How Monetary Policy Works – Part Two

I woke up last night thinking about an analogy that might explain the RBA's role in the world a little more clearly than Monday's rather convoluted post.

Imagine a man named Roy Barista Allesandro (RBA for short). Roy controls a dam and that dam regulates how much water flows down a river. There is a village called Martins Place at the end of the river and this village uses all of the water that is released from the dam. Four of the village elders, known across the land as The Big Four, collect all of the water every day and sell it to the townsfolk.

Back in the old days, Roy used to let the same amount of water out of the dam every day. On a hot day, in the middle of summer, when lots of farmers wanted to irrigate their crops and lots of locals wanted a glass of water, the price would be high. When it was cold and raining, the price would be low.

One day, Roy got fed up with everyone whinging about volatile water prices and decided he would adjust the amount of water he released so as to maintain a steady price. When demand was high, he would release more water. When demand was low, the river would slow to a trickle. Day in, day out, irrespective of demand, the price of water was now the same. Roy had nothing to do with the daily buying and selling of water but, because he controlled the supply, he was capable, indirectly, of controlling the price.

Now, something else important happened once Roy fixed the water price in Martins Place. Because people could now buy and sell water in this little village at a known price, the price of water everywhere else became hitched to the price in Martins Place. The prices were not identical – differences represented transport costs, water quality and the like – but, if the prices ever got out of whack, people would simply ship water from one place to another and make themselves a nice little profit.

All of a sudden, because Roy controlled the supply and indirectly the price of water in one little village, he was indirectly setting the price for water all over the country.

In the real world, the monetary system works because the Reserve Bank has a dam of infinite size – it can print as much money as it wants. By putting more money into the system, or taking it out, it can push cash interest rates around as it pleases. Because short and long-term loans are substitutes, of sorts, and because it is the only entity with the ability to create money, our RBA controls interest rates all over the country.

If I'm still talking Double Dutch, try the RBA's explanation.