Monetary Policy — Worksheet

Part A — The cash rate, the transmission mechanism and evaluation

This worksheet develops the monetary-policy skills the exam rewards: explaining the cash rate and the RBA's objectives, tracing the transmission mechanism channel by channel, showing a stance on AD/AS, and evaluating monetary against fiscal policy.

> For transmission-mechanism questions, write the chain as a sequence of arrows and name the **channel** at each step (lending rates, exchange rate, wealth, cash flow). Always finish at aggregate demand and then the macro objectives.

> **Worked example.** Cash rate ↓ → lending rates ↓ → consumption and investment ↑ → AD shifts right → output and employment ↑, with inflation rising toward the 2–3% target (after a lag).

Concepts

1. Define monetary policy and the cash rate, and state which body conducts monetary policy in Australia. ______________

2. State the RBA's inflation target and explain why an inflation *target* (rather than a fixed inflation rate) guides policy.

3. Distinguish between conventional and unconventional monetary policy, and explain when the RBA would turn to unconventional measures.

The transmission mechanism

4. Complete the chain for a cash-rate **cut** by filling in each effect:

Cash rate ↓ → lending rates ____ → borrowing and spending ____ → aggregate demand ____ → output and employment ____, inflation moves ____ the target. ______________

5. Explain how each channel transmits a cash-rate cut to aggregate demand: (a) the lending-rate channel; (b) the exchange-rate channel; (c) the wealth (asset-price) channel.

6. On a fully labelled AD/AS diagram, show the effect of an expansionary monetary stance. Label the AD shift and the change in output and the price level.

Evaluation

7. Compare monetary policy and fiscal policy as tools for managing aggregate demand. In your answer, address independence from the political cycle, implementation lags, and the ability to target specific regions or sectors.