Overview

Combating the spread of COVID-19 has required severe restrictions on economic activity in many countries. The result has been a large and near-simultaneous contraction across the global economy. Heightened uncertainty about the future has exacerbated the contraction, both directly through weaker investment and consumer spending and via tighter financial conditions. In Australia, output is expected to contract significantly over the first half of 2020, mostly in the June quarter. While the exact size of the contraction is still uncertain, a decline in GDP of around 10 per cent from peak to trough is expected.

The contractions in output in many other economies are likely to be at least as large as that in Australia; the size and timing of these declines depend both on the duration of the containment measures and on how stringent these measures have needed to be. March quarter GDP data for a number of economies show significant contractions, even though in many cases the lockdowns only began in the last few weeks of the quarter.

China is in the process of recovery, having been hit by the COVID-19 pandemic earlier than other countries. Although output contracted by nearly 10 per cent in the March quarter as a whole, industrial production staged a substantial recovery in the month of March and fixed asset investment spending also increased. In contrast, retail spending remained weak, suggesting that households have been slow to venture out and resume earlier spending patterns once the lockdowns have ended.

In many other economies, the most intense phase of the contraction is likely to occur in the June quarter. Gradual recoveries should follow in the second half of the year, supported by the easing of restrictions and the significant expansion in both fiscal and monetary policies. Central banks have provided support to businesses and households, and addressed the financial market disruptions that arose in March.

The contraction in activity has affected labour markets severely. Large and rapid increases in unemployment are occurring in many countries. Official unemployment rates, including in Australia, will not capture the full extent of the decline in labour demand. Lockdowns, school closures and other restrictions on activity have meant that many workers who have been laid off will not be actively searching for another job for a time and therefore not be counted as unemployed, while other workers will have left the labour force. In addition, many firms have cut the hours of their employees rather than laying them off entirely. More of the labour market adjustment is likely to occur through hours worked rather than job losses in economies with more comprehensive wage subsidy programs. And by preserving employment relationships over the period of lockdowns, these programs should also hasten the subsequent recoveries in activity and employment.

In Australia, although there is expected to be a large increase in the unemployment rate – perhaps peaking at around 10 per cent – the increase would have been much larger were it

not for the JobKeeper wage subsidy program. Total hours worked are likely to contract by around 20 per cent over the first half of 2020. This is larger than the decline in output partly because many of the most-affected industries are quite labour-intensive.

A shock of this size and uncertain effect has been difficult for financial markets to price. Globally, risk premiums widened in late February and into March. The resulting very sharp increase in volatility induced investors to reduce leverage and raise cash. A widespread sell-off of even relatively safe assets such as government bonds ensued, which contributed to severe market dysfunction, including in Australia. Government bond yields increased despite the worsening economic outlook. The dysfunction in the US Treasury market was especially consequential because of its role as a pricing benchmark for other markets. US dollar funding and foreign exchange markets were also severely disrupted for a time.

Central banks around the world, including in Australia, moved swiftly to implement comprehensive policy packages in response to the deterioration in the economic outlook and the market dysfunction. These included reductions in policy rates, large-scale market operations and purchase programs for government bonds and other securities, the provision of term funding to banks and the establishment of foreign exchange swap lines. These measures complemented fiscal stimulus aimed at supporting incomes and the flow of funding to households and businesses.

These various policy measures – and a slowing in the rates of new infections in many countries – contributed to an easing in financial conditions in April. Market functioning has improved and central bank bond purchases and market operations have been scaled back accordingly. Earlier tightness in money markets has also eased, and corporate bond issuance has rebounded in major markets. Following very sharp declines in March, equity prices have since recovered around half the losses, but remain volatile, while exchange rates have reversed some of the sharp movements of February and March. Financial conditions more broadly remain quite fragile, however, consistent with the uncertain economic outlook.

In Australia, the Reserve Bank Board held an unscheduled meeting on 18 March, at which it agreed to implement a comprehensive package of measures to support the economy and promote functioning of key financial markets. The package had four elements:

1. A reduction in the cash rate to 25 basis points. This followed an earlier reduction of 25 basis points at the scheduled March meeting. The Board also announced that it will not increase the cash rate target until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2–3 per cent target band. Given the outlook for the Australian economy, this means that the cash rate is unlikely to be increased for an extended period of time.

2. A target for the three-year Australian Government bond yield of around 0.25 per cent. The Board chose to implement the target at the three-year horizon as it influences funding rates across much of the Australian economy. It is also consistent with the Board's expectation that the cash rate will remain at its current level for some years. The three-year bond yield target extends and complements the Reserve Bank's practice to target the cash rate, which forms the anchor point for the risk-free term structure. To achieve this target, as well as to address dislocation in the government bond market, the Bank has conducted purchases of Australian Government Securities (AGS) and semi-government securities (semis) across the yield curve in the secondary market.

3. A Term Funding Facility for the banking system, with particular support for credit to small and medium-sized businesses. The Reserve Bank is providing a three-year funding facility to authorised deposit-taking institutions (ADIs) at a fixed rate of 0.25 per cent. ADIs can obtain initial funding of up to 3 per cent of their existing outstanding credit. They have access to additional funding if they increase lending to business, especially to small and medium-sized businesses. The facility is for at least $90 billion. The Australian Government has developed a complementary program of support for the non-bank financial sector, small lenders and the securitisation market, implemented by the Australian Office of Financial Management.
4. The remuneration of exchange settlement balances at the Reserve Bank at 10 basis points, rather than zero as would have been the case under the previous arrangements. This mitigates the cost to the banking system associated with the large increase in banks' settlement balances at the Reserve Bank that has occurred as a result of these policy actions.

In addition, the Bank has provided substantial liquidity to the financial system through its daily open market operations. This has included the provision of liquidity at three and six-month horizons on a frequent basis. Furthermore, at its May meeting, the Board decided to broaden the range of eligible collateral for these operations to include Australian dollar securities issued by non-bank corporations with an investment grade credit rating. This will assist with the smooth functioning of Australia's capital markets.

These measures complement each other and work to lower funding costs across the economy and support the provision of credit, especially to small and medium-sized businesses. Importantly, the package of measures is part of a substantial, coordinated and unprecedented fiscal and monetary policy response to the COVID-19 outbreak.

So far, this package of measures has been working broadly as expected.

The target for the three-year government bond yield was achieved quickly, and the yield has remained around 25 basis points subsequently. To achieve the target and to support market functioning, the Bank has purchased $50 billion of AGS and semis in the secondary market. Market functioning in both the AGS and semis bond markets has improved significantly. Issuance by Commonwealth and state governments has picked up. Reflecting the improvement in market functioning and the achievement of the three-year yield target, the Bank has scaled back the frequency and size of its operations. Nevertheless, the Bank is prepared to scale up these purchases again if necessary to achieve the yield target and ensure that government bond markets remain functional.

By the beginning of April, $50 billion of additional liquidity had been provided to the banking system through open market operations and the average residual maturity of the Bank's repo book had increased noticeably. Since then, the size of the Bank's daily market operations has declined in response to improved market conditions, reflecting the large amount of liquidity already in the system and reduced demand from the banking system as a whole. In response to the very large rise in cash balances in the banking system, as expected, the cash rate has declined below 25 basis points. It is currently trading at a rate of 14 basis points, and market pricing indicates it will remain around this level for some time.

Borrowing rates for businesses and households have declined to record low levels in response to the package of policy measures. The cost of funding for banks has also declined to very low

levels. Lenders are beginning to draw down on their Term Funding Facility allowances, with some of the larger institutions expected to do so in coming months. These developments will provide support to the economy in the period ahead.

As the spread of the virus is contained and public health measures are relaxed, both the domestic and global economies will begin to recover. Governments in Australia and elsewhere have introduced very significant fiscal stimulus, supported by further monetary policy accommodation. These policy initiatives will support incomes over this challenging period and be instrumental to the recovery. The initial stages of these recoveries could start quite soon, as activities that were previously restricted become possible again. But a full recovery will take time. Many households and businesses have reduced spending in response to declines in income and wealth, and heightened uncertainty. This may take a while to reverse, especially if there are lingering concerns about control of the virus. In addition, some workers who have been laid off will take time to find other employment, especially if their previous jobs were in industries facing lower ongoing demand.

Beyond the next few months, the speed and timing of the economic recovery is very uncertain. It therefore makes sense to think in terms of plausible scenarios. The path of the recovery will depend crucially on how successful countries are in containing the spread of the virus, and thus how long containment measures need to be in place. In a number of countries, including Australia, some restrictions are beginning to be lifted. A plausible baseline scenario for the outlook in Australia involves the relaxation of domestic activity restrictions over coming months, with most of these restrictions lifted by the end of the September quarter; restrictions on large public gatherings and international travel could remain in force for longer than this.

Under this baseline scenario, activity and employment begin to recover in the second half of the year. After an initial surge of retail spending in March, as households prepared for the period of self-isolation and social distancing, household consumption is expected to contract by around 15 per cent before recovering over the next couple of years. Much of the decline is expected to be concentrated in services, such as travel and entertainment, most affected by activity restrictions. Travel restrictions have also induced a sharp decline in tourism-related and education service exports, and it is not clear how quickly these will recover.

The uncertainty about future demand prospects will also curtail business investment intentions. In addition, mining investment is likely to be weaker than previously expected, as some large proposed LNG projects have been delayed given low oil and LNG prices. More positively, though, drought conditions have been easing in recent months. Activity restrictions have limited turnover in the established housing market, and uncertainty about future job prospects and income is likely to dampen demand for housing. Slower population growth is also expected to translate into less demand for new construction.

The pace of recovery in the labour market is uncertain. Much will depend on how well employment relationships can be preserved over the period of restrictions – including through the use of the JobKeeper Payment – or restored quickly as activity recovers. Longer-run behavioural responses to the pandemic could involve lasting shifts in industrial structure; achieving a rapid recovery in the face of these shifts will also place a premium on the flexibility and adaptability in the labour market. Under the baseline scenario, unemployment begins to gradually decline from later this year. However, it is expected to remain elevated for some time.

Turning to inflation, inflation pressures had picked up a little in the March quarter. Inflation was 2.2 per cent over the year to the March quarter, and 1¾ per cent in underlying terms. However, oil prices have fallen dramatically in response to lower global demand and limited storage capacity. Recently announced production cuts globally have not been enough to offset this. As a result of this and the temporary removal of childcare fees, year-ended headline inflation is expected to turn negative in the June quarter, for the first time since the early 1960s. Trimmed mean inflation is also expected to be lower (but still positive) in the June quarter, to be around 1½ per cent over the year. Declines (or delayed increases) in a number of administered prices will also contribute to inflation remaining low in the near term. From this low point, inflation is likely to increase gradually, but in this baseline scenario it is likely to remain below 2 per cent for some time, for a number of reasons. The ongoing spare capacity in the labour market is likely to result in a period of slower growth in wages and thus labour costs. Growth in rents is also likely to remain weak: demand for housing will be lower, while some properties previously used as short-term holiday accommodation are now being offered for long-term rental.

Other scenarios for the recovery phase can readily be envisaged. Given the relatively rapid decline in the number of new COVID-19 cases in Australia, it is possible to contemplate an upside scenario where most domestic restrictions on activity are relaxed a little sooner and the economy recovers somewhat faster than in the baseline scenario. The greater is public confidence in positive health outcomes, the more likely it is that the easing in restrictions on activity spurs a recovery in spending; better health outcomes elsewhere in the world would reinforce this positive dynamic. In such a scenario, the unemployment rate could return to around 5 per cent in a couple of years and the level of GDP would return to a path that is close to that implied in the forecasts published in the February *Statement on Monetary Policy*.

Alternatively, if the lifting of restrictions is delayed or 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. The unemployment rate would drift down much more gradually and the level of output would remain around its trough for several quarters and recover only slowly. A longer downturn would involve more job losses and business failures, and therefore more lasting damage to economic performance.

In the context of these extraordinary times and consistent with its broad mandate to promote the economic welfare of the people of Australia, the Reserve Bank will continue to play its role in building the bridge to the time when the recovery takes place. It will maintain its efforts to keep funding costs low in Australia and credit available to households and businesses. The Board will not increase the cash rate target until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2–3 per cent target band. The Board is committed to do what it can to support jobs, incomes and businesses during this difficult period and to make sure that Australia is well placed for the expected recovery.