EconoBite

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Year 12

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Falling interest rates

Interest rates in Australia have been decreasing. Economic forecasters are predicting that the Reserve Bank 'cash rate' may be cut by 0.25% at the bank's monetary policy meeting in July or in August.

Most home buyers borrow from a financial institution. The borrowing interest rates for home loans are typically a few percentage points above the cash rate. Changes in the cash rate therefore influence the standard of living of millions of mortgage holders across Australia.

Read the following Guardian Newspaper article:
https://www.theguardian.com/business/2019/jun/21/australian-interest-rates-head-for-1-as-emergency-measures-loom-for-economy

Finding out

- If you were displaying the cash rate over time what type of chart (graph) would be best to use for this task?
- Find data for the cash rate over the past 30 years. Copy the data into an Excel spreadsheet and create a chart (graph).
- Use the chart to determine whether the current cash rate is historically:
  - high
  - moderate, or
  - low.
- If home lending rates fall to 3%, what effect do you think this will have on:
  - the demand for houses
  - the prices of houses
  - consumer spending on other 'big ticket' consumer goods and services (such as new cars and overseas holidays).
- Make a list of the effects of falling interest rates (on people, businesses and the level of economic activity) that are mentioned in the article.
- Explain how low interest rates and a fiscal stimulus (through infrastructure spending and "structural policies that support firms expanding, investing, innovating and employing people") are complementary policy settings.

Teacher notes

Purpose

This 'bite' aims to tap into the most current interest rate data. It also takes into consideration development of the skills in Unit 4 of the syllabus.

Prior knowledge

Students need to have been exposed to the following syllabus content before undertaking this 'bite':

- the concepts of monetary policy and the cash rate

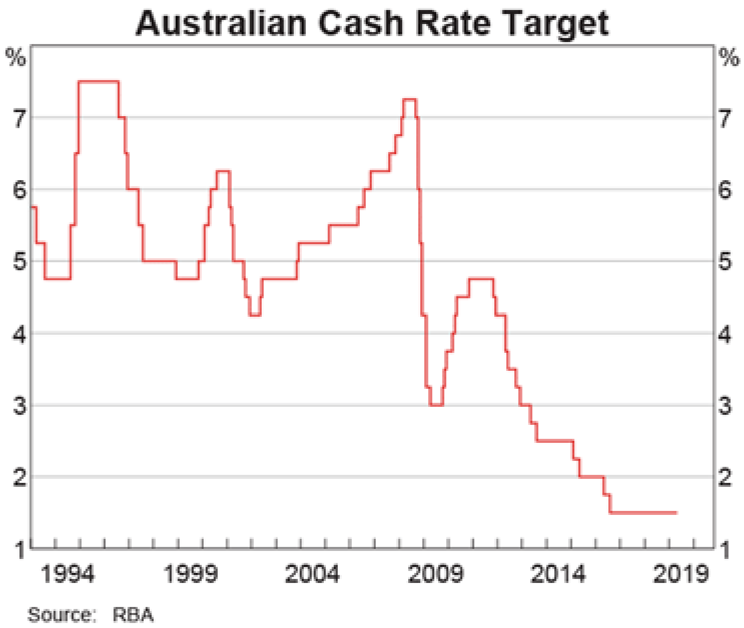
Note: This 'bite' could be used early in the monetary policy teaching sequence and then followed by the teaching of the other six syllabus dot points on monetary policy **OR** at the end of the sequence when dealing with the final dot point - contemporary (the last three years) monetary policy stances in Australia.

They also need to familiar with the following skills:

- select appropriate print and electronic media sources of economic information and data on Australia's economic policy and management
- apply appropriate methods of recording and organising macroeconomic information, including spreadsheets, graphs and tables
- identify and organise relevant information within sources
- identify trends and relationships in economic information and data regarding Australia's economic policy and management

Answers

- A line graph
- Here is an example from the RBA Chart Pack at https://www.rba.gov.au/chart-pack/interest-rates.html



- Historically low
- Impacts of low home lending rates
  - Cheaper borrowing should increase demand for house as most buyers rely on a loan from a financial institution
  - The impact on house prices is hard to predict – assuming ceteris paribus, prices will increase BUT this will not be the case if:
    - other factors may offset the increase in demand (i.e. demand may be decreased by factors such as: lack of buyer confidence, expectations of lower prices in the future, lower rents) AND/OR
    - other factors increase the supply of houses on the market
  - Assuming ceteris paribus, consumer spending on other 'big ticket' consumer goods and services will increase as consumers (who have a variable interest rate loan) will be paying less to repay their mortgage BUT this will not be the case if home buyers expect the low rates to be 'short lived' or there is a continuing lack of consumer confidence.

- the effects of falling interest rates mentioned in the article are:
  - reduced spare capacity in the labour market (i.e. decreased unemployment) thereby helping push up wages
  - the Australian dollar is expected to fall
  - bad news for savers (as they earn less interest on money in financial institutions)
  - very welcome for indebted homeowners
  - the housing/property market could 'fired up' if homeowning is seen as a cheaper option than renting
- These policy settings are complementary as both are aimed at increasing aggregate demand. Cutting the cash rate is transmitted to other interest rates which should increase borrowing by households and businesses which will increase consumption and investment. Fiscal stimulus will increase government spending (directly through spending on infrastructure) and policies aimed at supporting businesses will increase investment.

Note: If you want to link this 'bite' to teaching of the transmission mechanism, ask the students to read the **RBA Explainer** titled ***The Transmission of Monetary Policy*** available at: https://www.rba.gov.au/education/resources/explainers/the-transmission-of-monetary-policy.html

To check your students' understanding, ask them to complete the RBA Learning Activity on the Transmission Mechanism available for download from: https://www.rba.gov.au/education/resources/learning-activities/

Hint: You need to print two copies of the activity for each student (one for a decrease in the cash rate and a second for an increase in the cash rate).

Follow-up activity

Some economists are suggesting that in 2020 the Reserve Bank could resort to 'quantitative easing' of the type seen in the US, Britain and Europe after the global financial crisis.

Use the internet to investigate how quantitative easing operates.