**Applied Economic Exercise**

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

**The full statement can be accessed here: https://www.rba.gov.au/media-releases/2021/mr-21-19.html**

At its meeting today, the Board decided to maintain the cash rate target at 10 basis points and the interest rate on Exchange Settlement balances of zero per cent [as well as] **maintain the target of 10 basis points for the April 2024 Australian Government bond** [and] purchase government securities at the rate of $4 billion a week.

…Prior to the Delta outbreak the Australian economy had considerable momentum. GDP increased by 0.7 per cent in the June quarter and by nearly **10 per cent over the year. Business investment was picking up and the labour market had strengthened**. The **unemployment rate** had fallen below 5 per cent and **job vacancies** were at a high level.

The recovery in the Australian economy has, however, been interrupted by the Delta outbreak and the associated restrictions on activity. GDP is expected to decline materially in the September quarter and the unemployment rate will move higher over coming months. While the outbreak is affecting most parts of the economy, **the impact is uneven, with some areas facing very difficult conditions while others are continuing to grow strongly**.

This setback to the economic expansion is expected to be only temporary. The Delta outbreak is expected to delay, but not derail, the recovery. As vaccination rates increase further and restrictions are eased, the economy should bounce back. There is, however, uncertainty about the timing and pace of this bounce-back and it is likely to be slower than that earlier in the year. Much will depend on the health situation and the easing of restrictions on activity. In our central scenario, the economy will be growing again in the December quarter and is expected to be back around its pre-Delta path in the second half of next year.

Notwithstanding the strong economic and labour market outcomes pre-Delta, **wage and price pressures remain subdued**. Over the year to the June quarter**, the Wage Price Index increased by just 1.7 per cent**. Housing prices are continuing to rise, …[and] given the environment **of rising housing prices and low interest rates**, the Bank is monitoring trends in housing borrowing carefully and it is important that lending standards are maintained.

Very accommodative financial conditions will continue to support the recovery of the Australian economy. **Borrowing rates are at record lows, sovereign bond yields are at very low levels and the exchange rate has depreciated over recent months**. The **fiscal responses by the Australian Government** and the state and territory governments are also providing welcome assistance in supporting household and business balance sheets.

The Board's decision to **extend the bond purchases** at $4 billion a week until at least February 2022 reflects the delay in the economic recovery and the increased uncertainty associated with the Delta outbreak. The Board will continue to review the bond purchase program in light of economic conditions and the health situation, and their implications for **the expected progress towards full employment and the inflation target**. These bond purchases, together with the low level of the cash rate, the yield target and the funding that has been provided under the Term Funding Facility, are providing substantial and ongoing support to the Australian economy.

The Board is committed to maintaining highly supportive monetary conditions to achieve 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 central scenario for the economy is that this condition will not be met before 2024. Meeting this condition will require the **labour market to be tight enough to generate wages growth** that is materially higher than it is currently.

**Questions**

1. **Explain how the government maintains the target of 10 basis points for Australian Government bonds.**
2. **Examine the relationship between economic growth for the year ended June 2021 and wages growth.**
3. **Examine the recent relationship between the unemployment rate and job vacancies and outline the implications this has for interest rates.**
4. **Discuss whether monetary policy is less suited (compared to budgetary policy) to combating a downturn in economic activity that is uneven in its impact.**
5. **Apart from slower economic growth in the June and September quarters, describe one other factor that accounts for ‘wage and price pressures’ remaining subdued.**
6. **Given that growth in the Wage Price Index was 1.7 per cent for the year to end June 2021, and headline inflation over the same period was 3.8%**
7. **Describe the relationship between housing prices and interest rates. [Ensure that you describe the relationship in both directions.]**
8. **Explain how more accommodative financial conditions influence Australia’s exchange rate.**
9. **Outline one example of a ‘fiscal response’ [to the economic effects of Covid-19] and discuss the implications for economic growth and full employment.**
10. **Describe the implications for interest rates following the decision by the RBA board to extend the bond purchases.**
11. **Describe two other ways that the RBA is exerting downward pressure on interest rates.**
12. **Explain how the current monetary policy stance is influencing ‘the expected progress towards full employment and the inflation target’.**
13. **Describe the relationship between labour market spare capacity and wages growth.**
14. **Outline the conditions that would need to exist before the RBA tightens monetary policy. In your answer, make reference to NAIRU.**