6. Economic Outlook

During the first half of the year, the COVID-19 pandemic led to the most severe contraction in global and domestic economic activity in decades. Since around May, economic conditions have started to recover as containment measures have been eased and fiscal and monetary policies have provided significant support. But a high degree of uncertainty surrounds the outlook domestically and abroad. The main source of uncertainty is the evolution of the pandemic and medical developments. Indeed, a resurgence in new cases has already led to the reinstatement of containment measures in some economies, which has slowed their recoveries, including in Australia. Beyond the direct effects from reinstated containment measures, there is also considerable uncertainty over the voluntary response from households and businesses. Inflationary pressures are likely to remain subdued globally for some time because of considerable spare capacity, though in the longer term there is more uncertainty over the inflation profile given supply will also be lower.

Assuming a widespread and synchronised global resurgence in infections is avoided, GDP of Australia's major trading partners is expected to contract by around 3 per cent (in year-average terms) in 2020, with the trough in activity in the June quarter, followed by an increase of around 6 per cent in 2021. This would leave the level of major trading partner GDP around 3 per cent below what was expected before the outbreak. The global outlook is discussed in more detail in the 'International Economic Conditions' chapter.

Domestically, a gradual recovery in GDP is now underway across much of the country, following the largest shock to growth since the 1930s. Employment and hours worked are also expected to increase slightly over the second half of the year in most of the country. However, the effects of the heightened activity restrictions in Victoria are likely to offset the pick-up in GDP growth in other parts of the economy in the September quarter. The restrictions in Victoria, alongside some job losses occurring as a result of the JobKeeper program beginning to be tapered nationally after September, will weigh on labour market outcomes in the September and December quarters; this is likely to more than offset any employment growth elsewhere. The unemployment rate is expected to continue to rise over this period as a result of employment losses in Victoria, as well as increased labour force participation elsewhere in Australia. After a sharp fall in the June quarter, headline inflation is expected to rebound in the second half of the year following the end of the free child care program and a pick-up in fuel prices. However, underlying inflation is expected to remain subdued over the forecast period, given low wages growth and substantial spare capacity in the economy.

Further outbreaks of the virus and associated restrictions on activity are the key risks to the outlook. For example, the recent outbreak of the virus in Victoria and the associated introduction of restrictions on activity are likely to reduce national GDP growth in the September quarter by at least 2 percentage points, relative to the situation if the outbreak had not occurred. Other considerations include how long uncertainty and diminished confidence weigh on household spending and businesses' hiring and investment plans.

Given the high degree of uncertainty for the outlook, as with the May *Statement on Monetary Policy* a number of scenarios are considered, with different assumptions about the outbreak and restrictions, and their effects on household and business confidence. In all scenarios, fiscal policy settings are assumed to be in line with current public guidance.

- The baseline scenario assumes the heightened restrictions in Victoria are in place for the announced six weeks and then gradually lifted. In other parts of the country, restrictions continue to be gradually lifted or are only tightened modestly for a limited time, although restrictions on international departures and arrivals are assumed to stay in place until mid 2021. Under this scenario: GDP is expected to contract by around 6 per cent over the year to December 2020, but then grow by around 5 per cent over 2021; the unemployment rate is expected to rise to almost 10 per cent over the next six months and gradually decline to around 7 per cent over the latter part of the forecast period; and underlying inflation is expected to remain below 2 per cent over the next couple of years.
- A stronger economic recovery is possible if faster progress in controlling the virus is achieved in the near term. A series of positive health outcomes would help limit the damage to consumer and business confidence and support a more rapid economic recovery. In this scenario, the virus is assumed to be rapidly controlled domestically (but not overseas) and activity restrictions are lifted (with the exception of international travel), leading to a faster recovery in consumption, investment and employment. The unemployment rate would peak at a lower level and decline faster than in the baseline scenario.
- However, a plausible downside scenario is where Australia faces further periods of outbreaks and heightened restrictions in certain areas, and the world experiences a widespread resurgence in infections in the near term. In this scenario, it is likely that the recovery in service exports would be delayed further and consumer spending would continue to fall through the second half of 2020, despite continued policy stimulus and income support measures. Business investment would also decline sharply. Domestic activity would take much longer to recover in this scenario, resulting in the unemployment rate remaining close to its peak throughout 2021.

Baseline scenario: a gradual recovery in domestic activity is underway

Over the past three months, it has become apparent that the short-run direct effects of the pandemic from activity restrictions were smaller than was assumed in the May *Statement*, but that the ongoing effects of weak demand are likely to be larger. This shifting balance has implications for the path of the labour market recovery as well as output.

Under the assumptions for activity restrictions and border closures set out above in the baseline scenario, GDP grows modestly over the second half of 2020 (Graph 6.1). Growth is driven by household consumption, as activity in much of the rest of the economy continues to contract. Household income is expected to decline over coming quarters as government support is tapered. How households and businesses adjust to this, after having increased savings over recent months, will be an important determinant of the outlook over the rest of the forecast period. Employment is expected to decline further over the second half of the year, as the job losses resulting from the

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	−6	4	5	4	4
(previous)	(−8)	(−6)	(7)	(6)	(5)	(n/a)
Unemployment rate[(c)]	7.0	10	9	8½	7½	7
(previous)	(10)	(9)	(8½)	(7½)	(6½)	(n/a)
CPI inflation	−0.3	1¼	3	1	1¼	1½
(previous)	(−1)	(¼)	(2¾)	(1¼)	(1½)	(n/a)
Trimmed mean inflation	1.2	1	1¼	1	1¼	1½
(previous)	(1½)	(1¼)	(1¼)	(1¼)	(1½)	(n/a)
	Year-average					
	2019/20	**2020**	**2020/21**	**2021**	**2021/22**	**2022**
GDP growth	0	−4	−3	2	5	4
(previous)	(−1)	(−5)	(−3)	(4)	(6)	(n/a)

(a) Forecast assumptions (May Statement in parenthesis): TWI at 61 (57), A$ at US$0.72 (US$0.64), Brent crude oil price at US$46/bbl (US$35/bbl); the cash rate remains at its current level and other elements of the Bank's monetary stimulus package, including the 0.25 per cent target for the 3-year Australian Government bond yield, are assumed to remain unchanged.

(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. Figures in parentheses show the corresponding baseline scenario forecasts in the May 2020 Statement.

(c) Average rate in the quarter

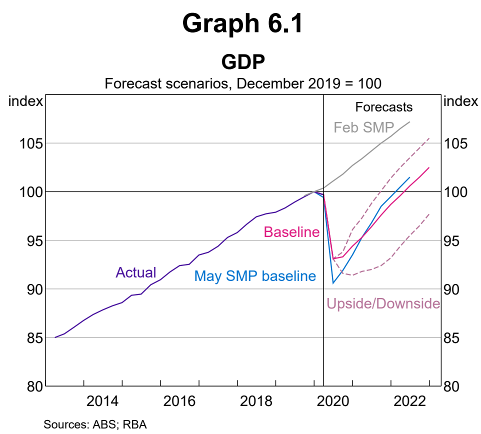
Sources: ABS; RBA

heightened restrictions in Victoria as well as the tapering of the JobKeeper program more than offset the continued recovery in jobs elsewhere in the economy. The unemployment rate is expected to continue to increase over the second half of 2020, peaking at almost 10 per cent by the end of the year (Graph 6.2).

The profile for GDP over the second half of the forecast period is broadly similar to the baseline scenario presented in the May *Statement* (Table 6.1). However, the pace of recovery in the unemployment rate is now expected to be more gradual.

Labour market

Although the deterioration in the labour market over April and May was not as severe as previously expected, the large increase in labour market underutilisation that occurred over this period will take a number of years to unwind. The baseline scenario anticipates that restrictions will gradually be lifted over the second half of the year in most of the country,



but uncertainty around the outlook is likely to see businesses defer hiring workers and many workers remain cautious about spending.

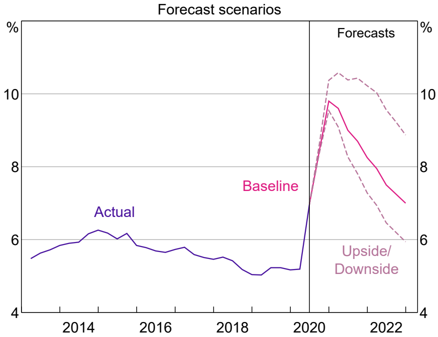
The JobKeeper program ensures that many more workers remain attached to their job than otherwise. However, it is expected some workers will be retrenched once they are no longer eligible for the subsidy in late 2020 and early 2021. Moreover, the reinstatement of job search requirements for the JobSeeker program outside of Victoria in the September quarter and the lifting of restrictions will result in more people looking for jobs, boosting the participation rate. These developments, alongside further job losses in Victoria, will contribute to the expected increase in the unemployment rate over the second half of the year, peaking at almost 10 per cent in the December quarter.

The peak in the unemployment rate is similar to that of the May *Statement* baseline scenario, but occurs a little later than previously expected. The lag between the period of heavy job losses and the increase in the unemployment rate in late 2020 is because many workers who lost jobs during this period did not initially actively search for work and so have been outside the labour force. After peaking in late 2020, the unemployment rate is expected to decline gradually, to be around 7 per cent by end 2022. This end point is a little higher than previously forecast, following

Graph 6.2

Unemployment Rate

Forecast scenarios



Sources: ABS; RBA

a reassessment of the balance between job losses related to activity restrictions and those related to ongoing softness in demand.

Overall, employment is expected to decline further over the second half of the year, as job losses from activity restrictions in Victoria and the tightening of the JobKeeper program more than offset a continued recovery in jobs elsewhere in the economy. Total hours are expected to decline a little further between the June and December quarters of 2020 (Graph 6.3). Employment will grow faster than both its long-term average pace and population growth over 2021 and 2022, but the employment-to-population ratio will remain much lower than it was prior to the pandemic.

Under the updated baseline scenario, the unemployment rate declines gradually over the forecast period. While the first part of this downturn has been driven by health policy decisions, the uncertainty around the economic and health outlook is weighing on hiring and investment intentions across most of the economy, and the pace of decline in the unemployment rate is very uncertain. Any given increase in labour demand could be met by a varying mix of higher employment and existing workers working more hours. Measured unemployment will also depend on whether more people than expected will remain discouraged by labour market conditions and not actively search for work. Regardless, it is expected that there will be ample spare capacity in the labour market over the next few years, with broader measures of labour market underutilisation remaining elevated.

Household consumption, income and saving

The forecast recovery in consumption in the near term is underpinned by the unwinding of restrictions that has occurred in many states, and substantial income support. Household disposable income is expected to be broadly steady in the June and September quarters, compared with expectations of a large decline at the time of the May *Statement*. This reflects the sizeable upward revision to labour income because employment outcomes have been better than expected, as well as stronger-than-expected growth in social assistance payments. Other policy measures that are not classified as income in the national accounts – most notably the temporary early withdrawals from superannuation accounts – have also contributed to households' cash balances and supported consumption.

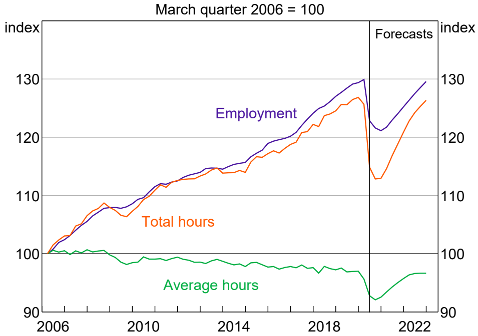
A range of timely indicators suggest that consumption will increase in the September quarter, following an extremely weak June quarter, even as renewed restrictions further constrain consumption in Victoria. The recovery in consumption beyond the September quarter is expected to be much more gradual. Household income is expected to decline in late 2020 and the first half of 2021 as government support is gradually withdrawn and unemployment remains elevated. Early withdrawals from superannuation accounts will also cease by year end. Many affected households will be able to smooth consumption over time with their savings, but some households will have to cut back due to job losses and reductions in income. Consumption is not expected to reach its pre-COVID-19 level until early 2022, consistent with the elevated unemployment rate and the gradual recovery in household income.

With consumption having been constrained in the June quarter but income supported by fiscal transfers, the saving ratio increased strongly, as it did in some other countries. The resulting accumulated savings are expected to allow households to smooth through the drop in income expected later on, and thus maintain consumption growth. The baseline forecast is consistent with roughly half of the savings accumulated in the June and September quarters being consumed over the following two years, relative to the level of savings in 2019.

Graph 6.3

Employment and Hours Worked

March quarter 2006 = 100



Sources: ABS; RBA

Dwelling investment

Dwelling investment is expected to decline in the near term. Activity in Melbourne in the September quarter will be significantly reduced by the restrictions on the number of people permitted on each construction site and the ban on movement between sites. Elsewhere, there have been very few site shutdowns as a result of the virus, and new health and safety requirements have constrained building site output by less than expected. The HomeBuilder program is expected to support investment in detached housing and alterations & additions towards the end of this year and in the first half of 2021. However, the outlook for higher-density activity is weak. The pipeline of existing projects continues to be worked through and fewer new projects have commenced recently. Furthermore, information from liaison suggests that pre-sales of apartments remain muted, and developers have reported that they will continue to defer new projects until demand conditions improve.

Business investment

Business investment is expected to decline significantly this year, led by a sharp fall in non-mining investment. This fall is consistent with investment intentions reported in surveys, as well as liaison information that continues to indicate that non-mining businesses are scaling back planned discretionary investment to preserve liquidity in response to weak demand and heightened uncertainty. While survey measures of business conditions have picked up since May, there have been few reports of investment plans being reinstated.

The timing and pace of the recovery in non-mining investment remains highly uncertain, but is expected to lag the recovery in consumption. This reflects the assumption that firms will first use up spare capacity as demand picks up, as well as the typical long lags in the planning and approval of construction projects. By the end of the forecast horizon, non-mining business investment is forecast to still be below its pre-pandemic level.

By contrast, mining investment is expected to increase over the next year or so, led by work on iron ore and coal projects. Further out, this expenditure is expected to ease as the announced pipeline of projects is worked through. Together with the delay of some large liquefied natural gas projects because of the fall in oil prices earlier this year, this is expected to result in mining investment gradually declining from around the middle of 2021.

Public demand

Public consumption is forecast to increase in the near term because of the temporary expansion of government services in the health, aged care, public order and safety & defence sectors in response to the virus. Public investment is forecast to increase over coming years, supported by ongoing expenditure on existing transport infrastructure projects and recent government announcements of fast-tracked projects.

External sector

Service exports continue to be an important driver of the trade outlook (Graph 6.4). International travel restrictions are assumed to ease around the middle of 2021 – two quarters later than assumed at the time of the May *Statement*. Thereafter, tourism exports are expected to increase, but only gradually because of lingering caution on the part of travellers and a gradual return of airline capacity. Assuming allowances are made for some international students to arrive for the start of the academic year in 2021, education exports are expected to remain broadly stable over the next year.

The level of resource export volumes is expected to be a little lower than previously expected; lower coal and gold exports are expected to more than offset stronger iron ore exports. Manufactured exports are also expected to be lower, consistent with recent weak partial trade data, the heightened restrictions in Victoria, and the appreciation of the exchange rate since the May *Statement*. By contrast, rural exports are expected to be higher over most of the forecast period, as a result of favourable weather conditions, particularly in New South Wales and Victoria, since the start of the year.

Import volumes are expected to be lower over the forecast period. This is largely the result of lower overseas spending by Australians because of the revised assumption that borders will not reopen until mid 2021. Some of this spending will be redirected to domestic tourism, which will offset to some extent the effect of fewer international tourists on activity.

The terms of trade are forecast to be higher over the forecast horizon than was expected at the time of the May *Statement*. The improved outlook reflects higher expected prices for bulk commodities and lower import prices as a result of the appreciation of the exchange rate. The trade surplus is expected to be higher than previously expected over the next year or so, largely driven by lower import values.

Wages and inflation

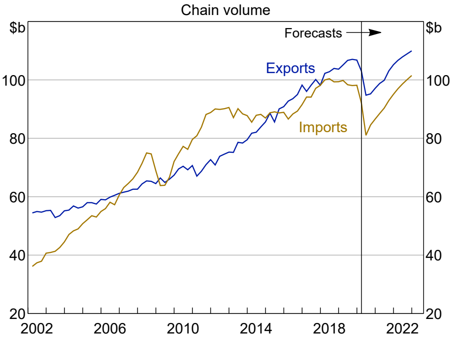
Wages growth has been revised a little lower in the baseline scenario, with year-ended growth in the wage price index (WPI) expected to remain below 2 per cent over the next few years. In the near term, the downward revision is consistent with indications from the liaison program that wage freezes have been more common than previously expected. Year-ended WPI growth is expected to trough at around 1 per cent before picking up gradually to around 1¾ per cent by end 2022. How quickly wages growth picks up will largely depend on how much spare capacity there is in the labour market and how this affects the bargaining position of workers in wage determinations. Over recent years, growth in wages has been anchored at a little over 2 per cent. It is possible that after an unusually sharp adjustment to wages, wages growth will return to around that 2 per cent norm after economic and labour market conditions start to normalise and spare capacity is gradually reduced.

Consistent with the lower wages profile, inflation is also expected to be a little lower than expected in the baseline scenario of the May *Statement* (Graph 6.5). After a brief rebound in inflation in the second half of 2020, both headline and underlying inflation are expected to remain very subdued. This is due to the disinflationary effects from the spare capacity in the labour market and in the economy more generally. Underlying inflation is expected to pick up from a trough of 1 per cent to be around 1½ per cent by end 2022. It is possible, though, that slower growth in the supply-side of the economy in the medium term could contribute to some inflationary pressures.

Graph 6.4

Trade in Goods and Services

Chain volume



Sources: ABS; RBA

In this scenario, inflation expectations remain anchored around existing levels; however, this could depend on how business and household inflation expectations respond to the large price movements that are likely to be seen in some components of expenditure over the period ahead. For instance, rent growth is expected to remain very weak as a result of lower population growth and weaker household income growth, but this may be offset to some extent by reduced growth in supply. Heightened demand for groceries and certain consumer durable products could persist for some time. However, the boost to food prices over recent years from strong international demand for meat and supply disruptions from the drought are expected to subside. Retail prices will continue to be affected by exchange rate movements, but it is unlikely that most retailers will be able to reduce discounting behaviour given expected weaker consumer spending and household income. It is uncertain whether the downward pressure on administrative prices in recent years because of government policies aimed at reducing cost-of living inflation will continue.

Upside scenario: faster recovery

A stronger economic recovery is possible if further progress in controlling the virus is achieved in the near term. Together with the significant policy support already in place, a series of positive health outcomes could be expected to strengthen consumer confidence and lift consumption above the profile in the baseline scenario. If the outbreak in Victoria is effectively controlled, and further major outbreaks nationally are prevented, this is likely to bolster household confidence. Households would then be willing to draw down more of the precautionary savings accumulated in the first half of 2020, supporting a recovery in private demand. A loosening of barriers to domestic movement would increase households' ability to divert funds previously earmarked for international travel towards domestic travel spending. Assuming the international situation does not worsen significantly and borders are able to reopen by mid 2021, inbound international travel would start to resume in the second half of the forecast period.

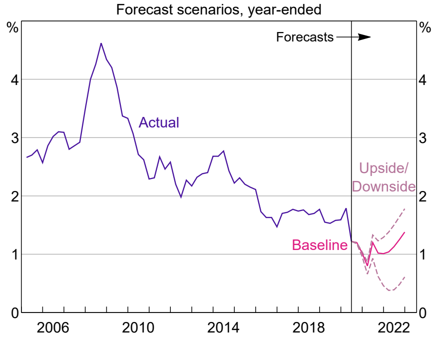
In this scenario, much of the near-term decline in GDP is reversed over 2020–21 as consumption and employment growth rebound strongly. The improvement in private demand and reduced uncertainty about the outlook would lead to increased labour demand; unemployment would peak at a lower level and decline faster than in the baseline scenario. This would underpin a more rapid rebound in wages growth and a faster pick-up in inflation over the next few years.

The upside scenario presented here assumes that, even if a vaccine is developed soon, it will not be distributed globally soon enough to bring forward the date that Australia's borders fully reopen. But if other medical treatments for COVID-19 become more effective, and greater progress is made in bringing the virus under control globally over the coming year, growth in Australia's major trading partners could recover more quickly than assumed in the baseline scenario. Such an outcome, combined with control of the virus in Australia, could also give rise to stronger domestic population growth, underpinned by renewed inflows of foreign nationals seeking work or study opportunities.

Graph 6.5

Trimmed Mean Inflation

Forecast scenarios, year-ended



Sources: ABS; RBA

Downside scenario: slower recovery

An alternative possibility is that Australia faces a series of periodic regional outbreaks and 'rolling' lockdowns to contain these outbreaks in coming quarters, and the world experiences a widespread resurgence in infections. In this scenario, a global 'second wave' of infections eventuates and peaks in early 2021, world demand would decline further, and Australia's international borders would remain effectively closed until at least late 2021. This scenario would result in a delay in the recovery in services exports and have other knock-on effects. To prevent transmission of locally acquired infections, affected regions would need to increase distancing restrictions and corresponding curbs on some business activities. Even Australian states remaining unaffected by the resurgence would be expected to further tighten restrictions on interstate population movement, narrowing the scope for households to substitute from international to domestic travel and further weighing on business activity.

This scenario involves a more damaging and lasting impact on activity than envisaged in the baseline scenario. An extended period of lockdown would see consumer spending continue to fall through the second half of 2020, despite continued policy stimulus and income support measures. Heightened uncertainty about the outlook would further erode household and business confidence and materially slow the recovery in consumption and investment, even after the lifting of restrictions. Domestic activity would be expected to remain close to its trough until the second half of 2021. This would induce businesses to keep employees on reduced hours and delay hiring new staff, with annual growth in employment only turning positive in the second half of 2021. In this downside scenario, the unemployment rate rises further through the second half of 2020 and remains at high levels throughout 2021. The increased slack in the labour market would place downward pressure on wages growth. In this environment, inflation would continue to trend lower until the second half of 2022, although it is possible that supply disruptions arising from reduced international trade and domestic border restrictions could offset these disinflationary pressures at the margin.

Other risks and uncertainties

The scenarios incorporate uncertainty regarding the course of the virus and how households and businesses respond to that. A key downside risk would be if there were ongoing cycles of infections and restrictions, which weighed on activity and household and business confidence. By contrast, positive surprises on the health front, at a time of unprecedented fiscal and monetary policy support, would help bolster the recovery.

The scale and effectiveness of fiscal support also introduces both upside and downside uncertainty to the near-term outlook for the domestic economy and the global outlook. Domestically, the baseline scenario assumes a modest lift in demand by households and businesses due to the fiscal support, but it is possible that private expenditure could increase more strongly. By extension, how households and businesses respond to general uncertainty and changes in fiscal settings will influence the pace of the recovery. In Australia and other countries with programs similar to JobKeeper, many businesses will need to resume funding their full wage bill with revenue from activity as government income support policies are tapered. If this is difficult for a larger share of businesses than has been assumed, jobs or hours lost would be larger, which would result in a much slower recovery in income and associated risks to private consumption.

The longer the economy remains weak, the more households and firms will suffer severe financial stress after running down their liquidity buffers. These stresses could slow the recovery further and increase the chance of labour market scarring for many workers. Unemployed people or younger workers entering the labour market may need to take jobs that are poor matches for their skills. It will also become more difficult for unemployed people to find work if they have been unemployed for some time because of a loss (perceived or otherwise) in skills or because they become discouraged and exit the labour force. However, a sustained decline in the effective supply of labour could have other effects, such as reducing downward pressure on wages growth. Indeed, in the longer term there is more uncertainty over the inflation profile compared with the near term, given it is unclear by how much potential growth in the supply-side of the economy is likely to have declined.

If households conclude that low income growth will be more persistent than previously expected, they may permanently adjust their spending and the recovery in consumption growth could be weaker for longer. Furthermore, households that are more indebted are likely to be more sensitive to changes in their expected income growth and wealth. Consumption growth may be weaker for a time if households are concerned about their debt levels and choose to pay down debt more quickly, even with interest rates at record lows. Households' responses to the expiration of other temporary cash flow support measures – such as mortgage and rent deferrals and early access to superannuation – is another source of uncertainty.

Businesses could be expected to revise down their investment plans further if they become less confident about future demand. A prolonged period of heightened uncertainty could further reduce firms' willingness and capacity to undertake large investments that are costly to reverse, such as construction of office towers and hotels. This would have long-lived effects because these projects, which have made a sizeable contribution to non-mining investment in recent years, generally take several years from initial planning to commencement. Continued uncertainty may also lower firms' risk appetite, and they may choose to pay down debt and increase cash buffers rather than invest once profits recover. A sustained period of lower investment in physical capital, combined with rising long-term or 'structural' unemployment, could also damage the economy's productive potential over a longer period.

Internationally, decisions on fiscal policy will shape the path of the global economic recovery (alongside virus outcomes). Governments have shown considerable willingness to support household incomes during the initial health crisis. A successful transition to more direct support for demand, for example through public investment in infrastructure such as transport, communications and education and health services, would help sustain the recovery further out.

Geopolitical tensions were already heightened before the outbreak, and the pandemic has increased them further. This includes US–China trade and technology tensions, which are spilling over into broader geopolitical friction between the two countries. The pandemic has also increased domestic political tensions in some countries. A worsening of these geopolitical and domestic political tensions could derail the global recovery.