**Applied Economic Exercise**

**Read** **the edited Minutes of the Monetary Policy Meeting of the RBA (April 2021) and answer the questions that follow.**

**The full document can be accessed here:** https://www.rba.gov.au/monetary-policy/rba-board-minutes/2021/2021-04-06.html

**International economic developments**

Members commenced their discussion of international developments with a cross-country review of economic activity and developments in labour markets during the pandemic. A recurring theme was that **Australia had fared relatively well in terms of output levels and labour market outcomes**. The December quarter 2020 national accounts showed that GDP in Australia had recovered to close to pre-pandemic levels, whereas GDP was still considerably below pre-pandemic levels in many other countries. The loss of output over 2020 as a whole had also been smaller in Australia than in many other countries. This reflected both the relatively smaller initial decline in output in Australia and the swift recovery since then.

Turning to labour market outcomes, members noted that most countries had experienced a large contraction in both employment and labour force participation since the pandemic. Australia's experience had been unusual in that **employment and participation** were now higher than the levels prevailing at the end of 2019. Favourable health outcomes in Australia, the design of the JobKeeper and other temporary support programs and the swift recovery in activity had all contributed to a strong bounce-back in the domestic labour market.

Despite the rapid recovery in employment in Australia, members noted that wages growth domestically had slowed to a greater extent and had been more subdued than in other countries. **The labour market adjustment in Australia in response to the pandemic had principally taken the form of adjustment to hours worked and widespread wage restraint.** In contrast, in some other countries, including the United States, the adjustment had mainly been through a decline in employment.

**…Domestic economic developments**

Members noted that the strong recovery in the Australian economy had continued into 2021. The Australian economy grew by 3.1 per cent in the December quarter, following the 3.4 per cent rebound in the September quarter. This meant that **GDP was around 1 per cent below its December 2019 level at the end of 2020**. **Consumption had continued to recover in the December quarter despite a decline in household income**. Growth in business and dwelling investment had been stronger than expected, supported by targeted fiscal measures. Exports had been supported by a sharp jump in rural production following the return of **more favourable weather conditions**. Public investment had increased in the December quarter, but by less than anticipated. Indications at the time of the meeting were that the rollout of public investment programs over the first half of 2021 would be slower than foreshadowed in state budgets. Overall, preliminary data suggested that GDP in the March quarter was likely to have recovered further to around its pre-pandemic level, earlier than previously expected.

Members discussed the unusual behaviour of household disposable income during 2020. Growth in incomes had been particularly strong in the June and September quarters of 2020, as **fiscal transfers such as social assistance and subsidy payments had more than offset the declines in labour and financial income**. Part of this increase in household disposable income had been unwound in the December quarter, and further declines were expected over the first half of 2021 as fiscal transfer payments and other temporary support measures expired.

…Members noted that **reduced uncertainty and higher net wealth** for many households were likely to support the recovery in consumption in the period ahead. However, much would depend on the extent to which households consume or invest the savings accumulated in 2020. Survey data suggested that income and savings had increased for most household income groups, with most of the additional saving being undertaken by higher-income households. This was partly because higher-income households spend more on the types of discretionary services that had been unavailable during the pandemic. Fiscal programs had also supported the incomes of self-employed people and business proprietors.

…Members discussed the strength in the recent run of labour market outcomes. Employment had returned to pre-pandemic levels considerably faster than expected. There had also been a **shift in growth from part-time to full-time employment**. Forward-looking indicators of labour demand had remained strong, with job vacancies and advertisements above pre-pandemic levels, and employment intentions trending higher. This partly reflected the need for firms to rehire for positions vacated during the pandemic and a period of catch-up in hiring that had been delayed in 2020. These indicators suggested that at least some of the job losses that were likely to follow the end of the JobKeeper program would be offset by new hiring.

…Members noted that housing prices had increased significantly in recent months. … This had partly reflected strong demand from **first-home buyers** and owner-occupiers seeking more space. … Members noted that **low interest rates** had been one of the factors contributing to the increase in demand for housing, alongside other policies such as government grants.

**…Considerations for monetary policy**

In considering the policy decision, members observed that the rollout of COVID-19 vaccines was supporting the recovery of the global economy. While the path ahead remained uneven, there were better prospects for a sustained recovery. **Global trade had picked up and commodity prices were generally higher** than at the start of the year. The global outlook remained dependent on responses to the pandemic and the risks of further outbreaks of COVID-19 infections, as well as on the significant fiscal and monetary support around the world. Inflation remained low and below central banks' targets in many economies.

Financial markets had responded to the positive news on vaccines and the additional fiscal stimulus in the United States. Sovereign bond yields had increased over recent months, including in Australia. This increase partly reflected **inflation expectations lifting from near record lows to be closer to central banks' targets**. The Australian dollar was around its level at the beginning of the year.

The economic recovery in Australia was well under way and had been stronger than previously expected. There had been a welcome fall in the unemployment rate to 5.8 per cent in February, and the number of employed people had returned to the pre-pandemic level. GDP had increased by a strong 3.1 per cent in the December quarter 2020, boosted by a lift in consumption as the health situation improved. **The economic recovery was expected to continue, with above-trend growth forecast in 2021 and 2022**. Household and business balance sheets were in good shape overall and this was expected to continue to support spending. An important near-term issue was how households and businesses would adjust to the **tapering of several fiscal support measures**. Members noted that there might be a temporary pause in the pace of improvement in labour market conditions.

Despite these generally positive developments, **wage and price pressures had remained subdued** and were expected to remain so for several years. The economy had been operating with considerable spare capacity and the unemployment rate was still too high. It would take some time to reduce this spare capacity and for the labour market to be tight enough to generate **wage increases consistent with achieving the inflation target**. It was likely that wages growth would need to be sustainably above 3 per cent, which was well above its current level. While annual CPI inflation was expected to rise temporarily to around 3 per cent around the middle of the year as a result of the reversal of some pandemic-related price reductions, in **underlying terms inflation was expected to remain below 2 per cent** over both 2021 and 2022.

…Since the start of 2020, the Bank's balance sheet had increased by around $215 billion and a further substantial increase was in prospect. The initial $100 billion government bond purchase program was almost complete and the second $100 billion program would commence the following week. Beyond this program, the Bank was prepared to **undertake further bond purchases if doing so would assist with progress towards the goals of full employment and inflation**. $95 billion of low-cost funding had been accessed through the Term Funding Facility and a further $95 billion was available to be drawn down under the facility until the end of June 2021. This low-cost funding would continue to provide support through to mid 2024.

…The Bank's monetary policy settings had continued to support the economy by **keeping financing costs very low, contributing to** **a lower exchange rate than otherwise**, encouraging the supply of credit to businesses and strengthening household and business balance sheets. Monetary and fiscal policy had supported the recovery in aggregate demand and the pick-up in employment. The Board remained committed to doing what it reasonably could to support the Australian economy, and would maintain highly supportive monetary conditions until its goals were achieved.

Members affirmed that the cash rate target would be maintained at 10 basis points, and the rate of remuneration on Exchange Settlement balances at zero, for as long as necessary. They continued to view a negative policy rate as extraordinarily unlikely. 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 would need to be materially higher than it is currently. This would 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.

**The decision**

The Board reaffirmed the existing [expansionary] policy settings…

**Questions**

1. **Provide evidence to support the claim that during the pandemic *‘Australia had fared relatively well in terms of output levels and labour market outcomes’.***
2. **Provide an explanation for Australia’s employment and participation being higher than the levels prevailing at the end of 2019 when other countries have experienced declines in both employment and participation.**
3. **Explain what is meant by the following statement: ‘*The labour market adjustment in Australia in response to the pandemic had principally taken the form of adjustment to hours worked and widespread wage restraint’*. Make reference to the labour force underutilization rate.**
4. **Explain why GDP was around 1 per cent below its December 2019 level at the end of 2020 when the economy grew by 3.1% and 3.4% in the December and September quarters respectively.**
5. **Explain how more favourable weather conditions influenced both the current account and economic growth in the December quarter of 2020.**
6. **Provide an explanation for continuing growth in Consumption demand when household incomes declined and explain why household incomes fell in the December quarter after rising in the June and September quarters.**
7. **Explain why households have experienced reduced uncertainty and higher net wealth over the past 3-6 months and describe the implications for the achievement of full employment and price stability.**
8. **Explain why there has been a shift in growth from part-time to full-time employment and outline how this is likely to have influenced the unemployment rate and underemployment rate.**
9. **Describe two factors that have contributed to growth in the housing market.**
10. **Explain how a *‘pick-up’* in global trade and higher commodity prices are likely to influence both the achievement of price stability and monetary policy settings.**
11. **Explain why inflation expectations have risen and examine the implications for monetary policy settings.**
12. **Provide two factors that support the view that economic recovery is well underway and outline how a stronger than expected recovery will influence the setting of both fiscal policy and monetary policy over the next year.**
13. **Explain what is meant by the ‘*tapering of several fiscal support measures’* and examine the implications for the labour market.**
14. **Explain why ‘wage and price pressures are expected to remain subdued for several years and examine the implications for price stability.**
15. **Identify the rate at which wages would need to grow before the inflation target is likely to be achieved. Explain the role of the unemployment rate in achieving this outcome.**
16. **Explain why headline inflation is expected to climb above 3% and examine the implications for the achievement of price stability. In your answer, refer to the underlying rate of inflation.**
17. **Explain how the RBA purchase of bonds [in the secondary market] helps to promote full employment and price stability.**
18. **Describe how the RBA has kept ‘financing costs very low’ and explain how exerts downward pressure on the exchange rate.**
19. **Outline the conditions that would need to exist before the RBA decided to increase the cash rate from 0.1%.**