Macro IA Commentary

URL	https://nairametrics.com/2022/06/07/australias-central-bank-raises-interest-rate-to-0-85/
Word count of the commentary	714

Article: "Australia's Central Bank raises interest rate to 0.85%" Nairametrics by Ubah Jeremiah Ifeanyi, 2022.

As Australia's central bank attempts to curb inflation before it spirals out of control, the Reserve Bank has announced the largest single increase in the cash rate in 22 years.

The Reserve Bank of Australia (RBA) board raised the cash rate target by 50 basis points to 0.85%, its first back-to-back monthly hike in 12 years, and signals that further tightening will be needed, according to Bloomberg.

The headline consumer price inflation rate was 5.1% for the March quarter, with automotive fuel up 35%, the most since Iraq's 1990 invasion of Iraq. The current spike in energy prices has similarly been made worse by war after Russian invaded Ukraine in February.

What you should know:

- Costsforeverythingfromfoodtoconstructionmaterialsandenergyarealreadyrisingforhouseholds and businesses. Larger repayment expenses for people on variable loans will be added to this strain, with the major commercial banks certain to pass on today's rate hike quickly.

- TheRBA'smedium-termgoalistohaveanunderlyinginflationrangebetween2%and3%,compared with a 3.7% pace in the March quarter that's expected to accelerate in the current quarter if not beyond. Power price increases of 10% or more will kick for many households and businesses from 1 July, a rise that will have knock-on effects

- Despitetheimportedsourceofmuchoftheinflation,theRBAseestheneedtoreininexcessive demand to ensure expectations of further prices don't lead to a spiral of costs.

- TheRBAobservedthatwhilehomevalueshavefalleninseveralmarketsinrecentmonths,theyare still more than 25% higher than they were before the outbreak, creating a wealth effect that will underpin spending even as interest rates rise.

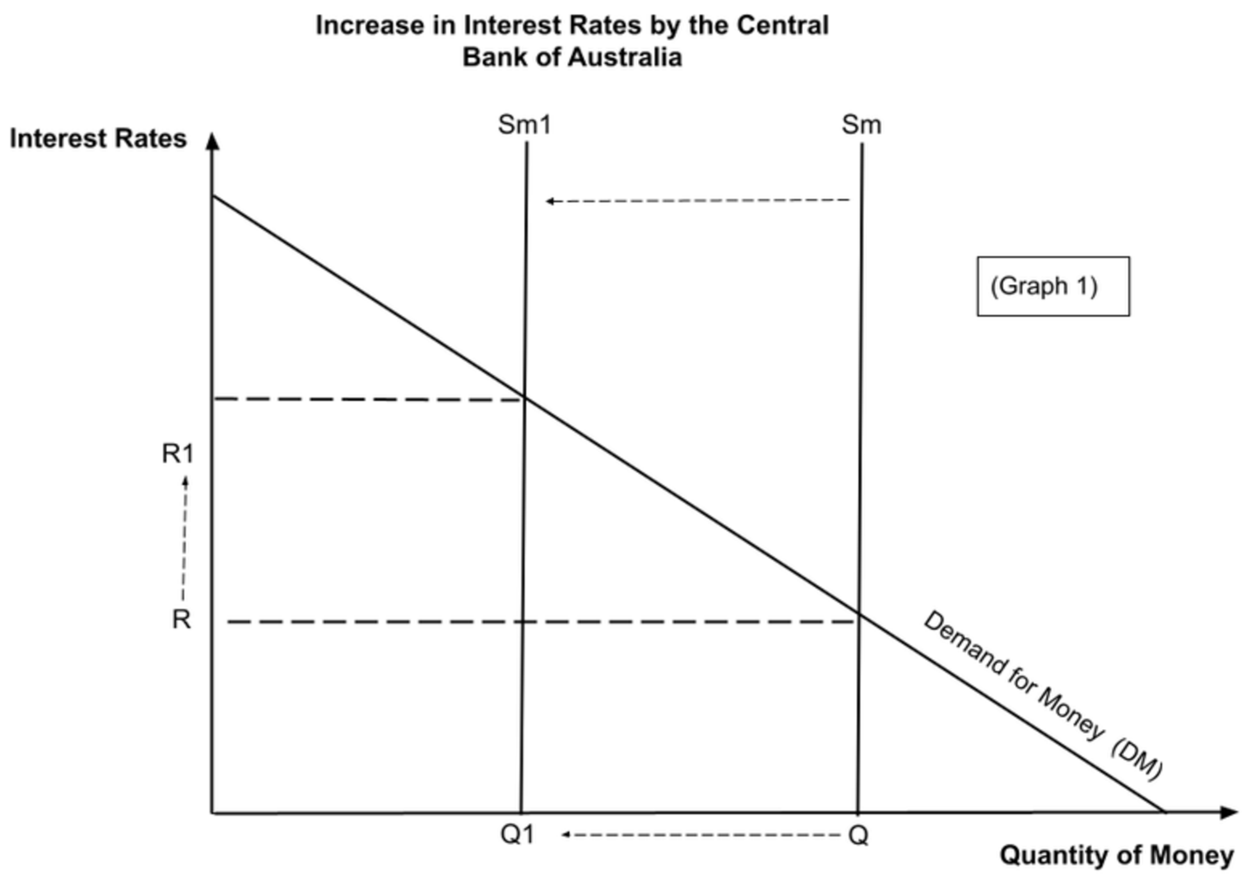
- Mostcentralbanksaregrapplingwithhowtorestoreinterestratestopre-Covidcrisislevelswhilealso limiting price increases without plunging economies into recession.

- Manyeconomieshavesimilardifficultiestoaustralia's.TheBankofCanadaraiseditscashrateby50 basis points for the second month in a row last week.

Commentary

The Australian central bank raised interest rates (the cost of borrowing money) in hopes of slowing inflation (a sustained increase in price levels). Through the use of a monetary policy (manipulating the quantity of money available in an economy), specifically using contractionary monetary policy, as there is a decrease in the supply of money, consequently leading to a contraction in aggregate demand. Despite this type of policy being a primary tool for the central bank to fight against inflation, it can be hard to apply properly, and is damaging to economic activity and consumers' **economic-well being** - their quality of life and prosperity as well as present and future economic security. Such a policy requires a balance when reducing the quantity of money in the economy to avoid a recession.

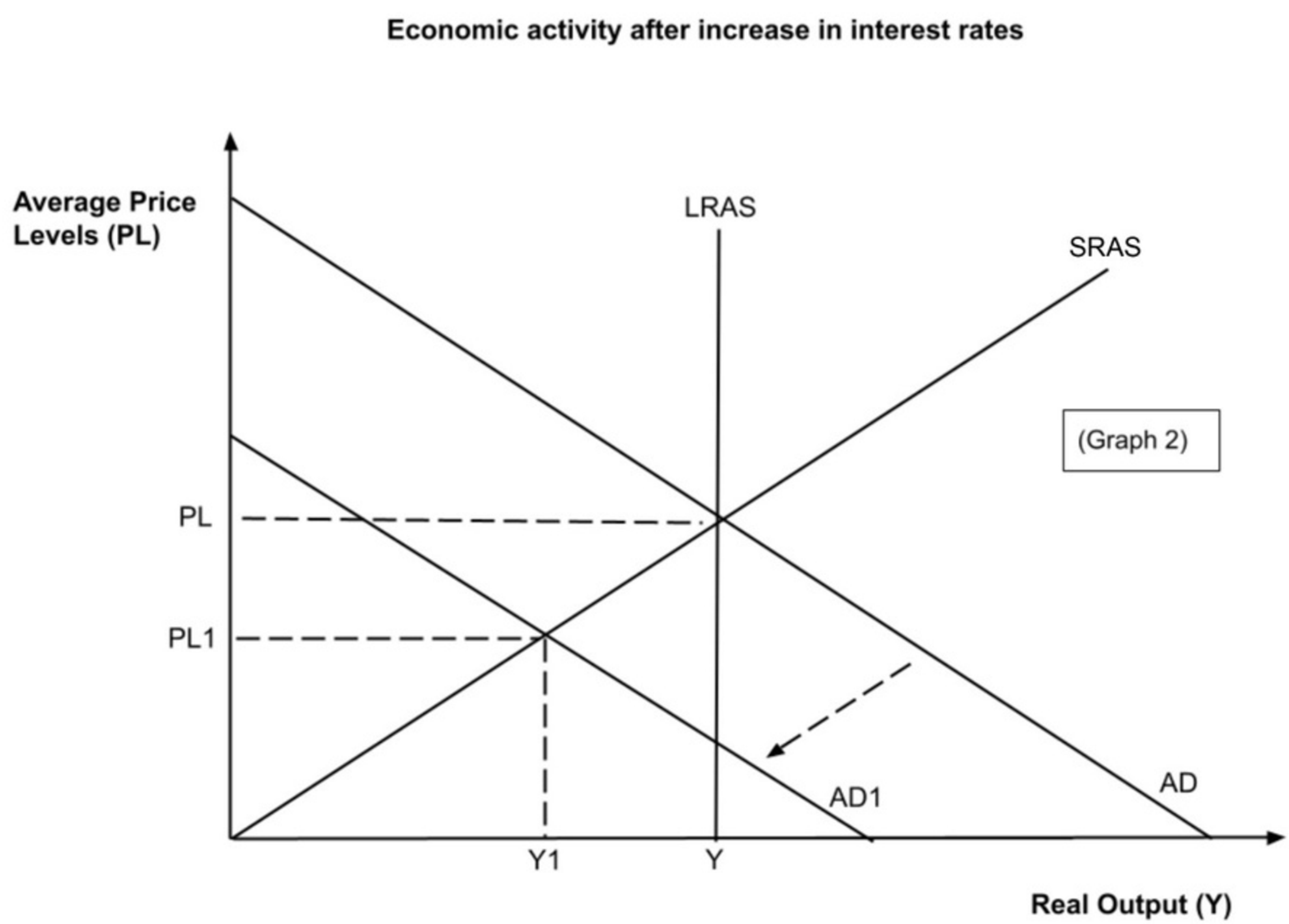
The Reserve Bank of Australia (RBA) has significantly increased interest rates "by 50 basis points to 0.85%" ***(Ubah Ifeanyi)***, reducing the quantity of money in the economy as seen below:



(Constantine Ziogas)

Australia has seen a lot of inflation recently as the cost of goods rose for both consumers and businesses, the inflation rate hitting 5.1%, whereas governments and the Central bank usually aim for a healthy inflation rate of 2%. Such increases in inflation rates, despite leading to an increase in nominal wages, mean overall, a decrease in real wages, a decrease in the value of savings, and decreased **economic well-being** amongst consumers. So it is important for the Central Bank of Australia to slow the rate of inflation, which they are attempting through the use of contractionary monetary policy. Which works by causing a contraction in the economy, in this case, the RBA did this by increasing its lending rates, seen in graph 1 as a movement from R to R1. As a result, this means the cost of borrowing money for commercial banks (who take loans from the central bank) has increased, thus the demand for such loans, or the demand for money, has decreased amongst commercial banks. Consequently, because commercial banks now have less money to give out to consumers and firms, the supply of money decreases from Sm to Sm1, as seen in the graph. Finally leading to a decrease in the quantity of money available in the economy for these consumers and firms, shown in graph 1 as a shift from Q to Q1.

Summarising, contractionary monetary policy works by decreasing economic activity. Commercial banks have less money and so the cost of borrowing this scarce money increases, the quantity of loans decreases and thus there is less money in the economy, and because firms then have less money to invest, and consumer spending decreases as they have less disposable income (explored further later), there is a contraction in aggregate demand as both investment and consumer spending are components of it. Overall as a response to this, there is decreased economic activity meaning as fewer goods and services are bought they become less scarce meanwhile businesses become weary to raise prices as there will be a significant decline in demand, thus slowing inflation rates or even driving prices down, reversing the effects of inflation ***(The Economist)***.



However, there is a downside to the Central Bank increasing interest rates, as despite it being a fairly immediate tool when slowing the inflation rate, it can be hard to come back from when trying to slow or reverse the negative impacts. When interest rates rise people with variable loan rates have to pay more for the money they borrow, and so have less disposable income; also as seen in the article, house prices fall as there is a decrease in the demand for house mortgages (amongst new buyers due to the higher interest rate) meaning a decrease in the scarcity and demand for houses, driving prices down. Which because of the wealth effect means people feel as though they have less money so spend less; also businesses make less money as consumer spending declines meaning they may have to cut down on wages or the number of employees shown in the diagram above as a shift from Y to Y1, overall this is damaging to consumers **economic well-being** and means consumers have far less disposable income causing this big drop in consumer

spending. However, consumers are not the only ones impacted, as businesses will also be less willing to take out loans for investments due to the higher costs. Meaning overall investment in the economy will decline which is another component of aggregate demand, overall resulting in a leftward shift, as seen above from AD to AD1.
This consequently also shows a lowering in real output (from Y to Y1) which is why manipulating interest rates can be dangerous to an economy as if not managed properly real output can drop further and even send the economy into a recession. However, on the other hand, this leftward shift in aggregate demand has also resulted in the intended goal, a lowering of price levels or in other words reversing inflation, as can be seen in graph 2, as a fall in average price levels from PL to PL1.

Bibliography

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