Year 12 Economics ATAR

Unit 4

Monetary Policy Decision

Description of task	Students will read a statement about a monetary policy decision from Phillip Lowe, Reserve Bank of Australia (RBA) Governor. Students then answer a series of questions related to the extract.
Assessment Conditions	Students will have 25 minutes to answer all questions. 12 marks in total.
Content from the Year 12 Economics ATAR curriculum	**Monetary policy** • the concepts of monetary policy and the cash rate • circumstances under which the RBA may change the cash rate • the impact of different monetary policy stances on the level of economic activity
Economic Skills	• Economic Reasoning and Interpretation • Communication

Task preparation

Prior learning	Students are familiar with the following economic knowledge and understandings: • how monetary policy affects the level of economic activity i.e. the transmission mechanism • the concepts of expansionary, contractionary and neutral monetary policy stances • strengths and weaknesses of monetary policy • contemporary (the last three years) monetary policy stances in Australia

Assessment task

Resources	**" Statement by Philip Lowe, Governor: Monetary Policy Decision "** by Phillip Lowe, Reserve Bank of Australia, and published on 3 May 2022. Retrieved May 2022, from https://www.rba.gov.au/media-releases/2022/mr-22-12.html

Data interpretation/Short answer **(12 marks)**

Read the following extract of a statement from Phillip Lowe, Reserve Bank of Australia (RBA) Governor and answer the questions that follow.

Statement by Philip Lowe, Governor: Monetary Policy Decision

3 May 2022

At its meeting today, the Board decided to increase the cash rate target by 25 basis points to 35 basis points. The economy has proven to be resilient.

The resilience of the Australian economy is particularly evident in the labour market, with the unemployment rate declining over recent months to 4 per cent and labour force participation increasing to a record high. Both job vacancies and job ads are also at high levels. The central forecast is for the unemployment rate to decline to around 3½ per cent by early 2023 and remain around this level thereafter. This would be the lowest rate of unemployment in almost 50 years.

The outlook for economic growth in Australia also remains positive, although there are ongoing uncertainties about the global economy arising from: the ongoing disruptions from COVID-19, especially in China; the war in Ukraine; and declining consumer purchasing power from higher inflation. The central forecast is for Australian GDP to grow by 4¼ per cent over 2022 and 2 per cent over 2023. Household and business balance sheets are generally in good shape, an upswing in business investment is underway and there is a large pipeline of construction work to be completed. Macroeconomic policy settings remain supportive of growth and national income is being boosted by higher commodity prices.

Inflation has picked up significantly and by more than expected, although it remains lower than in most other advanced economies. Over the year to the March quarter, headline inflation was 5.1 per cent and in underlying terms inflation was 3.7 per cent. This rise in inflation largely reflects global factors. But domestic capacity constraints are increasingly playing a role and inflation pressures have broadened, with firms more prepared to pass through cost increases to consumer prices. A further rise in inflation is expected in the near term, but as supply-side disruptions are resolved, inflation is expected to decline back towards the target range of 2 to 3 per cent. The central forecast for 2022 is for headline inflation of around 6 per cent and underlying inflation of around 4¾ per cent; by mid-2024, headline and underlying inflation are forecast to have moderated to around 3 per cent. These forecasts are based on an assumption of further increases in interest rates.

Wages growth has been picking up. In a tight labour market, an increasing number of firms are paying higher wages to attract and retain staff, especially in an environment where the cost of living is rising. While aggregate wages growth was subdued during 2021 and no higher than it was prior to the pandemic, the more timely evidence from surveys is that larger wage increases are now occurring in many private-sector firms.

Given both the progress towards full employment and the evidence on prices and wages, some withdrawal of the extraordinary monetary support provided through the pandemic is appropriate.

The Board is committed to doing what is necessary to ensure that inflation in Australia returns to target over time. This will require a further lift in interest rates over the period ahead. The Board will continue to closely monitor the incoming information and evolving balance of risks as it determines the timing and extent of future interest rate increases.

[Reserve Bank of Australia. (2022). *Monetary Policy Decision* [Excerpt from the RBA Governor Philip Lowe statement]. Retrieved May, 2022, from https:// https://www.rba.gov.au/media-releases/2022/mr-22-12.html]

Questions

a) Explain the concept of the ‘cash rate’. (2 marks)

b) With reference to economic information and data, discuss the economic circumstances as to why the Reserve Bank of Australia increased the cash rate. (5 marks)

c) With the aid of the aggregate demand/aggregate supply model, explain the likely impact of the recent increase in the cash rate on the Australian economy. (5 marks)

Model

Marking key

a) Explain the concept of the 'cash rate'. (2 marks)

Description	Marks
Explains the concept of the cash rate by outlining the influence it has on the Australian economy.	2
Provides a basic definition of the cash rate	1
Total	**2**
Answer	
The cash rate is the interest rate on overnight loans in the money market. The RBA changes the cash rate which indirectly affects interest rates and the level of spending in the Australian economy.	

b) With reference to economic information and data, explain the economic circumstances as to why the Reserve Bank of Australia increased the cash rate. (5 marks)

Description	Marks
Circumstances where the RBA changes the cash rate	
Explains the economic circumstances as to why the Reserve Bank of Australia increased the cash rate.	3
Describes the economic circumstances as to why the Reserve Bank of Australia increased the cash rate.	2
Identifies a reason why the Reserve Bank of Australia increased the cash rate.	1
Subtotal	**3**
Reference to economic information and data	
Using the data makes reference to **two** reasons why this latest change in the cash rate may have occurred	2
Using the data makes reference to **one** reason why this latest change in the cash rate may have occurred	1
Subtotal	**2**
Total	**5**
Answer	
• The Reserve Bank Board decided to increase the cash rate by a quarter of a percentage point to 0.35%. This is the first time there has been a change in the cash rate since November 2020. • Explains that monetary policy is implemented with a medium-term outlook in mind – expectations about the future. The Reserve Bank increases the cash rate when the economy expands too fast and inflation rises above the target range of 2–3%. • Explains in detail the circumstances where the RBA changes the cash rate with reference to the objectives of monetary policy – stability of the currency, maintenance of full employment and economic prosperity and welfare. • The Reserve Bank increases the cash rate when the economy is expanding, unemployment falls and inflation is increasing. This is when inflation is above the target range (>3%), the economy is growing above the long run average rate of growth (>4%), when actual GDP is exceeding potential GDP, or when unemployment is below the NAIRU (<4.5%).	

Reference to economic information and data • Unemployment: Unemployment rate to decline to around 3½ per cent by early 2023 • Economic growth: Australian GDP to grow by 4¼ per cent over 2022 and 2 per cent over 2023 • Inflation: Headline inflation was 5.1 per cent and in underlying terms inflation was 3.7 per cent. The central forecast for 2022 is for headline inflation of around 6 per cent and underlying inflation of around 4¾ per cent; by mid-2024, headline and underlying inflation are forecast to have moderated to around 3 per cent. The decision was taken to support employment growth and to provide greater confidence that inflation will be consistent with the medium-term target of 2–3%. Currently: • inflation pressures are high driven by global factors (ongoing disruptions from COVID-19, especially in China; the war in Ukraine) • wages growth is starting to increase in the private sector

c) With the aid of the aggregate demand/aggregate supply model, explain the likely impact of the recent increase in the cash rate on the Australian economy. (5 marks)

Description	Marks
Increase in the cash rate	
Explains in detail the expansionary impact on the economy (due to controlled inflation and increased certainty allowing for increased consumption spending and investment by individuals and businesses), with reference to a range of economic indicators, i.e. growth, inflation, unemployment, trade balance, exchange rate, terms of trade.	3
Describes the medium term expansionary impact on the economy (due to controlled inflation and increased certainty allowing for increased consumption spending and investment by individuals and businesses), with reference to some economic indicators.	2
Identifies the contractionary impact, with reference to the increased cost of borrowing.	1
Subtotal	**3**
Using the AD/AS Model to analyse the RBA's policy stance	
Provides a correctly-drawn and fully-labelled diagram showing the AD curve shifting to the right resulting in a rise in real GDP and an increase in price pressure over time. The diagram links to the description	2
Provides a diagram showing the correct shift in the AD curve. The diagram is not fully-labelled or linked explicitly to the description	1
Subtotal	**2**
Total	**/5**

Answer

The cash rate is 0.35%. This is the first time there has been a change in the cash rate since November 2020. Despite the increase in the cash rate, interest rates are historically very low and it can be assumed that the RBA still has an **expansionary monetary policy stance.**

Explains in detail the expansionary impact on the economy (due to controlled inflation and increased certainty allowing for increased consumption spending and investment by individuals and businesses), with reference to a range of economic indicators, i.e. growth, inflation, unemployment, trade balance, exchange rate, terms of trade.

An expansion occurs when growth in real GDP increases above trend or when real GDP increases towards potential GDP.
A diagram to show the AD, SRAS and LRAS curves intersecting at potential GDP
An increase in AD can cause a business cycle expansion. The AD demand curve would shift to the right from AD1 to AD2 – the short run equilibrium would move towards the right in line with the LRAS curve from Y1 to Yp. Real GDP and the price level (inflation) would rise (P1 to P2) and unemployment would fall.

AD/AS model