**Applied economic exercise**

**economicstutor.com.au**

**May 2020**

**Read the (heavily edited) the overview of the May Statement on Monetary policy and answer the questions that follow.**

**The full overview (or Statement) can be accessed here:** <https://www.rba.gov.au/publications/smp/2020/may/>

Combating the spread of COVID-19 has required severe restrictions on economic activity in many countries. The result has been a large and near-simultaneous contraction across the global economy. Heightened uncertainty about the future has exacerbated the contraction, both directly through **weaker investment** and **consumer spending** and via tighter financial conditions. In Australia, output is expected to contract significantly over the first half of 2020, mostly in the June quarter. While the exact size of the contraction is still uncertain, **a decline in GDP of around 10 per cent** from peak to trough is expected.

The contractions in output in many other economies are likely to be at least as large as that in Australia; **the size and timing of these declines** depend both on the duration of the containment measures and on how stringent these measures have needed to be. March quarter GDP data for a number of economies show significant contractions, even though in many cases the lockdowns only began in the last few weeks of the quarter.

…The contraction in activity has affected labour markets severely. Large and rapid increases in unemployment are occurring in many countries. **Official unemployment rates… will not capture the full extent of the decline in labour demand**. Lockdowns, school closures and other restrictions on activity have meant that many workers who have been laid off will not be actively searching for another job for a time and therefore not be counted as unemployed, while other workers will have left the labour force. In addition, many firms have cut the hours of their employees rather than laying them off entirely. More of the labour market adjustment is likely to occur through hours worked rather than job losses in economies with more comprehensive wage subsidy programs. And by preserving employment relationships over the period of lockdowns, these programs should also hasten the subsequent recoveries in activity and employment.

In Australia, although there is expected to be a large increase in the unemployment rate – perhaps peaking at around 10 per cent – the increase would have been much larger were it not for the **JobKeeper wage subsidy program**. Total hours worked are likely to contract by around 20 per cent over the first half of 2020. This is larger than the decline in output partly because many of the most-affected industries are **quite labour-intensive**.

…Australia [has] moved swiftly to implement comprehensive policy packages in response to the deterioration in the economic outlook and the market dysfunction. …These measures complemented **fiscal stimulus aimed at supporting incomes** and the flow of funding to households and businesses. The comprehensive package of [RBA] measures to support the economy and promote functioning of key financial markets had four elements:

1. A **reduction in the cash rate to 25 basis points**. This followed an earlier reduction of 25 basis points at the scheduled March meeting. The Board also announced that it will not increase the cash rate target until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2–3 per cent target band. Given the outlook for the Australian economy, this means that the cash rate is unlikely to be increased for an extended period of time.
2. A **target for the three-year Australian Government bond yield of around 0.25 per cent**. The Board chose to implement the target at the three-year horizon as it influences funding rates across much of the Australian economy. It is also consistent with the Board's expectation that the cash rate will remain at its current level for some years. The three-year bond yield target extends and complements the Reserve Bank's practice to target the cash rate, which forms the anchor point for the risk-free term structure. To achieve this target, as well as to address dislocation in the government bond market, the Bank has conducted purchases of Australian Government Securities (AGS) and semi-government securities (semis) across the yield curve in the secondary market.
3. A **Term Funding Facility for the banking system**, with particular support for credit to small and medium-sized businesses. The Reserve Bank is providing a three-year funding facility to authorised deposit-taking institutions (ADIs) at a fixed rate of 0.25 per cent. ADIs can obtain initial funding of up to 3 per cent of their existing outstanding credit. They have access to additional funding if they increase lending to business, especially to small and medium-sized businesses. The facility is for at least $90 billion. The Australian Government has developed a complementary program of support for the non-bank financial sector, small lenders and the securitisation market, implemented by the Australian Office of Financial Management.
4. The remuneration of **exchange settlement balances** at the Reserve Bank at 10 basis points, rather than zero as would have been the case under the previous arrangements. This mitigates the cost to the banking system associated with the large increase in banks' settlement balances at the Reserve Bank that has occurred as a result of these policy actions.

…These measures complement each other and work to lower funding costs across the economy and support the provision of credit, especially to small and medium-sized businesses. Importantly, the package of measures is part of a substantial, coordinated and unprecedented **fiscal and monetary policy response** to the COVID-19 outbreak.

So far, this package of measures has been working broadly as expected… [and] in response to the very large rise in cash balances in the banking system, as expected, ***the cash rate has declined below 25 basis points. It is currently trading at a rate of 14 basis points***, and market pricing indicates it will remain around this level for some time.

**Borrowing rates for businesses and households have declined to record low levels** in response to the package of policy measures. The cost of funding for banks has also declined to very low levels. Lenders are beginning to draw down on their Term Funding Facility allowances, with some of the larger institutions expected to do so in coming months. These developments will provide support to the economy in the period ahead.

…Beyond the next few months, the speed and timing of the economic recovery is very uncertain. It therefore makes sense to think in terms of plausible scenarios. … In a number of countries, including Australia, some restrictions are beginning to be lifted. A plausible baseline scenario for the outlook in Australia involves the relaxation of domestic activity restrictions over coming months, with most of these restrictions lifted by the end of the September quarter; restrictions on large public gatherings and international travel could remain in force for longer than this.

Under this baseline scenario, **activity and employment begin to recover in the second half of the year**. After an initial surge of retail spending in March, as households prepared for the period of self-isolation and social distancing, household consumption is expected to contract by around 15 per cent before recovering over the next couple of years. Much of the decline is expected to be concentrated in services, such **as travel and entertainment**, most affected by activity restrictions. Travel restrictions have also induced a sharp decline in **tourism-related** and **education service exports**, and it is not clear how quickly these will recover.

The uncertainty about future demand prospects will also curtail business investment intentions. In addition, mining investment is likely to be weaker than previously expected, as some large proposed **LNG projects** have been delayed given low oil and LNG prices. More positively, though, **drought conditions** have been easing in recent months. Activity restrictions have limited turnover in the established housing market, and uncertainty about future job prospects and income is likely to dampen demand for **housing**. Slower population growth is also expected to translate into less demand for new construction.

…Turning to inflation, inflation pressures had picked up a little in the March quarter. Inflation was 2.2 per cent over the year to the March quarter, and 1¾ per cent in underlying terms. However, **oil prices have fallen dramatically** in response to lower global demand and limited storage capacity. Recently announced production cuts globally have not been enough to offset this. As a result of this and the temporary removal of **childcare fees**, year-ended headline inflation is expected to turn negative in the June quarter, for the first time since the early 1960s. **Trimmed mean inflation** is also expected to be lower (but still positive) in the June quarter, to be around 1½ per cent over the year. Declines (or delayed increases) in a number of administered prices will also contribute to inflation remaining low in the near term. From this low point, inflation is likely to increase gradually, but in this baseline scenario it is likely to remain below 2 per cent for some time, for a number of reasons. The ongoing **spare capacity in the labour market** is likely to result in a period of slower growth in wages and thus labour costs.

In the context of these extraordinary times and consistent with its broad mandate to promote the economic welfare of the people of Australia, the Reserve Bank will continue to play its role in building the bridge to the time when the recovery takes place. It will maintain its efforts to keep funding costs low in Australia and credit available to households and businesses. **The Board will not increase the cash rate target until progress is being made towards full employment** **and it is confident that inflation will be sustainably within the 2–3 per cent target band**. The Board is committed to do what it can to support jobs, incomes and businesses during this difficult period and to make sure that Australia is well placed for the expected recovery.

**Application/review questions**

1. Identify the extent to which real GDP is expected to decline and outline whether this means that Australia will experience a recession.
2. Outline how and why both Investment and Consumption are expected to contract during the downturn.
3. Describe two key factors that will ultimately determine whether Australia experiences a (deep) recession.
4. Explain why the unemployment rate will ‘not capture the full extent of the decline in labour demand’. In your response, refer to the labour force underutilisation rate.
5. Describe how a wage subsidy (or the actual $130B JobKeeper wage subsidy program implemented in Australia) will influence economic growth and the rate of unemployment.
6. Outline what is meant by a ‘labour intensive industry’ and explain why hours worked in Australia is expected to fall by more than real GDP.
7. Describe how the RBA has implemented a more expansionary monetary policy stance and analyse the impact this is expected to have on the goals of Full employment and Price stability. In your answer, reference to at least two of the four measures referred to by the RBA.
8. Outline one example of ‘fiscal stimulus’ that has been introduced under the umbrella of budgetary policy and explain how this can lift incomes and assist with the achievement of stronger economic growth.
9. Referring to two transmission channels of monetary policy, explain ‘record low’ borrowing rates influences AD.
10. Summarise the scenario in which economic activity and employment will begin to recover in the second half of 2020.
11. Identify those services sectors experiencing the biggest declines in demand and explain these sectors have been disproportionally affected by the (responses to the) coronavirus.
12. Describe why Investment in Liquified Natural Gas (LNG) projects in Australia have been stalled and outline the impact on economic growth.
13. Use an AD/AS diagram to illustrate how the breaking of the drought is influencing economic activity in Australia.
14. Describe how the housing market is being impacted by the (responses to the) coronavirus.
15. Explain why oil prices have fallen and examine the impact on Australia’s trade balance given that we are a net importer of oil.
16. Discuss how lower prices for oil and childcare are expected to influence the RBA’s ability to achieve price stability.
17. Define ‘trimmed mean inflation’ and describe how it is expected to move in the June quarter, relative to the headline rate of inflation.
18. Explain how spare capacity in the labour market is likely to influence wages growth and labour costs.
19. Identify the conditions that would need to prevail before the RBA adopts a tightening of monetary policy. When this occurs, outline whether this means that the monetary policy stance becomes restrictive.

**Extension question:**

1. Explain how it is possible for the cash rate to be trading well below the target cash rate of 0.25% during May 2020.