Monetary Policy

Wednesday, 23 October 2019 7:51 PM

Definition

- The RBA's ability to influence the levels of economic activity through manipulation of the cash rate
- The cash rate refers to the rate at which the banks trade exchange settlement funds in the overnight money market

The Transmission Mechanism

- The mechanisms through which a cash rate change is filtered through the economy through changes in aggregate demand
    - Cost of Borrowing (Investment)
    - Household cash flow (Consumption)
    - Asset prices (Consumption)
    - Exchange rate (Net exports)

Cash Rate changes

1. At the monthly governors meeting the Reserve bank sets a new cash rate
2. The RBA engages in open market operations (OMO) in the short term money market
3. The RBA then buys or sells Commonwealth government securities to impact the liquidity in the overnight money market
    - Cash rate increase= Selling CGS
    - Cash rate = Buying CGS
4. The banks will then respond by changing the retail rate of funs (Note: They are not legally obligated to so)
5. The transmission channels carry the interest rate change into the economy
6. Aggregate demand shifts

Strengths	**Weaknesses**
Effective at contracting the economy	Ineffective as an expansionary policy
Short decision lag	Long impact lag
Independent authority	Cannot target individual sectors