**Applied economic exercise**

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**Read the (heavily edited) Statement by the RBA Governor explaining the Monetary Policy Decision in May 2020. The unedited speech can be accessed here: https://www.rba.gov.au/media-releases/2020/mr-20-13.html**

At its meeting today, the Board decided to maintain the current policy settings, including the targets for the **cash rate** and the **yield on 3-year Australian Government bonds of 25 basis points**.

The global economy is experiencing a severe downturn as countries seek to contain the coronavirus. Many people have lost their jobs and a sharp rise in unemployment is occurring. At the same time, the containment measures have reduced infection rates in a number of countries. If this continues, a recovery in the global economy will start later this year, supported by both the **large fiscal packages and the significant easing in monetary policies**.

…In Australia, the functioning of the government bond markets has improved and the yield on 3-year Australian Government Securities (AGS) is at the target of around 25 basis points. Given these developments, the Bank has scaled back the size and frequency of **bond purchases**, which to date have totalled around $50 billion. The Bank is prepared to scale-up these purchases again and will do whatever is necessary to ensure bond markets remain functional and to achieve the yield target for 3-year AGS. The target will remain in place until progress is being made towards the goals for full employment and inflation.

….The Australian economy is going through a very difficult period and there is considerable uncertainty about the outlook. Reflecting this uncertainty, the Board considered a range of scenarios at its meeting. In the baseline scenario, **output falls by around 10 per cent** over the first half of 2020 and by around 6 per cent over the year as a whole. This is followed by a bounce-back of 6 per cent next year.

There has been a substantial, coordinated and **unprecedented fiscal and monetary response in Australia** to the coronavirus. [This includes a $130 billion wage subsidy provided by the federal government as well as large scale purchases of second-hand bonds by the RBA.] Without this response, the outlook would have been even more challenging. These **policies are supporting the economy** right now and will help when the recovery comes. They are supporting people's incomes, maintaining the important connections between businesses and their employees, underpinning the supply of credit to businesses and households, and keeping borrowing costs low. The deferral of loan and other payments is helping people manage their cash flows. The Australian banking system, with its strong buffers of capital and liquidity, is also helping the economy traverse this difficult period.

In the baseline scenario considered by the Board, the **unemployment rate peaks at around 10 per cent** over coming months and is still above 7 per cent at the end of next year. A lower unemployment rate than this is possible if the reduction in labour demand is accompanied by a larger reduction in average hours worked, rather than by people losing their jobs. [This of course means that the **underemployment rate** rises along with the **labour force underutilisation rate**.]

The Board also considered other scenarios. A stronger economic recovery is possible if there is further substantial progress in containing the coronavirus in the near term and there is a faster return to normal economic activity. On the other hand, if the **lifting of restrictions** is delayed or the restrictions need to be reimposed or household and business confidence remains low, the outcomes would be even more challenging than those in the baseline scenario.

In the various scenarios considered by the Board, inflation remains below 2 per cent over the next few years. In the March quarter just passed, CPI inflation rose to 2.2 per cent, but it is expected to turn negative temporarily in the June quarter [which means that we will experience a **quarter of deflation**], due to falls in oil prices, the introduction of free child care and deferrals of various price increases. Further out, in the baseline scenario inflation is 1 to 1½ per cent in 2021 and gradually picks up further from there.

Given this outlook, the Bank will maintain its efforts to keep funding costs low in Australia and credit available to households and businesses. 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. 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.

**Application/review questions**

1. **Distinguish the cash rate from the yield on Australian Government Bonds.**
2. **Explain why the RBA is now targeting the yield on Australian Government Bonds (at 0.25%) and illustrate how the RBA goes about reducing the yield on these bonds towards 0.25%.**
3. **Explain how a global recovery will impact on both economic activity in Australia and Australian macroeconomic demand policy settings.**
4. **Explain what is meant by ‘fiscal packages’ and the ‘easing in monetary policies’. Use an example of each to illustrate.**
5. **Identify the expected rate of economic growth for the first half of 2020 and discuss whether this means that Australia will experience a recession.**
6. **Identify examples of the ‘unprecedented fiscal and monetary response in Australia’ and briefly explain how this response assists with the achievement of strong and sustainable economic growth and full employment.**
7. **Identify the expected rate of unemployment over the coming months.**
8. **Distinguish the underemployment rate from the labour force underutilisation rate and explain why a fall in the demand for labour might not lead to a corresponding rise in the unemployment rate.**
9. **Discuss the nature of the trade-off between ‘lifting of restrictions’ and ‘economic activity’.**
10. **Distinguish disinflation from deflation and outline why deflation is expected in the June quarter of 2020.**
11. **Outline the conditions required for the RBA Board to consider increasing the target cash rate in the future.**