

MACROECONOMICS AT WORK EXERCISE

MONETARY POLICY

REFERENCES: Morgan Mellish, ‘**Rate rise: RBA taps the brakes**’; Alan Mitchell, ‘**First strike, and it won’t be the last**’; David Bassanese, ‘**RBA pursues optimum speed for the economy**’; Alan Mitchell, ‘**Treading the fine line between boom and bust**’, *The Australian Financial Review*, 6 November 2003, pp. 1, 8, 9.

CHAPTERS RELEVANT TO THIS EXERCISE: Chapters 10, 16.

OVERVIEW

At its meeting in early November 2003 the Reserve Bank of Australia lifted the target cash rate (the effect of which would be to increase interest rates) by 25 basis points (0.25%). The increase came slightly earlier than expected. But further increases were nevertheless anticipated within the next six months to bring interest rates back to more ‘normal’ or ‘neutral’ levels. While the level of inflation – the main factor influencing the setting of interest rates by the central bank – was not an immediate concern, there were a number of other factors that influenced the decision. Among these were: the effect of the international economic situation on the Australian economy; the ‘housing boom’; the rate of recovery of the domestic economy from the effects of the drought; the high and growing level of consumer debt; and the considerable differential between interest rates in Australia and most other countries (4% higher in the case of the US)

QUESTIONS

1. Why did the Reserve Bank raise interest rates when – as the Treasurer put it – inflation was ‘bang in the middle of the bank’s own target’?
2. What is the meaning and significance of the suggestion that the statement by the Governor of the Reserve Bank on the international economic situation was ‘surprisingly bullish’?
3. Explain the meaning of, and the reason for concern about, the level of consumer debt.
4. How has the housing boom been a major influence on the central bank’s decision to raise interest rates. How can it be said that – to the contrary – the housing boom may even be a factor in holding interest rates down?
5. What is meant by, and what is the significance for interest rates of, the ‘renewed strength of the Australian economy’?

6. Explain the concept of a 'normal' or 'neutral' level of interest rates.