**Applied economic exercise**

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**Read the (edited) Minutes of the RBA’s March 2020 special Board meeting and answer the questions that follow. The unedited Minutes can be accessed here:** <https://www.rba.gov.au/monetary-policy/rba-board-minutes/2020/2020-03-18.html>

**Recent Developments**

In a special meeting convened to consider options for monetary policy responses to the economic effects of the novel coronavirus disease (COVID-19), members commenced their discussion with a review of recent developments. The outbreak was noted as first and foremost a public health issue. Many countries were shutting their borders and placing restrictions on businesses and individuals to slow the spread of COVID-19. This was causing very significant disruption to economies around the world.

Financial markets had been very volatile and there had been sharp falls in the prices of risky assets as market participants struggled to price the risks, given their unprecedented nature. Equity [share] prices in the advanced economies, including in Australia, had fallen by around 30 per cent. The falls had been broadly based across sectors, although **equity prices in the energy and tourism sectors had fallen particularly sharply**.

…In foreign exchange markets…members observed that the Australian dollar had depreciated against the US dollar by around 10 per cent over the preceding month, to be at its lowest level since 2002. Among other advanced economies, the **exchange rates of commodity exporters such as Norway, Canada and New Zealand had also depreciated** notably.

…A number of major central banks had made sizable **interest rate reductions** at unscheduled meetings. The Federal Reserve had cut its policy rate by 100 basis points after an earlier cut of 50 basis points. The Federal Reserve, the Bank of England and the Reserve Bank of New Zealand had each lowered policy rates to ¼ per cent, and interest rates were lower than this in Japan and Europe. ...To support Australian financial markets, the Bank had injected liquidity through its open market operations, increasing Exchange Settlement (ES) balances from around $2.5 billion to $14 billion. [At this stage of the course, just think of this as the RBA reducing interest rates in the economy.]

…Members discussed how these developments and the rapidly changing situation were affecting the outlook for economic activity. The immediate outlook for the Australian and global economies was highly uncertain, but members viewed it as very likely that **most countries would experience a very sharp contraction in economic activity**.

…While it was not possible to provide an updated set of forecasts for the economy given the fluidity of the situation, it was likely that Australia would experience a **very material contraction in economic activity**, which would spread across the March and June quarters and potentially longer. The size of the fall in economic activity would depend on the extent of the social distancing requirements, and potential lockdowns, put in place to contain the virus. The **composition of consumption** was changing considerably, with spending at supermarkets and pharmacies increasing substantially, while spending on hospitality and other services was falling sharply. Many service industries were being severely disrupted, with significant spillovers across the economy.

There were likely to be **significant job losses over the months ahead**, although the extent of this would depend on the capacity of businesses to retain employees during this period. At the same time, some industries were employing more workers, particularly those involved in the retail supply chain and delivering goods. In time, following containment of COVID-19, the economy is expected to recover, but the timing of this was uncertain.

**Questions**

1. **Explain why share prices in the energy and tourism sectors fell more steeply than other share prices.**
2. **Explain why the exchange rates for commodity exporting countries, including Australia, have depreciated since the outbreak of the coronavirus.**
3. **Explain why central banks (including the RBA) has decided to reduce interest rates.**
4. **Examine the implications for the exchange rate once interest rates fall in Australia.**
5. **Explain whether ‘a very sharp contraction in economic activity’ or a ‘very material contraction in economic activity’ will be equivalent to a ‘recession’ in the Australian context.**
6. **Describe how the ‘composition of consumption’ is changing and examine the implications for relative prices and resource allocation. Use demand and supply diagrams to illustrate.**
7. **Explain how the decline in economic activity will be related to hours employed, employment and unemployment.**
8. **Since this RBA meeting, the Federal Government announced a $130 billion wage subsidy for employers. Explain how this is expected to influence the rate of unemployment.**

**Considerations for Monetary Policy**

…Members acknowledged that the primary response to the COVID-19 outbreak was to manage people's health, but that other arms of policy, including monetary and fiscal policy, would play an important role in reducing the economic and financial disruption. Members noted the measures that the Bank had taken to support the Australian economy and operation of financial markets over the days preceding the meeting.

The Governor proposed a package of policy measures, which together would assist in supporting the Australian economy through the period ahead. The focus of the package was on ensuring that funding costs were low across the entire economy and that credit remained available to businesses and households. This would help build the necessary bridge to the economic recovery and support that recovery once the COVID-19 outbreak is contained.

The elements of the package were discussed in turn. [One of which is] …a further reduction in the cash rate target to 0.25 per cent.

The proposed cut in the cash rate to 0.25 per cent would bring the cumulative decline over the preceding year to 1¼ percentage points. Members noted that this would be a **substantial easing of monetary policy** [i.e. a policy induced reduction in interest rates], which, to date, had been boosting the cash flow of businesses and the household sector as a whole and also helping trade-exposed industries through the exchange rate channel. Members acknowledged that very low interest rates have **uneven effects and negative consequences** for some people – especially those relying on interest income – but the evidence was that lower interest rates were benefiting the community as a whole.

Members supported the proposal and agreed that **the cash rate would not be increased from its lower level until progress is made towards full employment** and there is confidence that inflation will be sustainably within the 2–3 per target cent range. Given this, it was considered likely that the cash rate would remain at a very low level for an extended period. Members also agreed that the cash rate was now at its effective lower bound. **Members had no appetite for negative interest rates in Australia**.

**Questions**

1. Describe the ‘substantial easing of monetary policy’ undertaken by the RBA and explain how it might help to boost Consumption and net exports.
2. Outline how lower interest rates negatively impact on some groups within society and explain why this negative impact is likely to be outweighed by the beneficial impact on other groups.
3. Define ‘full employment’ and explain what is meant by the statement that ‘the cash rate would not be increased from its lower level until progress is made towards full employment’.
4. Explain why the RBA is not interested in further reducing the cash rate.

**The following should be revisited after the commencement of monetary policy in Unit 4**

[Another of which is that] …exchange settlement (ES) balances at the Reserve Bank to be remunerated at 10 basis points, rather than zero as would have been the case under the previous arrangements.

The Governor outlined the implications of the proposed policy measures for the cash market. The existing ‘corridor system’ means that the balances financial institutions hold with the Reserve Bank overnight earn an interest rate 25 basis points below the cash rate, and in the event that a financial institution needed to borrow from the Reserve Bank overnight, it would be charged 25 basis points above the cash rate. Should the cash rate be reduced to 25 basis points, the interest rate on ES balances would be zero. In view of the significant increase in the balances held in ES accounts resulting from the combined effect of the Bank's enhanced liquidity operations, bond purchases and the term funding program [just think of this as the RBA pumping more funds into the system], **maintaining a zero interest rate on these balances would increase the costs to the banking system**.

Members agreed that such an outcome would be undesirable in the current environment. They endorsed the proposal to alleviate this cost by **increasing the rate of interest on [exchange] settlement balances to 10 basis points**. No change to the arrangements for the top of the corridor were proposed. Members noted that the increase in ES balances would be likely to change the way that the cash market operates. In particular, large increases in ES balances could result in the cash rate drifting below the target as transaction volumes in the cash market decline, as had occurred in other countries in similar circumstances.