ANZ Research

Australian Economic Insight

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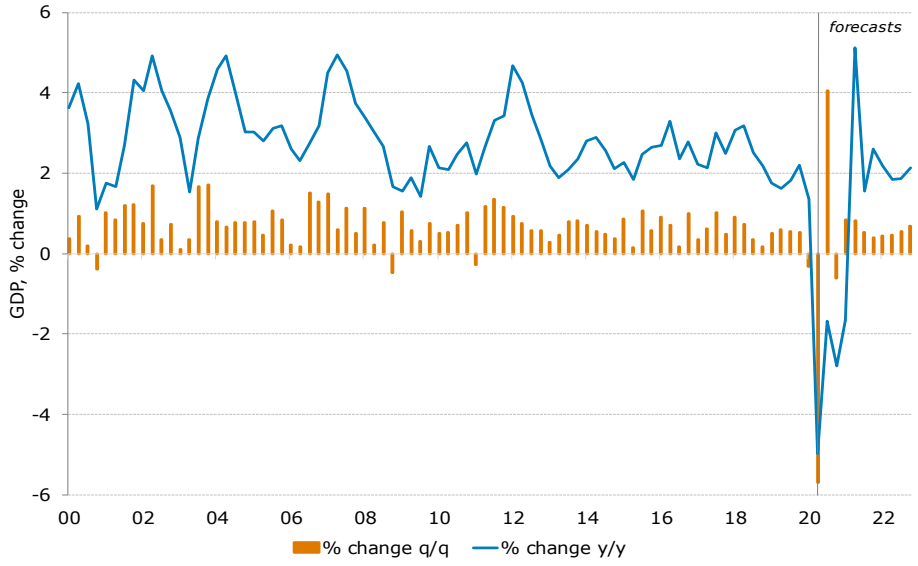
A forecast upgrade, but no V-shaped recovery

- We have upgraded our forecasts, and now expect GDP to decline 2% in 2020 (previously –4.7%) before rising 1.8% in 2021. The shutdown response to COVID-19 was not as extensive as we expected, the health outcomes have been much better than feared, and the fiscal response has been material.
- We continue to expect the recovery, post a sharp bounce in Q3, to be relatively slow and grinding, with both GDP and employment not expected to return to pre-pandemic levels until early 2022.
- Even factoring in some extension of the current fiscal stimulus past September, we expect that GDP will decline in Q4, as the level of support for the economy is cut back. We have factored in some additional stimulus, but to avoid a negative quarter, stimulus will need to taper off more gradually than we are currently assuming.
- The unemployment rate is forecast to remain in the high-6s until well into 2021. Like GDP, employment is not likely to reach pre-pandemic levels until early 2022. The extended period of elevated labour underutilisation will put downward pressure on wage growth, and we expect growth in the Wage Price Index to slow to an historic low of 0.7% y/y in H1 2021 before a gradual improvement.
- We expect trimmed-mean inflation to remain well below the RBA's 2–3% target band to the end of our forecast period.
- There is little doubt that fiscal policy will need to play a much larger role in supporting growth over the next few years, and we expect further announcements of targeted support packages over coming months. At this stage, the RBA seems content to wait and see how the recovery evolves. If the economy disappoints next year and the labour market does not improve, then the RBA would need to consider further measures.

Figure 1. We expect close to a 6% decline in GDP in Q2

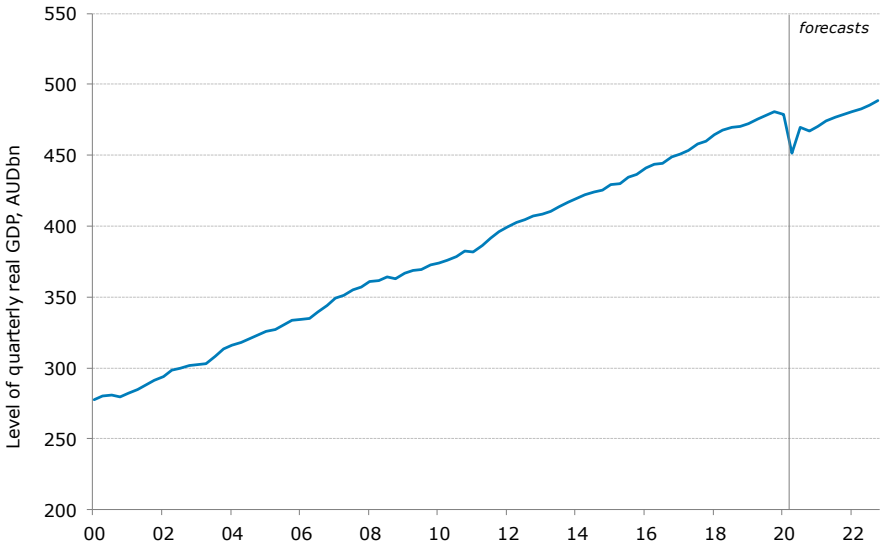


Source: ABS, ANZ Research

A forecast upgrade, but no V-shaped recovery

The outlook for the Australian economy has improved substantially. The shutdown in response to COVID-19 was not as extensive as we expected, the health outcomes have been much better than initially feared, and the fiscal response has been material. We now expect GDP to decline 2% in 2020 (previously –4.7%), before rising 1.8% in 2021. While our new forecast has a smaller drop in activity in Q2, we still expect recovery to be relatively slow, with no expectation of either GDP and employment returning to pre-pandemic levels until early 2022.

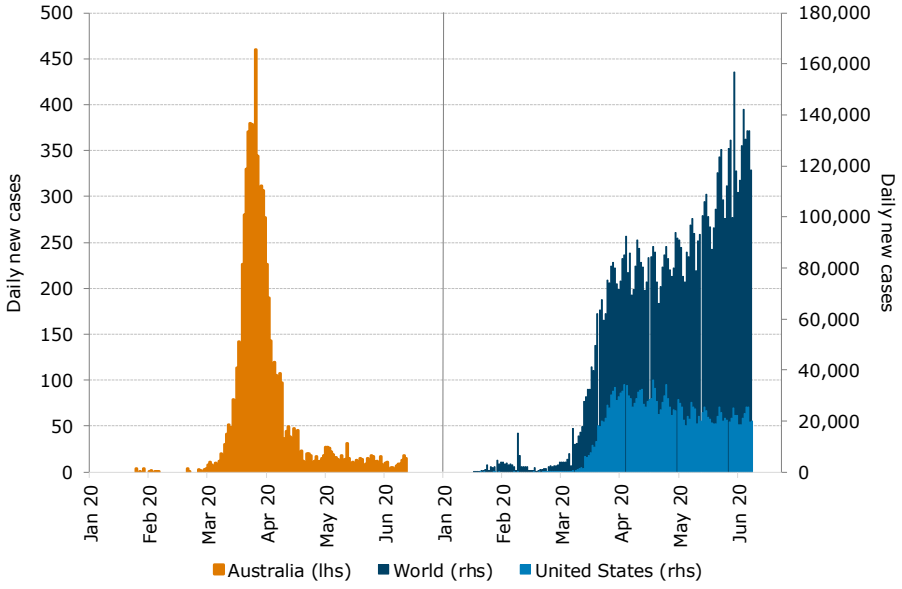
Figure 2. GDP is not expected to reach its pre-crisis level until early 2022



Source: ABS, ANZ Research

In late March, when we last published GDP forecasts, Australia was averaging more than 350 new cases of COVID-19 each day, and health experts were warning of an outcome similar to Italy's. After closing the borders and instituting a gradual shutdown of the economy, Australia's case numbers improved rapidly. Daily new cases averaged less than ten in June, with around two thirds of those coming from international arrivals (Figure 3).

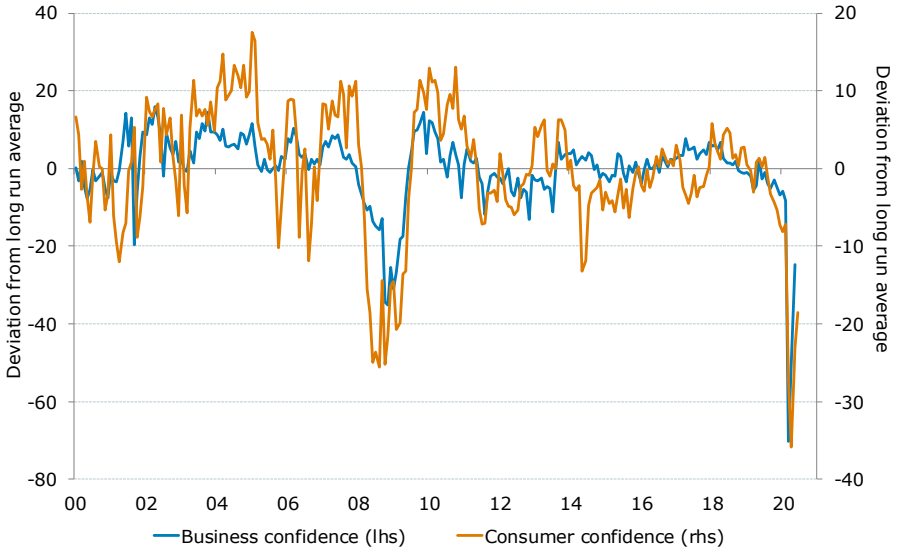
Figure 3. Australia has flattened the pandemic curve successfully



Source: Bloomberg, COVID-19 data, ANZ Research

Better-than-anticipated economic outcomes have mirrored the better health outcomes. In late March, we expected a full shutdown (New Zealand style) for six weeks. While the period of shutdown was broadly as expected, the extent was much less severe. Partly as a result, the decline in activity has not been as sharp as we expected, and the easing of restrictions to date has seen an early pick-up in activity. Both business and consumer confidence have fallen sharply, but both have begun to recover (Figure 2).

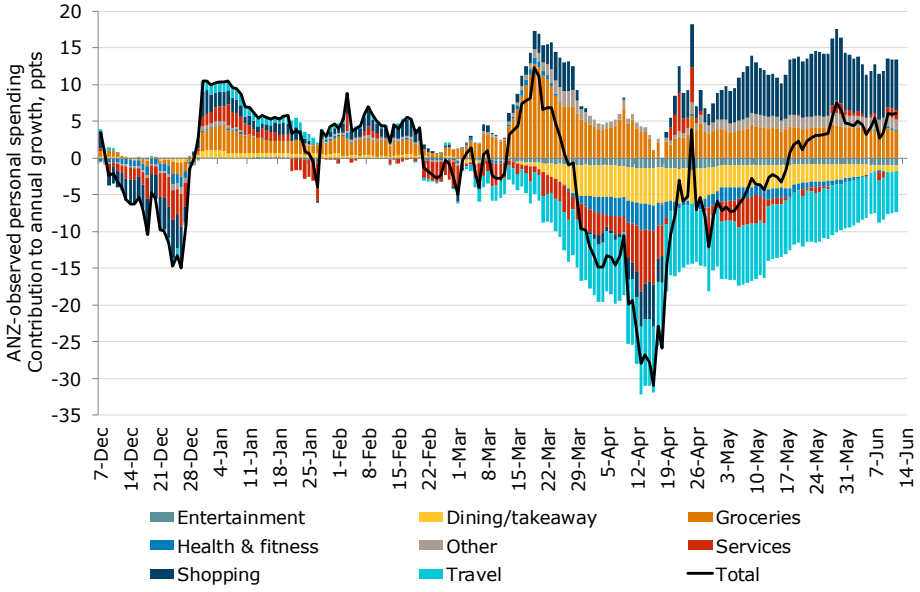
Figure 4. Business and consumer confidence have recovered but remain well below average



Source: NAB, ANZ-Roy Morgan, ANZ Research

Moreover, ANZ-observed card data show retail spending has picked up quickly since the low in mid-to-late April and has accelerated through May and into June as states have incrementally opened up. This boost in spending is encouraging, but is unlikely to be sustained given the weakness in the labour market.

Figure 5. ANZ-observed card data show a solid pick-up in spending as the lockdown eases



Source: ANZ Research

Easing of fiscal support will be challenging

Helping to support the recovery has been an extraordinary amount of fiscal stimulus. The JobKeeper payment in particular (worth an estimated AUD70bn) has helped to support incomes, while at the same time maintaining the connection between employer and employee. The increase in unemployment benefits in the JobSeeker payment (AUD14bn) as well as household cash payments (AUD9bn) and the Boosting Cashflow for Employers measure (AUD32bn) have all been very significant supports to the economy.

Much of the fiscal stimulus is due to finish by the end of September. Alongside the end of both the mortgage repayment deferrals offered by the banks and the residential eviction moratorium, this poses an enormous challenge for the economy. If the support is withdrawn on the current timetable, the economy will deteriorate rapidly in Q4 and with it both business and consumer confidence, with the likely consequence that the recovery could stall. In our view, policy will need to remain extremely supportive for some time. The private economy looks to be starting the long slow process of recuperation, but it will need considerable support for some time until the recovery gathers momentum.

While the government clearly has one eye on the budget balance and public debt forecasts, we expect that it will consider a targeted extension of the JobKeeper program, focussing on sectors still impacted by restrictions, such as businesses reliant on international tourism. In fact, our forecasts assume that JobKeeper will be extended in some form into Q4 (possibly under a different name), and also that the JobSeeker payment will not be fully wound back to the extremely low levels of Newstart prior to the crisis.

Even assuming a modest extension of fiscal stimulus past September, we expect that GDP will decline in Q4. Consider that growth in Q2 and Q3 will be propped up by fiscal injections in the order of 13% of GDP. By Q4, it is very unlikely there will be enough strength in private sector demand to offset the withdrawal of this magnitude of support. To avoid a negative quarter, stimulus will need to taper off more gradually than we are currently assuming.

The labour market will take time to fully recover, with implications for wage growth

Australia has endured the initial impact of the crisis better than expected, and there is likely to be a short period of strong growth as the economy reopens, but a V-shaped recovery seems unlikely. Many businesses will not resume trading after the shutdown period, and many more will not restore employment to pre-shutdown levels. This will be reflected in the labour market's recovery.

In April, almost 600,000 workers lost employment, hours worked fell by 9.2%, and the underemployment rate jumped 4.9ppt to a record 13.7%, from an already close-to-record high. But the unemployment rate rose only 1ppt to 6.2%, as almost three quarters of people who lost employment during the month withdrew from the labour market because of the dearth of job opportunities, the temporary suspension of job search obligations to receive JobSeeker and extra caring responsibilities. Furthermore, an estimated 3.5m workers on JobKeeper were counted as employed even if they were working zero hours.

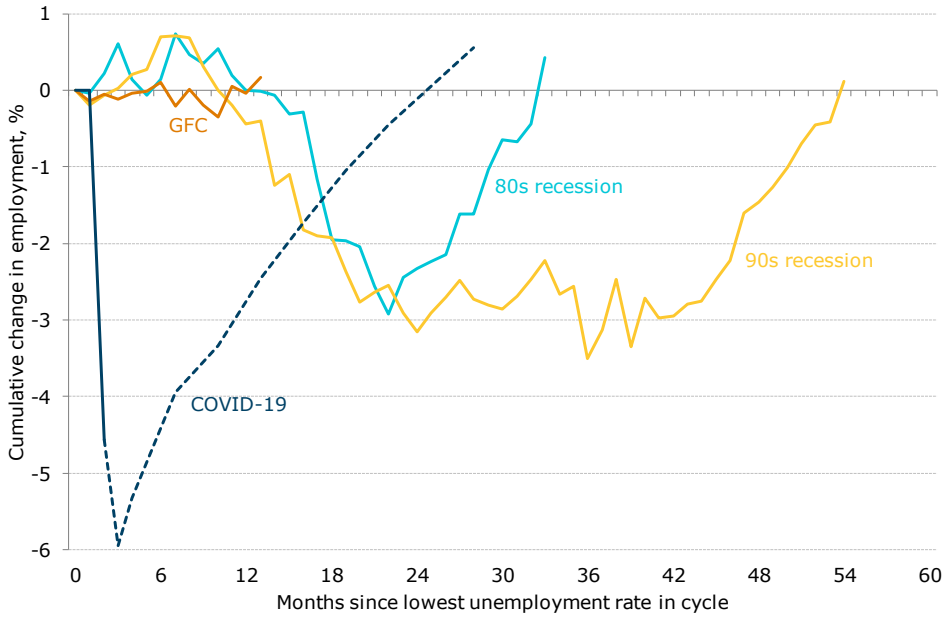
Still, almost a fifth of workers were underutilised in April, well above anything recorded since the monthly data began in 1978. While JobKeeper and the coronavirus supplement for JobSeeker have cushioned the blow, the hit to the labour market has had a devastating impact on income, security and wellbeing for many people.

Unfortunately, the labour market likely deteriorated further in May, but we expect employment will start to pick up again from June. This is consistent with the weekly payroll data. In Q3, with many restrictions lifted and a surge in economic activity, a strong but partial rebound in employment is likely. But we think employment growth will be more subdued in Q4. JobKeeper will likely have ended for most businesses and many employers will prioritise increasing current workers' hours over hiring or rehiring to meet demand.

Despite the initial recovery in employment, it will take a long time to reduce underutilisation. In fact, we are forecasting the unemployment rate to rise to a peak of 7.5% by Q4, even as employment increases, as participation also recovers. Improved employment prospects, the reintroduction of job search obligations to receive JobSeeker and a return to more normal caring responsibilities (ie much less home-schooling) will see many people enter or re-enter the labour force.

We expect that the unemployment rate will remain in the high-6s until well into 2021. Like GDP, employment is not likely to reach pre-pandemic levels until early 2022.

Figure 6. The drop in employment is unprecedented

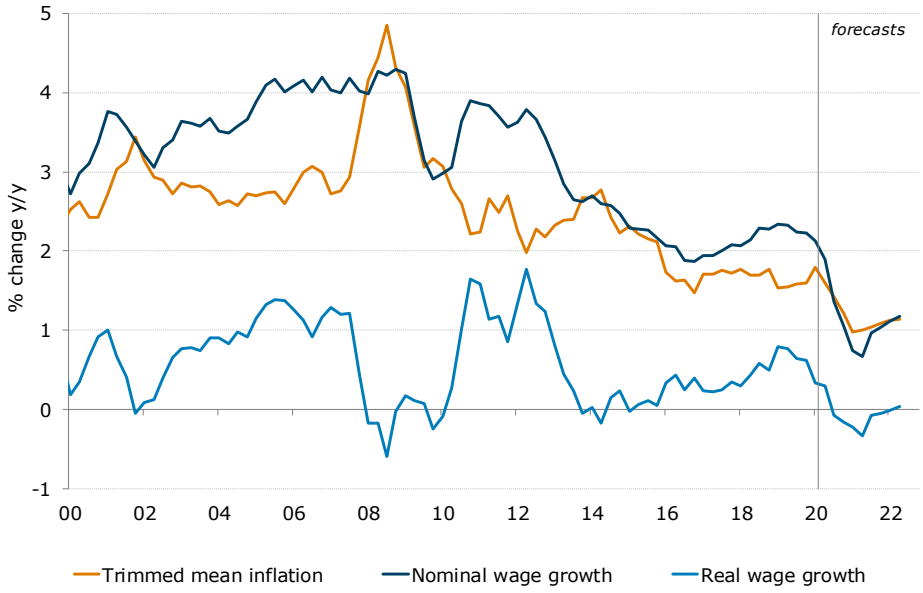


Source: ABS, ANZ Research

The extended period of elevated labour underutilisation will put downward pressure on wage growth. A minimum wage freeze would worsen the impact. While we expect a freeze will be announced by the Fair Work Commission for the first time since 2009, we think this would hinder, rather than help, the economic recovery and exacerbate inequality. Consequently, we expect nominal growth in the Wage Price Index to slow to an historic low of 0.7% y/y in H1 2021, from 2.1% y/y in Q1 2020.

From mid-2021, we should see a gradual improvement in wage growth to 1.2% y/y by mid-2022, as spare capacity is slowly eroded. But taking into account our muted inflation forecasts, this means that real wage growth would turn negative later this year and into 2021.

Figure 7. We expect real wage growth to turn negative



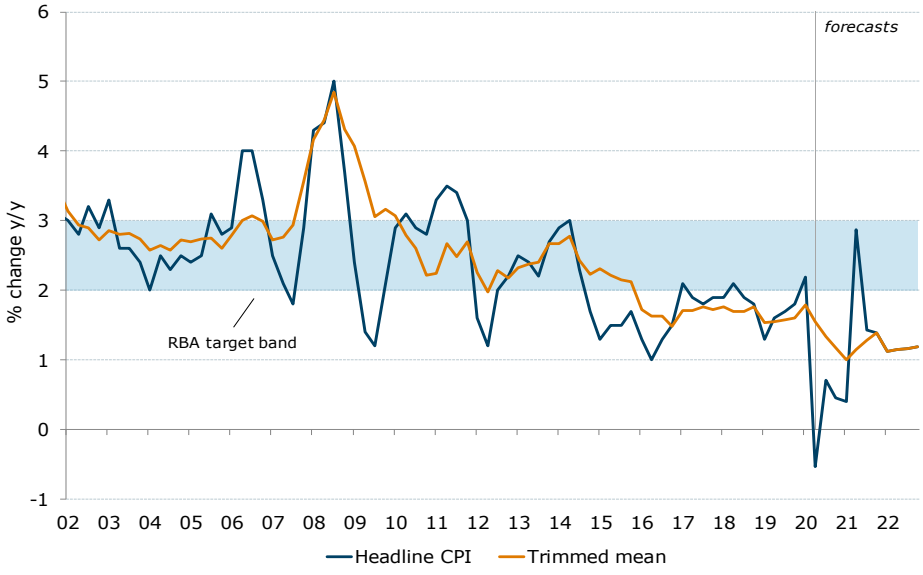
Source: ABS, ANZ Research

Inflation outlook very subdued

The significant amount of labour slack and low nominal wage growth is expected to weigh on inflation. We think annual trimmed mean inflation will continue to slow to a low of 1% by early next year, before very gradually lifting as the economy continues to improve and labour market slack is absorbed. While GDP growth will bounce in Q3, as most sectors of the economy return to operating without restrictions, we don't expect this will translate to upward pressure on prices, because the economy will still be operating well below its productive capacity. With the level of GDP not expected to return to its pre-pandemic levels till 2022, we don't see a material risk of inflation surprising on the upside. Furthermore, we think trimmed mean inflation is likely to miss the RBA's 2–3% target through to at least the end of 2022 and most likely for some years beyond that.

Headline inflation is expected to follow a similar path to trimmed mean inflation on a quarterly basis from later this year. However, the large fall in oil prices in Q2 and the free child-care policy which is due to be unwound in Q3 will cause large swings in annual headline inflation through to mid-2021.

Figure 8. Underlying inflation is set to stay outside the RBA's target band



Source: ABS, RBA, ANZ Research

Outlook by sector

Given elevated unemployment and falling real wages, we expect consumer spending will take some time to recover. Many households will have drawn on savings, including superannuation, and will want to rebuild savings buffers. Households will also need to resume mortgage payments at the end of the deferral period. Given Australia went into this crisis with very high household debt, there is a significant possibility that households reassess their appetite for debt, and enter into a period of balance sheet repair.

Low income growth and elevated uncertainty is likely to also weigh on the housing sector. We continue to expect house prices to fall around 10%, with the drop in population growth and a weak rental market also weighing on home values. We have slightly upgraded our housing construction forecasts in the wake of the HomeBuilder announcement. We expect this program to bring forward spending for renovations, as well as new home building, particularly for regional and outer urban greenfield developments.

Business investment is likely to be weak over the next year or so. In the latest CAPEX survey, firms were planning a large drop in investment in Q2. For 2020-21, the outlook was for a small decline, but we see a solid fall in non-mining investment due to weak demand, low capacity utilisation and ongoing uncertainty. A rise in mining investment over the coming year will provide some offset.

The external sector is expected to remain in surplus, with export growth outperforming import growth. Once again the Australian economy will benefit from being an exporter of raw commodities, with iron volumes remaining solid and farm exports lifting on much more normal rainfall patterns. Moreover, many overseas students who were in the country before the travel ban remain, and their spending will add to exports of services. On the import side, the closed international borders have seen a huge drop in Australians travelling overseas, and imports of services have collapsed. With the government flagging some easing of restrictions around overseas students, our forecasts assume that some students begin to trickle into the country over coming months. We do not expect international borders to fully opening until a vaccine is found, which we are currently assuming will be H2 2021.

Policy outlook

There is no doubt that fiscal policy will need to play a much larger role in supporting growth over the next few years. In terms of monetary policy, we expect the cash rate will remain at 0.25% for some years, with RBA Governor, Phil Lowe, recently noting that the RBA is "not going to be raising interest rates until full employment is achieved and we're sustainably within the two per cent to three per cent target range [for inflation]". The Bank is also likely to continue with its yield curve control policy targeting the 3y bond at 0.25% and its term funding facility. At this stage, it seems content to wait and see how the recovery evolves. Further policy measures seem unlikely in the near term, unless markets become dysfunctional. Longer term, if the economy disappoints next year and the labour market does not improve then the RBA would need to consider further measures.

Forecast table

	% change q/q					% ch yr average		
	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	2019	2020	2021
Real GDP								
GDP	**-0.3**	**-5.7**	**4.0**	**-0.6**	**0.8**	1.8	**-2.0**	**1.8**
Labour market								
Unemployment rate	**5.2**	**6.8**	**7.3**	**7.5**	**7.2**	5.3	**6.7**	**6.9**
Employment growth	**0.4**	**-5.2**	**1.4**	**0.6**	**0.9**	2.7	**-2.1**	**1.8**
Inflation								
Headline	**0.3**	**-1.9**	**1.6**	**0.2**	**0.2**	1.6	**0.6**	**1.1**
Trimmed mean	**0.5**	**0.2**	**0.2**	**0.2**	**0.2**	1.6	**1.5**	**1.0**

*Forecasts in bold. Annual data and forecasts are year-averages.

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[28 January 2020]

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