SUMMARY OF RECENT TRENDS IN MONETARY POLICY

During the period April to July 2011, the RBA board maintained that the *'current mildly restrictive stance was appropriate'* so there was no need to raise the cash rate; however, they remained focused on inflation saying *'in future meetings, the Board will continue to assess carefully the evolving outlook for growth and inflation'.*

When the bank met in August 2011, they were faced with a dilemma – inflation for the June quarter had risen to 3.6% - outside of the RBA's 'comfort zone' but there was also another round of economic uncertainty in the global economy and financial markets. *'At today's meeting, the Board considered whether the recent information warranted further policy tightening. On balance, the Board judged that it was prudent to maintain the current setting of monetary policy (mildly restrictive), particularly in view of the acute sense of uncertainty in global financial markets over recent weeks. In future meetings, the Board will continue to assess carefully the evolving outlook for growth and inflation'.*

By November 2011 inflation had slowed and the RBA considered it appropriate to begin easing interest rates – and the policy stance became more neutral. This was followed by another rate cut of 0.25% the following month (December 2011) mainly due to concerns regarding financial uncertainty in Europe and the possible flow-on effects on Australia's economy.

Five months later, in May 2012, the RBA had concerns regarding the outlook for Australia's economy *'new information had led the Bank to lower somewhat its assessment of the pace of growth of the economy…….. Members noted that interest rates faced by the general community had tended to increase a little since the Board's previous change to the cash rate in December. They judged it to be desirable that interest rates move below those that had prevailed in December. Accordingly, the Board decided that a reduction of 50 basis points in the cash rate was, in this instance, necessary in order to deliver the appropriate level of borrowing rates'.* Financial institutions had not passed on the full rate cuts from November and December 2011 – arguing that debt on international markets was costing them more due to the financial crisis in Europe. The RBA therefore took a decisive step in reducing the cash rate by 0.50% - they had not altered the cash rate by more than 0.25% since February 2009. MP became expansionary.

The RBA followed quickly with another rate cut of 0.25% in June 2012. '……*clear evidence suggesting a softening in global conditions, and uncertainty about the future in Europe had increased significantly. ….. and with inflation expected to remain in the lower part of the targeting range over the next year or so, members considered that there was scope for monetary policy to be a little more supportive of domestic activity…… a reduction in the cash rate of 25 basis points, combined with the earlier reductions, would mean that monetary policy would be providing a measure of stimulus that would be expected to flow through to the domestic economy over the coming months'.*

Rates were once again cut in October 2012 by 25 basis points to 3.25%, followed by an equal cut in December 2012 to 3.00%, returning to the 50 year low seen in 2009.
These cuts were prompted by a softening labour market, subdued non-resource investment and lending rates clearly below their medium term averages. As inflation was within the target range, the RBA saw that monetary policy could be accommodative and provided support to demand.

The RBA kept rates on hold until May 2013 when they were reduced to 2.75%, a cut of 25 basis points. As growth was expected to be below trend, credit growth subdued and the inflation outlook had been revised down slightly, the Board saw this reduction appropriate to help encourage sustainable growth.

A further reduction to a record low of 2.50% occurred in August 2013. "…with growth expected to remain below trend for longer and inflation to remain within the target even with the effects of a lower exchange rate, members concluded that a lower level of the cash rate would better contribute to achieving sustainable growth in demand consistent with the inflation target."

QUESTION 3

(a) List the reasons given by the Governor of the RBA for lowering the cash rate since May 2012.

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(b) Describe the current stance of Monetary Policy.

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THE RBA AND THE EXCHANGE RATE (DIRTY FLOAT)

Australia has a floating exchange rate where the value of the Australian dollar is determined by the forces of supply and demand in the foreign exchange market (FOREX). Although the RBA does not normally interfere with these market forces, it will, on occasions, implement a 'dirty float' to influence the value of the currency. It may do this to smooth fluctuations if there are extreme levels of market speculation, or erratic changes in the currency which may lead to high levels of uncertainty in international transactions.

- If the RBA believes there is an unacceptable fall in the AUD and it wishes to increase the value of the Australian dollar (AUD), it would buy AUDs in the FOREX using foreign currencies from its foreign exchange reserves. Increased demand for the AUD relative to supply will cause an appreciation of the AUD.

- If the RBA wishes to reduce the value of the AUD due to an unacceptable rise, it will sell AUDs, exchanging them for foreign currencies. The increased supply of AUDs relative to demand will result in a depreciation of the AUD.

PERSUASION

The RBA may attempt to influence indirectly the direction and levels of lending by financial institutions by making public comment in the media. On some occasions, it may try to talk up lending and spending; on other occasions, it may try to talk down activity. In these situations, businesses and banks are likely to respond.

INTEREST RATES AND THE AUD

The level of interest rates has an **indirect** influence on the exchange rate. The RBA recognises that when it changes the cash rate, it will also influence the exchange rate. The RBA does not, however, use the cash rate to target or deliberately alter the exchange rate.

- High interest rates (especially if they are relatively higher than those overseas) attract capital inflow due to the higher rate of return on:

  - Interest earning investments such as bonds.
  - Loans to Australian banks and companies.
  - Funds from overseas must be swapped for AUDs in the FOREX creating demand for AUDs, appreciating the AUD.

Currency on the hop *The Age* May 23, 2012

One reason for the stronger Australian dollar is our relatively high interest rates. When interest rates around the rest of the world are low, global capital chases high interest rates, which helps support our dollar

MONETARY POLICY AND DOMESTIC ECONOMIC STABILITY

Monetary policy is considered the main macroeconomic policy used to achieve domestic stability (the simultaneous achievement of low inflation, strong and sustainable economic growth, full employment) and is used in a counter-cyclical manner.

- The primary focus of monetary policy is the achievement of **low inflation** (2-3% CPI per annum on average over the business cycle – 7-10 years). This is achieved by increasing interest rates when inflation is rising.

- **Using Monetary Policy to achieve low inflation.**

  When demand runs ahead of the economy's productive capacity there will be demand inflation pressures. Shortages result in consumers bidding up prices and may allow firms to widen profit margins and for workers to demand higher wages.

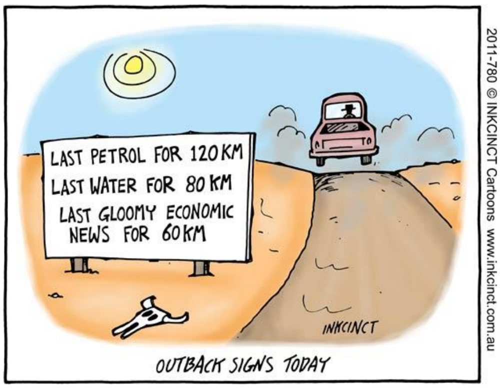
  The RBA will adopt a contractionary stance. An increase in interest rates will decrease AD and therefore reduce some of the demand inflationary pressures in the economy, helping to achieve low inflation. The RBA will try to increase interest rates before the price pressures arise (pre-emptive approach).

- **Using Monetary Policy to achieve strong and sustainable economic growth and full employment.**

  In times of an economic downturn or recession, the RBA will turn its focus to the achievement of strong and sustainable growth and full employment. If inflation is under control, they will adopt an expansionary stance and lower interest rates to stimulate spending and AD. As a result, production increases and more labour is employed. This helps to achieve strong growth and full employment.

MONETARY POLICY AND OTHER ECONOMIC GOALS

NOTE: The study design makes mention only of domestic economic stability – students are not required to have knowledge of Monetary Policy and the goals of external stability and equity in the distribution of income. The management of these goals is not considered to be a part of the role of current MP although policy changes may have some impact on these goals.



EVALUATION OF MONETARY POLICY

STRENGTHS

- **Short implementation lag** – A change in the cash rate occurs immediately following the RBA board meeting and flows through to the retail financial sector quickly. Interest rates usually change within a few days of an RBA announcement.

- **Flexible** – The RBA meets monthly to decide if the cash rate should be changed. Incremental changes can be made frequently in order to fine–tune policy stance.

- **No political constraints** – The RBA operates outside the political sphere and makes its decisions independently of the government. MP is not affected by the political cycle.

- **Pre-emptive approach** – The RBA has successfully kept inflation under control since 1990 by adopting a pre-emptive approach. They set an inflation target and carefully monitor economic data in order to implement policy changes to subdue inflationary pressures before they get out of control.

WEAKNESSES

- **Blunt instrument** – Unlike budgetary policy, it is unable to discriminate between sectors. An increase in interest rates will affect all borrowers - businesses and consumers – which may not be desirable.

- **'Psychological' constraints** – Changes in interest rates attempt to influence the way in which individuals and business react. If consumer and business confidence is high, rises in interest rates may not have the desired effect. Low interest rates may not increase borrowing and spending if confidence is low.

- **Long impact lag** – There can be up to 9-18 months delay before an interest rate change affects economic activity – by which time economic conditions may have changed resulting in the policy acting pro-cyclically instead of counter-cyclically.

- **Conflict** – High interest rates reduce demand inflation but increase cost inflation.

- **Liquidity problems** – As a result of the GFC, there has been a shortage of funds available for financial institutions. This may limit the response of banks to changes in the cash rate. The availability and cost of funds globally is now a factor influencing the movement of home-loan, personal and business interest rates. This has been particularly evident in recent years where increases in interest rates have at times, been greater than the increase in the cash rate and cuts to the cash rate have not been passed on in full by financial institutions.

QUESTION 4
Which of the following is most likely to lead to the Reserve Bank of Australia decreasing interest rates?

A A decrease in demand for consumer products and rising unemployment.
B Capacity constraints and rising inflation.
C High levels of consumer and business confidence.
D A depreciation of the Australian dollar.

QUESTION 5
Decreasing the cash rate in the money market is likely to lead to:

A Increased interest rates and more borrowing.
B Increased interest rates and less borrowing.
C Decreased interest rates and more borrowing.
D Decreased interest rates and less borrowing.

QUESTION 6
If the Reserve Bank of Australia wishes to tighten monetary policy, it would:

A Buy government securities and raise the cash rate.
B Buy government securities and lower the cash rate.
C Sell government securities and raise the cash rate.
D Sell government securities and lower the cash rate.

QUESTION 7
A tightening of monetary policy in Australia is most likely to occur if the:

A Exchange rate suddenly appreciates.
B Unemployment rate significantly increases.
C Size of the budget surplus increases.
D Rate of inflation moves above the RBA’s target range.

QUESTION 8
If the RBA wishes to stimulate economic growth it would:

A Decrease personal income taxes.
B Increase interest rates.
C Increase government spending on infrastructure.
D Decrease interest rates.

QUESTION 9 (VCAA 2011 examination Question 3c)
Discuss how consumers becoming more cautious might influence the RBA when setting the cash rate.

4 marks

QUESTION 10 (VCAA 2016 – QUESTION 3B)
Analyse, with reference to the cash flow transmission mechanism/channel and the exchange rate transmission mechanism/channel, how cuts in official interest rates might operate to assist in the achievement of the goal of full employment.

Cash flow mechanism:

Exchange Rate Mechanism:

6 marks

BUDGETARY (FISCAL) POLICY

DEFINITION

Budgetary policy refers to changes in the level (amount $) and composition (type) of government revenue (receipts) and expenses (outlays). It is:

- Implemented through the annual federal budget announced in May each year by the Federal Treasurer. The budget outlines the anticipated revenue and expenses for the forthcoming financial year. The government may also use mini-budgets to implement changes at other times and adjust budgetary policy.

- A macroeconomic demand-management policy instrument.

AIMS OF BUDGETARY POLICY

The overriding goal of budgetary policy is to improve the welfare or living standards of all Australians, or to achieve the most efficient allocation of the nation's resources. It is used to assist in the achievement of ALL economic goals, which will clearly help to boost economic prosperity and welfare for all Australians.

The fiscal strategy involves the government layout out a plan for how it intends to meet its goal and how this budget is 'sustainable' over time in its ability to promote the economic prosperity and welfare of Australians.

The **'medium term fiscal strategy'** is to achieve budget surpluses, on average over the course of the economic cycle. The key elements of the strategy are for the government to:

- Invest in a stronger economy by investing to boost productivity & workforce participation.

- Maintain strong fiscal discipline to reduce government's share of economy to free up resources for private investment to create jobs & boost economic growth.

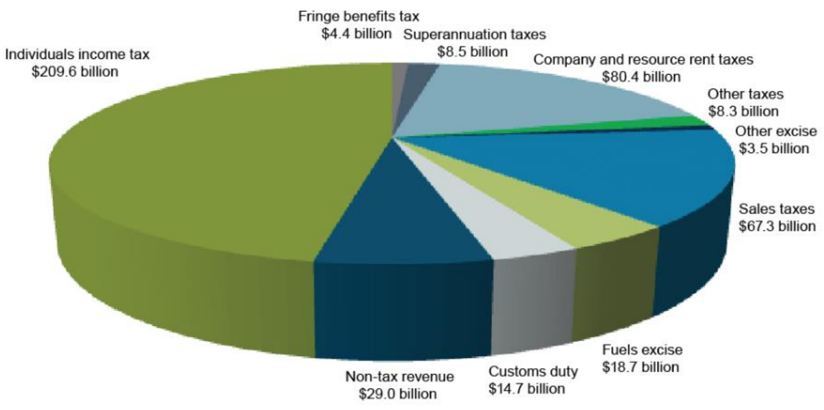
- Strengthen the government's balance sheet by improving net financial worth.

Source: www.heraldsun.com.au

BUDGET REVENUE & OUTLAYS

Budget Revenue (Receipts)	Budget Outlays (Expenses)
Tax revenue (around 92% of total revenue) **Direct Taxes, E.g.** • PAYG income tax. • Company Tax. • Capital gains tax . • Medicare Levy. • MRRT (Minerals Resource Rent Tax). **Indirect Taxes, E.g.** • Carbon Tax. • Excise duty. • Tariffs. **Non-tax revenue:** Currently raises around 8% of total revenue and includes money earned from licence revenue (E.g. TV licences); petroleum royalties; profits from government Business Enterprise such as Australia Post; repayment of HECs loans by students.	**Types of expenses** include spending on health, education, transport & communication, housing and community amenities, general public services, public debt interest on borrowings). These are classified as either G1 or G2. • **G1:** Government Consumption expenditure. NOTE – G1 includes all defence expenditure. • **G2:** Government Capital expenditure. • **Social Welfare Payments** (Transfer payments). **NOTE:** Asset sales associated with privatisation – sale of government owned businesses to the private sector – are included in expenses as a 'negative outlay'.

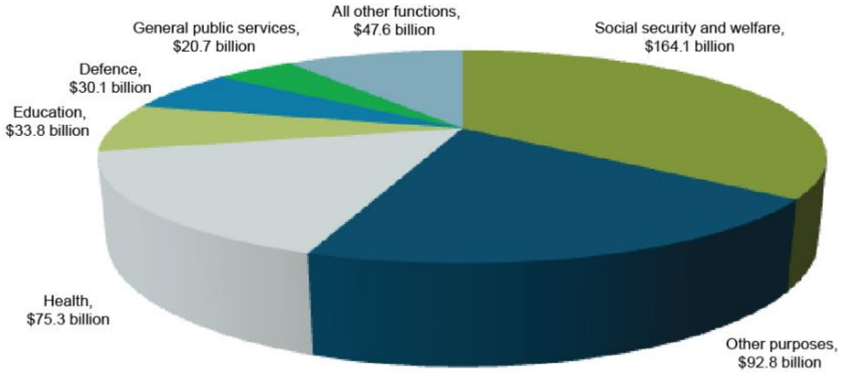
Where revenue comes from (2017-18)



The three main sources of revenue are:

- ____
- ____
- ____

Where taxpayers' money is spent (2017-18)



The three main areas of expenses are:

- ____
- ____
- ____

Source: Budget Overview www.budget.gov.au

TYPES OF TAXES

Taxes can be categorised in two ways. They may be:

(a) Direct or Indirect.
(b) Progressive, Regressive or Proportional.

DIRECT TAX

The person on whom the tax is levied bears (or pays) the tax. For example: Personal income tax, company tax.

INDIRECT TAX

- The tax is levied on one person who passes it onto another to pay. For example: the GST, excise duties, carbon tax.

- The tax is levied on producers or businesses who pass the cost on to consumers in their prices.

PROGRESSIVE TAX

- As income increases, the percentage of total income paid in taxation increases. This type of tax narrows the gap between the rich and the poor and helps to achieve the government's goal of equity in the distribution of income.

- Examples include personal income tax, capital gains tax.

- If tax rates are not adjusted, bracket creep (fiscal drag) may occur – as incomes increase, taxpayers are 'pushed' into higher tax brackets and this increases their average rate of tax payable.

PERSONAL INCOME TAX RATES AND THRESHOLDS

From 1 July 2012		From 1 July 2016	
Taxable income ($)	**Rate (%)**	**Taxable income ($)**	**Rate (%)**
0 – 18 200	0	0 – 18 200	0
18 201 – 37 000	19	18 201 – 37 000	19
37 001 – 80 000	32.5	**37 001 – 87 000**	32.5
80 001 – 180 000	37	**87 001 – 180 000**	37
180 001+	45	180 001 +	45

*As part of the 2014-15 Federal budget the Government announced that it will impose a temporary Budget Repair levy of 2% on that part of a person's taxable income which exceeds $180,000 and this will end in July 2017.

The Government will assist households through an $8 billion tax reform package including $7 billion of tax cuts. In 2012, people will pay less tax because the Government will more than triple the tax free threshold from $6,000 to $18,200.

As a result, from 1 July 2012, taxpayers with income below $80,000 will all get a tax cut, with most receiving at least $300 a year, and up to one million additional Australians will be freed from having to lodge a tax return. A higher tax free threshold and tax cuts mean more money in people's pocket from week to week and better returns for work. The tax cuts will benefit low-income workers in particular, including part-time secondary earners and those returning to the workforce. For example, someone earning $20,000 will get $600. Someone earning $25,000 will get $500 and someone earning $30,000 will get $300 in tax cuts.

From http://www.cleanenergyfuture.gov.au/household-assistancesupporting/

QUESTION 11
Using the information on the previous page (table and paragraph) showing changes to personal income tax rates from July 2016. Describe the impact of the changes on high income earners to the impact on low income earners and the distribution of income.

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REGRESSIVE TAX

- Low income earners pay a higher proportion of their income in tax than high income earners.

- This type of tax widens the gap between the rich and the poor, resulting in income being distributed less evenly.

- Examples include the carbon tax, GST, excise duties.

FOR EXAMPLE: The purchase of a TV for $1100 would include GST of $100. The $100 GST represents a larger proportion of a low income compared to a high income.

QUESTION 12
A progressive tax is one where:

A As income rises, the proportion of income paid in tax increases.
B Higher income earners pay more tax than lower income earners.
C As income decreases, less tax is paid.
D As income decreases, the proportion of tax paid is the same.

PROPORTIONAL TAX

- The rate of tax remains constant regardless of income. It has a neutral affect on income distribution.

- Example is company tax, which is levied at a constant rate of 30% of profits.

- Another example was the MRRT (Minerals Resource Rent Tax) – announced in the 2010-11 budget, which is a 30% tax on mining (iron-ore & coal) company profits above a ‘normal’ return on capital invested. It took effect from 1 July 2012 and was abolished as of 1 July 2014.

TYPES OF BUDGET OUTCOMES

- **Balanced Budget** – Revenue equal to expenses.
- **Surplus Budget** – Revenue greater than expenses.
- **Deficit Budget** – Revenue less than expenses.

It is important to remember that the revenue and expenses announced in the budget are estimates and unforseen circumstances will alter the values estimated.

There are different ways of measuring the budget outcome:

HEADLINE CASH BALANCE

- The difference between total revenue and total outlays.
- Uses the cash recording method of accounts – the transaction is recorded when the cash is received or paid.

UNDERLYING CASH BALANCE

- Removes 'one-off' influences from headline balance, such as asset sales from privatisation (E.g. Telstra) of GBES and is therefore considered a better indicator of the government's actual financial position.
- Uses the cash recording method.

FISCAL BALANCE

- Used since the introduction of accrual method of accounting in 1999-2000 where transactions are recorded when earned or incurred even if the cash has not been received or paid. For example: Funding for the ABC.
- Does not include one-off influences such as asset sales.

THE GOVERNMENT'S MEDIUM TERM FISCAL STRATEGY

This involves achieving surplus budgets, on average, over the economic cycle. This means during booms, the budget should be in surplus so that any debt can be repaid and funds saved to cover deficits that occur during recessions, without the need to borrow. This helps to ensure that government finances are stable and sustainable.

The turnaround in the budget outcome from the $37.1bn deficit recorded in 2016-17 to a budgeted deficit of $6bn for 2019-20 is projected to be the largest in Australia's history and illustrated the government's focus on FISCAL CONSOLIDATION in recent years. This will enable the government to pay off its debt and use surpluses to add to national savings.

FINANCING A BUDGET DEFICIT OR USING A BUDGET SURPLUS

- If outlays > revenue (**a budget deficit**), the government must borrow to finance the additional spending. There are three ways to finance a deficit:

  (a) **Borrowing from the RBA.**

  - Directly increases money supply ('new' money).
  - Directly stimulates economic activity.

  (b) **Borrowing from overseas**.

  - Increases foreign debt.
  - Increases the CAD due to increased interest payments on foreign debt.

  (c) **Borrowing from the general public.**

  - The preferred option used by current government where they sell Commonwealth Government Securities to the private sector to raise funds.
  - Does not add to money supply as the government spends money which has been withdrawn from the private sector to purchase the securities.
  - Puts upward pressure on interest rates as RBA offers higher rates to attract buyers of securities. This has a 'crowding out' effect where the private sector have to compete with the government for funds – the government 'squeezes out' businesses and this can reduce private sector investment.
  - Budget deficits can also be financed from the savings accumulated from previous surpluses.

- If expenses < revenue (**a budget surplus**), the government may:

  (a) Repay debt (local and overseas) incurred in previous years' budget deficits (so that the government no longer has a net debt).

  (b) Save with the RBA so that funds are available to finance future budget deficits in the event of an economic downturn.

  (c) Deposit surplus in a range of infrastructure investment funds to help finance future commitments – E.g. The Education Investment Fund and Building Australia Fund.

QUESTION 13 (VCAA 2015 – Question 4ci)
Describe the link between government budget deficits and the government/national debt.

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THE OPERATION OF BUDGETARY POLICY

There are two ways the budget operates to manage the economy – through **automatic stabilisers** (the cyclical component of the budget) and **discretionary stabilisers** (the structural component of the budget).

AUTOMATIC STABILISERS

- Automatic stabilisers (built-in or cyclical stabilisers) operate automatically to smooth out fluctuations in the economic cycle.

- Automatic stabilisers respond to changes in the economic cycle without the need for deliberate changes to revenue and outlays by the government and act counter-cyclically to steady aggregate demand.

- In times of low economic activity or recession, higher unemployment increases outlays due to increased payments of unemployment benefits. At the same time, tax receipts fall – rising unemployment means less people are working and paying income tax, lower company profits means lower company tax receipts. This helps to boost aggregate demand and cushion the economy from the full impact of a downturn.

- In times of strong economic activity when incomes are increasing, company profits increase and fewer people are receiving unemployment benefits, revenue increases relative to outlays and this reduces aggregate demand.

DISCRETIONARY STABILISERS

Although automatic stabilisers are an effective counter-cyclical response to changes in economic activity, there are times when their effect is not sufficient to deal with severe economic downturns (E.g. recent GFC) or booms. In such cases, the government will implement discretionary stabilisers which reinforce automatic stabilisers.

- Discretionary stabilisers involve deliberate decisions made by the government to change revenue or expenses.

- For example, in a downturn/recession the government may reduce tax rates (E.g. personal income tax, company tax) to stimulate spending by households and firms to increase aggregate demand. They may also increase outlays through increased government expenditure on public works and infrastructure (e.g. roads, schools) and increase social welfare benefits (e.g. job search allowance, aged pensions). These actions increase aggregate demand through G1, G2, C and I.

QUESTION 14 (VCAA 2014 – Question 8)
Which one of the following is an example of discretionary budgetary policy?

A A decrease in the cash interest rate target.
B A decrease in the company tax rate from 30 per cent to 29 per cent.
C An increase in welfare payments due to a rise in cyclical unemployment.
D Lower revenue from a minerals resource rent tax (MRRT) due to falling commodity prices.

THE BUDGET STANCE

- The budget stance indicates the effect of the budget on the level of economic activity – is it expansionary (increasing economic activity) or contractionary (decreasing)?

- In itself, a deficit budget is expansionary because revenue < outlays meaning more money is being pumped into the economy than taken out whereas, a surplus budget is contractionary because revenue > outlays meaning more money is being taken out of the economy than pumped in.

- Another way of accurately determining the stance of the budget is to **compare the outcome with the previous year**. A **larger deficit** or a **smaller surplus** than the previous year, would result in an expansionary budget and may be used to stimulate the economy in time of slowdown or recession. A **smaller deficit** or a **larger surplus** than the previous year would result in a contractionary budget and may be used to slow the economy if it is growing too fast or when there is a boom.

- A more accurate method of determining the budget stance is to isolate the effect of automatic stabilisers compared to discretionary stabilisers on the budget outcome. If for example, the budget moved into deficit due to the operation of automatic stabilisers in response to a slowing economy, this is not seen as a deliberate change in policy stance. However, if as occurred in 2008-09 and 2009-10, the government makes deliberate changes to reduce revenue and increase outlays, then the structural component of the budget becomes expansionary.

CURRENT BUDGET OUTCOMES

Budget aggregates and major economic parameters(b)

	Actual	Estimates			Projections	
	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21
Underlying cash balance ($b)(a)	**-39.6**	**-37.6**	**-29.4**	**-21.4**	**-2.5**	**7.4**
Per cent of GDP	-2.4	-2.1	-1.6	-1.1	-0.1	0.4
Net operating balance ($b)	**-33.6**	**-38.7**	**-19.8**	**-10.8**	**7.6**	**17.5**
Per cent of GDP	-2.0	-2.2	-1.1	-0.6	0.4	0.8

(a) Excludes expected net Future Fund earnings before 2020-21.