6. Economic Outlook

The outlook for the Australian and global economies is being driven by the COVID-19 pandemic. The necessary social distancing restrictions and other containment measures that have been in place to control the virus have resulted in a significant contraction in economic activity, but economic conditions will improve as the pandemic is brought under control and containment measures are relaxed.

Global GDP is expected to fall sharply in the first half of 2020. The declines in the March quarter were driven by a contraction in Chinese and euro area activity as well as the rollout of containment measures elsewhere late in the quarter. A further fall in global GDP is expected in the June quarter, with many countries expected to record quarterly declines in GDP. The global outlook is discussed in more detail in the 'International Economic Conditions' chapter.

The Australian economy is expected to record a contraction in GDP of around 10 per cent over the first half of 2020; total hours worked are expected to decline by around 20 per cent and the unemployment rate is forecast to rise to around 10 per cent in the June quarter. Headline inflation is expected to be negative in the June quarter largely as a result of lower fuel prices and free child care; underlying inflation is expected to decline notably.

Beyond the first half of 2020, the outlook for the domestic economy depends on how long social distancing remains in place and its effects on economic activity. Other factors include how long uncertainty and diminished confidence weigh on households' and businesses' spending, hiring and investment plans. The initial phase of the recovery is likely to be primarily driven by the easing in restrictions, which will lead to an improvement in employment outcomes as businesses re-open, as well as a pick-up in household spending. In the latter part of the forecast period, business investment decisions will more strongly shape the recovery. It is difficult to be precise about the magnitude and timing of these effects, so it makes sense to think in terms of scenarios.

A plausible baseline scenario is that the various restrictions are progressively relaxed in coming months and are mostly removed by the end of September, except for some restrictions such as international travel. If this occurs, and the spread of the virus in Australia remains limited, GDP growth is likely to turn around in the September quarter and the recovery would strengthen from there.

A stronger economic recovery is possible, however, if further gains in controlling the virus are achieved in the near term, allowing most containment measures to be phased out over coming months and with more limited damage to business and household confidence and balance sheets. In this scenario, much of the near-term decline in GDP growth and the rise in the unemployment rate would be reversed over the next few years.

On the other hand, it is also possible that the outbreak persists for longer than expected or flares up again, which would see mandated

restrictions on domestic activity eased more gradually, international travel restrictions in place well into next year, and prolonged precautionary behaviour. In this scenario, the recovery in GDP would be delayed and there would be more lasting effects on household and business balance sheets, as well as damage to employment and supplier relationships as jobs are lost and businesses fail.

Domestic output and employment have fallen significantly

The peak-to-trough decline in GDP is expected to be around 10 per cent, mostly concentrated in the June quarter. The decline in activity in the June quarter is expected to be the largest in the history of the quarterly national accounts. The initial contraction in activity has been driven by necessary public health measures rather than the economic and financial developments that are typically involved in sparking economic downturns, so the speed and shape of the recovery could differ from the experience in the past.

The near-term outlook assumes that, despite the relaxation of some measures, many domestic containment measures remain in place for much of the June quarter. International border closures are likely to be in place for an extended period. These assumptions are consistent with the available information at the time of publication. Based on these assumptions and the available evidence from a broad range of indicators, likely economic outcomes for the first half of 2020 are coming into focus.

Household consumption is forecast to decline by around 15 per cent in the June quarter. Reduced spending due to social distancing measures accounts for over half the decline; the decline in international travel also subtracts from consumption, although much of its effect on GDP is offset by lower imports. Because of social distancing restrictions and precautionary behaviour, household consumption is expected to decline by more than household income, which will be supplemented by increased social assistance payments, and the saving rate is expected to increase sharply.

Dwelling investment and business investment are also expected to contract in the June quarter. The fall in non-mining machinery & equipment investment is expected to be particularly sharp, as firms seek to preserve cash flow in response to the actual and expected falls in private demand.

Almost all the fiscal stimulus that has been announced to date is in the form of transfers to households and businesses which will not contribute directly to public demand in the national accounts. Nevertheless, public demand is expected to grow quite strongly in the June quarter, driven by a temporary expansion of some government services such as health and aged care. These expenses are expected to boost public consumption. The level of public investment is expected to be broadly steady in the near term. Beyond the June quarter, the outlook for public demand is broadly unchanged from the February *Statement on Monetary Policy*; a formal update of spending intentions by state and federal governments will be undertaken when the delayed budgets are released in October.

Service exports are expected to have dropped sharply in the March quarter, and again in the June quarter, as a result of successive waves of travel restrictions. To date, there have been no reports of material disruptions to resource exports as a result of COVID-19. The large drop in domestic demand is also expected to see a large decline in import volumes.

It is estimated that total hours worked will decline by around 20 per cent in the June quarter. Some of this adjustment will happen through people losing their jobs, but a significant part of the adjustment will happen through people retaining their jobs, but working

fewer hours. Hours worked are likely to have declined across all industries, but the decline will be most acute in hospitality, entertainment and tourism-related industries and for casual workers. The decline in hours worked is likely to be larger than the decline in output during the next six months. This is because output in higher productivity industries such as mining and utilities is expected to be relatively less affected. However, there is much uncertainty around productivity outcomes in other areas of the economy, given the shift to working remotely.

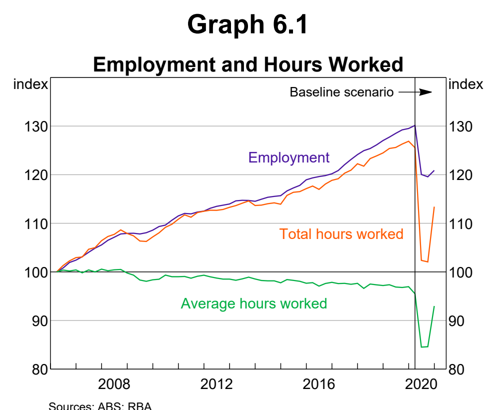
The total hours lost during the June quarter will be associated with both large-scale job losses and a large decline in the average hours worked of other workers (Graph 6.1). The introduction of the JobKeeper Payment has significantly reduced the number of job losses that would otherwise have occurred, but employment is still expected to fall by 8 per cent in the June quarter (or by around 1 million workers). This is expected to see a sharp increase in the unemployment rate to around 10 per cent and a sizeable decline in the participation rate. If realised, this would be the highest rate of unemployment since 1994. It is possible that there will be a larger measured decline in the participation rate and a smaller increase in the unemployment rate than is currently expected. This is because more of the recently dismissed workers may not be actively searching for work – a requirement to be counted as unemployed in the labour force data – given the weak labour market and the temporary suspension of requirements to look for work to receive JobSeeker Payments.

Headline CPI is expected to fall by around 2¼ per cent in the June quarter and headline inflation is expected to be negative in year-ended terms for the first time since the early 1960s. This is mainly driven by the large fall in oil prices in the quarter-to-date and the introduction of temporarily free child care. There will also be a deferral or reduction in some price increases. These factors will more than offset any price rises that stem from the recent exchange rate depreciation or supply disruptions. In underlying terms, inflation is also expected to be much lower in the quarter.

The pace of recovery beyond the June quarter is especially uncertain

The outlook beyond the June quarter will be shaped by the extent to which activity and the labour market continue to be affected by social distancing and other containment restrictions, which in turn will be determined by what is necessary to manage the health aspects of the current crisis. Other factors that will be important are the responses of households and businesses to changes in the economic environment, and the effectiveness of policy support. It is quite plausible that the current economic disruption will have some long-lasting effects, not only because it will take some time to restore workforces and re-establish businesses but also because it could also affect mindsets and the behaviours of consumers and businesses. This could result in structural change in the economy. Changes in the financial position of households and businesses could also have long-lasting effects.

To explore the consequences of a range of plausible health outcomes and the associated policy responses, we have considered three scenarios for the domestic recovery. A baseline



scenario for a gradual recovery, described in some detail below, is based on a plausible path for health outcomes and, relatedly, government-mandated restrictions, as well as existing economic policy measures. Upside and downside scenarios are then described to illustrate how the recovery paths could look in the near term under different plausible assumptions about the outbreak and related activity restrictions, and behavioural responses of households and businesses.

In all scenarios we assume that current fiscal policy settings remain in place in accordance with public guidance. However, the extent of the stimulus provided by the JobKeeper Payment – which is the largest component of the fiscal response – and other assistance payments will depend on outcomes for business cash flow and employment in each scenario. The scenarios are also conditioned on a set of technical assumptions, as usual. The cash rate and other elements of the Bank's monetary stimulus package are assumed to remain around current settings. The exchange rate is assumed to be constant at its current level, which is around 2 per cent lower than where it was at the time of the February *Statement*. The Brent crude oil price is assumed to be constant at US$35 per barrel, based on futures pricing; this is 35 per cent lower than at the time of the February *Statement*. Growth in the population aged 15 years and over is assumed to slow considerably over the next year owing to the closure of borders, before picking up to be 1½ per cent over the year to mid 2022. However, in the upside scenario, population growth is expected to pick up sooner than this.

Comparisons with others' economic forecasts are difficult to interpret due to large differences in underlying assumptions for the duration of restrictions, as well as differences in technical assumptions. That said, outcomes for GDP growth, unemployment and inflation in the 'gradual recovery' baseline scenario are broadly in line with the average market forecasts for these variables in 2020 and 2021. (Graph 6.2). The ranges of market forecasts demonstrates the extremely high degree of uncertainty about the economic outlook.

Scenario 1: baseline – 'gradual recovery'

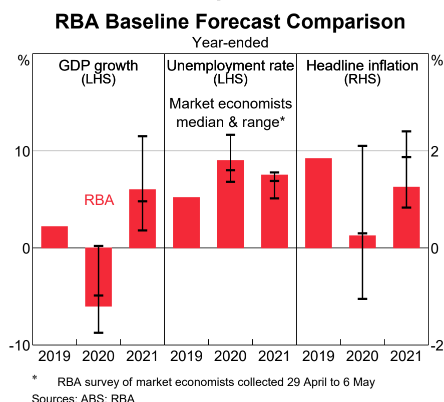
This scenario assumes that most of the current domestic containment measures remain in place for most of the June quarter. Most of the restrictions are assumed to have been lifted by the end of the September quarter, aside from the limits on very large public events and gatherings, which are assumed to remain in place for longer. International border closures are assumed to be in place until the end of the year, consistent with recent statements from the Australian Government.

In this scenario, GDP growth is expected to start recovering in the second half of 2020, led by consumption, although the very large contraction in the March and June quarters would still result in a year-ended decline over 2020 (Table 6.1; Graph 6.3). Growth would then be stronger over 2021 as business and dwelling investment gradually recovered, although the level of GDP by mid 2022 would still be below the level expected at the time of the February *Statement*. Under these conditions, the unemployment rate is expected to decline

Graph 6.2

RBA Baseline Forecast Comparison

Year-ended



* RBA survey of market economists collected 29 April to 6 May

Sources: ABS; RBA

Table 6.1: Output Growth and Inflation Baseline Forecasts[(a),(b)]

Per cent

	Year-ended					
	Dec 2019	June 2020	Dec 2020	June 2021	Dec 2021	June 2022
GDP growth	2.2	−8	−6	7	6	5
(previous)	(2)	(2)	(2¾)	(3)	(3)	(3)
Unemployment rate[(c)]	5.2	10	9	8½	7½	6½
(previous)	(5.2)	(5¼)	(5)	(5)	(4¾)	(4¾)
CPI inflation	1.8	−1	¼	2¾	1¼	1½
(previous)	(1.8)	(1¾)	(1¾)	(1¾)	(2)	(2)
Trimmed mean inflation	1.6	1½	1¼	1¼	1¼	1½
(previous)	(1.6)	(1¾)	(1¾)	(1¾)	(2)	(2)
	Year-average					
	2019	**2019/20**	**2020**	**2020/21**	**2021**	**2021/22**
GDP growth	1.8	−1	−5	−3	4	6
(previous)	(1¾)	(2)	(2¼)	(2¾)	(3)	(3)

(a) The cash rate is assumed to remain at its current level, with other elements of the Bank's monetary stimulus package, including the 0.25 per cent target for the 3-year government bond yield, assumed to remain consistent with current settings. Other technical assumptions include the TWI at 57, A$ at US$0.64 and Brent crude oil price at US$35 per barrel; shaded regions are historical data; figures in parentheses show the corresponding forecasts in the February 2020 *Statement on Monetary Policy*.

(b) Rounding varies: Activity to the nearest whole number; unemployment to the nearest half point; wages and prices to the nearest quarter point

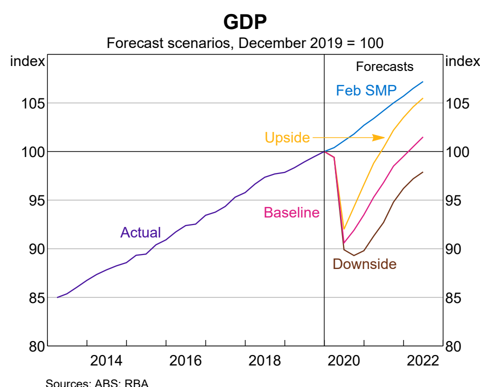
(c) Average rate in the quarter

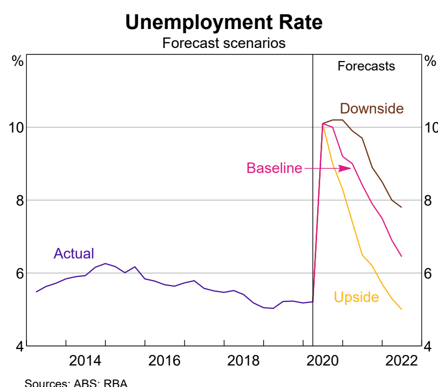
Sources: ABS; RBA

substantially from its June 2020 peak of around 10 per cent but to remain above its pre-COVID-19 level in two years' time (Graph 6.4). In underlying terms, inflation is expected to remain below 2 per cent over the next couple of years.

Labour market

The JobKeeper Payment ensures that more workers remain attached to their job, even if on significantly reduced hours than otherwise. Nonetheless, there is still expected to be a sharp increase in labour market underutilisation in the





near term, which is likely to take a few years to unwind. This is because businesses are likely to delay rehiring workers until the uncertainty around the outlook has subsided. Any post-outbreak reconfiguration of the industrial composition of the economy will take time due to the transition and possible retraining of workers. It will also take time for businesses to find suitable workers from the pool of unemployed, and for workers who had previously withdrawn from the labour force to return.

In this scenario, businesses would be expected to begin gradually hiring workers after restrictions are lifted, although average hours worked are expected to pick up more sharply as existing workers start to resume normal working arrangements. The unemployment rate is expected to decline significantly, but still be above its pre-COVID-19 level in mid 2022. The level of employment is also expected to be lower in mid 2022 than previously forecast because both the employment-to-population ratio and population growth are expected to be lower over the next few years.

The decline in the unemployment rate in this scenario is expected to be quicker than in most previous recoveries because the downturn has been driven by health-related restrictions not economic factors, and will therefore be short-lived. Further, the industries that will experience the largest number of job losses over this period typically have higher rates of labour turnover, so the process of recruiting may take less time than in other industries. However, there are risks to the downside. In particular, there is a material risk that the sharp increase in unemployment expected over the first half of 2020 will have a more pronounced scarring effect on the labour force than is currently anticipated. A slower-than-expected decline in the unemployment rate could create an adverse feedback loop whereby a slower pick-up in private demand could cause further knock-on effects to the labour market.

Consumption, household income and saving

The effect of unwinding social distancing measures on consumption is expected to occur over several quarters. This goes beyond the time the actual measures are in place because some types of consumption are likely to take time to recover and some households may continue to maintain social distance beyond what is mandated. Further out, higher unemployment and lower income and wealth will weigh on consumption and the level of consumption is expected to remain well below that forecast in the previous *Statement* over coming years.

Following a sharp decline in the June quarter, household income is expected to recover gradually. Fiscal policies will provide support for household income. The outlook for labour income would have been much weaker in the absence of the JobKeeper Payment. Increased social assistance payments, such as the Economic Support Payments and Coronavirus Supplement, will also support income. Growth in households' tax and interest payments is also expected to ease. Some additional measures – such as the temporary withdrawal of superannuation and policies to allow the deferral of mortgage payments by some households – will contribute to households' cash flows but will have a limited impact on measured income in the national accounts. Income from unincorporated businesses is forecast to decline, as are other non-labour household income components such as financial and rental income.

The saving rate is expected to unwind its near-term spike as restrictions are lifted and more normal consumption patterns resume.

Dwelling investment

The deterioration in established housing market conditions is expected to prolong the decline in

dwelling investment. Dwelling investment is expected to be significantly lower over most of the forecast period than forecast in the previous *Statement*. The trough in construction activity is now projected to occur in early 2021, half a year later than previously expected. The near-term downgrade to activity incorporates information from liaison citing significantly weaker demand for new dwellings.

Business investment

After falling sharply in the June quarter, business investment is expected to remain subdued over the remainder of 2020, as many businesses cut back on discretionary capital expenditure in response to a sharp fall in private demand. Taken together with the sluggish growth prior to the outbreak of COVID-19, non-mining business investment is not expected to recover to its pre-outbreak levels by the end of the forecast period.

It is likely that non-mining business investment will lag the recovery in other components of private demand. This reflects the assumption that firms will first use up spare capacity as demand picks up, as well as the typical lags in the approval and planning of construction projects. In the near term, the fall in non-mining investment is expected to be led by machinery & equipment investment, consistent with information from liaison that firms intend to defer or cancel planned discretionary investment to preserve cash in response to weaker demand and heightened uncertainty. Non-residential building and infrastructure activity is expected to hold up in the next couple of quarters, reflecting the substantial pipeline of work yet to be done and relatively limited evidence to date of disruptions to the supply of labour and materials in the construction industry. However, construction activity is expected to fall later in the year, consistent with liaison information that indicates that many projects that have not yet commenced have been put on hold or cancelled.

Mining investment is expected to remain relatively resilient in the near term. Work on replacement iron ore and coal mines is expected to be only modestly affected by workforce impacts, although some minor delays have been factored in. Further out, though, some large liquefied natural gas (LNG) projects are assumed not to commence within the forecast period due to the collapse in oil prices; long-term LNG supply contracts are typically priced off an oil reference price.

External sector

In this scenario, service exports are an important driver of the trade outlook. International travel restrictions have materially reduced Australia's exports of education, tourism and transport services, which together comprise around 16 per cent of total exports. Assuming international travel restrictions are gradually lifted from the start of 2021, education exports could increase fairly quickly at the start of the 2021 academic year. By contrast, other tourism and transport exports are likely to pick up more gradually, reflecting lingering caution on the part of travellers and potentially continued quarantine requirements.

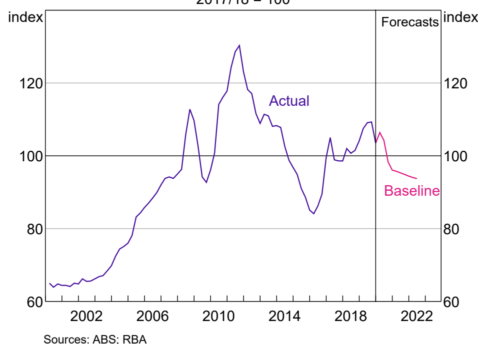
The level of resource export volumes is lower than previously expected over the remainder of the forecast period, reflecting expectations of a small reduction in LNG production and weaker global demand for iron ore and coal. The outlook for manufactured exports is expected to be lower in the near term because of reduced global demand, although further out the depreciation of the Australian dollar should provide support. Rural exports are expected to be higher throughout the forecast period compared with the February *Statement*, reflecting an easing in drought conditions since the start of the year.

The sharp decline and subsequent recovery in domestic demand will be the primary driver of import volumes, although the depreciation of the exchange rate is also likely to weigh on import demand throughout the forecast period.

The terms of trade are forecast to decline more sharply over 2020 than was expected at the time of the February *Statement*, largely as a result of lower global demand for bulk commodities (Graph 6.5). The downward revision also reflects the considerably lower oil price assumption because Australia is a small net exporter of oil and gas; export prices for LNG are assumed to be significantly lower at end of the forecast period, based on current pricing of longer-dated oil futures contracts.

Wages and inflation

Wages growth is expected to be lower over the next year. As has been the case during other downturns, it is likely that businesses will make most of the adjustment to their labour costs through reducing both hours worked and the number of employees. However, it is also expected that many businesses and employees will agree to wage freezes and, to a lesser extent, to some cuts to hourly wages. Bonuses are also likely to be reduced. Wages growth is expected to gradually pick up over 2021; how quickly this happens will depend on whether there are catch-up increases in wages after a period of lower outcomes, but also on award wage determinations and how much spare capacity there is in the labour market. The degree of spare capacity is a key area of uncertainty and it will depend on a range of factors, including the extent of underemployment and the number of discouraged people that have left the labour market. If those available workers are not able to be matched to jobs during the recovery phase, there may also be an increase in the number of long-term unemployed or structural unemployment in the economy.



The inflation forecast takes into account the weak domestic demand conditions but also the supply disruptions to production that will increase inflationary pressures; the deflationary effects from the spare capacity in the labour market and in the economy more generally are expected to be the dominating influence. Underlying inflation is expected to remain below 2 per cent over the forecast period (Graph 6.6). In this scenario, inflation expectations remain anchored to pre-existing levels; however, this will depend on how business and household inflation expectations respond to the large relative price adjustments over the period ahead. The extent of the recovery in consumer demand will also determine whether businesses will be able to pass on higher import prices to consumers from the depreciation in the exchange rate.

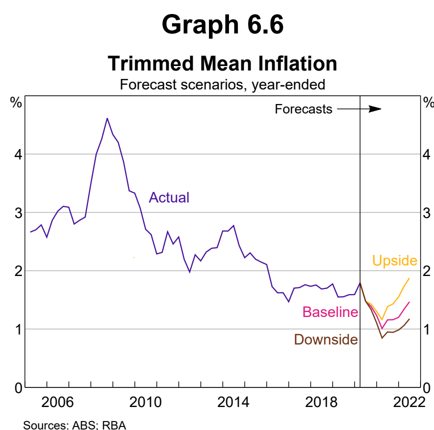
Scenario 2: faster recovery

A stronger economic recovery would be possible if further gains in controlling the virus were achieved in the near term and most containment measures were phased out over coming months. This, alongside the considerable policy support already in place, would help limit near-term damage to business and household balance sheets, and help drive a more rapid recovery in the economy. An important precondition for this scenario is that

households and businesses expect a sustained economic recovery to build over coming months, underpinned by a high degree of confidence in the ongoing management of health outcomes.

In this scenario, much of the near-term decline in GDP could be reversed over 2020–21 as consumption and employment growth rebound. By the end of the forecast period, the level of GDP could still be a little below the level expected at the time of the February *Statement*. Some of this difference can be explained by lower business investment because it tends to lag other components of private demand during recoveries, in part due to lags in planning and construction. In addition, given the assumed ongoing low level of the oil price, work on the currently postponed large LNG projects is not expected to commence within the forecast period.

In this scenario, the labour market begins its recovery as soon as the containment measures are phased out. Because of the better health outcomes and policy stimulus in place, the rebound in consumer demand and reduced uncertainty about the outlook would allow businesses to rehire workers and resume investment plans quickly. The hours of existing workers would also increase in response to rising demand, and the unemployment rate would be expected to move from a peak of around 10 per cent to be around its pre-COVID-19 level by mid 2022. The stronger recovery would enable some catch-up in wages growth. Similarly, the stronger recovery would be consistent with a faster pick-up in inflation over the next few years, albeit from a low starting point.



Scenario 3: slower recovery

Alternatively, if the lifting of restrictions is delayed, the restrictions need to be reimposed or household and business confidence remains low, the outcomes would be even more challenging than those in the baseline scenario. For this scenario, we assume that many restrictions remain in place until closer to the end of 2020 and international travel restrictions are in place well into next year. In this scenario it is likely that household and business confidence would remain subdued for longer and income and spending would take longer to recover, notwithstanding the policy stimulus in place. Under this downside scenario, domestic activity would be expected to remain close to its June quarter trough for the rest of the year. A greater share of households would be likely to continue to engage in distancing activities beyond what is required because they remained concerned about the virus. Damage to consumer and business balance sheets and weak expectations for the outlook would mean consumption and investment would pick up slowly even after the restrictions are lifted. Employment growth would be much slower, and the unemployment rate would remain close to its peak well in to 2021.

There may also be some negative effects on the longer-term outlook for commercial property. A number of contacts in the Bank's liaison program have indicated that valuations of commercial property assets are expected to decline over the period ahead because of lost rental income and lower expectations of future

rental growth. In turn, lower valuations may affect the viability of future projects, in combination with many firms expecting to reduce their long-term floor space requirements. This is likely to be most pronounced in the office and retail sectors, given the large-scale shift to working from home and the acceleration in the shift towards online retailing.

A slower economic recovery would have ongoing adverse consequences for the labour market. The longer the economy remains weak, the more employment relationships are severed and the more households and firms will suffer severe financial stress. This would slow the recovery further and increase the chance that workers need to take jobs that are poor matches for their skills. Slow recovery and poor skill-matching are particularly likely if the economy's industrial structure changes significantly to adapt to the post-outbreak realities. The longer someone is unemployed, the more difficult it is for them to find employment because of a loss (or a perceived loss) in skills or because they become discouraged and exit the labour force. Past experience also suggests that workers who first enter the labour market during a downturn are especially affected and can suffer long-term income and employment consequences. And with lower investment as well as poor skill-matching, the economy's productive potential could also be damaged over a longer period. A slower recovery in economic activity would be consistent with inflation remaining low for longer. A more protracted period of low inflation outcomes could also lead businesses and consumers to adjust down their inflation expectations, which would make the subsequent pick-up in inflation more gradual. ✠