**Applied Economic Exercise**

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

**The full statement can be accessed here:** https://www.rba.gov.au/media-releases/2021/mr-21-13.html

At its meeting today, the Board decided to maintain the cash rate target (TCR) at 10 basis points and the **interest rate on Exchange Settlement balances of zero per cent**. …These measures will provide the continuing monetary support that the economy needs as it transitions from the recovery phase to the expansion phase. The Board is committed to achieving the goals of **full employment and inflation consistent with the target**. Today's decisions, together with those taken previously, have the economy on a path to achieve those objectives.

The economic recovery in Australia is stronger than earlier expected and is forecast to continue. The outlook for investment has improved and **household and business balance sheets are generally in good shape**. **National income is also being supported by the high prices for commodity exports**. Domestic financial conditions are very supportive and **the exchange rate has depreciated a little recently**. One near-term uncertainty is the effect of the recent virus outbreaks and the lockdowns. But the experience to date has been that once outbreaks are contained and restrictions are eased, the economy bounces back quickly.

The labour market has continued to recover faster than expected. The unemployment rate declined further to 5.1 per cent in May and more Australians have jobs than before the pandemic. There has also been a welcome decline in **underemployment** and **labour force participation** is around record highs. **Job vacancies** are high and more firms are reporting **shortages of labour**, particularly in areas affected by the closure of Australia's international borders. Despite the strong recovery in jobs and reports of **labour shortages, inflation** and wage outcomes remain subdued. While a pick-up in inflation and wages growth is expected, it is likely to be only gradual and modest. In the central scenario, inflation in underlying terms is expected to be 1½ per cent over 2021 and 2 per cent by mid 2023. In the short term, **CPI inflation is expected to rise temporarily to about 3½ per cent** over the year to the June quarter because of the reversal of some COVID-19-related price reductions a year ago.

[In relation to **non-conventional monetary policy measures**]…the bond purchase program is playing an important role in supporting the Australian economy. The Bank will continue to purchase bonds given that we remain some distance from the inflation and employment objectives. However, the Board is responding to the stronger-than-expected economic recovery and the improved outlook by adjusting the weekly amount purchased. It will conduct a further review in November, allowing the Board to respond to the state of the economy at that time. The final draw-downs under the Term Funding Facility were made in late June. In total, $188 billion has been drawn down under this facility, which has contributed to the Australian banking system being highly liquid. Given that the facility is providing low-cost fixed-rate funding for 3 years, it will continue to support low borrowing costs until mid 2024.

**Housing markets have continued to strengthen**, with prices rising in all major markets. Housing credit growth has picked up, with strong demand from owner-occupiers, including first-home buyers. There has also been increased borrowing by investors. Given the environment of **rising housing prices and low interest rates**, the Bank will be monitoring trends in housing borrowing carefully and it is important that lending standards are maintained.

The Board remains committed to maintaining **highly supportive monetary conditions** to support a return to full employment in Australia and inflation consistent with the target. It will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. The Bank's central scenario for the economy is that this condition will not be met before 2024. Meeting it will require the labour market to be tight enough to generate wages growth that is materially higher than it is currently.

**Questions**

1. **Explain why the interest rate on Exchange Settlement balances is below the target cash rate.**
2. **Define full employment and explain how the maintenance of a TCR of 0.1% is likely to have influenced the achievement of this goal. Refer to the statistics contained in the statement.**
3. **Explain how the maintenance of a TCR of 0.1% influences the achievement of *‘inflation consistent with the target’*.**
4. **Explain what is meant by *‘household and business balance sheets are generally in good shape’* and outline the implications for the monetary policy setting.**
5. **Outline how high commodity prices boosts national income and influences the monetary policy setting.**
6. **Identify one possible cause of the recent exchange rate depreciation and describe the influence that the depreciation has on the achievement of full employment. In your response refer to one of the transmission channels of monetary policy.**
7. **Outline the relationship between the following economic variables:**
   1. **Job vacancies and unemployment**
   2. **Labour shortages and job vacancies**
   3. **Unemployment and the participation rate**
   4. **Underemployment and Job vacancies**
   5. **Labour shortages and inflation**
   6. **Unemployment and wages**
8. **Identify the expected rate of headline inflation for the year to end 30 June 2021 and outline the implications for the achievement of price stability and monetary policy settings.**
9. **Describe how ‘non-conventional monetary policy measures’ have supported economic growth and explain how smaller bond purchases of recent weeks suggests that the RBA is prepared to adopt a slightly less expansionary stance.**
10. **Explain how the expansionary monetary policy stance has contributed to growth in housing prices. Refer to one of the transmission channels of monetary policy.**
11. **Describe the conditions that would need to exist before the RBA tightens monetary policy. In your answer, make reference to NAIRU.**