Overview

Economic developments continue to be driven by the COVID-19 pandemic and the responses to it. The initial outbreaks prompted significant restrictions on activity and resulted in very large contractions in output. Most economies have been recovering from these initial contractions. But in most cases, economies still remain well below pre-pandemic levels, and in Europe fresh outbreaks are threatening even this progress.

In Australia, economic activity contracted substantially in the early months of the pandemic and has since recovered some of that decline. The 7 per cent contraction in GDP in the June quarter was the largest peacetime contraction since at least the 1930s, and certainly one of the most sudden. It was nonetheless not as big a fall as had been feared, and was less than that experienced in many other countries. The less negative outcome stemmed largely from Australia's early success in bringing new infection rates down, which allowed restrictions on activity to be eased sooner than earlier thought.

The deterioration in labour market conditions has also been significant. After contracting by 7 per cent between February and May, employment has recovered about half of this decline. The number of people working reduced or zero hours for economic reasons has also reversed about half of the initial increase. Even so, the unemployment rate remains well above where it had been prior to the outbreak of the pandemic, at 6.9 per cent in September.

The unemployment rate is likely to increase in the near term, partly because some workers who withdrew from the labour force in the early months of the pandemic are expected to return, in response to improving job prospects in some areas and tightening eligibility requirements for JobSeeker. The unemployment rate is expected to peak a little below 8 per cent around the end of the year. This peak represents a very high level of spare capacity in the labour market. The unemployment rate is expected to decline only gradually, to just above 6 per cent by the end of 2022. With significant spare capacity remaining in the labour market over this period, wages growth and inflation are both likely to remain low. Both headline and trimmed mean inflation are forecast to bottom out below 1 per cent in 2021, and reach 1½ per cent by end 2022.

The recent COVID-19 outbreak in Victoria and associated activity restrictions slowed the initial phase of the overall economic recovery. Output growth in the September quarter is estimated to be around 2 percentage points lower than if that outbreak had not occurred. Outside Victoria, consumer spending has recovered noticeably and labour market conditions have improved, but both still remain below levels seen prior to the pandemic. Now that new case numbers have come down in Victoria and activity restrictions are being eased, a similar pattern of recovery can be expected there.

The significant support from both fiscal and monetary policy has been effective at preserving many jobs and businesses through the period of activity restrictions. The scale of the support has been in sharp contrast to the experience in past downturns. The Australian

Government Budget in October announced significant further stimulus, and forthcoming state budgets are expected to add to this. Loan deferrals have also assisted borrowers affected by the pandemic.

Because of the fiscal support via JobKeeper and social assistance payments, aggregate household income in Australia increased in the June quarter, despite the enormous contraction in output; household income is estimated to have increased a bit further in the September quarter. Households' ability to spend this income was constrained by health restrictions, which resulted in a very large rise in household savings. Although incomes are expected to decline as these support measures are scaled back, these accumulated savings should help support consumption.

The combination of policy support and the opening up in Victoria will enable further recovery in national economic activity in coming quarters. After contracting by 4 per cent over 2020 as a whole, GDP is expected to increase by around 5 per cent over 2021 and 4 per cent over 2022. This would bring GDP back to its end-2019 level by the end of 2021, but leave it well short of the path expected prior to the outbreak of the pandemic. The recovery can be expected to be bumpy and uneven, and highly sensitive to further virus outbreaks.

Policy support measures have also materially affected near-term inflation outcomes. The introduction of free child care and preschool resulted in a significant decline in headline CPI in the June quarter, and a substantial increase in the September quarter as this subsidy was unwound. Measures of inflation were also affected by the need to impute prices of items that were not available because of activity restrictions. Over the year to the September quarter, headline inflation was 0.7 per cent and underlying inflation was around 1¼ per cent.

Within the overall inflation outcome, some prices shifted considerably in recent quarters. As well as the effects of subsidies and other policy decisions on administered prices, the prices of many other items have been affected by swings in demand and disruptions in supply. Prices of homewares and many other consumer durables increased in response to strong demand from households spending more time at home. Grocery prices had previously been boosted by drought, and by reduced discounting during the period of strong demand at the beginning of the pandemic. This turned around in the September quarter as supermarkets resumed pre-pandemic patterns of discounting for most product categories.

The extensive monetary support provided by central banks globally has helped to underpin very accommodative financial conditions. Government bond yields are close to historic lows. Borrowing costs for households and businesses are also at historic lows in many economies, including in Australia. Supply of debt and equity finance in markets remains ample; although equity markets have been volatile around the US election, the cost of equity remains low and has encouraged considerable equity raising both in Australia and globally. In Australia, historically low interest rates for households and businesses are enabled by very low bank funding costs. A large fraction of deposits currently attract close to zero interest; bond spreads are at very low levels; and the Term Funding Facility (TFF) is available at low cost, especially for lenders that expand their business lending.

The availability of finance at low rates has been one factor supporting demand for housing in Australia. Consistent with this, new commitments for housing finance have recovered significantly, and housing credit growth has also picked up, most notably to owner-occupiers. Housing prices have increased in most cities and regional Australia over recent

months, but have declined in Sydney and Melbourne. The HomeBuilder subsidy from the Australian Government and some state government subsidies have also supported demand for new housing, despite the lower near-term outlook for population growth. Rental markets, however, remain soft, with advertised rents, especially for apartments, declining in Sydney and Melbourne.

In contrast to housing credit, business credit has declined over recent months, reversing most of the increase recorded in the early months of the pandemic, when many firms sought to build precautionary liquidity buffers. Business investment contracted noticeably in the June quarter, although by less than had been expected because firms took advantage of tax incentives to pull forward equipment purchases. Further declines are likely in the near term; investment intentions are weak and unlikely to recover much until demand conditions have improved. Conditions are a bit stronger in the mining sector, and mining investment is likely to increase over coming quarters as several large projects are constructed. Investment in iron ore projects has been made more attractive by ongoing high prices. Iron ore prices have been supported partly by supply disruptions elsewhere, especially Brazil, and partly by strong demand from China, where the industrial and construction sectors have recovered rapidly.

As in the previous couple of *Statements*, the significant uncertainty around the outlook has been represented using downside and upside scenarios around the baseline scenario. The main driver of the different scenarios is again the course of the pandemic. In the baseline scenario, it is assumed that no further large outbreaks occur in Australia, and that restrictions on activity do not need to be tightened materially at any point. However, international borders are assumed to remain largely closed until the end of next year, reducing services exports and imports.

In the downside scenario, Australia does see some major outbreaks and tighter activity restrictions. International borders are also assumed to remain closed for longer. Unemployment would increase more and stay high under this scenario. After peaking at around 9 per cent, the unemployment rate would still be around 8½ per cent by the end of 2022.

An upside scenario can also be envisaged, especially if there is additional progress in the control and treatment of the virus in the near term. Better health outcomes and ongoing control over the virus would boost confidence and help sustain a swifter recovery in household consumption and business investment. This would see the unemployment rate decline faster, reaching around 5½ per cent by the end of next year.

Both in Australia and overseas, the outlook for growth involves considerable uncertainty related to the course of the pandemic. Fresh outbreaks are prompting new lockdown measures and could therefore slow the recovery in many advanced economies. Trade and geopolitical tensions also pose downside risks to the recovery. Spare capacity is likely to persist for some time and global inflation is accordingly likely to remain subdued.

In mid March, the Reserve Bank Board introduced a significant policy package designed to support households and businesses by ensuring ample funding was available at low cost. The package involved a reduction in the cash rate target, to 0.25 per cent, a target for the yield on the 3-year Australian Government bond of around 0.25 per cent, a reduction in the remuneration rate for Exchange Settlement balances to 0.10 per cent and the introduction of a TFF for authorised deposit-taking institutions (ADIs) at an interest rate of 0.25 per cent. The TFF offers low-cost funding to lenders to support the provision of credit. The initial allowance was for an amount equivalent to 3 per cent of credit outstanding as at March;

an additional allowance was also made available to ADIs that increased their lending to business, especially to small and medium-sized businesses. These measures were in addition to the liquidity support provided to the market during the period of disruption around March.

Over the subsequent months, the Board continued to monitor economic developments to assess whether further support might be needed. At its September meeting, as the deadline for drawings under this initial allowance of the TFF approached, the Board decided to extend the TFF via a supplementary allowance to further support the economic recovery. This allowance amounts to 2 per cent of total credit and can be drawn upon until the end of June 2021. The Board also decided at that meeting to extend the deadline for drawing the previously announced additional funding allowance to June 2021.

At its November meeting, the Board discussed the updated forecasts. It concluded that, despite the somewhat better recent outcomes in Australia, the recovery was expected to be extended and bumpy. The outlook implied a large shortfall in activity and employment from levels that would be consistent with full employment. To further support the recovery and complement the significant support coming from fiscal policy, the Board therefore decided to introduce a further package of measures

- a reduction in the cash rate target to 0.1 per cent
- a reduction in the interest rate on Exchange Settlement balances to zero
- a reduction in the target for the yield on the 3-year Australian Government bond to around 0.1 per cent
- a reduction in the interest rate on new drawings under the Term Funding Facility to 0.1 per cent
- the purchase of $100 billion of government bonds of maturities of around 5 to 10 years over the next six months.

Under the program to purchase longer-dated bonds, the Bank will buy nominal bonds issued by the Australian Government and by the states and territories, with an expected 80/20 split. These bonds will be purchased in the secondary market through regular auctions. The Bank will not purchase bonds directly from the government. The longstanding separation of monetary policy and fiscal financing in Australia remains in place. The Australian Government and the states and territories continue to fund themselves in the market and their bond auctions have been heavily oversubscribed, notwithstanding the significant increase in the size of these auctions.

The Bank's monetary policy measures package will support economic activity and job creation through the normal transmission channels. The lower risk-free yield curve will flow through to lower rates for borrowers, thus boosting available cash flows for some people. The exchange rate will also be lower than otherwise. Some asset prices could also be expected to be higher than otherwise, helping to strengthen balance sheets. The Bank's measures to ensure a high level of liquidity in the Australian financial system will also support the supply of credit to households and businesses.

The Board is not contemplating a further reduction in interest rates. With the cash rate target at 10 basis points and the interest rate on Exchange Settlement balances at zero, interest rates have been lowered as far as it makes sense to do so in the current environment. The Board considers that there is little to be gained from short-term interest rates moving into negative territory and continues to view a negative policy rate as extraordinarily unlikely.

The Board has committed not to increase the cash rate target until actual inflation is sustainably within the target range of

2–3 per cent. This will require a period of strong employment growth and a return to a tight labour market. The 3-year yield target will be removed prior to an increase in the cash rate.

The focus over the period ahead will be the government bond purchase program. If the circumstances require, the Board is prepared to do more and undertake additional purchases. At its future meetings, the Board will be closely monitoring the impact of bond purchases on the economy and on market functioning, as well as the evolving recovery from the pandemic, including the outlook for jobs and inflation. ✠