In February 2014, the Reserve Bank of Australia (RBA) cash rate was 2.50%. In February 2017, it was 1.50%.

Explain how the transmission mechanism would operate to affect the level of economic activity because of this monetary policy stance. (12 marks)

Monetary Policy refers to to the interest rate decisions taken by the Reserve Bank of Australia to affect monetary and financial conditions within the economy with the aim of achieving the governments macroeconomic reforms of price stability and sustainable economic growth. The current monetary policy stance is expansionary as the cash rate is at 1.5% and any cash rate being below 3% is considered to be expansionary. Changes in the cash rate influence the expectations of the private sector and the level of domestic demand in the economy. How changes in interest rates affect the level of the level of economic activity in the economy is referred to as the transmission mechanism. Through the transmission mechanism Australias level of economic activity will increase as interest rates are lowered.

Changes in interest rates affect the spending decisions of both households and business firms (i.e consumption and investment). The savings investment channel of the transmission mechanism will affect consumer consumption and saving as well as firms level of investment. The low interest rate of 1.5% reduces the appeal to save as returns are significantly lower. As a result of this the cost of borrowing also has decreased reducing the cost of consuming and increases consumers purchasing power. As a result this tends to lead to reduce savings and increase consumptions. For domestic firms/business's the cost to borrow will have reduced and since business's often borrow to invest the decrease in the cash rate will lower the cost of borrowing and make firms more inclined to invest. Low interest rates will have a positive effect on private spending, especially durable and consumption and investment spending. These changes are aimed to stimulate the economy.

Changes in the cash flow channel will significantly impact both household and firms. For existing loans such as mortgages the cost of repayment decreases due to the cut in the cash rate to 1.5%, this also causes interest rates to decrease. After loans are paid off households have more disposable income which increases households cash flow and purchasing power and usually raises consumption levels. A fall in interest rates will decrease the cost of borrowing funds and repaying loans and increase the disposable income of households and the cash flow of firms.

The asset/wealth channel of the transmission mechanism will positively impact households who own properties and shares as the cost of borrowing is less when the interest rates are low. This increases the demand for purchasing homes when the cash rate is at 1.5% and will increase asset prices. As interest rates decrease the risk associated with purchasing assets decreases causing the assets to increase in value, thus resulting in the owners of the assets being more inclined to consume, ceteris paribus. This will help stimulate the economy as consumptions levels will increase increasing firms cash flow.

The exchange rate channel of the transmission mechanism will be impacted by the change in the cash rate to 1.5% through the expansionary stance taken up by the RBA. The low interest rate of 1.5% will cause the Australian dollar to depreciate as there will be a decrease in capital inflow and/or an increase in capital outflow as domestic holders of excess funds seek higher interest rates overseas as they will get a higher return. A lower AUD will help stimulate net exports and decrease net exports. A low interest rate will reduce Australia's interest rate differential, portfolio investment (investment of less then 10% ownership) will reduce in Australia as it becomes more appealing to invest elsewhere. The decrease in credits recorded in the financial account of Australia's balance of payments reflects the decrease in demand in the AUD and explains why there is a depreciation. Despite the value of the AUD depreciating Australias economic activity will be stimulated due to the J curve effect.

When in an expansionary stance the four transmission channels of the transmission mechanism will increase investment, consumption and net exports. These all increase aggregate demand in the economy due to the expansionary stance designed to stimulate economy activity.

Explain the concept of net foreign liabilities and distinguish between Australia's two main foreign liabilities.(10 marks) book

Foreign investment transactions involve changes in the levels of Australian foreign assets and liabilities. Net foreign liabilities is the difference between total foreign liabilities and total foreign assets. Foreign liabilities is the stock of foreign investment into Australia(FIA), while foreign assets is the stock of Australia's investment abroad (AIA). Foreign liabilities are created when Australian residents borrow money from overseas or sell assets such as shares to overseas residents. Foreign assets are created when Australian residents lend money to foreign residents or purchase foreign assets. Australia's two main foreign liabilities are debt and equity

Net foreign liabilities is foreign investment into Australia take Australian investment abroad. Both FIA and AIA have been increasing since 1991 but FIA has been increasing at a faster rate with it rising from 75% of GDP to 186% by 2015 compared to AIA which increased from 28% of GDP in 1991 to 130% by 2105. Net foreign liabilities increase each year because there is a net inflow of capital which account for the financial account surplus or the current account deficit.

Foreign debt is the amount money that Australian residents, both the public (25%) and private (75%) sector owe to the rest of the world. Examples of debt include government securities issued to overseas residents and borrowing by Australian firms from overseas financial institutions. Currently all of Australia's net foreign liabilities are in the form of foreign debt. Australia's net foreign debt is approximately $1000 billion.

Foreign equity represents the extent to which foreign residents own Australian assets. Australia's net foreign equity is -$25 billion AUD which means that Australia has a positive net equity asset position. A positive net equity position means that Australia owns more assets overseas than overseas residents own of Australia's assets.

Explain why Australia has a high level of foreign debt and the effect this has on the current account in the balance of payments. (10marks)

The balance of payments is a systematic record of all economic transitions between the residents of Australia and the rest of the world. The B.O.P has two main accounts the Current account and the Capital and financial account. These two accounts offset each other so the overall balance is zero. For example if the financial and capital account had a surplus then the current account would have to record a deficit.

Foreign debt is the amount money that Australian residents, both the public (25%) and private (75%) sector owe to the rest of the world. Australia has a high level of foreign debt because of Australia's savings-investment gap. Australia has a small population and overseas funding to help close this gap. Australia records current account deficits and/or financial account surpluses because its investment is significantly greater than its savings. Australias collection of the current accounts deficits over the recent years represents the amount of net foreign liabilities. All of Australia's net foreign liabilities are in the form of foreign debt this is because Australia's net foreign equity position is positive. A positive net equity position means that Australia owns more assets overseas than overseas residents own of Australia's assets.

Each year the capital and financial account records a surplus, thus causing the current account to record a deficit. This increases the amount of foreign liabilities (which consists of both foreign debt and foreign equity). The Australian government funds its budget deficit by borrowing thus increasing foreign investment in Australia. The government sector has recorded a series of deficits since the global financial crisis in 2008. The government/public sector now accounts for around one quarter of Australia's foreign debt. The private sector predominantly opts to borrow from overseas residents rather then sell assets to obtain funds which increases foreign debt. The private sector accounts for approximately 75% of Australias foreign debt.

Australia's high level of foreign debt effects the current account through the servicing costs (interest and dividends) associated with foreign liabilities, this results in a large primary income deficit in Australias current account. Another effect Australia's high level of foreign debt has on the current account is the interest paid by Australia for foreign debt and dividend for foreign equity. These payments further increase the income deficit of the current account increasing the current account deficit. Since Australia has a high level of foreign debt, net income will always be in a deficit causing the current account to always be in deficit.