**Applied economic exercise**

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**August 2021**

**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/2021/aug/overview.html***

1. The Australian economy had been recovering faster than expected over the first half of this year. Output had surpassed pre-pandemic levels and, as at June, the unemployment rate had declined below pre-pandemic levels. Supported by **fiscal and monetary policy stimulus**, the Australian economy – along with many others globally – was on track to a robust expansion. In the absence of the latest virus outbreaks and lockdowns, the outlook would have been noticeably upgraded from 3 months ago.
2. The **recent outbreaks of the Delta variant of the COVID-19 virus are interrupting the recovery**. The near-term outlook is highly uncertain and dependent on health outcomes. Further large outbreaks are possible, but the need for extended lockdowns should diminish as vaccination coverage increases. **GDP will contract noticeably in the September quarter**, and it is expected that **employment will decline** and the **unemployment rate increase** for a time. The experience of previous lockdowns is that **much of the labour market adjustment will come through a decline in hours worked and labour force participation**. The longer the lockdowns continue, however, the more likely it is that jobs are lost.
3. …The experience both in Australia and overseas is that the **recent lockdowns have been less damaging to the economy** than the lockdowns in the first half of last year. This is because business models have adapted to restrictions on activity, and the restrictions themselves have generally become more targeted now that more is known about how the virus is transmitted. Past experience has also shown that when virus outbreaks are contained and restrictions are eased, spending bounces back as consumption possibilities return.
4. The **Australian economy is expected to bounce back**, although further major outbreaks and extended lockdowns would delay this. Under the baseline scenario, output and employment are expected to have returned to their previously anticipated paths by early next year. GDP growth is expected to be a little over 4 per cent over 2022 and around 2½ per cent over 2023. The unemployment rate is expected to resume its downward path, approaching 4 per cent by the end of 2023. Measures of growth in wages and labour costs more broadly are expected to return over the next few quarters to pre-pandemic rates, and increase gradually from there. This baseline scenario is premised on a significant share of the population being vaccinated by the end of this year and a gradual opening up of Australia's international border from mid 2022.
5. As foreshadowed in previous Statements, **CPI inflation spiked over the year to the June quarter, reaching 3.8 per cent**. Most of this increase reflected the earlier reversals of price falls related to the pandemic. CPI inflation was also higher in the quarter, driven by increases in the prices of petrol, fruit and vegetables, which tend to be volatile. In underlying terms, inflation remains low, at around 1¾ per cent. The introduction and unwinding of government rebates and other subsidy programs continues to affect prices of some items.
6. In the Bank's baseline scenario, it takes some years for the stronger economy to feed through into wage and price increases that are consistent with the inflation target. In underlying terms, inflation is expected to be 1¾ per cent over 2022 and 2¼ per cent over 2023. One source of uncertainty is **how wages and prices will behave once unemployment reaches the low levels currently forecast**. It has been some decades since Australia has sustained an unemployment rate around 4 per cent, so there is little historical experience to guide estimates of the **sensitivity of this relationship**.
7. Fiscal and monetary policy have been instrumental in supporting the economy during lockdowns and other restrictions, as well as underpinning the subsequent recoveries. In response to the latest outbreaks, the Australian Government has extended disaster payments to affected households, and state governments have introduced packages to support affected businesses. While different from the combination of JobKeeper and higher welfare payments used previously, the level of support for those most affected is broadly similar. The Bank is directly supporting these measures through its government banking services, which enable rapid payments to households and firms.
8. Although the global outlook remains uncertain, economic activity and labour markets are recovering quickly as vaccination rates rise and many economies open up. Conditions in services sectors are improving noticeably where health-related restrictions have been eased. Global demand for goods nonetheless remains strong, as has been the case throughout most of the pandemic. This has been positive for many economies in Asia, including China, where recent growth has been led by exports and manufacturing investment. The Chinese economy continues to grow in line with pre-pandemic expectations, having recovered ahead of many other economies. Stronger manufacturing investment to expand production capacity, particularly for semiconductors, has also featured in the response to strong global demand for goods in some of the export-oriented economies in the Asian region. However, supply chain bottlenecks are still being worked through and shipping costs are unusually high.
9. Strong demand for goods has also boosted the **prices of many commodities**, including some of Australia's main exports. Australia's terms of trade are therefore expected to reach a record high in the September quarter, surpassing the peak reached during the mining boom. Despite these high commodity prices, the **Australian dollar has depreciated** to around its lowest levels this year.
10. … the rapid recovery to date in the labour market had resulted in solid growth in labour income, more than offsetting the withdrawal earlier in the year of the JobKeeper program and other fiscal support measures. This and **the strong rise in household wealth** had underpinned a robust increase in consumption. However, consumption is the category of spending most affected by lockdowns and, as in the previous outbreaks, it is expected to decline in the September quarter before rebounding as restrictions are eased later in the year.
11. After declining during the initial virus outbreak last year, housing prices have been rising in all major markets. **Demand for existing housing has been boosted by the economic recovery and the low level of mortgage interest rates**. Growth in housing credit has picked up. On top of the strong demand from first-home buyers and existing owner-occupiers, demand for finance from investors has also increased recently. Given the environment of rising housing prices and low interest rates, it is important that lending standards are maintained. The Bank is monitoring trends in housing borrowing carefully.
12. Dwelling investment has been increasing strongly and is likely to remain at high levels despite slow population growth and the closure of the HomeBuilder program to new applications. Residential building approvals have declined since the program ended; however, they remain well above pre-pandemic levels, which implies that underlying demand for new housing is strong. A significant pipeline of HomeBuilder-supported projects remains to be completed over this year and next; **the prices of these new homes as recorded in the CPI will be held down as the subsidies under the program are paid out**. Health-related restrictions will interrupt construction in some parts of Australia in the near term. Given the strength of underlying demand, however, dwelling investment is expected to recover quickly.
13. Likewise, tax incentives and other policy measures have encouraged some types of **business investment**, especially purchases of machinery & equipment. High levels of business confidence, declining spare capacity and strengthened balance sheets have also supported the rebound. By contrast, the near-term outlook for non-residential construction is weak; indicators such as building approvals have increased lately, however, supporting expectations of a recovery in the new year.
14. The package of monetary policy measures introduced by the Bank in response to the pandemic has been supporting the Australian economy. By **lowering the structure of interest rates,** **funding costs across the economy have declined to historic lows and the exchange rate is lower than it would otherwise be**. Interest rates on business and housing loans continue to move lower, which is positive for the cash flows of businesses and households overall. Very low interest rates have also supported asset prices, which has strengthened the balance sheets of firms and households. Banks' funding costs have benefited from significant final drawdowns from the Term Funding Facility. This effect will persist, as funding under this facility is being provided to mid 2024.
15. At its July meeting, the Reserve Bank Board decided to retain the yield target for the April 2024 Australian Government bond, rather than extend the target to the November 2024 bond. This decision was taken in light of the significantly faster-than-expected recovery to that point. The Board also decided to continue with the bond purchase program once the second $100 billion of purchases is completed in September. **Doing so will assist with progress towards the goals of full employment and inflation consistent with the target**. The purchases until at least November will be at the rate of $4 billon a week, rather than the current $5 billion. This adjustment reflected the better-than-expected progress that has been made towards the Bank's goals and the improved outlook for the next couple of years.
16. …At its August meeting, the Board decided to maintain the current settings for the cash rate and yield target. It also decided to continue with the previously announced change in the rate of bond purchases, having considered the case for delaying this change. The recent virus outbreaks and lockdowns have interrupted the recovery, and many households and firms are facing difficult conditions. The need for additional policy support in response to the outbreaks is in the short term; the economy entered the current episode of outbreaks with more momentum than previously thought, and fiscal and monetary policy support are already cushioning the economic effects. Strong growth is expected to resume next year. In the Board's assessment**, fiscal policy is the more appropriate instrument in the current circumstances of a temporary, localised reduction in incomes**. The Board therefore welcomed the additional fiscal measures announced recently. The Board will nonetheless keep the rate of bond purchases under review in light of the evolving health situation, and is prepared to act if worsening health outcomes affect the economic outlook.
17. The Board remains committed to maintaining highly accommodative monetary conditions to support a return to full employment in Australia and inflation consistent with the 2–3 per cent target. It will not raise the cash rate until inflation is sustainably within the target range. Meeting this condition will require the labour market to be tight enough to generate wages growth that is materially higher than current levels. Under the current central scenario for the economy this will not be until 2024.

**Questions**

1. **Explain what is meant by fiscal and monetary policy stimulus.**
2. **Provide examples of how the fiscal and monetary policy stimulus has been implemented over the past year.**
3. **Explain the relationship between recent outbreaks of the Delta variant and economic growth.**
4. **Define economic contraction and explain why the expected economic contraction in the September quarter is expected to increase the rate of unemployment and underemployment. In your answer, refer to the labour force participation rate.**
5. **Explain why recent lockdowns have been less damaging to the economy.**
6. **Describe the RBA’s forecasts for the economy based on its baseline scenario and describe how lower vaccination rates (than those anticipated) are likely to impact on the accuracy of these forecasts.**
7. **Identify the rate of inflation over the year to the end of the June quarter 2021 and outline the implications this has for the achievement of price stability. In your answer, refer to the underlying rate of inflation.**
8. **Explain how the rate of unemployment falling to around 4% is likely to influence both wages growth and inflation. In your answer, provide a possible explanation for the RBA to be uncertain about the ‘sensitivity of this relationship’.**
9. **Define the terms of trade and explain why Australia's terms of trade is expected to increase further in the September quarter.**
10. **Describe the likely relationship between Australia's terms of trade and the value of the Australian dollar, and account for the depreciating exchange rate over recent months.**
11. **Explain why there has been a strong rise in household wealth despite the withdrawal of Jobkeeper at the start of 2021.**
12. **Describe some of the factors contributing to growth in housing prices.**
13. **Examine the impact that HomeBuilder-supported projects is likely to have on the underlying rate of inflation over the next year.**
14. **Describe the separate factors that have contributed to growth in business investment over the past year.**
15. **Explain how the RBA has lowered the structure of interest rates across the economy and, in turn, how this has influenced the exchange rate.**
16. **Apart from the exchange rate channel, identify the two transmission channels referred to in paragraph 14 and explain how each is influencing AD.**
17. **Explain how bond purchases by the RBA [not to be confused with bond purchases as a means of manipulating the cash rate] assist with the achievement of full employment and price stability.**
18. **Explain why the RBA Board considered that ‘fiscal policy is the more appropriate instrument in the current circumstances of a temporary, localised reduction in incomes’. Outline whether this relates to a weakness of monetary policy.**
19. **What economic conditions will need to prevail for the RBA to consider a tightening of monetary policy?**