**Applied Economic Exercise**

**Read** **the edited Statement by Philip Lowe, Governor: Monetary Policy Decision (March 2021) and answer the questions that follow.**

**The full statement can be accessed here:** [**https://www.rba.gov.au/media-releases/2021/mr-21-03.html**](https://www.rba.gov.au/media-releases/2021/mr-21-03.html)

…The outlook for the global economy has improved over recent months due to the **ongoing rollout of vaccines**. While the path ahead is likely to remain bumpy and uneven, there are better prospects for a sustained recovery than there were a few months ago. Global trade has picked up and commodity prices have increased over recent months. Even so, the recovery remains dependent on the health situation and on significant **fiscal and monetary support**. Inflation remains low and below central bank targets.

The positive news on vaccines together with the prospect of further significant fiscal stimulus in the United States has seen longer-term bond yields increase considerably over the past month. This increase partly reflects **a lift in expected inflation over the medium term** to rates that are closer to central banks' targets. Reflecting these global developments, there have been similar movements in Australian bond markets. Changes in bond yields globally have been associated with volatility in some other asset prices, including foreign exchange rates. The **Australian dollar remains in the upper end of the range of recent years**.

In Australia, the economic recovery is well under way and has been stronger than was earlier expected. There has been **strong growth in employment and a welcome decline in the unemployment rate to 6.4 per cent**. Retail spending has been strong and most of the households and businesses that had deferred loan repayments have now recommenced repayments. The recovery is expected to continue, with the central scenario being for **GDP to grow by 3½ per cent over both 2021** **and 2022. GDP is expected to return to its end-2019 level by the middle of this year**.

Wage and price pressures are subdued and are expected to remain so for some years. The economy is still operating with **considerable spare capacity** and the unemployment rate remains higher than it has been for some years. Further progress in reducing spare capacity is expected, but it will be some time before the labour market is **tight enough to generate wage increases** that are consistent with achieving the inflation target. In the central scenario, the unemployment rate will still be around 6 per cent at the end of this year and 5½ per cent at the end of 2022. In **underlying terms, inflation** is expected to be 1¼ per cent over 2021 and 1½ per cent over 2022. **CPI inflation** is expected to rise temporarily because of the reversal of some COVID-19-related price reductions.

The **current monetary policy settings are continuing to help the economy** by keeping financing costs very low, contributing to a lower exchange rate than otherwise, and supporting the supply of credit and household and business balance sheets. Together, monetary and fiscal policy are supporting the recovery in aggregate demand and the pick-up in employment.

**Lending rates for most borrowers are at record lows and housing prices across Australia have increased recently.** Housing credit growth to owner-occupiers has picked up, but investor and business credit growth remain weak.

…The Board remains committed to maintaining highly supportive monetary conditions until its goals are achieved. The **Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range**. For this to occur, wages growth will have to be materially higher than it is currently. This will require significant gains in employment and a return to a tight labour market. The Board does not expect these conditions to be met until 2024 at the earliest.

**Questions**

1. **Explain why the ‘ongoing rollout of vaccines’ is expected to assist with the global economic recovery.**
2. **Briefly outline what is meant by ‘fiscal and monetary support’, providing an example of each in the context of the Australian economy over the past year.**
3. **Explain why inflation is expected to increase over the medium term and discuss the implications for price stability.**
4. **Outline one likely factor that accounts for the stronger AUD in early 2021.**
5. **Describe the relationship between employment and the unemployment rate. In your answer, discuss the possibility of a simultaneous increase in employment and the unemployment rate.**
6. **Identify the expected rate of economic growth for Australia over 2021 and explain whether this is consistent with the goal of strong and sustainable economic growth.**
7. **The Australian economy has grown by more than 3% since the middle of 2020. Analyse whether this means that the size of the economy (i.e. the level of real GDP) is larger at the start of 2021 than it was in the middle of 2020.**
8. **Explain what is meant by spare capacity in labour markets and provide two indicators that might suggest that there is considerable spare capacity in the economy.**
9. **Explain how a ‘tight labour market’ influences wages growth.**
10. **Distinguish underlying inflation from CPI inflation and explain why CPI inflation is expected to be higher than underlying inflation in the short term.**
11. **Explain how the current monetary policy settings (i.e. effectively the maintenance of low interest rates) are helping to stimulate and assist with the achievement of full employment.**
12. **Describe the relationship between lending rates and housing prices.**
13. **Describe the conditions that would need to exist before the RBA seeks to raise interest rates.**