6. Economic Outlook

Following the largest contraction in decades, the global economy is in the early stages of recovery, as is Australia. However, the level of GDP in a number of major economies is expected to remain below pre-pandemic forecasts for the next couple of years, and a high degree of uncertainty continues to surround the outlook. The main source of uncertainty relates to the evolution of the pandemic, and the policy and behavioural responses to it.

The initial phase of the recovery in the global economy was enabled by improving health outcomes, which in turn allowed containment measures to be eased. Substantial policy stimulus also contributed. Even still, the global recovery remains fragile and uneven, with differences in health outcomes and relative positions in global supply chains largely accounting for the wide variation in economic outcomes. Economic activity in Australia's major trading partners is forecast to contract by 3 per cent in 2020 (in year-average terms) and then grow by 6 per cent in 2021 and 4 per cent in 2022. These forecasts are broadly similar to those presented in the August *Statement on Monetary Policy*; however, a recent resurgence in COVID-19 infections in a number of key economies has increased near-term risks to this outlook. Underlying inflationary pressures are likely to remain subdued globally for some time given considerable spare capacity.

In Australia, the recovery in activity has been underway for several months after the economy experienced the deepest peacetime contraction since the Great Depression in the first half of the year. The domestic recovery is set to be supported by the further easing in activity restrictions and substantial monetary and fiscal policy stimulus. The baseline scenario for GDP growth has been upgraded a little relative to the August *Statement*. This reflects stronger-than-expected household consumption and additional policy support (including that announced in the Australian Government Budget), though a downward revision to resource exports has partly offset the firmer outlook for domestic demand. Even after the GDP forecast upgrade, the severity of the downturn in the first half of the year means that GDP is not expected to return to its pre-pandemic level until the end of 2021.

Conditions in the labour market have improved a bit faster than expected at the time of the August *Statement* but remain soft overall. Employment remains well below its pre-pandemic level and measures of labour market underutilisation are high. Growth in employment is expected to be subdued over the next few months, as policy support measures, such as JobKeeper, are tapered. The unemployment rate is anticipated to peak at a little below 8 per cent, above current levels but lower than the 10 per cent peak that was previously expected. The unemployment rate is then expected to gradually decline, with employment expected to grow steadily and more people expected to be drawn back into the labour market; the unemployment rate is expected to remain above pre-pandemic levels at the end of the forecast period. Substantial spare capacity, including high underemployment, is likely to keep wages growth and inflation low for a considerable period.

Given the high degree of uncertainty about the outlook, two scenarios are considered in addition to the baseline. These represent two out of a range of plausible outcomes around the baseline projections (upside and downside), and are largely based on different assumptions about health outcomes and activity restrictions. Alternative outcomes, including outside the ranges discussed here, are also possible, some of which are addressed later in the 'risks and uncertainties' discussion. In summary:

- The baseline scenario assumes that no additional large outbreaks and accompanying strict containment measures occur within Australia and that restrictions continue to be gradually lifted nationally (or are only tightened modestly for a limited time). Some restrictions on international departures and arrivals are assumed to be in place until around the end of 2021. Under this scenario, GDP is expected to contract by around 4 per cent over the year to December 2020, but then grow by 5 per cent over 2021 and 4 per cent over 2022. The unemployment rate peaks at a little below 8 per cent in coming months, before gradually declining in 2021 and 2022 to just above 6 per cent at the end of the forecast period. Inflation is expected to pick up a little alongside a modest reduction in spare capacity, to be around 1½ per cent by the end of 2022.
- A plausible downside scenario is that Australia experiences further major outbreaks and there is a loss of control of the virus in other economies. In this scenario a substantial share of the population faces renewed distancing restrictions and curbs on business activities, and the opening of international borders is delayed further. The reimposition of restrictions domestically is assumed to weigh heavily on confidence and significantly slow the recovery in consumption and business investment, with the unemployment rate peaking at around 9 per cent in late 2021 and declining only a little in 2022.
- A stronger economic recovery than envisaged in the baseline scenario is also possible, especially if additional progress in the medical treatment and control of the virus is achieved in the near term, resulting in a faster withdrawal of containment measures. A sustained improvement in health outcomes domestically and abroad would boost confidence and support private consumption, investment and services exports. In this scenario, the unemployment rate peaks at 7½ per cent before declining to 5½ per cent by the end of 2021.

The recovery in domestic activity is underway, but spare capacity is expected to remain high for an extended period

In the baseline forecasts, GDP is expected to recover over coming quarters at a faster pace than expected at the time of the August *Statement*. But the pandemic will have long-lasting effects on the Australian economy, with GDP unlikely to return to its pre-pandemic level until the end of 2021 (Table 6; Graph 6.1). Overall, the economy is expected to be noticeably smaller at the end of the forecast period than anticipated prior to the pandemic, partially because of a sharp slowing in population growth.

In the near term, growth is driven by household consumption and public demand. Households are expected to consume a larger share of their income than they did over the June and September quarters, when the savings ratio was unusually high. Household income, which has been boosted by COVID-19 policy support measures, is expected to decline over coming quarters as these measures come to an end. But

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

Per cent

	Year-ended					
	Jun 2020	Dec 2020	Jun 2021	Dec 2021	Jun 2022	Dec 2022
GDP growth	−6.3	−4	6	5	4	4
(previous)	(−6)	(−6)	(4)	(5)	(4)	(4)
Unemployment rate[(c)]	7.0	8	7½	6½	6½	6
(previous)	(7.0)	(10)	(9)	(8½)	(7½)	(7)
CPI inflation	−0.3	½	2¼	1	1¼	1½
(previous)	(−0.3)	(1¼)	(3)	(1)	(1¼)	(1½)
Trimmed mean inflation	1.2	1	1¼	1	1¼	1½
(previous)	(1.2)	(1)	(1¼)	(1)	(1¼)	(1½)
	Year-average					
	2019/20	**2020**	**2020/21**	**2021**	**2021/22**	**2022**
GDP growth	0	−4	−2	3	4	4
(previous)	(0)	(−4)	(−3)	(2)	(5)	(4)

(a) Forecast assumptions (August Statement in parenthesis): TWI at 60 (61), A$ at US$0.70 (US$0.72), Brent crude oil price at US$42/bbl (US$46/bbl); the cash rate remains around its current level and other elements of the Bank's monetary stimulus package are in line with the announcements made following the November Board meeting.

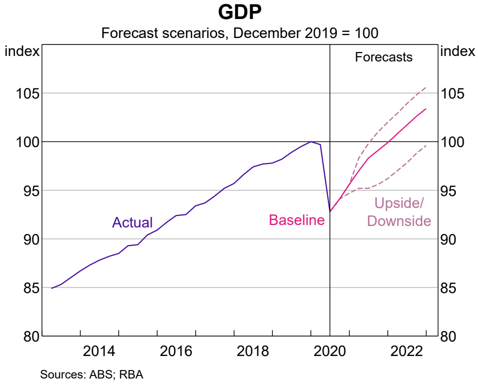
(b) Rounding varies: GDP growth to the nearest whole number; unemployment rate to the nearest half point; inflation rates to the nearest quarter point. Shaded regions are historical data and are shown to one decimal place. Figures in parentheses show the corresponding baseline scenario forecasts in the August 2020 Statement.

(c) Average rate in the quarter

Sources: ABS; RBA

the easing of restrictions on the consumption of some services and the previously accumulated savings will support household consumption through this period of lower income. The contribution of business investment to growth is also expected to increase across the forecast period. Exports are set to contribute to growth over coming years, but by less than expected at the time of the August *Statement*.

Graph 6.1



The forecasts incorporate a material downward revision to the outlook for population growth, in line with updated estimates prepared by the Australian Treasury. These updated projections are for population growth of around 0.2 per cent in 2020/21 and 0.4 per cent in 2021/22; this is the slowest rate of population growth since the First World War.

Labour market

Labour market conditions in most of the country have improved since May, but total employment remains much lower than before the pandemic. In the near term there will be several cross-currents affecting the labour market; further easing of domestic activity restrictions will boost employment, but there will likely be some offsetting effects from changes to temporary support policies such as JobKeeper. From mid 2021 through to the end of the forecast period, employment is expected to increase steadily as activity picks up, returning to its pre-pandemic level by the end of 2022.

Employment recovered more strongly in the September quarter than was expected at the time of the August *Statement*. The unemployment rate – which was 6.9 per cent in September – has also been held down as a large number of employees have remained attached to jobs through working reduced or zero hours; this is particularly the case in Victoria. In the next few months labour market participation is expected to increase as restrictions ease further, outpacing the expected growth in employment.

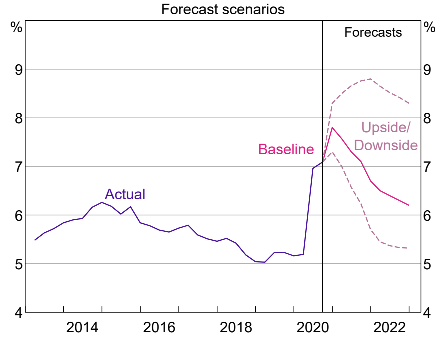
Under the baseline, the unemployment rate is expected to increase to a little below 8 per cent in coming months, lower than the 10 per cent peak expected a few months ago, and then gradually decline over 2021 and 2022 to be just above 6 per cent at the end of the forecast period (Graph 6.2).

- In the near term, employment is expected to be supported by further easing of activity restrictions, particularly in Victoria, as well as an ongoing improvement in general economic conditions. Average hours worked should also increase as fewer employed people work reduced (or zero) hours (Graph 6.3). This improvement in conditions is also likely to encourage more people to return to searching for work, as will tighter eligibility tests for JobSeeker recipients.
- Labour market outcomes in coming months will also be shaped by changes to Australian Government employment subsidy programs. The JobKeeper program extension commenced at the end of September, and is due to expire at the end of March 2021. However, several new labour market subsidy and training programs were announced in the October Budget, including a JobMaker Hiring Credit to support new jobs for people under 35, and subsidies for apprenticeships and traineeships. Take-up of these programs is expected to increase gradually over the coming period, which should lend some support to employment.

The participation rate is expected to increase gradually over the forecast period, as improving conditions encourage workers back into the labour market; longer-run structural drivers of increased participation (such as incremental increases in the pension eligibility age) also remain in place. Employment is expected to grow faster than both its long-term average

Graph 6.2

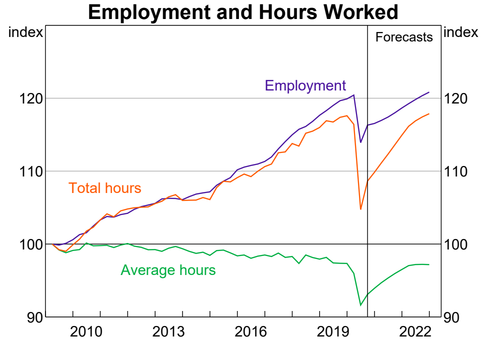
Unemployment Rate
Forecast scenarios



Sources: ABS; RBA

Graph 6.3

Employment and Hours Worked



Sources: ABS; RBA

pace and population growth over 2021 and 2022.

Given the divergent forces shaping the near-term outlook for employment and the participation rate, there is considerable uncertainty over unemployment rate outcomes over coming months. The expected pace of decline in the unemployment rate is similar to that seen in most other economic recoveries in Australia since the 1980s. That said, a key difference between the current downturn and previous episodes is the much higher degree of underemployment at present. Average hours worked by existing employees remain well below their pre-pandemic levels, and it is possible that more of the anticipated increase in labour demand could be met by existing employees working more hours in the first instance, rather than hiring additional employees. If this were to occur, it would slow the pace of decline in the unemployment rate. More generally, measures of labour market underutilisation are expected to remain high throughout the forecast period.

Public demand

Public demand is expected to make a steady contribution to domestic final demand growth over the next year. The 2020/21 Australian Government Budget points to growth in public consumption, driven by spending on health, aged care and the national disability insurance scheme. Infrastructure spending is expected to support strong growth in public investment in coming years.

Household consumption, income and saving

After declining by 13 per cent over the first half of the year, household consumption is expected to have rebounded strongly in the September and December quarters, but will still be around 5 per cent below its pre-pandemic level at the end of 2020 (Graph 6.4). This forecast recovery is stronger than that published in the August *Statement* and is underpinned by the easing of restrictions and substantial income support. Growth in consumption is expected to remain robust over the second half of the forecast period, supported by the improvement in labour market outcomes and moderate growth in household wealth.

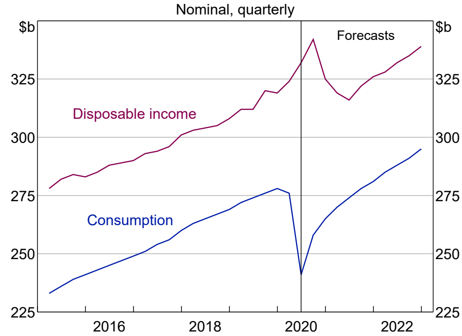
Household income is forecast to have increased further in the September quarter, reflecting increased social assistance payments and improved labour market outcomes. Income is still expected to decline over subsequent quarters, but the level in the first half of 2021 is expected to be a little above projections in the August *Statement*, partly due to tax cuts having been brought forward as announced in the Budget.

With consumption constrained in the June quarter by activity restrictions and a desire to build precautionary buffers, and income supported by fiscal transfers, the implied saving ratio increased to around 20 per cent. Households are expected to consume a larger share of their income over coming quarters as consumption possibilities broaden and confidence improves. To the extent that households also spend a portion of savings accumulated in prior quarters, this will further support consumption growth as households

Graph 6.4

Household Consumption and Income

Nominal, quarterly



Sources: ABS; RBA

smooth through the drop in income expected over coming quarters.

Dwelling investment

Following an anticipated decline in the September quarter, dwelling investment is expected to increase over coming quarters as the construction industry in Victoria resumes normal levels of activity and the HomeBuilder program supports detached building activity in most states. Growth over the latter part of the forecast period is expected to slow because the HomeBuilder program will have pulled some activity forward, particularly in the detached housing market, and because the protracted period of low approvals has diminished the pipeline of higher-density activity.

Business investment

Non-mining business investment is expected to be very weak over the next year or so, but not quite as weak as expected at the time of the August *Statement*. While disruptions to construction activity have been less severe than previously expected, non-residential construction investment is still anticipated to decline as the current pipeline of work yet to be done is completed and few new projects commence. The easing in restrictions in Melbourne will support construction activity in the near term as firms attempt to catch up on work that had been postponed in the September quarter.

A gradual recovery in non-mining business investment is expected to get underway in the first half of 2021 as the domestic recovery continues, led by investment in machinery & equipment. Tax incentives, which include the accelerated depreciation allowances over the next two years that were introduced in the Australian Government Budget, are expected to encourage some firms to bring forward investment plans and enable others to invest by easing cash flow constraints. A sustainable pick-up in non-residential construction activity is not expected until late 2021 because of the typical long lags in the planning and approval of construction projects.

The outlook for mining investment is similar to the baseline forecast in the August *Statement*. Mining investment is expected to be a little higher in the near term, led by work on iron ore and coal projects. Further out, mining investment is expected to ease slightly as construction on these projects winds down.

External sector

Exports are expected to contribute to growth over the forecast period but the outlook for exports has been downgraded compared with the August *Statement*. In the next year or so, extended maintenance at some liquefied natural gas (LNG) facilities is expected to weigh on LNG exports, and coal exports are expected to be lower because of weak global demand for coal. By contrast, iron ore exports are expected to remain strong.

The recovery in tourism and education exports is also expected to begin later than previously expected because international travel restrictions are assumed to ease around the end of 2021 – two quarters later than assumed at the time of the August *Statement*. The take-up of online study by international students and, to a lesser extent, pilot programs that allow some international students to enter Australia are expected to provide modest support to education exports. Forecast import volumes have been revised up over the next year or so, in line with upward revisions to domestic demand. Further out, the assumption that outbound international travel restrictions will remain in place for an additional two quarters weighs on the forecast for imports.

The trade surplus is expected to be lower over the forecast horizon than was previously anticipated; lower export and higher import volumes more than offset the effect of a higher terms of trade. The forecast for the terms of trade has been revised up over the next year or so, largely driven by higher prices for bulk commodities (Graph 6.5).

Wages and inflation

The outlook for wages growth is little changed compared with the baseline scenario in the August *Statement*. Although the unemployment rate is expected to peak at a lower level than previously forecast, labour market underutilisation remains very high throughout the period, suggesting limited upward pressure on wages. Year-ended growth in the wage price index (WPI) is expected to remain below 2 per cent over the next few years.

Wages growth was exceptionally weak in the June quarter, in part because some workers took temporary pay cuts. Wages growth is also expected to remain very weak in the near term. Liaison evidence suggests that around a quarter of surveyed firms intend to implement wage freezes in the year ahead, while around 30 per cent of surveyed firms already have a wage freeze in place. In addition, most wage cuts implemented in the June quarter remain in place; however, these will provide some modest support to wages growth as they unwind over coming quarters. Year-ended growth in the WPI is expected to trough at around 1 per cent in mid 2021, and then pick up only gradually to around 1¾ per cent by end 2022. As wage freezes unwind, it is possible that patterns of wage increases return to the '2–2½ per cent' norm seen in recent years. However, it is also possible that the widespread imposition of wage freezes, combined with a prolonged period of labour market slack, embeds a norm for wage increases that is below 2 per cent.

The outlook for underlying inflation in the baseline scenario is also little changed compared with the August *Statement* (Graph 6.6). Inflation remains very subdued at the end of the forecast period, reflecting the ample spare capacity that remains in the economy.

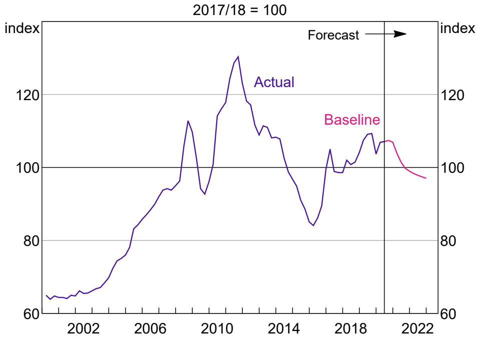
The near-term outlook for headline inflation has been revised down, reflecting the extension of several government subsidies until the end of the December quarter and the announcement of additional rebates in some states. Headline inflation is now expected to be around ½ per cent over the year to December 2020 (down from 1¼ per cent expected in August). Further out, both underlying and headline inflation are expected to increase gradually, reaching 1½ per cent by end 2022.

Compositionally, prices for some goods (such as consumer durables) are expected to continue

Graph 6.5

Terms of Trade

2017/18 = 100

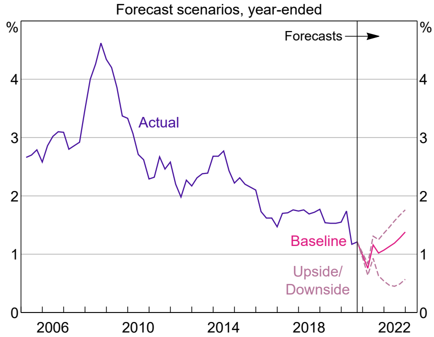


Sources: ABS; RBA

Graph 6.6

Trimmed Mean Inflation

Forecast scenarios, year-ended



Sources: ABS; RBA

increasing in the near term. Liaison information suggests there is strong ongoing demand for household goods; this has been compounded by depleted inventories early on in the pandemic and ongoing freight disruptions, putting upward pressure on prices. However, overall these effects are expected to be more than offset by weak demand more broadly and the deflationary effects of ongoing rental price declines driven by the increased stock of rental properties and slower population growth. The outlook for administered prices and government subsidies is a source of uncertainty; this may become a bit clearer over the course of November as various state budgets are announced.

Upside scenario: faster recovery

A stronger economic recovery than shown under the baseline forecasts is possible, especially if low virus case numbers are sustained, prompting domestic activity restrictions to be lifted more quickly and confidence to rebound strongly (this scenario does not presuppose the introduction of a vaccine, only enhanced control and management of the virus). A boost to consumer confidence could lift household consumption above its level in the baseline scenario. It is also likely that households would be more willing to draw down on savings accumulated over 2020, supporting a recovery in private demand; the scenario assumes that households consume around half of their accumulated unplanned savings over the coming year. It also assumes that international virus outbreaks are rapidly brought under control, such that tourism exports return to pre-pandemic levels more quickly once borders reopen.

In this scenario, the unemployment rate peaks below the level in the baseline scenario, and then declines more quickly as stronger activity and reduced uncertainty about the outlook support stronger labour demand and employment growth. This would be expected to underpin a stronger pick-up in wages growth and a faster increase in inflation over the next couple of years.

Downside scenario: slower recovery

An alternative possibility is that there are additional major outbreaks of infection in Australia and a sustained lack of virus control in other countries. This scenario assumes that around one-quarter of the domestic population faces a reintroduction of distancing restrictions and curbs on selected business activities in the first half of 2021. This would be expected to weigh heavily on consumer and business confidence in late 2020 and the first half of 2021, reinforcing the direct effect of restrictions on activity. The resurgence of infections abroad is assumed to see the reopening of international borders postponed until at least mid 2022, further delaying the rebound in services exports.

This scenario involves a more protracted and damaging slowdown in activity than envisaged in the baseline scenario. The reintroduction of measures to contain the virus, and the shock to confidence, would sharply reduce consumer spending and business investment over late 2020 and early 2021 and significantly delay the recovery. GDP would increase sluggishly throughout 2021, with growth starting to pick up only from early 2022. The loss of momentum in activity in this scenario would slow the recovery in employment as firms postpone hiring decisions and lay off additional workers, and the unemployment rate would increase to a peak of around 9 per cent in late 2021. The larger degree of spare labour market capacity would place further downward pressure on wages growth and see inflation trend lower until mid 2022.

Other risks and uncertainties

Risks to the domestic economic outlook in the very near term have eased as a result of favourable health outcomes, continued signs of recovery in private demand and the additional boost to growth expected from measures announced in the Australian Government Budget. Nevertheless, the medium-term outlook remains highly uncertain and there are a number of risks and uncertainties in addition to those described earlier.

Consumer spending is a significant driver of the expected economic recovery. One source of uncertainty relates to the net effect from the boost to consumption by recent fiscal stimulus measures (such as tax cuts) and the dampening effect from the expiry of temporary cash flow support measures. The propensity of households to save out of income is a related source of uncertainty, and will depend on confidence about the outlook. Households could respond to heightened uncertainty by choosing to save more (including paying down debt more quickly), despite record low interest rates. On the other hand, some households have already built up significant financial buffers over recent quarters, and if economic conditions continue to improve, could choose to draw on these buffers to fund consumption.

The housing market poses risks to the outlook in both directions. Although the national decline in housing prices has been limited to date, it is possible that conditions could weaken if there is a sharp increase in households that are unable to meet their mortgage obligations. This could be the result of a higher incidence of business failures and a further large rise in unemployment. Further out, the slowing in population growth could weigh on housing demand by more than is expected, resulting in lower prices and weaker dwelling investment. In the other direction, substantial policy stimulus could lead to a sharper recovery in housing prices supporting a stronger outlook for private demand than currently forecast.

The health of firms, particularly small businesses, is another a source of uncertainty. Many businesses have increased financial buffers, which is unusual during a recession. However, the longer the economy remains weak, the greater the likelihood that more firms will encounter financial stress as liquidity buffers are run down. There is a risk that business insolvencies will rise by more than expected as government support programs are tapered, slowing the recovery in activity, reducing investment and placing upward pressure on the unemployment rate. By the same token, the unprecedented government interventions to support businesses and enable them to build cash buffers could cushion firms as support is unwound and provide the basis for a faster recovery than currently forecast.

The amount of spare capacity in the labour market, and the speed at which this spare capacity is absorbed, are both significant sources of uncertainty. Average hours worked remain well below pre-pandemic levels, which means that as activity in the economy picks up, many firms could meet the demand for labour by increasing the hours of existing employees before taking on new workers. The degree of confidence about the economic outlook will also affect hiring decisions, with firms often tending to delay hiring decisions during an economic downturn. Participation in the labour market could rise more or less quickly than expected. This reflects that a large number of people who lost their jobs earlier in the year have not been actively looking for work and therefore are not currently considered as part of the labour force; it is difficult to assess how quickly these workers will return to the labour force, which will have implications for the unemployment rate. Structural change in the economy, the supply of skilled labour to match employment opportunities (including from immigrants), and 'scarring effects' on the long-term unemployed could all affect the amount of spare capacity in the labour market.

The combination of high labour market underutilisation and the extent of wage freezes at present mean that wage and price pressures are expected to remain subdued in the baseline scenario. It is possible that this results in nominal wage-setting norms and inflation expectations becoming anchored at lower levels than was observed before the pandemic. In the other direction, shortages in skilled labour and supply constraints in some parts of the economy could add more to wage and price pressures than currently expected.

The timing and pace of recovery in service exports once international travel restrictions are eased remain highly uncertain. Australia's relative success in managing the virus could make Australia a more attractive destination for international students and tourists. There is also likely to be some pent-up demand of people who wish to return to their home country, move country or visit family abroad. However, it is also plausible that the appetite for long-haul international travel could remain depressed for a long time, even after borders reopen.

Turning to global developments, a resurgence in infections in major economies and the measures taken to control them are the main factors shaping the outlook. It is unclear how long it will take to bring the virus back under control in parts of Europe and North America, and how much the recovery could be set back in the meantime. The global recovery will also depend on the scale and effectiveness of fiscal policy measures. US authorities have not yet agreed an extension of the fiscal support that lapsed in July or to new fiscal measures in support of the recovery; the longer the fiscal impasse, the more it will weigh on the recovery.

Finally, geopolitical and trade tensions remain elevated. The pandemic has heightened many of these pre-existing tensions and a worsening of the pandemic could increase them further, derailing the recovery. This includes US–China trade and technology tensions and the future of trade relations between the United Kingdom and the European Union.