓	
10 A sustained decrease in Australian interest rates would increase the level of economic activity and reduce the level of employment.	✓	

Short answers

Question 1

- (i) A fall in wages will reduce the savings in an economy, reducing supply of loanable funds and hence the rate of interest.
- (ii) This will reduce savings, as people keep money for transaction purposes, requiring banks to increase interest rates to attract loanable funds from consumers.
- (iii) This will reduce the supply of funds in Aust as money is sent overseas where there is higher return. This will result in an increase in interest rates

Question 2

A change in interest rates will impact upon the spending and saving decisions of individuals. An increase in official rates will encourage consumers to increase their savings, and reduce the spending which is dependent upon borrowing (eg houses, cars, or the use of credit cards). This will result in a fall in aggregate demand, a fall in producer output and hence a fall in GDP or the level of economic activity.

Question 3

Market operations refers to the buying and selling of second hand securities by the RBA to influence interest rates.

Deficit financing refers to the sale of new securities by the government to pay for a budget deficit.

Question 4

The cash rate is the foundation rate of interest in the economy. Any change will mean banks will bear a higher or lower cost in short-term borrowing. To maintain their profit margins they will adjust their retail rates accordingly.

Question 5

- a) According to the table, what is the value of:
 - i) The money base **65**
 - ii) M3 **345**
 - iii) Broad money **475**
- b) Advantage: Includes all deposits with financial institutions, and so is an accurate measure of money supply
Disadvantage: It is a complex figure to calculate and takes a long time to compile