By Yasindu Hettiarachchi,
Melbourne High School.

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Reserve Bank Announces Further Cut to Cash Rate

In response to the ravaging impacts of Coronavirus on the Australian Economy, The Reserve Bank has cut the official cash rate to 0.25%. The Reserve Bank's decision to further lower the cash rate was the second for the month of March with the nation's central bank evaluating the nations deteriorating economic condition. Through the actions of monetary policy, the Reserve Banks aims to minimise disruptions to the economy by minimising financial and economic disruptions.

Philip Lowe, the governor of the Reserve Bank of Australia commented that the bank would hold the cash rate at 0.25% 'until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2-3 per cent.' The cuts made by the reserve bank mimic the actions of similar central banks across the globe to combat the impacts of Coronavirus.

Before understanding the full intent of the Reserve Bank's decision to cut the official cash rate, lets understand what monetary policy is and how its central mechanism, the cash plays a central role in maintaining stability within an economy.

Key Points:

- The Reserve Bank has lowered the interest rate to 0.25% to combat the fall in unemployment, while attempting to maintain inflation between the desired 2-3%.
- Monetary policy is regulated by the Reserve Bank while is responsible for regulating the money supply within an economy, while satisfying a nation's macroeconomic goals.
- The cash rate is the rate which the reserve bank will charge commercial banks on overnight loans. Changes in the cash rate not only lead to changes in interest rates but also may be part of the Reserve Bank's contractionary or expansionary monetary policy.

Monetary Policy

Monetary Policy refers to the actions taken by a nation's central bank to control money supply and satisfy the macroeconomic goals that promote sustainable growth.

Inflation: is an increase in the general price of goods and services.

The Reserve bank has an inflation target of 2-3 percent and seeks to maintain this rate to preserve the value of the Australian dollar.

The macroeconomic goals of a nation, known as the Reserve banks objects of monetary policy, include: the stability of the currency, maintenance of full employment and economic prospect and welfare of the people of Australia. The Reserve Banks aims to meet these targets through maintaining a stable rate of inflation, creating an environment where there are enough jobs for people who want to work while also maintaining a microeconomic environment.

The central action implemented by the Reserve Bank in controlling monetary policy involves the manipulation of the cash rate.

Cash Rate

The Cash Rate is the interest rate which the Reserve Bank will charge commercial banks on overnight loans.

The cash rate differs from the interest rate as it is rate which commercial banks pay on overnight loans and is not available to the public. The interest rate is the cash rate passed down to consumers at a higher price. The Reserve Bank uses the cash rates to encourage or discourage spending by consumer, depending on the state of the economy.

Changes in the cash rate made offered by Reserve Bank serve is integral to its strategy in employing contractionary or expansionary monetary policy. Both policies are targeted at influencing a nations aggregate demand.

Aggregate Demand

Aggregate demand is the total demand for all finished goods and services produced in an economy. Aggregate demand can be represented by the formula.

C + I + G + (X-M)

Consumer Spending + Investment in Capital Goods + Government Spending + Net Imports (X-M).

Fiscal Policy: refers to the actions of a government to adjust spending levels and tax rates to influence a nation's economy.

Contractionary and expansionary policy are often applied in unison with the government's fiscal policy which function to maintain a reduce economic fluctuations.

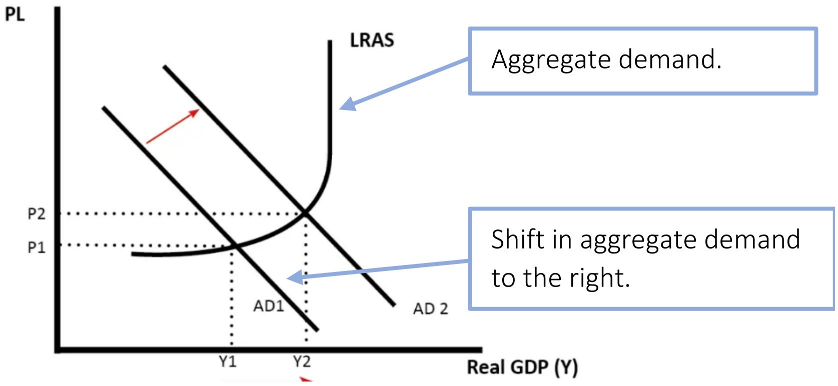
Expansionary policy

Expansionary monetary policy seeks to promote economic growth in an economy.

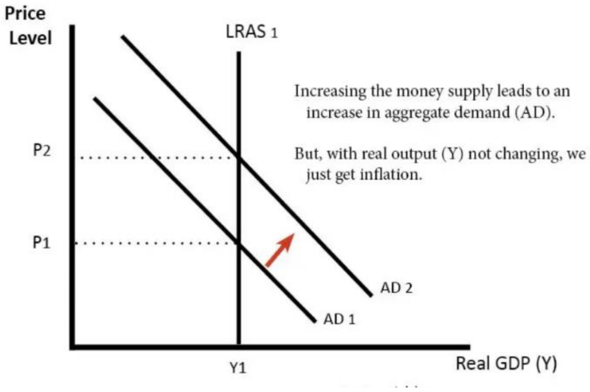
The policy aims to achieve this target through increasing aggregate demand within an economy through influencing C (Consumer Spending) and I (Investment Spending). The objective is achieved through the lowering of the interest rate to increase money supply, encouraging lending and investment within the economy.

The increase in the money supply results in inflation as more people can borrow money, increasing the demand for goods and services.

Impact of low interest rates on aggregate demand



Rise in inflation due to an increase in aggregate demand.



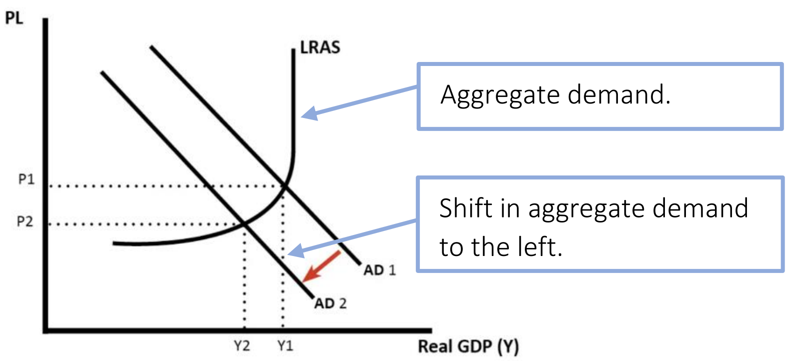
Contractionary Policy

Contractionary monetary policy seeks to restrict economic growth in an economy, through an increase in interest rates resulting in a decrease in aggregate demand. The initiation of contractionary monetary policy may be the result of an exorbitant level of inflation from an expanding money supply.

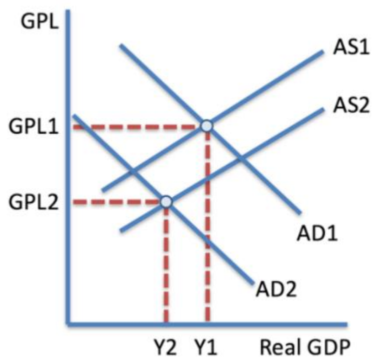
> Deflation: A general decline in the price of goods and services within an economy. It may decrease in the supply of money or credit.

The actions of contractionary monetary policy, through an increase in the interest rate seek to reduce money circulating within the economy. The fall in the money circulating within the economy results in deflation as less people can borrow money, reducing the demand for goods and services within an economy.

Impact of high interest rates on aggregate demand



Deflation due to a fall in aggregate demand



Reserve Bank's interest rate cuts

The decision by the Reserve Banks to hold the cash rate at 0.25% was delivered with the intent of making progress towards full employment while ensuring stability in inflation rates within the 2-3% target.

The lowering of the cash rate by the reserve bank is expected to support Australia's export rate through maintaining the exchange rate, however the decision was made with a compromise to Australians reliant on interest income.

Due to the uncertainty of Coronavirus on the Australian economy it is uncertain to what further measures will be employed by the nations central bank to combat its impacts on the nation's economy.

Comments

Anonymous – Hi, I am a small business owner, what measures has the RBA implemented to support my business during Coronavirus?

Author – In response to the outbreak of COVID 19, the RBA announced on the 19 of March 2020 a package to exert downward pressure on the borrowing costs for business. The RBA during this announcement revealed that they were implementing a $90 Billion term funding facility for banks. This facility is expected to support business through offering an incentive to lenders to support credit to business, particularly small and medium-sized.

Anonymous – When does the Reserve Bank of Australia expect to change its current cash rate of 0.25%. Will it continue to fall or will its increase?

Author – The Reserve Bank has remained firm with the Cash Rate since the implementation of a 0.25% rate on borrowing, implemented in March. The Reserve bank has treated its policy as 'appropriate', however did not dismiss the potential to further reduce the cash rate where it would help support the recovery. It is highly unlikely the Reserve banks would increase the cash rate as it has reaffirmed that the rate would not be raised until progress towards full employment was made and inflation was within the desired range of 2-3%.

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