**Applied economic exercise**

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**Read the (edited) the overview of the August 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/aug/overview.html>

The COVID-19 pandemic represents the largest shock to the global economy in many decades. Labour markets have been severely disrupted. While infection rates have declined in some countries, they have escalated in many others, including the United States and some large emerging market economies. Renewed outbreaks are also occurring in some other countries, including Japan and parts of Australia. The ongoing spread of the virus, and the responses to contain it, will combine to slow the recovery.

The Australian economy has experienced a severe contraction and, like many other economies, is now in the early stages of recovery. The contraction over the first half of 2020 was smaller than anticipated three months ago, though it was still very large. It was also not quite as large as in some other economies, where lockdown measures were more binding and were imposed for longer. However, the pace of recovery is expected to be slower than previously forecast. Generalised uncertainty and deficiency in demand have turned out to be more of a drag on growth than previously thought. The measures taken to address the current outbreak in Victoria will further delay the recovery. The most recently announced containment measures are expected to subtract at least 2 percentage points from national growth in the September quarter, relative to the counterfactual where the renewed outbreak had not occurred.

In light of the extreme uncertainty about the course of the pandemic and its economic effects, the outlook is again considered in the form of three scenarios. In the baseline scenario, the Australian economy is expected to contract by about 6 per cent over 2020, before growing by around 5 per cent over 2021 and 4 per cent over 2022. This would still leave the level of output below where it would have been had the pandemic not occurred. Under the baseline scenario, the unemployment rate is expected to peak at around 10 per cent by the end of this year.

A stronger economic recovery is possible if faster progress in controlling the virus is achieved in the near term. In this scenario, a faster unwinding of activity restrictions and greater confidence lead to a faster recovery in consumption, investment and employment. The unemployment rate would peak at a lower level and decline faster than in the baseline scenario. However, a plausible downside scenario is where the world experiences a widespread resurgence in infections in the near term, and Australia itself faces further outbreaks and lockdowns in certain areas. Activity restrictions would weigh on household consumption and business investment decisions, despite continued policy stimulus and income support measures. Domestic activity would take much longer to recover in this scenario, resulting in the unemployment rate remaining close to its peak throughout 2021.

The coronavirus outbreak has been enormously disruptive for Australia's labour market. Employment declined by more than 850,000 in April and May, and increased by around 200,000 in June. The measured unemployment rate increased by more than 2 percentage points over the course of a few months, reaching 7.4 per cent in the month of June, the highest rate in more than two decades. The scale of job losses to date and the increase in unemployment would have been much greater were it not for the JobKeeper program. The unemployment rate would also have risen more if the proportion of workers leaving the labour force entirely had not been unusually high. Under the baseline scenario, the unemployment rate is expected to increase from here. Some of this increase stems from the outbreak in Victoria; employment and hours worked are expected to decline at a national level over this period because of the further activity restrictions. Unemployment will also increase elsewhere in Australia, as people begin searching actively for work again. The unemployment rate is expected to decline gradually from this peak over the course of the next couple of years.

Support from public policy has been instrumental in cushioning the effects of the health-related activity restrictions on incomes and will crucially shape the recovery as well. In aggregate, household disposable income has been maintained through this period, even as many people lost their jobs or worked fewer hours. The largest contributor to this support domestically has been the JobKeeper program, which is estimated to have supported more than one-quarter of all workers. The program has been extended beyond September and will continue to support employment until March 2021, although at lower rates of subsidy and with changed eligibility criteria. Additional payments to recipients of other forms of social assistance have boosted household incomes and will continue to do so over the next few quarters. Many households were also able to supplement their cash flows by withdrawing from their superannuation.

At the same time, health-related activity restrictions have reduced consumption opportunities, particularly for services. Border closures continue to constrain domestic tourism, and overseas tourism and education. Households have substituted from services to goods consumption – a pattern also evident in other countries – and stocked up on items such as long-life food and household goods. Overall, consumption is still estimated to have contracted by about 10 per cent over the first half of 2020, although consumer spending has increased over recent months. With fiscal [i.e. budgetary] support maintaining household income at the same time that consumption declined significantly, some households have accumulated additional savings over this period, though others have had to draw down on their savings. Some of the additional savings went into paying down debt and building up buffers in mortgage offset and redraw accounts. These savings are expected to help sustain the recovery in consumption that is already underway, even as the fiscal support to incomes begins to taper off.

Public policy decisions to support the economy have also affected inflation. As flagged in the previous Statement, headline CPI declined by 2 per cent in the June quarter, which took year-ended headline inflation to –0.3 per cent. The quarterly decline was entirely accounted for by two temporary factors: the fall in petrol prices and the decisions to make child care (and some preschool) free. Looking through these effects using various measures suggests that underlying inflation was closer to zero in the quarter, rather than the large negative recorded in the headline CPI.

Most of the decline in headline inflation will reverse in the September quarter. Petrol prices increased a little in recent months, and fees for child care and preschool are being progressively reintroduced. Looking beyond this near-term volatility, both headline and underlying inflation are expected to remain low for some time yet, given the extent of spare capacity in the economy and resulting weak wages growth. In the baseline scenario, trimmed mean inflation is expected to increase gradually, reaching around 1½ per cent by the end of 2022. Other outcomes are possible depending on the strength of the recovery; nonetheless, both the upside and downside scenarios see inflation remaining below 2 per cent for the next couple of years.

Weak demand for rental housing also weighed on the June quarter outcome for inflation and is likely to do so in the period ahead. With international borders closed, migration to Australia has essentially halted. The resulting slowdown in population growth reduced demand for housing, especially rental housing. Weak labour market conditions have also discouraged existing residents from forming new households. In addition, some tenants have negotiated discounts on their leases, which has directly reduced rents as measured in the CPI.

More broadly, uncertainty about incomes and employment prospects have contributed to recent declines in established housing prices in some cities. Alongside slower population growth, this points to a weak outlook for dwelling investment. The HomeBuilder package is expected to provide some offsetting near-term support, mostly in the detached housing segment. Demand for higher-density housing is expected to be soft, however, and many planned projects in this segment are now likely to be deferred.

Business investment is expected to decline significantly this year. In surveys and liaison, many firms report that they have already deferred or cancelled discretionary investment spending. These decisions have generally not been mandated by health-related activity restrictions. Rather, firms have reacted to actual and anticipated declines in demand and the general heightened uncertainty about the future, and have scaled back spending in an effort to preserve liquidity. This component of activity will be slow to recover; firms will generally wait to see demand recover before committing to expand capacity. A number of mining-related projects are expected to continue, however, encouraged by strong Chinese demand for iron ore, which has also supported iron ore prices and boosted the outlook for the terms of trade. Other categories of exports are expected to be a bit weaker than previously envisaged. In particular, tourism exports (and imports) have collapsed to essentially zero and will remain there until Australia's borders open to tourists again. The forecast scenarios presented in this Statement assume that this will not occur until at least the middle of next year, and later if the global spread of the virus follows the course assumed in the downside scenario.

After depreciating significantly during the height of the market turmoil in March, the Australian dollar has since appreciated to be a bit above its level at the start of the year. This appreciation is in line with the currencies of a range of other advanced economies against the backdrop of a broad-based depreciation of the US dollar over recent months. The Australian dollar is now in a range that is broadly consistent with its fundamental determinants, namely the terms of trade and the differential between interest rates in Australia and rates in major advanced economies.

As detailed in the May Statement, in mid March the Reserve Bank Board introduced a comprehensive package of policy measures to support the economy through this difficult period. The cash rate was reduced to 0.25 per cent; a target of 0.25 per cent was introduced for the 3-year Australian Government bond yield; and a three-year term funding facility was provided for banks and other authorised deposit-taking institutions. Over recent months the Board has continued to monitor the effects of this package, concluding that it is supporting the economy broadly as expected. Funding costs for banks remain at historical lows, and the same is true of borrowing costs for businesses, households and governments. Take-up of the Bank's low-cost Term Funding Facility is increasing steadily. This, and the package of measures more broadly, is supporting the availability of credit to businesses and households.

Over recent months, the Board also reviewed monetary policy support measures in other countries and assessed whether there were any lessons for the configuration of the Australian package. It concluded that, given the nature of the challenges posed by the pandemic, there was no need to adjust the mid-March package. The Board has, however, not ruled out adjusting this package in the future if circumstances warranted.

As part of its review, the Board also discussed experience with a range of other possible monetary measures, including foreign exchange intervention and negative interest rates. It also reviewed historical experience of direct central bank financing of governments.

The Board concluded that, at a time when the value of the Australian dollar is broadly in line with its fundamentals and the market was working well, there was not a case for intervention in the foreign exchange market. Intervention in such circumstances is likely to have limited effectiveness.

The Board continues to view negative interest rates as being extraordinarily unlikely in Australia. The main potential benefit is downward pressure on the exchange rate. But negative rates come with costs too. They can cause stresses in the financial system that are harmful to the supply of credit, and they can encourage people to save rather than spend.

The Board also reaffirmed the importance of the longstanding principle of separating monetary policy from the financing of government. This principle has served Australia and other nations well. Australian governments are currently able to fund themselves at historically low interest rates and have retained ready access to capital markets. Monetary financing of budget deficits is not an option under consideration in Australia.

…The Board is committed to doing what it can to support jobs, incomes and businesses in Australia through this difficult period, and thereby help build the bridge to the 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.

**Questions**

1. **Explain the relationship between the severity of lockdown measures and economic growth.**
2. **Explain why the RBA believes that the pace of economic recovery is likely to be slower than previously forecast.**
3. **Describe the RBA’s forecasts for the economy based on its baseline scenario and describe how a stronger than expected economic recovery is likely to impact on the accuracy of these forecasts.**
4. **Describe the impact that the coronavirus outbreak has had on Australia’s labour market and explain how the implementation of the JobKeeper program has impacted on key labour market statistics.**
5. **Explain why the participation rate fell since the onset of the virus and outline how this influenced the rate of unemployment.**
6. **Outline two reasons for household disposable income being maintained over recent months despite the fact that underemployment and unemployment have increased significantly.**
7. **Households have substituted away from services and towards goods over recent months. Examine the implications for relative prices and the allocation of resources.**
8. **Identify the two temporary factors that have been responsible for headline deflation of 0.3% for the year ended June 2020 and examine the implications for the underlying rate of inflation over the same period.**
9. **Explain how continuing spare capacity in the economy and week wages growth are likely to have influenced monetary policy settings in the first half of 2020.**
10. **Describe two separate factors that are exerting downward pressure on housing prices and examine the implications for aggregate demand and economic growth.**
11. **Explain why business investment is expected to decline significantly over the remainder of 2020.**
12. **Explain why the terms of trade outlook has become more positive over 2020.**
13. **Explain why the Australian dollar has appreciated since March 2020 and describe the influence that each of the following would be expected to have on the value of Australia’s exchange rate:**
    1. **A higher terms of trade**
    2. **A further loosening of monetary policy**
14. **Describe how the RBA has used monetary policy over 2020 to support economic growth.**
15. **Explain what is meant by foreign exchange intervention and outline how, in theoretical terms, the RBA could intervene in the foreign exchange market to stimulate economic growth.**
16. **Explain why negative interest rates could exert downward pressure on the exchange rate.**
17. **Explain why negative interest rates could reduce the supply of credit in the economy, but at the same time encourage people to save rather than spend. [Hint: where might the savings of people end up and why might people be reluctant to spend?]**
18. **‘Monetary financing of budget deficits is not an option under consideration in Australia’. Explain what is meant by this statement.**
19. **What economic conditions will need to prevail for the RBA to consider a tightening of monetary policy?**