

Statement on Monetary Policy

AUGUST 2020



RESERVE BANK OF AUSTRALIA

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Overview

The COVID-19 pandemic represents the largest shock to the global economy in many decades. Labour markets have been severely disrupted. While infection rates have declined in some countries, they have escalated in many others, including the United States and some large emerging market economies. Renewed outbreaks are also occurring in some other countries, including Japan and parts of Australia. The ongoing spread of the virus, and the responses to contain it, will combine to slow the recovery.

The Australian economy has experienced a severe contraction and, like many other economies, is now in the early stages of recovery. The contraction over the first half of 2020 was smaller than anticipated three months ago, though it was still very large. It was also not quite as large as in some other economies, where lockdown measures were more binding and were imposed for longer. However, the pace of recovery is expected to be slower than previously forecast. Generalised uncertainty and deficiency in demand have turned out to be more of a drag on growth than previously thought. The measures taken to address the current outbreak in Victoria will further delay the recovery. The most recently announced containment measures are expected to subtract at least 2 percentage points from national growth in the September quarter, relative to the counterfactual where the renewed outbreak had not occurred.

In light of the extreme uncertainty about the course of the pandemic and its economic effects, the outlook is again considered in the

form of three scenarios. In the baseline scenario, the Australian economy is expected to contract by about 6 per cent over 2020, before growing by around 5 per cent over 2021 and 4 per cent over 2022. This would still leave the level of output below where it would have been had the pandemic not occurred. Under the baseline scenario, the unemployment rate is expected to peak at around 10 per cent by the end of this year.

A stronger economic recovery is possible if faster progress in controlling the virus is achieved in the near term. In this scenario, a faster unwinding of activity restrictions and greater confidence lead 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 the world experiences a widespread resurgence in infections in the near term, and Australia itself faces further outbreaks and lockdowns in certain areas. Activity restrictions would weigh on household consumption and business investment decisions, despite continued policy stimulus and income support measures. Domestic activity would take much longer to recover in this scenario, resulting in the unemployment rate remaining close to its peak throughout 2021.

The coronavirus outbreak has been enormously disruptive for Australia's labour market. Employment declined by more than 850,000 in April and May, and increased by around 200,000 in June. The measured unemployment rate increased by more than 2 percentage points

over the course of a few months, reaching 7.4 per cent in the month of June, the highest rate in more than two decades. The scale of job losses to date and the increase in unemployment would have been much greater were it not for the JobKeeper program. The unemployment rate would also have risen more if the proportion of workers leaving the labour force entirely had not been unusually high. Under the baseline scenario, the unemployment rate is expected to increase from here. Some of this increase stems from the outbreak in Victoria; employment and hours worked are expected to decline at a national level over this period because of the further activity restrictions. Unemployment will also increase elsewhere in Australia, as people begin searching actively for work again. The unemployment rate is expected to decline gradually from this peak over the course of the next couple of years.

Support from public policy has been instrumental in cushioning the effects of the health-related activity restrictions on incomes and will crucially shape the recovery as well. In aggregate, household disposable income has been maintained through this period, even as many people lost their jobs or worked fewer hours. The largest contributor to this support domestically has been the JobKeeper program, which is estimated to have supported more than one-quarter of all workers. The program has been extended beyond September and will continue to support employment until March 2021, although at lower rates of subsidy and with changed eligibility criteria. Additional payments to recipients of other forms of social assistance have boosted household incomes and will continue to do so over the next few quarters. Many households were also able to supplement their cash flows by withdrawing from their superannuation.

At the same time, health-related activity restrictions have reduced consumption opportunities, particularly for services. Border

closures continue to constrain domestic tourism, and overseas tourism and education.

Households have substituted from services to goods consumption – a pattern also evident in other countries – and stocked up on items such as long-life food and household goods. Overall, consumption is still estimated to have contracted by about 10 per cent over the first half of 2020, although consumer spending has increased over recent months. With fiscal support maintaining household income at the same time that consumption declined significantly, some households have accumulated additional savings over this period, though others have had to draw down on their savings. Some of the additional savings went into paying down debt and building up buffers in mortgage offset and redraw accounts. These savings are expected to help sustain the recovery in consumption that is already underway, even as the fiscal support to incomes begins to taper off.

Public policy decisions to support the economy have also affected inflation. As flagged in the previous *Statement*, headline CPI declined by 2 per cent in the June quarter, which took year-ended headline inflation to –0.3 per cent. The quarterly decline was entirely accounted for by two temporary factors: the fall in petrol prices and the decisions to make child care (and some preschool) free. Looking through these effects using various measures suggests that underlying inflation was closer to zero in the quarter, rather than the large negative recorded in the headline CPI.

Most of the decline in headline inflation will reverse in the September quarter. Petrol prices increased a little in recent months, and fees for child care and preschool are being progressively reintroduced. Looking beyond this near-term volatility, both headline and underlying inflation are expected to remain low for some time yet, given the extent of spare capacity in the economy and resulting weak wages growth. In

the baseline scenario, trimmed mean inflation is expected to increase gradually, reaching around 1½ per cent by the end of 2022. Other outcomes are possible depending on the strength of the recovery; nonetheless, both the upside and downside scenarios see inflation remaining below 2 per cent for the next couple of years.

Weak demand for rental housing also weighed on the June quarter outcome for inflation and is likely to do so in the period ahead. With international borders closed, migration to Australia has essentially halted. The resulting slowdown in population growth reduced demand for housing, especially rental housing. Weak labour market conditions have also discouraged existing residents from forming new households. In addition, some tenants have negotiated discounts on their leases, which has directly reduced rents as measured in the CPI.

More broadly, uncertainty about incomes and employment prospects have contributed to recent declines in established housing prices in some cities. Alongside slower population growth, this points to a weak outlook for dwelling investment. The HomeBuilder package is expected to provide some offsetting near-term support, mostly in the detached housing segment. Demand for higher-density housing is expected to be soft, however, and many planned projects in this segment are now likely to be deferred.

Business investment is expected to decline significantly this year. In surveys and liaison, many firms report that they have already deferred or cancelled discretionary investment spending. These decisions have generally not been mandated by health-related activity restrictions. Rather, firms have reacted to actual and anticipated declines in demand and the general heightened uncertainty about the future, and have scaled back spending in an effort to preserve liquidity. This component of activity will be slow to recover; firms will generally wait to see demand recover before

committing to expand capacity. A number of mining-related projects are expected to continue, however, encouraged by strong Chinese demand for iron ore, which has also supported iron ore prices and boosted the outlook for the terms of trade. Other categories of exports are expected to be a bit weaker than previously envisaged. In particular, tourism exports (and imports) have collapsed to essentially zero and will remain there until Australia's borders open to tourists again. The forecast scenarios presented in this *Statement* assume that this will not occur until at least the middle of next year, and later if the global spread of the virus follows the course assumed in the downside scenario.

After depreciating significantly during the height of the market turmoil in March, the Australian dollar has since appreciated to be a bit above its level at the start of the year. This appreciation is in line with the currencies of a range of other advanced economies against the backdrop of a broad-based depreciation of the US dollar over recent months. The Australian dollar is now in a range that is broadly consistent with its fundamental determinants, namely the terms of trade and the differential between interest rates in Australia and rates in major advanced economies.

Globally, financial market conditions have rebounded from the period of dislocation in March, and over the past few months financial conditions have remained accommodative. The expectation that significant fiscal and monetary stimulus will be provided for an extended period is supporting sentiment in financial markets. Large-scale central bank purchases of bonds have helped bond markets to absorb the substantial increase in sovereign debt issuance, while government bond yields remain at or near historic lows. Asset prices have increased and risk spreads are low. Financial conditions have also continued to improve in emerging markets.

Equity markets have recovered much of the sharp falls in prices from earlier in the year. Current valuations suggest that investors expect the declines in corporate earnings over the first half of 2020 to be short lived. In Australia, equity prices have recovered around half of their earlier decline. Corporations in advanced economies, including Australia, have been able to issue significant amounts of debt and equity in recent months.

As is the case for the Australian economy, the outlook for the global economy is highly uncertain. Taking 2020 as a whole, global GDP is expected to contract by more than 4 per cent, before rising by nearly 6 per cent in 2021. If realised, this would still leave GDP below where it would have been if the pandemic had not occurred. The expected recovery in the global economy will be supported by considerable fiscal and monetary policy easing, as well as accommodative financial conditions.

In many advanced economies, activity and incomes are being supported by significant fiscal measures, especially wage subsidy schemes and expanded unemployment insurance. Similar to the Australian experience, this has meant that the very large contractions in activity were in most cases a bit smaller than earlier feared, although some euro area economies look to have been exceptions to this pattern. Consumption has held up better than expected and recovered sooner in most advanced economies. Business conditions remain weak, however, and in many advanced economies, extended or additional fiscal support has either been announced or is currently being negotiated.

China was the first country to contend with an outbreak of COVID-19 and its contraction and recovery have therefore run ahead of those in other economies. Chinese GDP recovered strongly in the June quarter and many sectors have regained or surpassed their pre-outbreak levels of output. This outcome was stronger

than expected three months ago. As in other countries, fiscal and monetary policy have played an important role in supporting the economy during this period. However, relatively less of the stimulus has gone directly to households. This has contributed to the recovery in consumer spending in China being more gradual than in the industrial sector, in contrast to the experience of some other countries.

Some economies in east Asia have managed to reduce infection rates and keep them at low levels, and have seen the benefit of this in a recovery in domestic activity. However, weak global demand could hamper the recovery in the export-oriented manufacturing sectors in the region, as well as in China. In Asia and elsewhere, some emerging market economies are still facing rising infection rates and health systems are under extreme strain.

As detailed in the *May Statement*, in mid March the Reserve Bank Board introduced a comprehensive package of policy measures to support the economy through this difficult period. The cash rate was reduced to 0.25 per cent; a target of 0.25 per cent was introduced for the 3-year Australian Government bond yield; and a three-year term funding facility was provided for banks and other authorised deposit-taking institutions. Over recent months the Board has continued to monitor the effects of this package, concluding that it is supporting the economy broadly as expected. Funding costs for banks remain at historical lows, and the same is true of borrowing costs for businesses, households and governments. Take-up of the Bank's low-cost Term Funding Facility is increasing steadily. This, and the package of measures more broadly, is supporting the availability of credit to businesses and households.

Over recent months, the Board also reviewed monetary policy support measures in other countries and assessed whether there were any lessons for the configuration of the Australian

package. It concluded that, given the nature of the challenges posed by the pandemic, there was no need to adjust the mid-March package. The Board has, however, not ruled out adjusting this package in the future if circumstances warranted.

As part of its review, the Board also discussed experience with a range of other possible monetary measures, including foreign exchange intervention and negative interest rates. It also reviewed historical experience of direct central bank financing of governments.

The Board concluded that, at a time when the value of the Australian dollar is broadly in line with its fundamentals and the market was working well, there was not a case for intervention in the foreign exchange market. Intervention in such circumstances is likely to have limited effectiveness.

The Board continues to view negative interest rates as being extraordinarily unlikely in Australia. The main potential benefit is downward pressure on the exchange rate. But negative rates come with costs too. They can cause stresses in the financial system that are harmful to the supply of credit, and they can encourage people to save rather than spend.

The Board also reaffirmed the importance of the longstanding principle of separating monetary policy from the financing of government. This principle has served Australia and other nations well. Australian governments are currently able to fund themselves at historically low interest rates and have retained ready access to capital markets. Monetary financing of budget deficits is not an option under consideration in Australia.

At recent meetings, following its review of Australian and international experience, the Board has decided to maintain the mid-March package of measures at its current settings. The yield on 3-year Australian Government Securities (AGS) has been consistent with the target of around 25 basis points, but had been a little

higher than this over recent weeks. To ensure that the yield on 3-year bonds remains consistent with the target, the Bank purchased AGS in the market after the August Board meeting. Further purchases will be undertaken as necessary. The yield target will remain in place until progress is being made towards the goals for full employment and inflation.

The Board is committed to doing what it can to support jobs, incomes and businesses in Australia through this difficult period, and thereby help build the bridge to the recovery. 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. ✎

1. International Economic Conditions

The COVID-19 pandemic has led to the largest contraction in global economic activity in decades. Labour markets have been severely disrupted, and inflation has declined. However, since around May, global economic conditions have begun to recover as containment measures have been relaxed, supported by substantial fiscal and monetary policy easing. Global financial conditions have also stabilised after an earlier period of disorderly market conditions (see 'International Financial Conditions' chapter).

While global economic activity has picked up, a high degree of uncertainty surrounds the recovery. As set out in the 'Economic Outlook' chapter, the main source of uncertainty relates to the evolution of the virus and potential medical advances; already, a resurgence in new cases has seen the recovery lose some momentum, partly because of a reinstatement of containment measures and an increase in voluntary social distancing in some economies, including Australia. It is expected that the global economy will take some time to recover, given the significant economic disruption that has occurred, but how large or persistent these scarring effects will be is uncertain. Geopolitical and trade tensions have also escalated again, adding further uncertainty to the outlook.

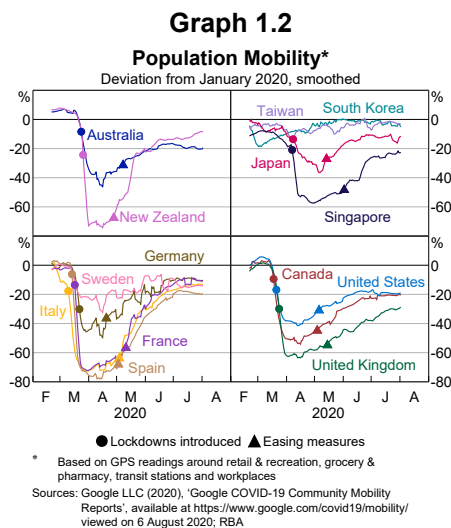
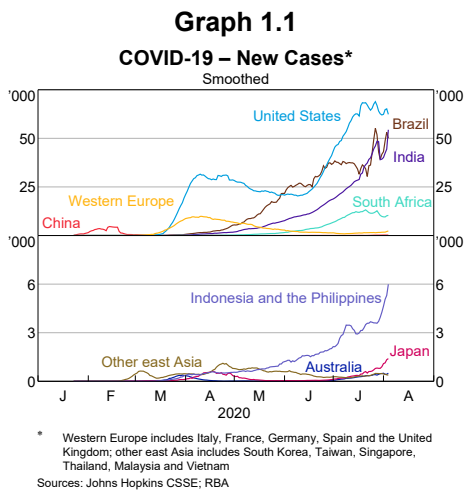
Success in containing the COVID-19 pandemic has varied, affecting the prospects of economic recovery

COVID-19 infection rates have varied significantly across the world. Case numbers have picked up sharply in a number of countries in recent weeks (Graph 1.1). Some of these economies started easing containment measures before infection rates had been reduced to a low level. Infections in much of the United States have increased sharply since the middle of June, leading some states to reinstate restrictions. Infections have increased significantly in Spain, Japan and Hong Kong more recently. Infections have also risen to very high levels in parts of Eastern Europe and the Middle East, prompting a tightening of some public health measures there, while infections in Latin America and parts of south Asia have continued to grow rapidly. By contrast, infections in New Zealand and much of Western Europe and east Asia were brought down by May, which has allowed restrictions to be substantially relaxed. In China, the authorities have managed to quickly contain a handful of localised outbreaks in recent months without resorting to widespread lockdowns.

High-frequency mobility indicators increased from April for many economies in response to the easing in restrictions at that time (Graph 1.2). However, mobility generally remains below pre-pandemic levels and, in places where infection rates are still rising, its recovery has slowed or even reversed.

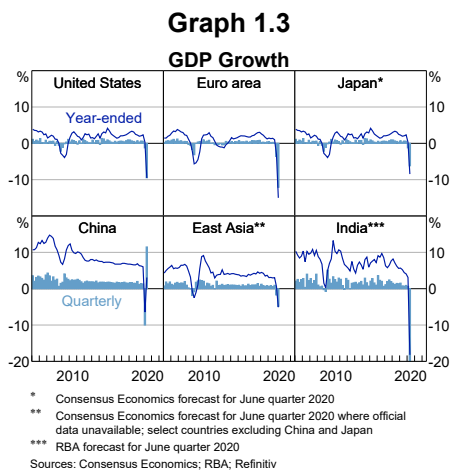
The economic contraction in the first half of 2020 was the most severe in decades

The pandemic led to a very severe contraction in global economic activity in the first half of 2020. The downturn was both sharper and more widespread than during the Global Financial Crisis. The contraction was generally concentrated early in the June quarter, with China, which experienced an earlier outbreak and lockdown, the main exception (Graph 1.3).



GDP fell by 11 to 15 per cent in both the United States and the euro area in the first half of the year; the contraction in UK GDP is estimated to have been similar. In the euro area, the GDP decline was largest in Spain, France and Italy; these economies were more severely affected by COVID-19 cases and therefore introduced stricter and longer-lasting containment measures. In Japan, where containment measures were more targeted, a smaller decline in GDP is estimated to have occurred in the first half of the year. Across the large advanced economies, consumption fell sharply because of mandated and voluntary social distancing, a decline in household income and weak labour market conditions. Prospects of lower demand, heightened uncertainty and production disruptions curtailed business investment.

In east Asia, GDP declined by around 4 per cent in the first half of the year. The decline was larger in economies with stricter containment measures, such as Singapore and the Philippines, compared to economies with more targeted restrictions, such as South Korea and Vietnam. Chinese GDP rebounded strongly in the June quarter to a little above pre-COVID-19 levels, reflecting success to date in containing the virus and an earlier easing in restrictions compared with other countries.



In other emerging economies, including some large economies like Brazil, Russia and India, domestic demand has been severely affected by the pandemic. In some of these economies, healthcare systems have been under intense strain, containment measures have been only partly effective and fiscal policy has had limited room to support household incomes.

The pandemic has interrupted global trade ...

International trade in both goods and services contracted sharply in the first half of 2020, weighed down by the weakness in demand and travel restrictions in most parts of the world (Graph 1.4). Merchandise trade declined by 18 per cent over the year to May. The weakness has been broad based by type of goods. Survey measures of new export orders have picked up since June, suggesting that global merchandise trade may have troughed late in the second quarter.

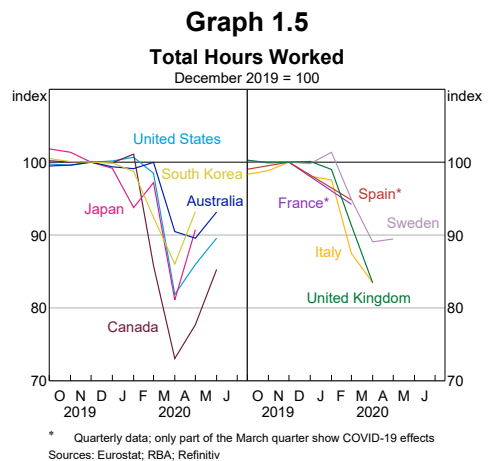
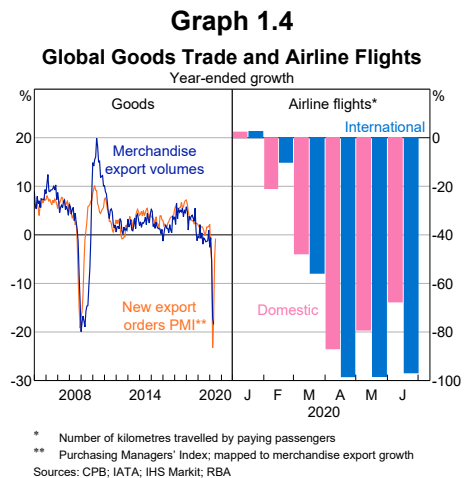
Services trade, for which timely data are limited, has also declined sharply as international travel has come to a near standstill. By contrast, domestic airline travel has picked up a little, especially in economies where the pandemic has been better controlled, such as China and parts of east Asia. US domestic airline travel has also increased a little since May despite high infection rates in parts of the country. Some international travel is also restarting, albeit with very low demand. The European Union (EU) reopened its internal borders in June and later allowed inbound travel from a number of non-EU countries with low infections. Cross-border travel is tentatively resuming in parts of Asia, initially limited mostly to business travel between selected destinations.

... and has severely disrupted labour markets

Labour markets have been severely disrupted everywhere. Officially reported labour market

outcomes have varied widely across countries because of differences in policy support, measurement approaches and country-specific requirements for receiving unemployment benefits. However, overall hours worked have declined significantly in all economies (Graph 1.5).

Unemployment rates have increased sharply in advanced economies that have used their existing unemployment insurance systems to cushion the COVID-19 shock; for example, the unemployment rate in the United States has been the highest since the late 1940s (Graph 1.6). The inclusion of temporary lay-offs



in reported unemployment has contributed to the sharp increase in unemployment rates in the United States and a few other economies. In contrast, unemployment rates have remained relatively low in economies that have used wage subsidies to support their labour markets, including most economies in Europe, Japan and New Zealand (see 'Box A: Using Wage Subsidies to Support Labour Markets through the COVID-19 Shock'). However, average hours worked have declined sharply in these economies, as elsewhere.

Spare capacity in the labour market has increased significantly given the combined increase in the number of people unemployed and underemployed. Participation rates have declined across advanced economies. Some workers stopped looking for work because they did not expect any jobs to be available during the height of restrictions. Some could also have been reluctant to seek work because of health concerns or caregiving responsibilities (for example, because children are learning from home). Job search requirements were also waived for some unemployment benefit recipients. Labour market conditions started to improve as containment measures were eased, with unemployment rates declining in Canada and the United States after a particularly sharp increase. But around the world, surveyed employment intentions remain low and the demand for labour is likely to remain subdued for some time.

In emerging economies, wage subsidy or unemployment insurance programs have been less feasible as a response to the pandemic's effects on labour markets because fiscal space is generally more limited and workers in the informal economy are hard to reach with these programs. The International Labour Organisation estimates that hours worked have declined substantially in the first half of the year in these economies.

The economic recovery is expected to be protracted and uneven

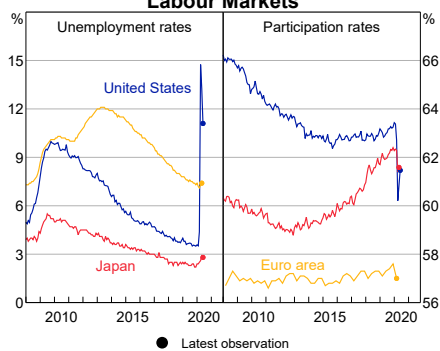
The global economic outlook remains highly uncertain. It depends on the evolution of the pandemic, including changes in social distancing and medical advances, fiscal and monetary policy support and behavioural changes among households and businesses.

In year-average terms, the GDP of Australia's major trading partners is expected to contract by around 3 per cent in 2020, with the trough in activity in the second quarter, followed by an increase of around 6 per cent in 2021 (Graph 1.7). This would leave the level of major trading partner GDP around 3 per cent below what had been expected before the outbreak. The central forecast is for an economic recovery that is protracted and uneven but assumes that a widespread and synchronised global resurgence in infections is avoided.

The global economic recovery is expected to be protracted for a variety of reasons: ongoing social distancing that constrains some activities, persistent precautionary behaviour by consumers, lower business investment, scarring effects in labour markets and a rise in business bankruptcies. It is also expected to be uneven because economies remain susceptible to fresh outbreaks that require restrictions to be reinstated, as has already occurred in some

Graph 1.6

Labour Markets



Sources: RBA; Refinitiv

places. The sustainability of the recovery remains particularly uncertain in economies where there has already been a significant resurgence in infections.

Weak external demand and restrictions on international tourism will weigh in particular on the recovery in export-oriented economies, including many emerging economies.

Underdeveloped healthcare systems and more limited fiscal space are contributing to the subdued outlook for many emerging market economies, including in a number of the larger emerging economies where infections are high or growing rapidly. The IMF expects GDP in emerging market and developing economies (excluding China) to contract by around 5 per cent in 2020 and to recover more slowly than advanced economies.

The rebound in Chinese economic activity in the June quarter is expected to continue in the second half of the year, though at a slower pace.

The recovery is being supported by low case numbers and, of particular relevance to Australia, is being driven by a recovery in industrial production to above pre-COVID-19 levels. However, the recovery in consumption has lagged the recovery in industrial production and ongoing weakness in consumer demand presents a downside risk to growth in the second half of the year. Higher

than usual uncertainty about the outlook has led the Chinese authorities to refrain from setting a target for annual economic growth for the first time since 1990.

Overall, the risks to the global outlook remain skewed to the downside. The main downside risk is from widespread resurgences in infections – whether that is because of near simultaneous lockdowns across a number of economies or a sequence of more localised events – leading to renewed lockdowns and other containment measures. Significant uncertainty regarding external demand will weigh on the outlook for export- and tourism-oriented economies. Separately, trade, technology and other geopolitical tensions remain an important ongoing risk to the outlook. The main upside risk relates to the swift development of effective and widely available vaccine and medical treatments.

In China, industrial production has recovered but households remain cautious

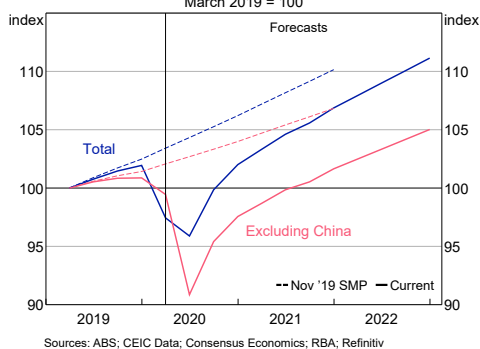
The strong recovery in Chinese economic activity in the June quarter was particularly evident in steel-intensive sectors that are most relevant for Australia's exports of bulk commodities (Graph 1.8). Measures of industrial production have generally recovered to be around or above pre-outbreak levels, including production of construction equipment and automobiles. Investment in the infrastructure and real estate sectors has also rebounded to around pre-outbreak levels, but has been slower to recover in the manufacturing and service sectors. Conditions in the residential property market have normalised, with monthly floor space sales around their highest level since early 2018 and growth in prices continuing to pick up modestly.

The rebound in consumption has been slower than for production, reflecting caution among households and a decrease in household

Graph 1.7

Australia's Major Trading Partner GDP

March 2019 = 100



income (Graph 1.9). Most of the decline in retail sales has now been reversed, reflecting a steady increase in purchases of discretionary and durable goods. Spending at restaurants and cafes has also picked up but, as of June, remained well below pre-outbreak levels. Similarly, there has been only a partial recovery in the number of local public transport and longer-distance trips, suggesting some ongoing reluctance to move about in public.

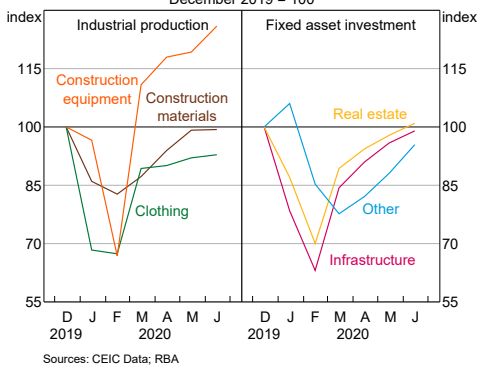
Fiscal and monetary policy has helped to support the economic recovery in China and will continue to do so in the second half of 2020. China's consolidated fiscal deficit is expected to widen by just over 5 per cent of GDP in 2020, reflecting the effect of the budget's automatic

stabilisers and discretionary policy support, including tax and fee cuts and increased spending (Graph 1.10). Fiscal spending has been mostly directed towards infrastructure projects; authorities have indicated a reluctance to direct stimulus towards property. Local governments in some areas have eased property restrictions to encourage purchases, although these remain fairly targeted and authorities have also been willing to tighten restrictions when necessary to limit speculative activity. Most of the other announced policy support has been targeted at businesses – particularly small businesses – which should indirectly benefit households by supporting employment and household income. In contrast to many advanced economies, little direct government support has been provided to households so far; some cities have issued consumption vouchers to encourage spending at restaurants and on other retail goods, but these measures have been limited in size.

Beyond fiscal policy measures, the People's Bank of China has provided increased monetary support to the economy this year and credit growth has started to pick up (see 'International Financial Conditions' chapter). The State Council has also directed banks to forgo a large share of their annual profits by lowering borrowing costs for businesses.

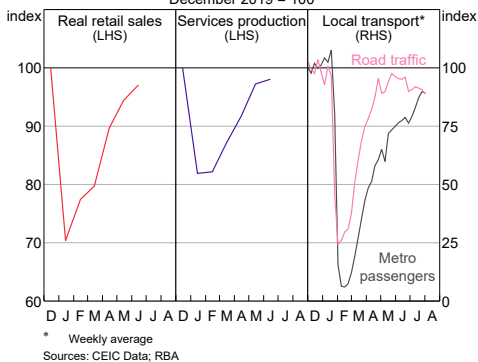
Graph 1.8

China – Activity Indicators
December 2019 = 100



Graph 1.9

China – Consumption Indicators
December 2019 = 100



A tentative recovery is underway in advanced economies but is reliant on policy support

Activity in advanced economies recovered in May following the slowing in new infections around that time, an easing of containment measures, reductions in voluntary social distancing and sizeable policy support. The recovery has been led by consumption, primarily of goods, which has been less constrained by social distancing measures that remain in place. By contrast, services consumption has remained very weak (Graph 1.11). The

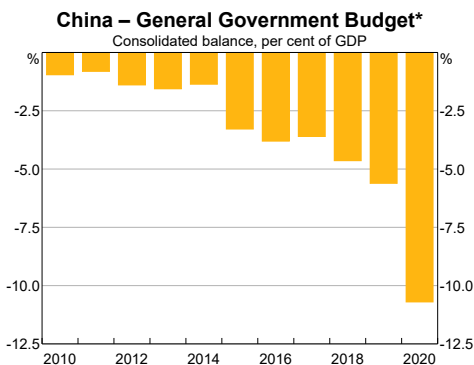
ongoing pace of the consumption-driven recovery depends on the evolution of the pandemic, with some indications that consumption has already slowed in places where infections have increased.

Surveyed business conditions point to an uneven recovery in activity across countries and sectors (Graph 1.12). Conditions in the services sector, which were especially weak, recovered to pre-COVID-19 levels in July in the euro area and the United Kingdom, but remain low in Japan.

Behavioural changes are also shaping the recovery and may have long-lasting effects. Household saving rates have increased sharply, reflecting the combined effects of constrained

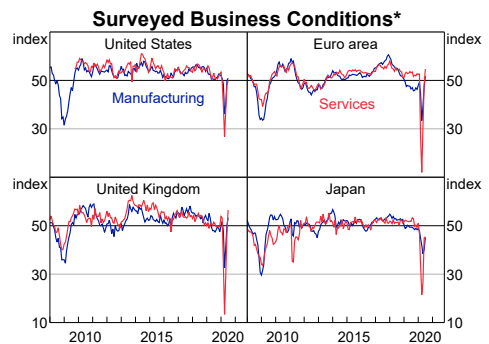
consumption, income support from fiscal measures and increased uncertainty. Consumer confidence has recovered a little since May in some advanced economies, including the United States and the euro area, but remains very low (Graph 1.13). Firms' investment intentions have declined sharply since March in response to weak demand and increased uncertainty. Some industries, such as international travel, tourism and hospitality, may have to significantly adjust their operations to meet new social distancing and other health requirements. Governments in many advanced economies are beginning to tailor their support to such sectors.

Graph 1.10



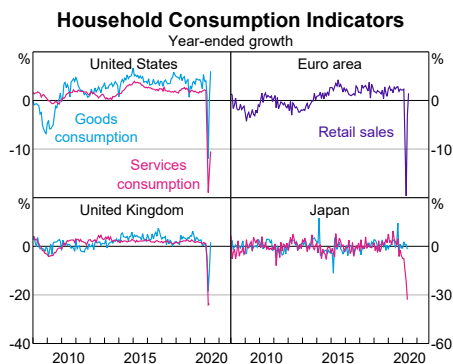
* Government budget balance including all levels of government and government-managed funds; special government bonds are treated as deficit financing; values for 2020 are projections and assume nominal GDP level implicit in the Budget documents
Sources: CEIC Data; MoF; RBA

Graph 1.12



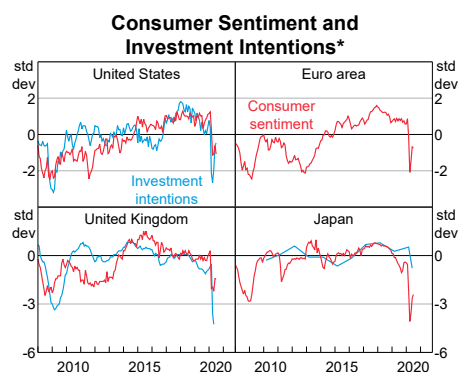
* Purchasing Managers' Index: below 50 indicates that activity is contracting
Sources: IHS Markit; RBA

Graph 1.11



Sources: RBA; Refinitiv

Graph 1.13



* Standard deviations from post-2000 average
Sources: Bank of Japan; RBA; Refinitiv

Unlike in typical recessions, household incomes have held up relatively well so far because of large and timely fiscal policy support. In the United States, household income increased sharply in April and May due to sizeable direct transfers and enhanced unemployment benefits. Unemployment benefits were raised to around the level of average full-time earnings until the end of July; many people recently classified as unemployed have therefore been receiving more in benefits than they earned in their previous job. The income support in European economies has been more modest, and household incomes are likely to have declined, because the wage subsidy schemes used there compensate only for part of the lost income from reduced hours (for further details see 'Box A: Using Wage Subsidies to Support Labour markets through the COVID-19 Shock'). Japan's sizeable support to household incomes initially faced administrative hurdles, but as these were overcome, income is expected to have been boosted to be above its pre-pandemic level.

Ongoing fiscal support will be important in determining the speed and shape of the recovery in advanced economies. So far, fiscal policy has mainly focused on supporting incomes of households and businesses (Graph 1.14). Governments in most advanced economies have extended many of the original support measures to avoid derailing the initial recovery. However, the US authorities are still to agree on an extension of the expanded unemployment benefits. Some economies where infections have subsided, including Germany, New Zealand and the United Kingdom, have begun a second stage of fiscal policy measures to support the recovery beyond its initial phase; these measures are aimed at directly stimulating demand through infrastructure and other public investment but also include consumption incentives, such as temporary consumption tax reductions (see 'Box B: Fiscal Policy Support for the Recovery

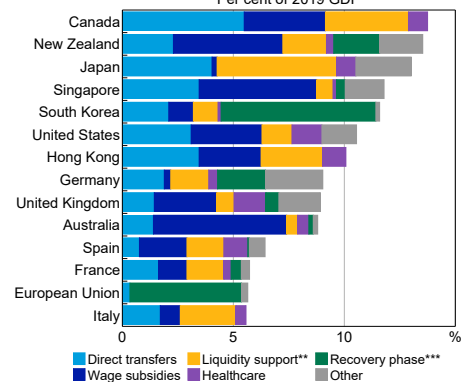
Phase in Advanced Economies'). Relatedly, the EU has established a recovery fund supporting public investment between 2021 and 2023, targeted at less developed and more heavily impacted member economies.

Weak demand and the resulting spare capacity in labour markets are putting downward pressure on inflation in advanced economies

Inflation has declined in year-ended terms since the outbreak of COVID-19 reflecting the decline in oil prices and weak aggregate demand, which have outweighed upward inflationary pressure from supply chain disruptions and temporary demand increases for some staple and medical goods (Graph 1.15). With excess capacity in labour markets expected to remain for some time, inflationary pressures are likely to remain low even with substantial fiscal and monetary policy support. As discussed in the 'Economic Outlook' chapter, the longer-term trajectory of inflation is more uncertain than the near-term outlook as it is unclear at this stage how the supply-side of the economy will evolve in the period ahead.

Graph 1.14

Direct Fiscal Response*
Per cent of 2019 GDP



* Excludes subnational governments, loan guarantees and unallocated funds; based on published estimates
 ** Deferred or reduced tax, social contributions and debt payments
 *** Investment, job training programs and consumption incentives
 Sources: IMF; national sources; RBA; Refinitiv

Economic conditions vary widely in east Asia ...

Domestic demand started to improve earlier in the Asian economies where case numbers are low and containment measures have eased. The recovery has been led by a pick-up in consumption (Graph 1.16). Some economies in the region have navigated the challenges of the virus better than most globally, in part reflecting their previous experience with the 2003 SARS outbreak. Infection rates came down quickly in South Korea and Vietnam, among others and, consequently, retail sales have recovered to be close to or above their pre-outbreak levels in these economies. Consumption started to recover in Hong Kong as well, but economic activity remains subdued there, hampered by social unrest and the fall in tourism from mainland China. In other regional economies, where stricter containment measures were in effect or outbreaks took longer to control, domestic activity fell further and the recovery has been slower. As discussed below, infection rates remain high for some economies in the region. Further fiscal policy measures have been announced in Singapore and South Korea in recent months to support their economic recovery.

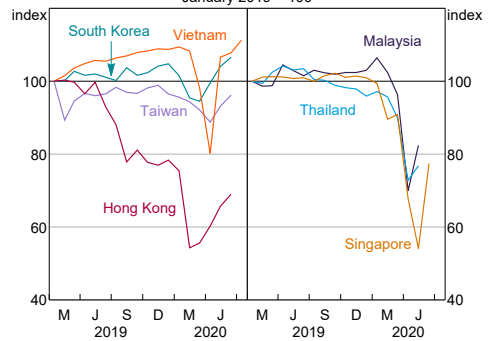
Weak external demand, especially from large advanced economies, has weighed on production and exports in the region. Overall, exports have declined despite a pick-up in exports to China since March and resilient demand for IT products due to increased remote working (Graph 1.17). Surveyed measures of output and export orders in the manufacturing sector remain subdued, suggesting that this weak global demand will continue to slow the recovery in the near term. But if consumer spending globally remains tilted towards goods over services, it could provide some offsetting support for the region's exports.

As elsewhere, labour markets in east Asia have been severely disrupted by the pandemic.

Graph 1.16

East Asia – Retail Sales

January 2019 = 100

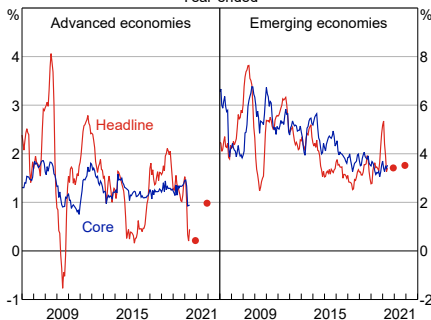


Sources: CEIC Data; RBA

Graph 1.15

Global Inflation*

Year-ended

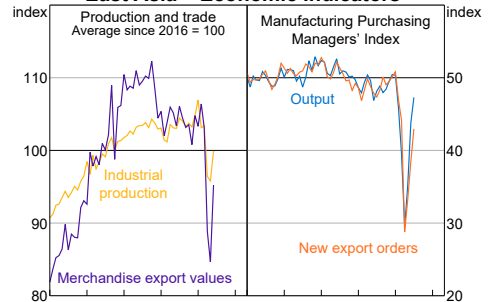


* PPP-weighted; sum of emerging and advanced economies accounts for around 80 per cent of world GDP; dots indicate year-average estimates derived from IMF forecasts

Sources: Bloomberg; CEIC Data; IMF; RBA; Refinitiv

Graph 1.17

East Asia – Economic Indicators*



* Excludes Hong Kong, Indonesia and the Philippines
Sources: CEIC Data; IHS Markit; RBA; Refinitiv

Unemployment rates have increased markedly in some economies, although wage subsidy schemes have helped temper the increase in Singapore and Malaysia (Graph 1.18).

... with a number of populous Asian economies being most severely affected

The more populous emerging economies of India, Indonesia and the Philippines continue to record significant numbers of new COVID-19 cases. This is despite a period of strict lockdown in India and some parts of the Philippines and Indonesia. Containment measures have led to sharp contractions in production and consumption (Graph 1.19). In April, industrial production fell by around two-fifths in India and the Philippines; timely data are not available for Indonesia. Production began to recover gradually in May as restrictions eased. There are few timely measures of consumption in India, but in June there was very little travel by air or rail due to restrictions on movement and, while credit card spending recovered slightly, it remains around half its pre-lockdown level. In Indonesia, retail sales in June were around 9 per cent below their levels of a year ago. There were also large declines in employment in these countries, including in Indonesia where containment measures were less stringent in much of the country. In India, timely data point to a recovery in employment as restrictions

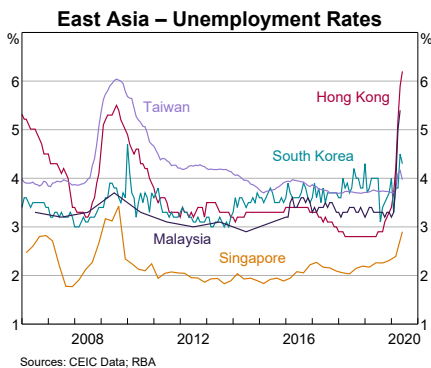
eased; some migrant workers fled urban areas during the initial lockdown and appear to have regained employment under the government’s rural work guarantee programmes, which reported a doubling of person-days worked in May and June. Direct fiscal support has been smaller in these emerging economies than in advanced economies and largely targeted at supporting vulnerable individuals and smaller firms.

Oil prices have partly reversed the falls earlier in the year

The price of Brent crude oil has increased since the previous *Statement*, but remains almost 35 per cent lower than at the start of the year (Graph 1.20). Over recent months, prices have been supported by a pick-up in global demand and global oil production being cut to its lowest level in almost a decade, driven by the cuts agreed by the OPEC+ group (Graph 1.21). The remaining schedule of agreed production targets will allow production to increase somewhat over the next few years.

The partial recovery in oil prices will support the revenues of Australian LNG exporters in the period ahead as the bulk of Australia’s LNG exports are sold via long-term contracts linked to oil prices at a 1–2 quarter lag. The earlier low

Graph 1.18



Graph 1.19

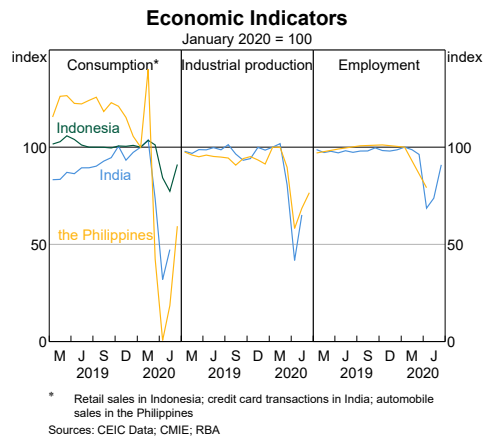


Table 1.1: Commodity Price Changes^(a)

Per cent

	Since previous <i>Statement</i>	Since start of the year
Bulk commodities	21	11
– Iron ore	32	28
– Coking coal	–2	–21
– Thermal coal	–7	–27
Rural	–3	–9
Base metals	15	–1
Gold	15	32
Brent crude oil ^(b)	63	–33
RBA ICP	2	0
– Using spot prices for bulk commodities	13	4

(a) Prices from the RBA Index of Commodity Prices (ICP); bulk commodity prices are spot prices

(b) In US dollars

Sources: Bloomberg; IHS Markit; RBA

prices will weigh heavily on revenues in the near term, however. For exporters that sell LNG in the spot market, prices have remained very low; the global oversupply of gas has been driven by earlier increases in capacity in Australia, the United States and Russia, and reduced demand since the outbreak of COVID-19.

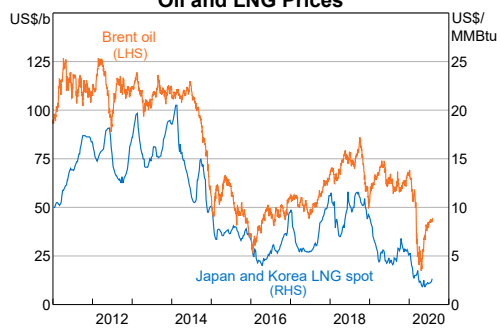
Iron ore prices have increased significantly in recent months

The benchmark iron ore price has increased by 32 per cent since the previous *Statement*

(Graph 1.22; Table 1.1). Chinese demand for imported iron ore has been strong, driven by increased construction activity and industrial production in China. Chinese authorities have also announced fiscal stimulus focused on infrastructure and this has further supported the outlook for steel demand. At the same time, iron ore supply from Brazil has been subdued as a result of earlier measures to contain COVID-19 in important mining regions, as well as operational issues and weather-related disruptions since the start of the year.

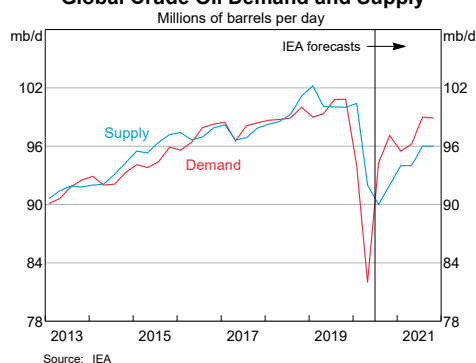
Graph 1.20

Oil and LNG Prices



Graph 1.21

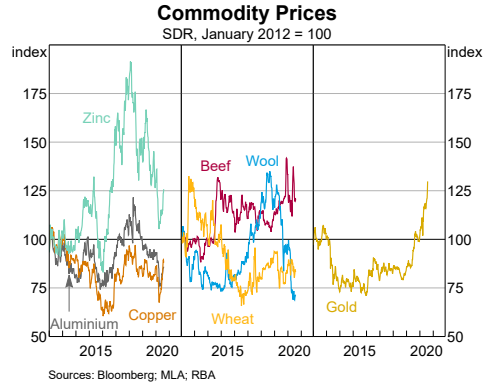
Global Crude Oil Demand and Supply



Coking and thermal coal prices have remained at low levels since the previous *Statement* because demand has been weak, particularly outside China. Steel production in India remains well below the levels at the start of the year, despite a recent pick-up, and this has continued to weigh on coking coal prices. At the same time, demand for thermal coal from key markets, especially in east Asia and India, has remained weak as a result of subdued industrial production. Thermal coal shipments from various countries have reportedly also taken longer to clear Chinese customs in recent months, which has added further uncertainty to the outlook for thermal coal demand.

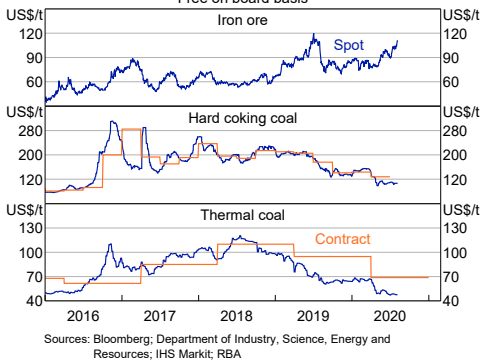
Base metal prices have increased since the previous *Statement*, as economies have eased containment measures, thereby supporting some recovery in industrial activity (Graph 1.23). In particular, copper, which is a key input for a range of industrial processes, has more than recovered its falls earlier in the year. At the same time, the price of gold, which many investors view as a safe asset, has continued to increase. The prices of rural commodities have decreased since the previous *Statement*. Wool prices are around 35 per cent lower than at the start of the year, reflecting the negative effect of lockdown measures on clothing demand and the associated fall in demand for textiles. ❖

Graph 1.23



Graph 1.22

Bulk Commodity Prices
Free on board basis



Box A: Using Wage Subsidies to Support Labour Markets Through the COVID-19 Shock

Wage subsidy schemes have been a key part of the economic policy response to COVID-19

Global labour markets have been severely disrupted by the COVID-19 pandemic. In most countries, the public health response to the COVID-19 outbreak included the temporary closure of non-essential businesses to slow the spread of the virus, which directly reduced labour demand. Labour demand declined even further than this as many sectors that were still able to operate responded to weak demand for their output and disruptions from health concerns and supply chains.

As part of a policy package to support affected households and businesses, many advanced economies have turned to wage subsidy schemes. Wage subsidy programs have a long history in parts of Europe but have been used less extensively elsewhere. For example, Germany has had wage subsidy schemes since the 1920s and France has had one since the late 1960s. The nature of the COVID-19 shock, and the experience of some economies with wage subsidies (particularly Germany) during the global financial crisis (GFC) have both encouraged the use of these schemes more broadly. The Organisation for Economic Co-operation and Development (OECD) reported that as of June this year, 28 of its 37 member economies had used wage subsidies as the main support for workers facing reduced hours or the risk of being stood down because of COVID-19.

These programs typically involve the government subsidising wages to help employers

retain employees during an economic shock, which preserves firm-specific human capital by maintaining the link between firms and their employees. This can speed up the recovery by reducing the need for firms to find new workers, who might be less suited to the available roles than the workers who were laid off.^[1] The wage subsidy schemes increase firms' flexibility to respond to reduced demand and they can limit unemployment increases by spreading the loss of hours across a larger share of the labour force. The schemes also support employee incomes by topping up wages where employees are working reduced hours. International experience suggests that the long-term effects of the schemes can work in different directions: while keeping workers attached to their original employers could reduce the scarring effects from prolonged unemployment, it might also slow needed adjustments if the shock results in lasting structural changes that require significant labour force reallocation.

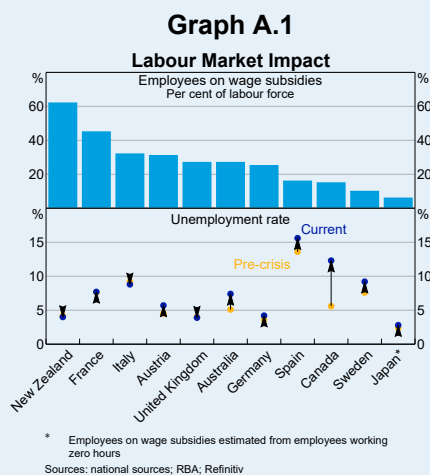
Following the initial COVID-19 outbreak, existing wage subsidy schemes were significantly enhanced. Eligibility was expanded to cover more sectors, a broader range of firms and more types of employment contracts. Some countries also introduced similar programs to support the self-employed. Many wage subsidy schemes allowed for a larger reduction in working hours than before the pandemic and were opened to less severely affected firms. Some schemes raised their payment caps and increased their replacement rates, which measure the ratio of income for employees in

the scheme relative to their pre-scheme earnings. A few economies, including Australia, Canada, New Zealand and the United Kingdom, introduced wage subsidy schemes for the first time. Unlike most wage subsidy schemes that pay the covered employees a share of their pre-scheme earnings, the Australian and New Zealand schemes pay fixed amounts.

Wage subsidy schemes have supported a significant share of the labour force in advanced economies over recent months, far more than were supported during the GFC (Graph A.1).^[2] The extent of support has varied across economies: around 60 per cent of the labour force in New Zealand, 15 to 45 per cent in the larger euro area economies, and 20 to 30 per in Canada and the United Kingdom. In Australia, more than a quarter of the labour force is covered by JobKeeper (for further discussion see the 'Domestic Economic Conditions' chapter). The United States is one of the few advanced economies that has not used a formal wage subsidy scheme, and instead has relied on significantly enhanced unemployment benefits to support household income.^[3]

So far, standard measures of unemployment rates in advanced economies that have used wage subsidy schemes have remained around their pre-outbreak levels (Graph A.1). The unemployment rate in the euro area is little changed since February, while the average increase in OECD economies without wage subsidies has been around 3 percentage points and as high as 11 percentage points in the United States (although direct comparisons are hampered by measurement differences). Canada is the only economy with a comprehensive wage subsidy scheme that has also experienced a large increase in the unemployment rate. Some of the difference in the increase in unemployment results from an unrelated measurement difference, in that workers who have been temporarily stood down (who are not covered by the scheme) are immediately counted as unemployed in the US and Canadian data, but only with a lag elsewhere. But for Canada, the initial take-up of the scheme was reportedly slow due to its perceived complexity, and so the scheme was less effective in forestalling an initial wave of layoffs, temporary or otherwise. Historically, wage subsidy schemes have required participating employees to work some hours with their employer. However, the distinction between subsidised employment and unemployment has become less clear during the COVID-19 shock; due to the public health considerations, all these schemes have been opened to employees working zero hours.

Timely cross-country data on hours worked is limited, but it confirms that the main form of labour market adjustment in economies with wage subsidy schemes has been through a larger decline in average hours worked than usual, rather than a fall in employment.



It is too early to judge the medium-term success of wage subsidy schemes, but international organisations, such as the OECD and the International Monetary Fund, generally expect them to limit the increase in unemployment rates over the next two years.^[4]

Wage subsidies have helped support household incomes and the nascent recovery in consumption as mandated containment measures have been unwound. The current wage subsidy schemes in Canada, the euro area and the United Kingdom generally compensate employees for a share of their gross pre-scheme earnings lost from the reduction in working hours. In most cases, the effective support to household income depends on actual hours worked and how it affects tax payable and other benefits given the complex interactions such schemes can have with the income tax system. Estimates for the euro area suggest that the after-tax replacement rates for employees in wage subsidy schemes working zero hours are between 60 to 80 per cent, which are comparable to the replacement rates from unemployment benefits in those countries (Graph A.2). However, it is likely that most participants in wage subsidy schemes will have more confidence they will return to their old job than an unemployed person has of getting a new job. Therefore, people receiving wage subsidies may be willing to spend more of their current income than an otherwise similar unemployed person.

Tapering the support

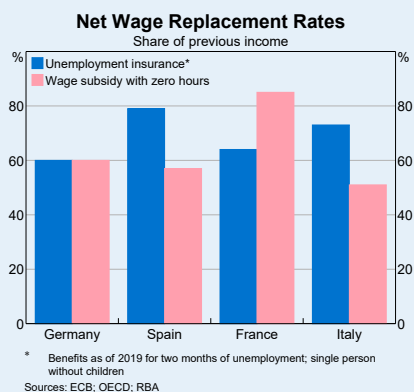
Governments have begun adjusting their wage subsidy schemes as their economies have moved beyond the acute phase of the COVID-19 shock, when lockdowns were the

most stringent. Governments are faced with competing considerations when determining the duration of the wage subsidies.

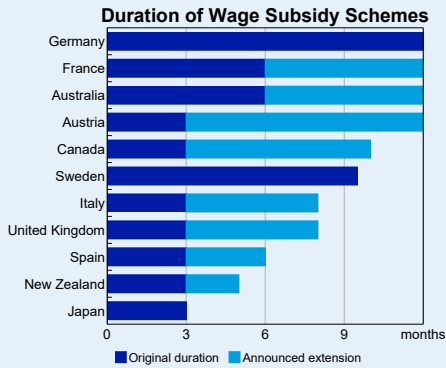
Prolonged use of wage subsidy schemes can have adverse long-run effects by reducing labour mobility and stymieing productivity growth.^[5] These effects can be minimised by limiting the duration of the schemes; however, abrupt withdrawal of wage subsidies can lead to a sharp increase in unemployment and loss of incomes.

The duration of most schemes was set at around three months at the start of the mandated COVID-19 restrictions. The schemes have since been extended as it has become clearer that the recovery will be slow and uneven (Graph A.3). Some schemes have tightened eligibility at the same time as they have been extended. For instance, New Zealand requires firms to have experienced a bigger loss in revenues in the extended phase, while the United Kingdom has closed its schemes for new applicants and has introduced cost sharing with employers during the extended phase. ✖

Graph A.2



Graph A.3



Endnotes

- [1] For more information on wage subsidies, see Lydon R, T Matha and S Millard (2019), 'The whys and wherefores of short-time work: Evidence from 20 countries', viewed 8 July 2020, available at <voxeu.org/article/whys-and-wherefores-short-time-work>.
- [2] Comprehensive data on wage subsidy schemes is limited and often lagged. Most schemes publish timely data on the number of applicants to the scheme, which is used here to estimate how many workers were covered by the scheme at the height of its use; this may overestimate actual coverage if not all applicants access the scheme.
- [3] The US Paycheck Protection Program (PPP) has been another key component of the US policy response and has some similarities to wage subsidy schemes but is structured very differently. The PPP extends forgivable loans to small businesses, via private sector banks. The forgiveness is achieved by maintaining employment at pre-outbreak levels but it is unclear how much employment PPP has already supported because borrowers have an extended period of time to qualify for forgiveness; estimates suggest that the PPP could support around 30 per cent of the US labour force.
- [4] For further information, see OECD (2020), 'Issue Note 5: Flattening the Unemployment Curve? Policies to Support Workers' Income and Promote a Speedy Labour Market Recovery', Economic Outlook, 2020(1). Available at <oecd-ilibrary.org/economics/oecd-economic-outlook/volume-2020/issue-1_0d1d1e2e-en> and IMF (2020), 'April World Economic Outlook'. Available at <<https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020>>.
- [5] For a discussion of the potential adverse effects of wage subsidies, see A Arpaia, N Curci, E Meyermans, J Peschner and F Pierini (2010), 'Short-time Working Arrangements as Response to Cyclical Fluctuations', European Commission Occasional Paper, viewed 8 July 2020. Available at <ec.europa.eu/economy_finance/publications/occasional_paper/2010/pdf/ocp64_en.pdf>.

Box B: Fiscal Policy Support for the Recovery Phase in Advanced Economies

Fiscal policy has played a key role in supporting economic activity in advanced economies during the COVID-19 pandemic, with the shock to private demand smoothed by a strong countercyclical fiscal response (Graph B.1). In the early stages of the pandemic, transfer payments to households were the main focus of this fiscal support. By bolstering household incomes, these transfers prevented a larger than otherwise contraction in private consumption, and enabled a faster recovery.

As the acute phase of the pandemic has started to pass, the emphasis of government support measures in some advanced economies has begun to extend beyond household transfer payments to directly stimulating aggregate demand through public consumption and investment. More generally, at a time of significant spare economic capacity and low interest rates, a sustained period of expansionary fiscal policy – aimed at stimulating aggregate demand both indirectly and directly – will be important in keeping the global recovery on track.

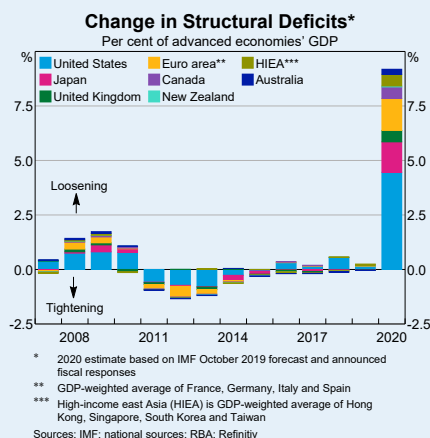
Expansionary fiscal policy is broadening in scope in some cases as focus turns to the recovery phase

The initial phase of the fiscal response to the pandemic in advanced economies was significant, exceeding 10 percentage points of GDP in a number of economies. Fiscal deficits were even larger as tax revenues also declined sharply. While public expenditure on health services and related equipment increased, much of this fiscal support

comprised transfer payments from the government to households, including through increased unemployment benefits and wage subsidies (for further discussion, see 'Box A: Using Wage Subsidies to Support Labour Markets through the COVID-19 Shock').

In recent months, a number of advanced economies have announced new fiscal measures in addition to the income support that have been aimed at directly supporting demand in the recovery phase. This has mainly comprised increased public investment, but has also included consumption and investment incentives and retraining programs (Graph B.2). To date, the extent of this new phase of fiscal support has ranged from ½ per cent to 7 per cent of GDP. While more modest than the initial phase of the fiscal response in these economies, the new 'recovery phase' of fiscal support is significant and is scheduled to commence in the second half of 2020 and extend into the next couple of years.

Graph B.1



New Zealand was the first advanced economy to announce fiscal measures focused on the recovery phase, after its strict containment measures brought infection levels down to negligible levels relatively quickly. In May, New Zealand announced its COVID-19 Response and Recovery Fund, which sets aside the equivalent of 16 per cent of GDP. A significant share of the fund, around 6½ per cent of GDP, is available to support the recovery phase, with specific public investment and training programs equivalent to 2 per cent of GDP.

In June, Germany, where the number of cases were brought down to low levels quicker than in other large euro area economies, announced the equivalent of 2 per cent of GDP for its recovery phase through temporary reductions in the consumption tax rate and increased public investment. South Korea, which managed to bring down and keep infections low after a large pandemic wave in February, has announced public investment and training programs equivalent to around 7 per cent of its 2019 GDP. The United Kingdom has also

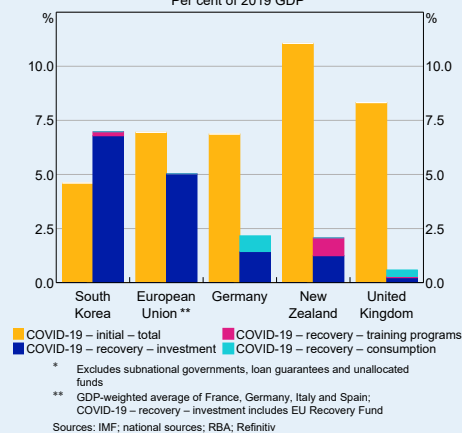
announced a small recovery-focused fiscal package, including increased public investment, job training and consumption incentives.

In July, the European Union (EU) agreed the largest fiscal stimulus for the recovery phase so far – the Next Generation EU Recovery and Resilience Facility – at around 5 per cent of GDP. This is focused on investment between 2021 and 2023.^[1] The facility will be funded by EU-issued bonds, with the proceeds distributed to EU members as grants and loans. These grants effectively allow for increased fiscal transfers within the EU to its members that are less developed and that entered the crisis in worse economic positions. The lending facility is designed to subsidise borrowing costs for the EU's member economies with more elevated government debt levels and sovereign bond yields. The details of the fiscal spending are yet to be decided, with EU member economies required to first submit investment proposals to the European Commission before receiving funding; the proposals will be assessed based on their ability to strengthen growth, create jobs and meet EU initiatives for 'green and digital' development.

To support the recovery in consumption, temporary reductions in consumption taxes (VAT) and consumption subsidies have also been implemented. Germany has applied a broad-based reduction in its consumption tax, reducing the key rate from 19 per cent to 16 per cent until December 2020. The United Kingdom has reduced its consumption tax (VAT) from 20 per cent to 5 per cent until January 2021 focused in hospitality, accommodation and attraction industries. Consumption subsidies in hospitality have also been announced in the United

Graph B.2

Fiscal Responses in Select Advanced Economies*
Per cent of 2019 GDP



Kingdom, and in South Korea they have focused on domestic products and energy-efficient durable goods.

Public investment is featuring prominently in the transition to direct stimulus of economic activity

In general, the public investment component of the recovery initiatives announced to date bring forward ready-to-go projects to help stimulate demand over the next couple of years. Many of the investments are focused around environmental initiatives – reducing carbon emissions, increasing renewable energy use and developing vehicle electrification infrastructure – and the development of information and telecommunication technologies.

Germany's investment package aims to modernise infrastructure, support structural change in industries such as automotive manufacturing and make significant investment in hydrogen technology.

Germany has also allocated ½ per cent of GDP towards expanding and modernising transport networks and vehicles. South Korea's package, which is split into the Digital and Green New Deal investment initiatives, includes 28 projects including energy and health care investment, and improvements to the energy efficiency of public buildings.

The United Kingdom is focusing public investment on local community infrastructure to support construction activity from 2020 until 2022. The government in New Zealand will invest in the construction of 8,000 public houses over the next four to five years, as well as regional environmental projects, including revegetation and habitat protection. The investment measures in the EU's Recovery and Resilience Facility are to be

proposed by individual countries for approval by the European Commission.

Training programs will also be funded to up-skill workers and limit the negative effects of longer-term unemployment. For economies entering the recovery phase, ensuring the workforce has the required skills as demand picks up is a key priority. These programs tend to focus on supporting youth employment by incentivising employers to provide apprenticeships, work placements and internships. South Korea is also retraining workers for technology sectors and middle-aged workers; this is to support the transition to digital and green industries outlined in South Korea's New Deal.

Large output gaps and low interest rates are conducive to public investment

As long as advanced economies have a significant amount of spare capacity, low interest rates and moderate public debt profiles, public investment can reduce long-term 'scarring effects' without generating high inflation, crowding out private investment or raising debt sustainability concerns. In addition to the direct effect of government spending on GDP, such spending also acts as a catalyst for further growth given the positive spillovers it creates. For example, the profits earned by firms and the incomes earned by workers involved in government-sponsored infrastructure projects boosts business investment and private consumption. These spillovers are more powerful when there is ample spare capacity and monetary policy is already accommodative, as is the case presently.^[2]

Public investment that increases the productive capacity of the economy can be self-financing as projects will generate

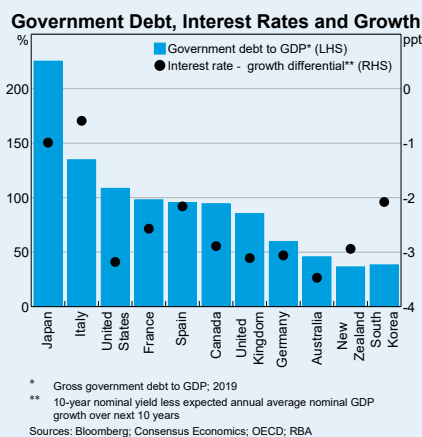
returns exceeding government borrowing costs.

In most advanced economies, government bond yields are currently below expected GDP growth rates, which will allow advanced economies to run fiscal deficits without raising concerns over debt sustainability (Graph B.3). A number of economies that have begun to transition the recovery phase of their fiscal support toward public investment – such as Germany, South Korea and New Zealand – also entered the crisis with relatively modest government debt levels, suggesting they have considerable scope to maintain or expand such programs into the future.

The international experience following the global financial crisis, and during recoveries from earlier deep recessions, suggests that economies that withdrew fiscal support or undertook fiscal consolidation too quickly experienced slower growth afterwards.^[3] With these considerations in mind, international organisations such as the International Monetary Fund and the

Organisation for Economic Co-operation and Development have urged governments to maintain substantial fiscal support through the recovery phase, where they have space to do so, including by stimulating aggregate demand directly through public investment as a complement to transfer programs aimed at supporting household income.^[4] ✎

Graph B.3



Endnotes

- [1] European Council (2020), 'European Council conclusions, 17–21 July 2020', Media Release, 21 July.
- [2] For example, see Ramey V (2019), 'Ten Years after the Financial Crisis: What Have We Learned from the Renaissance in Fiscal Research?' *Journal of Economic Perspectives*, 33(2), pp 89–114; Baum A, M Poplawski-Ribeiro and A Weber, 'Fiscal Multipliers and the State of the Economy', IMF Working Paper No 2012–286; or Blanchard O and D Leigh, 'Growth Forecast Errors and Fiscal

Multipliers', *American Economic Review*, 103(3), pp 117–120.

- [3] For example, see Ball L (2014), 'Long-term damage from the Great Recession in OECD countries', *European Journal of Economics and Economic Policies: Intervention*, 11(2), pp 149–160.
- [4] IMF (International Monetary Fund) (2020), 'World Economic Outlook Update, June 2020', p 19; OECD (Organisation for Economic Co-operation and Development) (2020), 'OECD Economic Outlook', 2020(1), p 8.

2. International Financial Conditions

Global financial markets have stabilised in recent months and financial conditions are supporting economic growth. Central banks continue to maintain highly accommodative policy settings, and in some cases have eased monetary policies a little further. Governments have taken policy action to address the COVID-19 pandemic and its effects on economic activity, and have thus needed to fund very large fiscal deficits.

Accordingly, government bond issuance has increased substantially. Government bond markets are nonetheless functioning well and yields have stabilised at historically low levels, supported by bond purchases by central banks and expectations that policy rates will remain low for an extended period.

Corporate borrowing costs have declined to around pre-COVID-19 levels, and non-financial corporations have issued record amounts of corporate debt. Corporate financing conditions have been supported by the introduction of central bank programs to support the flow of funding to businesses (see Box C: Central Bank Policy Responses to COVID-19). As expected, corporate earnings have fallen sharply in response to the downturn in economic activity brought on by COVID-19. At the same time, equity prices have risen, indicating that the market expects the decline in earnings to be short-lived. The US dollar has depreciated since late May and is around levels observed prior to the pandemic against the currencies of other advanced economies. In line with this, the Australian dollar has appreciated further since the previous *Statement* and is now a bit above

pre-pandemic levels, having depreciated sharply earlier in the year.

Central banks' policy settings are accommodative in advanced economies

Central banks in advanced economies have maintained accommodative policy settings or eased policies further. Policy rates remain near zero or lower, with central banks signalling that rates are likely to remain at very low levels until there is sustained evidence of progress towards employment and inflation goals. Consistent with this guidance and central banks' economic forecasts, market pricing implies that policy rates are expected to stay at present or lower levels for some time (Graph 2.1). Some central banks, including the US Federal Reserve (Fed) and the Bank of Canada (BoC), have indicated that any further reductions in interest rates (to be below zero) may have adverse side effects on financial markets. In contrast, the Bank of England (BoE) and the Reserve Bank of New Zealand (RBNZ) have highlighted that they are considering the possibility of lowering their policy rates below zero.

Central banks continued to purchase large volumes of government bonds, although their focus has shifted to the objective of easing financial conditions rather than alleviating market dysfunction (Table 2.1). The Fed has slowed the pace of Treasury purchases since April in response to signs of improved market functioning, and has now increased its holdings by around US\$1.8 trillion since the onset of COVID-19. The European Central Bank (ECB)

Table 2.1: Central Bank Net Purchases of Government Bonds

Programs announced since 3 March

Central bank	End date	Purchase target	Purchases to date		
			Nominal	Per cent of GDP	Per cent of target
Fed	Open-ended	Unlimited	\$1.8tn	8	n/a
ECB	June 2021	€1,176bn ^(a) ^(b)	€509bn ^(b)	4	43
BoJ	Open-ended	Unlimited (yield curve control)	¥34.3tn	6	n/a
BoE	End 2020	£290bn	£202.6bn	9	70
BoC	Open-ended	Unlimited	C\$235.8bn	10	n/a
RBNZ	Open-ended	NZ \$60bn ^(b)	NZ\$23.6bn ^(b)	7	39
Riksbank	June 2021	SEK 500bn ^(c)	SEK15.5bn	0.3	3
RBA	Open-ended	Unlimited (yield curve target)	A\$51.8bn ^(b)	3	n/a

(a) The total size of the PEPP (€1,350bn) includes government bonds and private sector assets. The estimated purchase target for government bonds is based on the current composition of asset holdings.

(b) Includes local and semi-government bonds.

(c) Includes purchases of private sector assets.

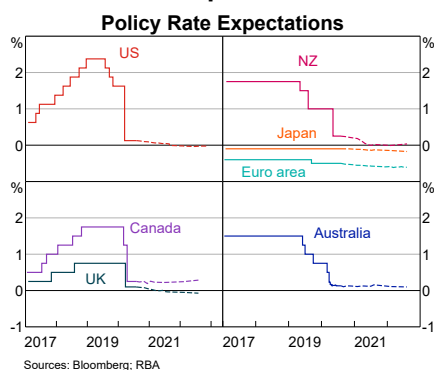
increased the size of its Pandemic Emergency Purchase Program (PEPP) by €600 billion to €1,350 billion, and extended the term of the program by six months to the end of June 2021. The ECB has also slowed the pace of its asset purchases since early July following a stabilisation in financial market conditions. The BoE has announced that it will conduct an additional £100 billion worth of government bond purchases by the end of the year, albeit at a slower pace than before. The RBNZ increased the size of its Large Scale Asset Purchase program from NZ\$33 billion to NZ\$60 billion, and announced that it will begin purchasing

inflation-indexed bonds in addition to its ongoing purchases of central and local government bonds.

Measures aimed at restoring market functioning have been scaled back

Conditions in short-term funding and sovereign bond markets have improved and central banks have responded by scaling back some measures aimed at addressing impaired market functioning. The Fed modified the timing of its overnight repurchase (repo) operations to occur after the peak period of daily repo market transactions and increased the minimum interest rate, signalling that it intends to shift to a backstop role in the repo market. As a result, there has been no participation at the Fed's recent repo operations (Graph 2.2). The Fed also announced that it will no longer conduct three-month repo operations. The BoC and the BoE have similarly reduced the frequency of some repo operations in response to a decline in the use of these facilities.

Graph 2.1



Sources: Bloomberg; RBA

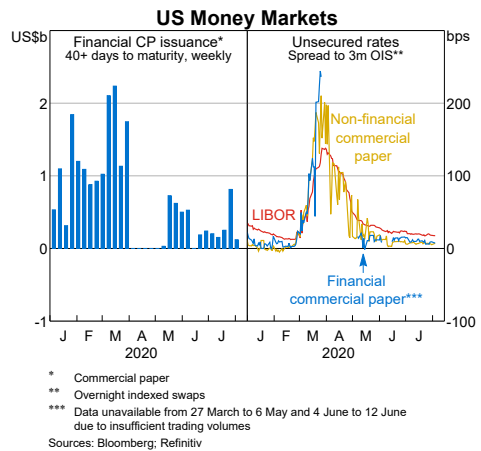
Conditions in short-term US dollar funding markets have improved significantly

US dollar funding conditions have eased as liquidity has improved and risk appetites have recovered. Inflows to prime money market funds (which invest in riskier money market assets) have recovered strongly, which has encouraged these funds to resume investing at terms longer than a few days. In turn, financial firms have been able to resume their issuance of longer-term commercial paper and the interest rates on commercial paper have declined (Graph 2.3). Reflecting these developments, Fed purchases of assets sold by money market funds have declined and there has been limited take-up of a backstop facility for firms unable to roll over their issuance of commercial paper.

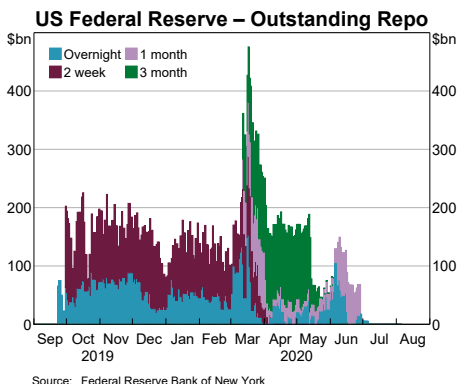
The cost of borrowing US dollars in foreign exchange swap markets has declined, having increased sharply in March. As conditions have eased, banks have begun to repay the US dollars they had obtained under the Fed’s swap lines with other central banks, and the total amount outstanding for these facilities has declined from around US\$450 billion to around US\$100 billion (Graph 2.4). Notwithstanding these improvements, the Fed has extended the duration of its US dollar swap lines with nine central banks, including the Reserve Bank. The

Fed noted that these extensions were not related to specific concerns but would help to sustain recent improvements in global US dollar funding markets. In Australia, there has been very little take-up of the swap line via the Reserve Bank’s US dollar operations as banks have been able to obtain US dollars from financial markets on more favourable terms. There have been no bids at auctions for US dollars via the swap line since the previous *Statement* and the Reserve Bank has paused its schedule of auctions for now.

Graph 2.3

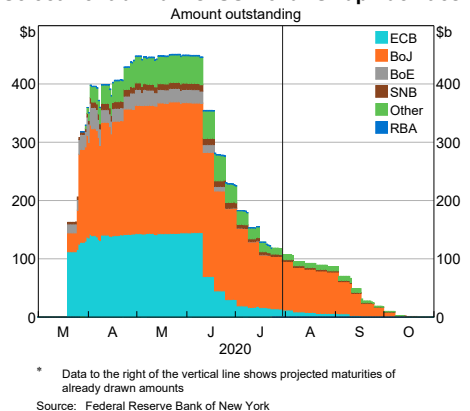


Graph 2.2



Graph 2.4

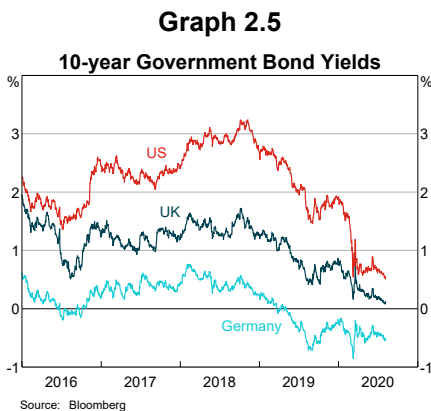
Select Central Banks' US Dollar Swap Facilities*



Government bond yields have stabilised around low levels

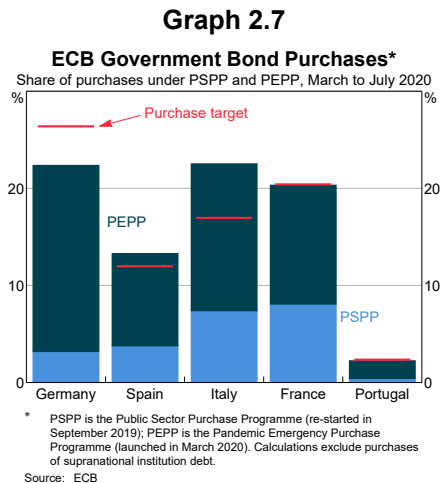
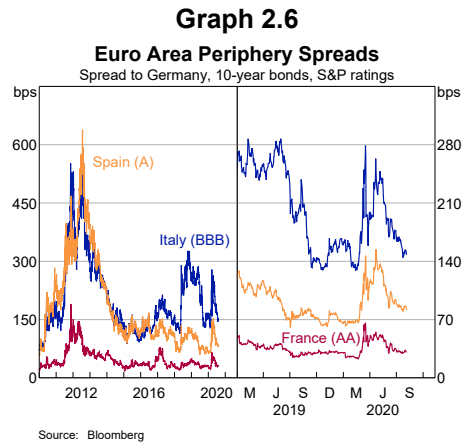
Yields on long-term government bonds are around historical lows in most advanced economies, and volatility has declined (Graph 2.5). After a period of severe dysfunction in March, government bond markets are functioning well. In the market for US Treasuries, the difference between the prices at which bonds can be bought and sold (bid-offer spreads) have largely normalised. At the same time, measures of market depth (such as the volume of bonds that can be transacted at the best bid and offer prices) have improved, but remain below pre-COVID-19 levels. Forward-looking measures of government bond market volatility remain low, despite volatility remaining elevated in a number of other markets and general uncertainty about the outlook for economic activity and the extent of fiscal deficits. Low government bond yields are consistent with the subdued outlook for global inflation and guidance from central banks that asset purchases will continue and policy rates will not increase for some time.

In Europe, spreads on periphery government bonds relative to those on German Bunds have narrowed since the previous *Statement* and are close to their pre-COVID-19 levels, largely in response to the ECB's pandemic-related bond purchases (Graph 2.6). Details released by the



ECB indicated that purchases in the first few months of the program were disproportionately weighted towards Italian and Spanish bonds relative to the long-term target for purchases, as those markets came under particular stress and higher spreads would have seen monetary conditions tighten relative to other parts of the euro area (Graph 2.7). ECB officials have stated that this is a natural consequence of the program as it is designed to be flexible enough to address the uncertain and potentially asymmetric effects of the COVID-19 crisis on the markets of individual euro area countries.

The narrowing of spreads in the periphery of the euro area has also reflected recent agreement



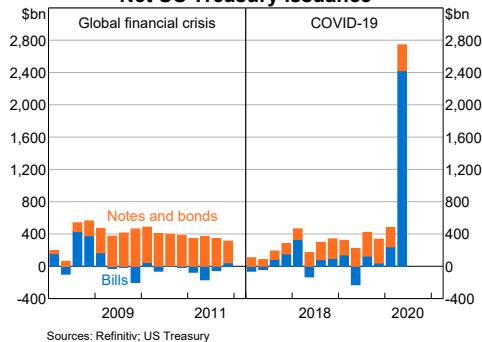
among EU member states on a stimulus package in response to COVID-19. The package includes €390 billion in grants and €360 billion in loans to member states, which the European Commission (EC) will finance by issuing €750 billion in debt. This represents a significant increase in EC debt on issue, which is currently around €52 billion and has been used to fund targeted assistance programs.^[1]

Government debt issuance has increased substantially

Sovereign debt issuance has increased sharply in recent months. Initially, governments concentrated most new borrowing in more liquid, short-dated instruments; for example, the US Treasury issued around \$2.4 trillion in bills during the June quarter (Graph 2.8). However, with conditions now having stabilised, governments are increasingly issuing at longer tenors, much as was observed during the global financial crisis. Relative to shorter-term instruments, long-term bonds carry less rollover and interest rate risk for governments but have a narrower investor base. A further increase in issuance may put upward pressure on long-term bond yields; however, central banks' purchases of longer-term government bonds in secondary markets will offset some of this pressure.

Graph 2.8

Net US Treasury Issuance



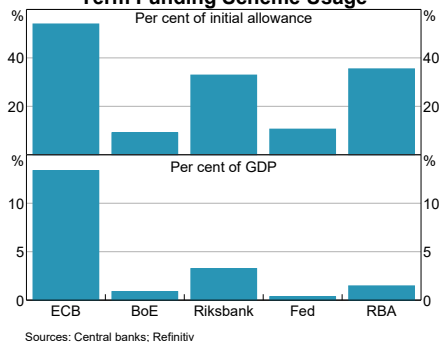
Central banks have introduced programs to reduce the cost and support the flow of funding to businesses

Central banks continue to support the flow of credit to the real economy through lending facilities that provide long-term, low-cost funding for banks, often with incentives to increase lending to the private sector (Graph 2.9).^[2] Most recently, the Bank of Japan (BoJ) introduced a facility providing funds to banks based on their lending to small and medium-sized enterprises (SMEs), including loans made under a government loan scheme. In Sweden, the Riksbank eased the terms of its onward lending program by extending loan maturities from two to four years, and reducing the interest rate penalty for failing to lend funds to non-financial companies from 0.2 to 0.1 per cent. In the euro area, the ECB conducted the first of its Targeted Longer Term Refinancing Operations (TLTRO III) at the lower funding rate announced in April. Under the program, banks that maintain their lending are able to borrow funds at a rate as low as -1 per cent. The lower pricing led to a large volume of take-up, reflecting both new borrowing and refinancing of previous ECB loans at a lower interest rate.

Several central banks have also introduced programs to purchase private sector assets in the secondary market. These programs aim to

Graph 2.9

Term Funding Scheme Usage



lower the cost of funding for, and support the flow of financing to, private sector borrowers that raise funds directly (rather than via banks). Following initial announcements in March and April, the Fed and the BoC began purchasing corporate bonds in June. More recently, the Fed extended the duration of its lending and asset purchase programs that were due to expire in September until the end of 2020. The Riksbank will also begin purchasing corporate bonds in September. The BoJ announced in March that it would purchase commercial paper and corporate bonds at an accelerated pace and subsequently extended the duration of these additional purchases by six months to March 2021 as part of a package of measures to support corporate financing. Meanwhile, the BoE and ECB continue to increase their existing holdings of corporate bonds in line with stated purchase targets. Most central banks retain spare capacity to increase corporate bond purchases within existing facilities (Graph 2.10).

The Fed will also provide targeted credit support to SMEs by purchasing up to US\$600 billion in loans made by banks to SMEs through the Main Street Lending Program. The terms of the program, first announced in April, have subsequently been eased to offer more favourable borrowing conditions and support a wider range of firms. The Fed expanded the range of eligible loans and eligible borrowers,

increased the term of each loan from four to five years and allowed for delayed principal repayments for two years instead of one. The program became operational in mid June, and has since purchased \$82 million in loans.

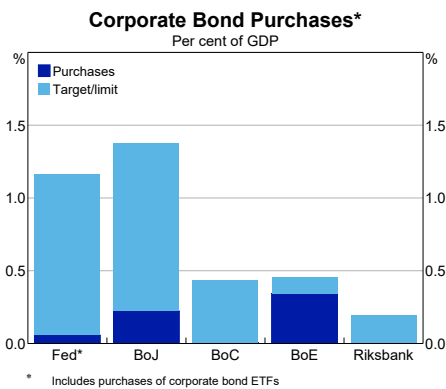
Some central banks have implemented programs to purchase assets in the primary market to improve market functioning and lower borrowing costs. The Fed, for example, has introduced facilities to conduct primary market asset purchases in municipal and corporate debt markets with the intention of stabilising funding conditions. The existence of a credible backstop in these markets has helped to alleviate market dysfunction and the take-up of these facilities has been low.

Corporate funding conditions are favourable

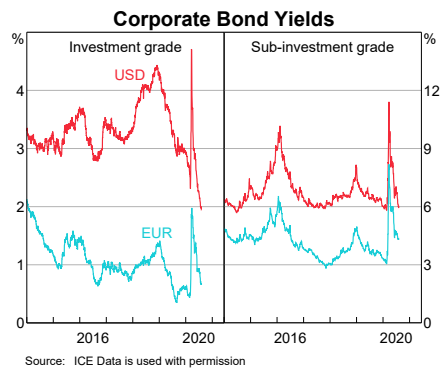
Funding conditions for corporations have eased significantly since March, reflecting substantial fiscal and monetary support. Credit spreads have narrowed and corporate bond yields have fallen back to around pre-COVID-19 levels (Graph 2.11). In the United States and Europe, investment grade borrowers have continued to raise record amounts of debt, and market access has generally improved for lower-quality borrowers.

In addition to significant issuance of bonds, non-financial corporations have raised significant

Graph 2.10



Graph 2.11



amounts of external funding from other sources since the onset of the pandemic. Business credit rose strongly in the major advanced economies in March and April as corporations drew down on pre-existing credit lines with banks. Listed corporations have also issued record amounts of equity. This is particularly true in Australia, where equity raisings as a proportion of GDP have been higher than in other advanced economies. In contrast, corporations in the United States and the euro area have sourced a larger share of their funding through debt issuance, reflecting the relative size and liquidity of corporate bond markets in those jurisdictions (Graph 2.12).

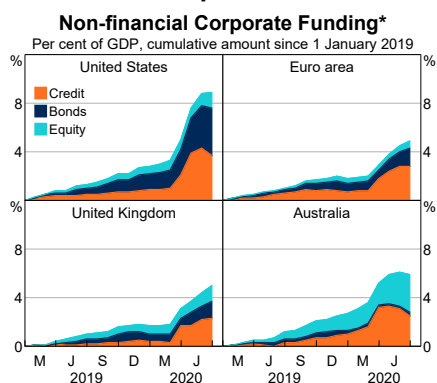
While funding conditions have eased, a sharp fall in corporate earnings is expected to see a rise in the number of companies that default on their debts. A large number of firms have had their credit ratings downgraded, although the pace of these downgrades has slowed since March (Graph 2.13). Annual default rates for large sub-investment grade borrowers in the United States and Europe have increased to around 3–5 per cent. These defaults have so far been concentrated in a few industries that are most directly exposed to the pandemic and the associated downturn in economic activity, such as the energy, retail, leisure and entertainment sectors. Analysts expect default rates in

aggregate to rise further but to remain below the levels of previous economic downturns in part due to significant fiscal spending, temporary debt relief and forbearance, and, in some countries, changes to bankruptcy laws.

Equity prices have increased, in part because market participants expect the decline in corporate profits to be short-lived

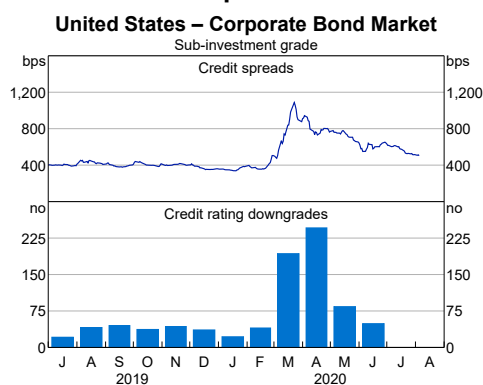
Global equity prices have recovered further in recent months following the extreme volatility of late February and March. Equity prices have risen by around 15 per cent since the previous *Statement* and by around 40 per cent from their recent trough (Table 2.2). Most indices are still below their peaks prior to the pandemic (Graph 2.14). Nonetheless, the recovery in global equity prices suggests recent declines in earnings are expected to be relatively short-lived (discussed below). Prices have also been supported by the significant easing of fiscal and monetary policies, a decline in COVID-19 infections in some parts of the world, and the associated gradual easing of containment measures. The volatility of equity prices has also declined since March, although it remains above long-term averages, in part reflecting concerns about rising COVID-19 cases in some countries.

Graph 2.12



* Net business credit, net bond issuance and gross equity issuance
Sources: Bank of England; Bloomberg; Dealogic; ECB; Federal Reserve Bank of St. Louis; RBA

Graph 2.13



Sources: ICE Data is used with permission; S&P Global Market Intelligence

Table 2.2: Changes in International Share Prices

Per cent

	From previous <i>Statement</i>	From recent trough	From pre-COVID-19 peak
United States	15	49	-2
Euro area	12	37	-15
United Kingdom	3	22	-19
Japan	14	36	-6
Australia	12	32	-16
China	21	35	14
World	14	41	-5

Source: Bloomberg

In the United States and Europe, corporate earnings are estimated to have fallen by 40–60 per cent in the June quarter relative to a year ago, the largest decline since the 2008 global financial crisis and among the largest of the past 50 years. While earnings have declined across most sectors, the falls for firms in the energy, consumer discretionary and industrial sectors have been especially large because demand for their output has been more adversely affected by the effects of COVID-19 on economic activity (Graph 2.15).

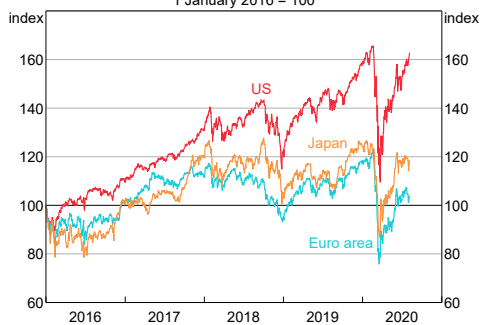
Despite the fall in corporate earnings, equity prices have recovered much of their losses from earlier in the year. As a result, the ratio of prices

to year-ahead earnings have increased to levels well above their long-term averages in a number of advanced economies (Graph 2.16). This suggests that market expectations are that the decline in corporate earnings will be short-lived, supported by significant fiscal and monetary policy stimulus and optimism that a COVID-19 vaccine will be developed. In the United States, equity prices have also been buoyed by strong gains in parts of the technology and consumer discretionary sectors, which have benefited from increased demand for digital goods and services (Graph 2.17).

Graph 2.14

Equity Prices

1 January 2016 = 100

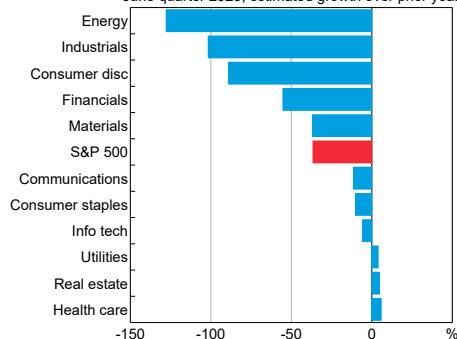


Source: Bloomberg

Graph 2.15

United States – Earnings Growth

June quarter 2020, estimated growth over prior year



Sources: Analyst reports; Bloomberg

In contrast, the share prices of banks have fallen by more than those in most other sectors because the pandemic is expected to have a large and prolonged effect on banks' profits. Bank profits in advanced economies fell by around 50–70 per cent over the first half of 2020, as provisions for loan losses increased sharply to around the highest levels seen since the global financial crisis. Banks' net interest margins have also declined and are expected to fall further, consistent with an extended period of low interest rates. Despite lower profits, banks have maintained strong capital and liquidity positions throughout this period. This follows significant reforms since the 2008 financial crisis aimed at increasing the resilience of financial institutions, and has allowed banks to act as an important

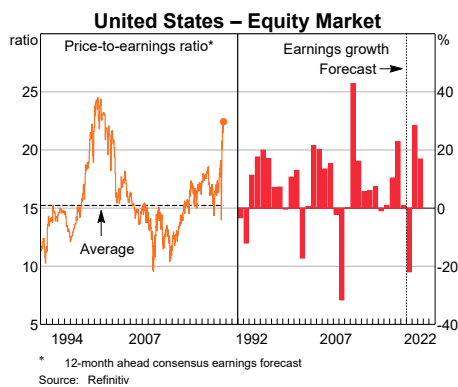
source of funding for households and businesses throughout the pandemic.

The US dollar has depreciated to pre-pandemic levels against a range of advanced economy currencies

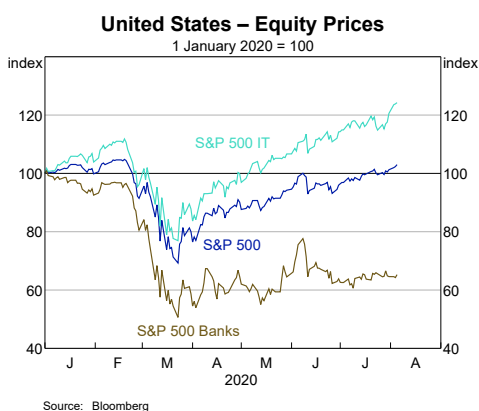
As conditions in foreign exchange markets have stabilised alongside a decline in global risk aversion and the implementation of large-scale monetary stimulus by the Fed, the US dollar has returned to levels around those observed prior to the pandemic against the currencies of other advanced economies (Graph 2.18).^[3] However, it still remains higher than earlier in the year against the currencies of a range of emerging market economies as they continue to contend with growing infection rates, lower commodity prices and pre-existing macroeconomic vulnerabilities (see below).

The euro has appreciated over recent months and is around its highest level since 2014, supported by the agreement on the EU recovery fund and as containment measures have been relaxed in the region (Graph 2.19). The Swiss franc has been little changed after appreciating earlier in the year partly because the Swiss National Bank (SNB) has intervened in the foreign exchange market at different points this year to limit further appreciation of the currency.

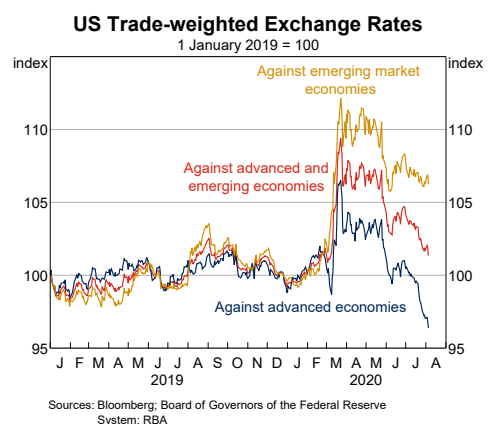
Graph 2.16



Graph 2.17



Graph 2.18



The SNB has reiterated that foreign exchange intervention plays a central role in its policy mix and that it remains willing to intervene further if required. Most other advanced economy exchange rates, including the Australian dollar, have appreciated further over recent months.

The Australian dollar has appreciated to levels a bit above those observed prior to the pandemic

The Australian dollar has appreciated further since the previous *Statement*, having depreciated sharply to US\$0.55 in March, which was its lowest level since the early 2000s. It is now around US\$0.72 against the US dollar. The depreciation and subsequent appreciation of the Australian dollar were large relative to the movements in the exchange rates of other advanced economies. Conditions in the market for Australian dollars have stabilised and the average daily trading range has returned to levels observed in the period before the pandemic (Graph 2.20).

Movements in the Australian dollar have continued to track US equity markets closely over recent months (Graph 2.21). Meanwhile, the prices of Australia’s key export commodities have increased since the previous *Statement*, most notably for iron ore, while the yields on

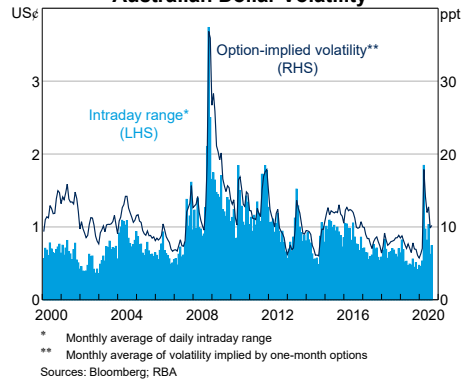
Australian Government bonds have been little changed relative to those of the major advanced economies. These medium-term influences on the value of the exchange rate are around or a bit above their levels at the start of the year. Based on historical relationships, the level of the Australian dollar appears broadly consistent with the terms of trade and interest rate differentials (Graph 2.22).^[4]

Australia experienced large capital flows in the March quarter

Australia recorded both large capital outflows and inflows in the March quarter, amid stressed conditions in financial markets (Graph 2.23).

Graph 2.20

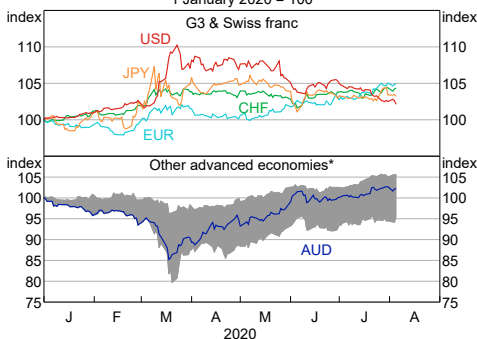
Australian Dollar Volatility



Graph 2.19

Nominal Trade-weighted Exchange Rates

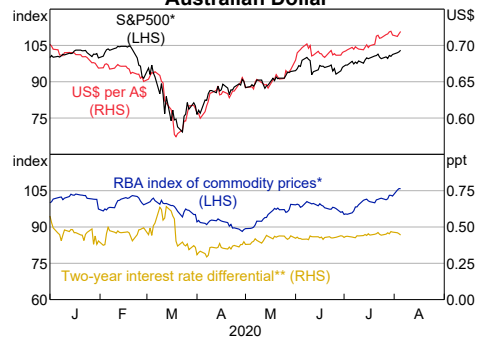
1 January 2020 = 100



* Shaded area indicates range of other advanced economy TWIs
 Sources: BIS; Bloomberg; Board of Governors of the Federal Reserve System; RBA

Graph 2.21

Australian Dollar



* Indexed to 1 January 2020 = 100
 ** Spread to equally weighted nominal yields in Germany, Japan, the United Kingdom and the United States
 Sources: Bloomberg; RBA

Outflows were mainly driven by the sale of Australian government bonds by non-residents. In part, this reflected an unwinding of trading positions in government bonds by foreign investors. In addition, outflows reflected foreign exchange intervention by a range of central banks in emerging markets, which involved selling bonds, including Australian government bonds, as they supported their exchange rates against depreciation pressures over this period.^[5] Capital outflows were partly offset by inflows from superannuation and other investment funds selling-off their holdings of foreign equities. In the superannuation sector, the demand for liquidity was partly in anticipation of some Australians gaining early access to their superannuation. Overall, there was a net outflow of capital in the March quarter, consistent with Australia recording a current account surplus (see ‘Domestic Economic Conditions’ chapter).

Australia’s net foreign liability position, relative to GDP, declined to its lowest level since the early 1990s (Graph 2.24). This decline was driven by an increase in Australia’s net foreign equity asset position, mostly owing to valuation effects resulting from the depreciation of the Australian dollar over the March quarter. The net income deficit, which is the difference between income

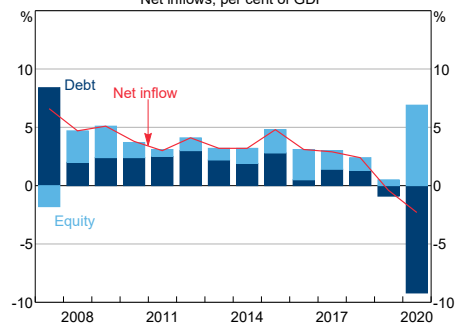
earned from Australia’s foreign assets and payments made on Australia’s foreign liabilities, narrowed in the quarter to be at its lowest level in a number of years.

Financial conditions in emerging markets have improved ...

Financial conditions in a wide range of emerging market economies (EMEs) have continued to improve in recent months, aided by the actions of policymakers globally and a partial recovery in commodity prices. Government bond yields have declined a little further, equity prices have continued to rise, exchange rates have generally appreciated, and portfolio outflows from EMEs have slowed or stopped (Graph 2.25). External

Graph 2.23

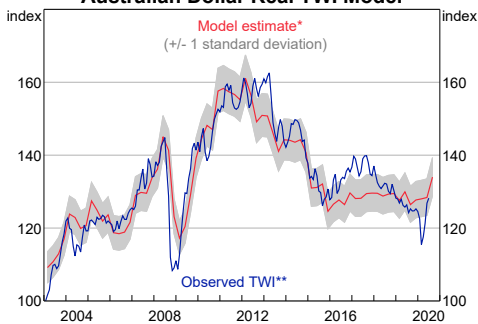
Australian Capital Flows*
Net inflows, per cent of GDP



* Last data point March quarter 2020, all other data annual
Sources: ABS; RBA

Graph 2.22

Australian Dollar Real TWI Model



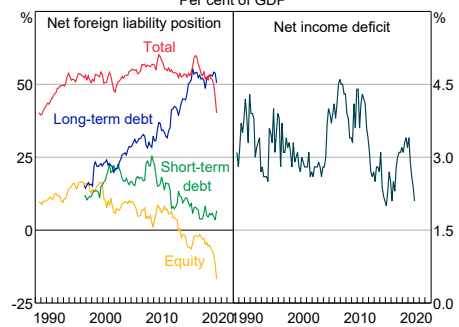
* Using terms of trade forecast and Australia-G3 government bond yield differential over entire yield curve; standard deviation based on model errors

** Indexed to March 2003 = 100; monthly average real TWI

Source: RBA

Graph 2.24

Net Foreign Position and Payments
Per cent of GDP



Sources: ABS; RBA

financial conditions have benefited from declines in US dollar funding costs in both government and corporate markets since March. While conditions have improved, the spreads that EMEs pay relative to US Treasuries remain higher and most EME exchange rates remain substantially lower than prior to the pandemic.

Financial market conditions in emerging Asia have generally been more resilient than in other regions. Many EMEs in Asia have contained the virus more effectively than their peers elsewhere, although infections in South Asia have continued to grow. The region also entered the crisis with stronger economic fundamentals, including more fiscal space and faster economic growth. Asian EMEs are generally less exposed to large falls in commodity prices, which have weighed on EMEs in other regions during the present crisis, and many Asian economies have in fact benefited from lower oil prices.

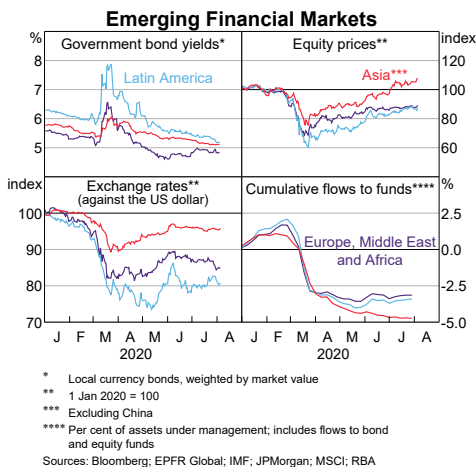
... in part because emerging market central banks have eased policy settings further ...

Central banks in emerging markets have provided further policy support, contributing to the improvement in emerging market financial conditions. Emerging market central banks have

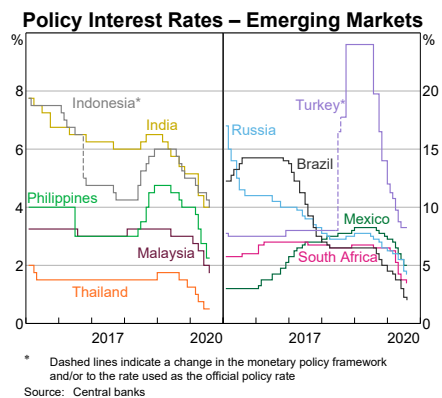
lowered their policy rates through 2020 as they observed the effects of COVID-19 on their economies (Graph 2.26). During previous crises, concerns about the exchange rate and capital outflows led EME central banks to maintain relatively high policy rates given the deterioration in their domestic economic outlooks. The larger scale easing observed this year reflects both the unusually sharp declines in domestic activity and inflation, and an improvement in the policy frameworks and financial market development in many EMEs. A number of central banks have also continued to buy governments bonds to support market functioning and lower the cost of financing for governments; however, these programs – which are in the order of 0.5–1.5 per cent of GDP – remain much smaller than those in advanced economies.

In addition to its existing bond buying program, Bank Indonesia and the Indonesian Ministry of Finance announced a deficit burden-sharing arrangement where Bank Indonesia will purchase government bonds in the primary market to support the government’s fiscal packages. The value of bonds purchased will be between 2½ and 6 per cent of GDP depending on the ultimate form of implementation and the degree of demand for the bonds from investors.

Graph 2.25



Graph 2.26



Some EMEs have also launched or extended credit support programs for small and medium-sized enterprises, although the programs are generally small at around 0.5 per cent of GDP. While some central banks have intervened in the foreign exchange market to support their currencies, the scale of intervention has eased in recent months.

... and use of multilateral financing arrangements has increased

Despite the improvement in financial conditions, EMEs continue to contend with the interaction of long-standing vulnerabilities with the current health and economic crisis. Concerns remain about the ability of some EMEs to finance large fiscal deficits, the reliance of some on external financing and unhedged foreign currency exposures. In recent months, many EMEs have experienced a rapid increase in the spread of COVID-19, including Brazil and South Africa. Both countries also entered the crisis with low and declining rates of economic growth, elevated levels of government (and state-owned enterprise) debt and relatively large fiscal deficits.

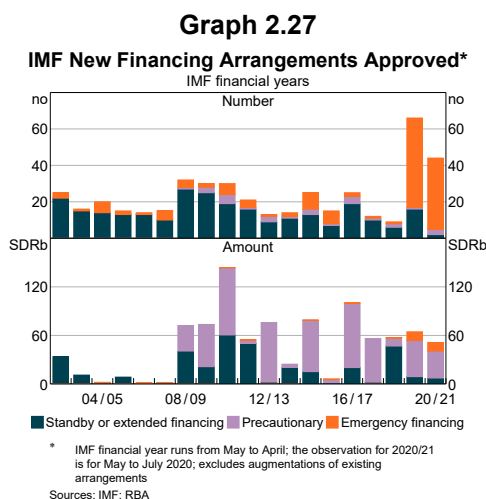
Multilateral measures have continued to support low-income countries and EMEs during the crisis. The International Monetary Fund has approved an unprecedented number of funding arrangements since late March, with the vast majority relating to emergency financing for low-income countries and smaller EMEs (Graph 2.27). Some larger EMEs have also received assistance from the IMF; for example, Nigeria and South Africa have received rapid financing loans, Egypt and Ukraine have received non-emergency conditional loans, while Chile, Colombia and Peru have had precautionary credit lines approved (but have not drawn down on these lines). In addition, the G20's Debt Service Suspension Initiative has granted debt forbearance to around 40 low-income countries. Some EMEs, particularly in

Asia, have taken loans with other supranational organisations to help finance government programs, including funds specifically tied to SME support. For example, India and Indonesia will each borrow US\$2.25 billion through loans from the Asian Infrastructure Investment Bank and Asian Development Bank.

Chinese policymakers are ensuring financial conditions remain accommodative, but are mindful of financial stability risks

Financial conditions remain broadly accommodative in China. Policymakers are focused on maintaining the flow of credit to the economy, and in turn supporting growth and employment. At the same time, however, the cost of debt has risen of late and policymakers are attentive to the potential for risks to build in parts of the financial system, particularly via off-balance sheet and non-bank financing.

Accordingly, monetary easing this year has been relatively modest and measures announced since May have been targeted at encouraging the provision of credit to smaller firms. In June, the People's Bank of China (PBC) cut the interest rates offered to financial institutions as part of their programs aimed at supporting bank



lending to micro and small enterprises, and established two new modestly sized funding facilities to support further lending to these firms. Micro and small enterprises account for a large proportion of employment in China and are relatively reliant on bank credit.

While the PBC has not adjusted any of its broader policy rates since April, it has allowed liquidity conditions to tighten and money market interest rates to rise (Graph 2.28). Money markets are a particularly important source of funding for some shadow finance in China and the slight rise in money market rates will help to curtail some of that activity that had been rising modestly in recent months. This is consistent with the attempt of the authorities to reduce the activities of non-bank financial institutions over recent years.

The price of longer-term credit in the corporate bond market has also risen since late May. This reflects a combination of factors, including: improved economic outcomes; a moderation in expectations of future easing by the PBC; an increase in government bond issuance; and the increase in money market rates. Nevertheless, growth in overall credit appears consistent with authorities' intentions. In particular, growth in total social financing has remained stronger than a year ago, in line with the announcement at this year's National People's Congress that

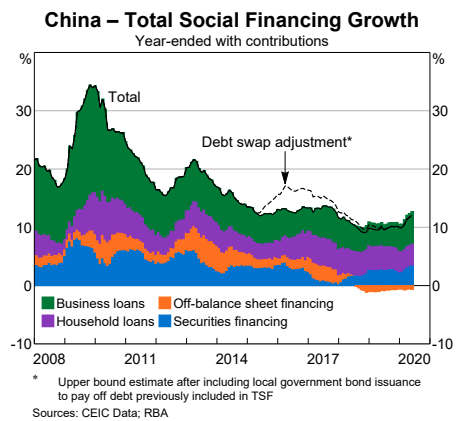
credit would grow at 'notably higher rates than last year' (Graph 2.29). The faster pace of growth owes primarily to bank lending to businesses and corporate bond issuance. That said, while the banking system has been able to maintain the flow of credit during the current crisis, China's banking regulator recently warned that risks from rising non-performing loan ratios remain high. These risks are more prominent for smaller banks, which were facing increased concern about their asset quality and capital adequacy even prior to the outbreak of COVID-19. Authorities have announced a number of measures to support smaller banks throughout the crisis. For example, CNY200 billion of the 2020 local special bond quota (around 0.2 per cent of GDP) has been allocated to replenishing the capital of small- and medium-sized banks.

Chinese equity prices increased sharply in early July and have remained relatively volatile since (Graph 2.30). Better-than-expected economic data and a continued low level of domestic COVID-19 cases supported the increase in prices, though encouraging statements from the state media also appeared to be an important factor. Historically, China's equity market has been prone to bouts of investor speculation led by the large share of retail investors in the market and widespread perceptions of state support for the

Graph 2.28



Graph 2.29



market. In this episode, share market turnover has increased and leverage in the market has risen, although the increase has been much smaller than during the sharp rise and then decline in equity prices around 2015. Price growth has moderated in recent weeks and more recent state media statements and actions by regulators suggest a desire to contain the growth of leverage.

The Chinese renminbi has been stable amid ongoing geopolitical and trade tensions

The Chinese renminbi has been little changed over recent months, despite further tensions between the United States and China

(Graph 2.31). The relative stability of the renminbi compared with other exchange rates since the start of the year is consistent with the more managed nature of the currency, although international trade and portfolio inflows are also likely to have contributed to the stability of the exchange rate since March. Meanwhile, China appears to have taken several additional steps in the direction of liberalising its capital account following announcements that some foreign investment restrictions have been eased recently. ✈

Graph 2.30



Graph 2.31



Endnotes

- [1] The European Investment Bank, which is jointly owned by EU member states, and the European Stability Mechanism and the European Financial Stability Fund, which are jointly owned by euro area member states, collectively have around €780 billion in outstanding debt.
- [2] See RBA (2020), 'Box A: Term Funding Schemes', *Statement on Monetary Policy*, May, pp 31–33. Available at <<https://www.rba.gov.au/publications/smp/2020/may/box-a-term-funding-schemes.html>>
- [3] For more information on developments in foreign exchange markets during the COVID-19 crisis, see Reserve Bank of Australia (2020), 'Box B: Recent Developments in Foreign Exchange Markets', *Statement on Monetary Policy*, May. Available at <<https://www.rba.gov.au/publications/smp/2020/may/box-b-recent-developments-in-foreign-exchange-markets.html>>. and <<https://www.rba.gov.au/publications/smp/2020/may/box-b-recent-developments-in-foreign-exchange-markets.html>>
- [4] For more information on the key determinants of the Australian dollar and the Reserve Bank's forward-looking model of the real TWI, see Chapman B, J Jaaskela and E Smith (2018), 'A forward-looking Model of the Australian Dollar', *RBA Bulletin*, viewed 17 July 2020. Available at <<https://www.rba.gov.au/publications/bulletin/2018/dec/a-forward-looking-model-of-the-australian-dollar.html>>. and <<https://www.rba.gov.au/publications/bulletin/2018/dec/a-forward-looking-model-of-the-australian-dollar.html>>
- [5] For more information see Debelle, G (2020) 'The Reserve Bank's Policy Actions and Balance Sheet' Speech at the Economic Society of Australia, Online, 30 June. Available at <<https://www.rba.gov.au/speeches/2020/sp-dg-2020-06-30.html>> and <<https://www.rba.gov.au/speeches/2020/sp-dg-2020-06-30.html>>

Box C: Central Bank Policy Responses to COVID-19

Central banks responded quickly and forcefully to the economic and financial disruptions brought on by the COVID-19 crisis. As financial conditions began to tighten, central banks rapidly injected liquidity through regular market operations and by reviving emergency facilities launched during the global financial crisis. This was followed by measures to support economic activity, including lower policy rates, new or expanded asset purchase programs, and schemes to support the flow of credit to businesses facing large reductions in income. Most of these facilities have been only partially utilised, in part owing to the easing in financial conditions (which, in turn was aided by the central banks' policies) (Graph C.1). The measures will remain in place for some time to help support economic recoveries. This Box sets out the policies that central banks in advanced economies have implemented since March and outlines the key objectives of each.

Supporting market functioning and meeting demand for liquidity

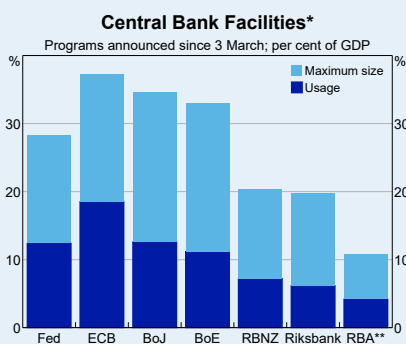
During March, critical financial markets became dislocated and threatened to lead to a tightening in financing conditions across economies. These stresses reflected a sharp increase in the demand for liquidity and constraints on the ability of dealers to intermediate markets.^[1] Conditions in short-term funding markets tightened significantly and there were unprecedented dislocations in government bond markets, including for US Treasuries.^[2]

In response, central banks adjusted their **short-term liquidity operations**. They expanded the volume of funding provided to the financial system through regular market operations and lengthened the maturity at which institutions could borrow. They also eased the terms for accessing backstop funding – lowering the cost, broadening the range of eligible collateral and providing access to a wider range of institutions.

Central banks also purchased a range of assets to restore market functioning. Purchases were largely concentrated in government bonds, given their crucial role in financial markets, but also included private sector assets (Graph C.2). These purchases helped to improve market liquidity at a time when dealers were unable to fully absorb significant one-sided flows.

A number of additional measures were implemented by the Fed with other central banks to meet the heightened demand for **US dollar funding**. US dollars, which play a central role in international trade and finance, had become more expensive to borrow in

Graph C.1



* Includes asset purchase programs (including loan purchases) and term funding schemes; excludes short-term liquidity facilities

** Maximum size assumes no further bond purchases; includes the AOFM structured finance support fund

Source: Central banks

the foreign exchange swap market. To improve cross-border access to US dollars, the Fed activated, expanded, lengthened maturities and lowered the cost of existing foreign exchange swap lines with central banks, introduced new swap lines with a number of other central banks (including the Reserve Bank of Australia), and introduced a new US dollar repo facility for other foreign monetary authorities.^[3]

Reducing risk-free interest rates

As the economic impact of the pandemic became apparent and global financial conditions tightened in March, many central banks reduced risk-free interest rates in their economies. In the first instance, many central banks in advanced economies lowered short-term **policy rates** to be close to zero. Others with policy rates already at or below zero left their rates as they were prior to the pandemic.

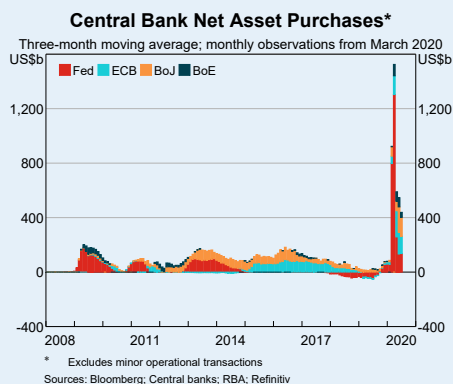
Central banks also introduced or strengthened **forward guidance** for policy rates to remain at their present low levels for an extended period. Many central banks have indicated that policy rates will not rise until the economic recovery is sufficiently

progressed ('state-based' guidance). In line with such guidance, risk-free yields have declined to very low levels out to a horizon of several years or more (Graph C.3).

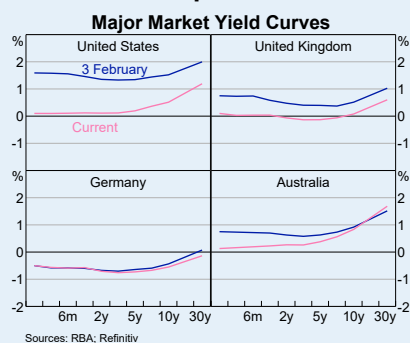
The lowering in risk-free rates can be reinforced with a **yield target**. This is a commitment by a central bank to buy or sell bonds as needed to ensure government bond yields on a particular part of the yield curve remain around a specified level. The Bank of Japan has had a target of around zero per cent on 10-year yields since September 2016. In Australia, the Reserve Bank introduced a target for the yield on 3-year Australian Government bonds of around 0.25 per cent, which reinforces its forward guidance on the cash rate.^[4]

Many central banks implemented **asset purchase programs** involving the purchase of particular quantities of government bonds in the secondary market. These purchases have helped to lower long-term risk-free rates, as well as having helped to alleviate severe dysfunction in government bond markets.

Graph C.2



Graph C.3



Supporting the flow of funding to businesses

Central banks have implemented programs to support the flow of funding to private-sector borrowers, especially those businesses coming under particular strain. Such programs have operated by supporting either bank lending or market-based funding, with the choice depending partly on the importance of these funding sources in a given economy. In some cases, programs have supported or supplemented government assistance to businesses, such as loan guarantees.

Supporting bank lending

Bank lending has been supported by **term funding schemes**. These schemes provide low-cost, long-term secured funding to banks or other financial intermediaries, which lowers bank funding costs and helps to reduce interest rates for borrowers.^[5] These schemes provide incentives for banks to increase their lending to certain borrowers. For example, the Reserve Bank's Term Funding Facility provides one dollar of additional funding to a bank for every dollar increase in credit outstanding to large businesses, and five dollars of additional funding for every dollar increase in credit

outstanding to small and medium-sized enterprises.^[6]

Supporting market-based funding

Finally, a number of central banks have supported markets in which firms raise funding directly (rather than via banks), by **purchasing corporate debt securities**. Some of these operations have been structured to provide a backstop that is only used when market conditions are quite strained. That said, their mere existence has alleviated market stresses because they provide certainty about the availability of funding at a known price. In other cases, central banks have purchased pre-specified amounts of securities, to promote market functioning and lower funding costs for borrowers.

Buying debt securities effectively involves the central bank lending directly to businesses on an unsecured basis. Accordingly, they involve a greater risk of loss due to defaults than do other types of lending, which are usually secured with collateral. Many central banks have been partly or wholly protected against potential losses on these programs by national governments. ✎

Endnotes

- [1] See Debelle G (2020), 'The Reserve Bank's Policy Actions and Balance Sheet', Speech to The Economic Society of Australia, 30 June. Available at: <<https://www.rba.gov.au/speeches/2020/sp-dg-2020-06-30.html>>. and <<https://www.rba.gov.au/speeches/2020/sp-dg-2020-06-30.html>>
- [2] For details, see RBA (2020), 'International Financial Conditions', *Statement on Monetary Policy*, May, viewed 6 August 2020. Available at

<<https://www.rba.gov.au/publications/smp/2020/may/international-financial-conditions.html>>. and <<https://www.rba.gov.au/publications/smp/2020/may/international-financial-conditions.html>>

- [3] The Fed also launched facilities to alleviate dysfunction in US money markets. These included a new facility to help banks purchase assets sold by money market funds and a facility to purchase

commercial paper to ensure that firms could continue to roll over their debt as it matured.

- [4] For further details see Kent C (2020), 'The Reserve Bank's Operations – Liquidity, Market Function and Funding', Speech to KangaNews, 27 July. Available at <<https://www.rba.gov.au/speeches/2020/sp-ag-2020-07-27.html>>. and <<https://www.rba.gov.au/speeches/2020/sp-ag-2020-07-27.html>>
- [5] See RBA (2020), 'Box A: Term Funding Schemes', *Statement on Monetary Policy*, May, viewed 6 August 2020. Available at <<https://www.rba.gov.au/publications/smp/>

[2020/may/box-a-term-funding-schemes.html](https://www.rba.gov.au/publications/smp/2020/may/box-a-term-funding-schemes.html)>.

Available at <<https://www.rba.gov.au/publications/smp/2020/may/box-a-term-funding-schemes.html>>

- [6] In the United States, the Fed's Main Street Lending Program is using asset purchases to support intermediated lending. The program allows banks to sell 95 per cent of eligible loans to the Fed, with credit risk to be shared between the Fed and the participating bank in proportion to the ownership share. This aspect of the program is similar to government-funded loan guarantee schemes in operation in other countries.

3. Domestic Economic Conditions

The outbreak of COVID-19 has caused the largest shock to economic activity in Australia since the 1930s (Graph 3.1). The peak-to-trough decline in GDP that has occurred over the first half of 2020 is expected to have been around 7 per cent. There have been correspondingly large declines in total hours worked and employment, and the rate of labour force underutilisation is the highest since the 1990s recession. Around 30 per cent of Australia’s working-age population is receiving JobKeeper, JobSeeker or equivalent payments. Although a gradual recovery is underway, the nature and speed of the recovery remains highly uncertain and the pandemic will have long-lasting effects on the economy.

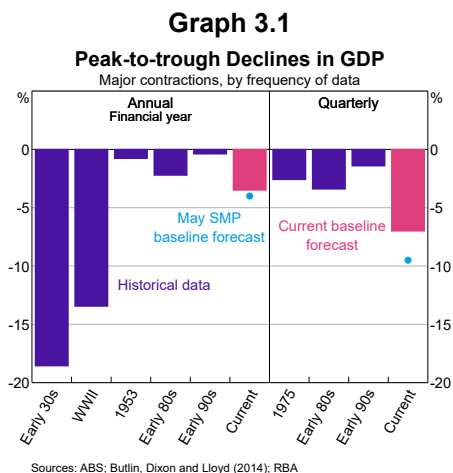
The decline in economic activity has been historically large but it is less than was assumed in the ‘baseline’ scenario at the time of the *May Statement on Monetary Policy*. Economic activity

and the labour market have both picked up since May as activity restrictions eased. Highly expansionary fiscal and monetary policy have also supported the recovery, including measures targeting household cash flow and employment. Household finances have also been supported by temporary measures including mortgage payment deferrals and early access to superannuation balances.

However, the pandemic and associated containment measures continue to weigh on activity. Even prior to the most recent set of restrictions applied in Victoria, the outlook for much of the economy was very uncertain, and forward indicators of activity and the labour market were weak. It will take a considerable period of time to recover the lost output and employment resulting from the COVID-19 outbreak.

Activity picked up as restrictions were eased, but the pace has slowed recently

Governments began to ease social distancing and other containment measures in May, following a decrease in the number of COVID-19 cases. Restrictions on activity were gradually lifted – including allowing larger public gatherings and permitting higher patron numbers at pubs, cafes and restaurants – and, by early June, most states were allowing regional travel. Capital city mobility indicators and a range of other indicators of economic activity picked up quite quickly over May and June as restrictions were eased (Graph 3.2).



The number of COVID-19 cases in Victoria increased in June, and accelerated further in July (Graph 3.3). In response, the Victorian Government reintroduced strict containment measures and remote schooling and, in early August, further tightened restrictions on large parts of the state's economy in order to sharply reduce the spread of infections. The Victorian border has effectively been closed, and some other restrictions on interstate movements have been introduced or reinstated. Mobility indicators for Melbourne started to slow in late June as the number of COVID-19 cases increased, and declined further as activity restrictions were reimposed; mobility is expected to have fallen sharply since the start of August.

Case numbers in New South Wales (and, to a lesser extent, some other states) have also increased, resulting in some targeted tightening of containment measures, including further restrictions on inter-state movements. Mobility indicators remain well above their April levels in capital cities other than Melbourne, although have moderated recently in Sydney.

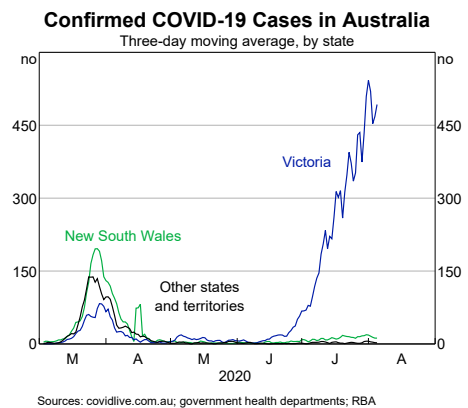
In line with the initial recovery in activity, survey measures of business sentiment picked up sharply from their April lows, although business conditions were still below average in June (Graph 3.4). Similarly, measures of consumer

sentiment have lifted from their April lows, but remain well below average and dipped in July as containment measures were reimposed in some states.

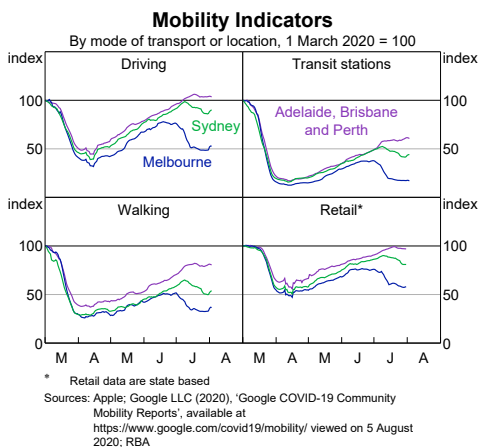
The recovery in employment has been uneven ...

The COVID-19 outbreak has severely affected the labour market. Employment fell by around 870,000 people over April and May (Graph 3.5). Some of these job losses have since been recovered as restrictions have been lifted and activity has picked up, but employment remains around 5 per cent lower than in mid March. Weekly ABS payroll data showed a large

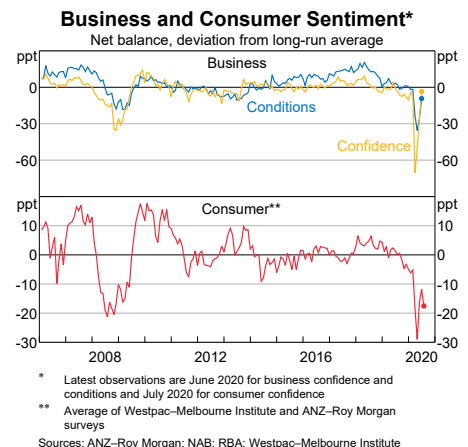
Graph 3.3



Graph 3.2



Graph 3.4



recovery in the number of paid jobs over May and June, but improvements have been mixed since late June. Compared to March, an additional 800,000 people are currently receiving JobSeeker support payments (around 1½ million people in total). The Australian Government’s JobKeeper program introduced in March is currently subsidising around 3½ million jobs; in the absence of this program, employment would have declined much further.

Around two-thirds of the jobs lost in April and May were casual jobs. This reflects the large share of casual workers in hospitality-related industries, as well as some restrictions in casual workers’ eligibility for JobKeeper payments. As social distancing restrictions have been eased since May in many parts of the country, the recovery has been largest in industries that had initially lost the most jobs, most notably in the accommodation & food services and the arts & recreation industries (Graph 3.6).

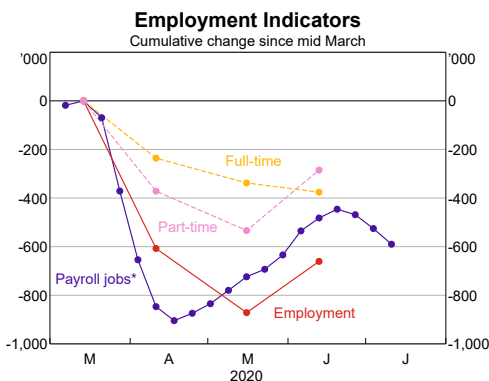
A number of other industries that were not as directly affected by activity restrictions – such as construction and business services – experienced relatively smaller initial declines in employment. In some of these industries, however, payrolls data indicate there has been some further weakness in recent weeks, in part because of ongoing subdued demand. Full-time

employment continued to decline in June, and accounts for over half of the job losses since March, though this is still less than the full-time share of total employment.

Across age groups, job losses have been much more pronounced for younger workers aged 15–24 years old (Graph 3.7). While younger workers are typically more affected by weak labour markets than are other age groups, this pattern has been exacerbated in the current episode by the concentration of job losses in hospitality-related industries that have a higher share of younger workers.

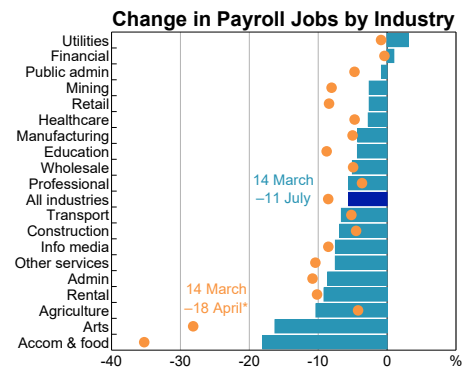
The pattern of job losses and initial recovery was similar across states in March and April, but has since become more varied (Graph 3.8). In

Graph 3.5



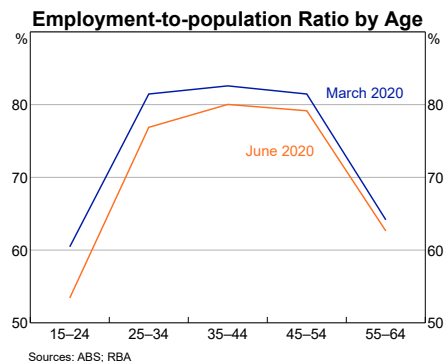
* ABS Weekly Payroll Jobs; excludes firms not reporting through single-touch payroll and self-employed persons
Sources: ABS; RBA

Graph 3.6



* The lowest weekly value of the aggregate payroll jobs index
Sources: ABS; RBA

Graph 3.7



Sources: ABS; RBA

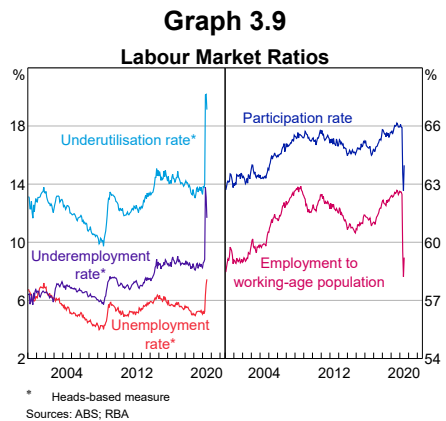
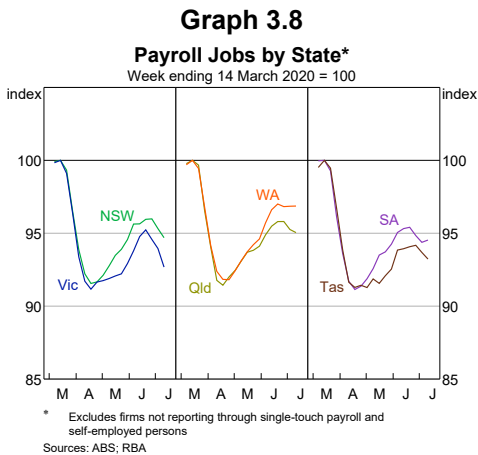
Victoria – which experienced a relatively subdued initial recovery, in part because restrictions had been eased more slowly – job numbers again turned down ahead of and during the reinstatement of activity restrictions in early July. Job losses in Victoria are likely to increase further in coming weeks as a result of the further tightening in activity restrictions in early August.

... and labour market underutilisation remains very high ...

The unemployment rate increased from 5.2 per cent in March to 7.4 per cent in June (Graph 3.9). Increases in the measured unemployment rate in April and May were not as large as they could have been. This was mainly because an unusually large share of people who left employment had exited the labour force altogether, resulting in a considerable decline in the participation rate rather than a surge in the measured unemployment rate. The number of people temporarily leaving the labour force increased because social distancing restrictions made searching for work difficult over April and May, and also because job search requirements for receiving the JobSeeker unemployment benefit were temporarily waived. Among this group of people, an increasing number have started to

actively search for work again as labour market conditions pick up and job search requirements for JobSeeker are gradually reintroduced. This contributed to the rise in the unemployment rate in June (when net employment gains were recorded), and further rises are expected over coming months as labour force participation increases and employment contracts.

Total hours worked in the economy fell by 10½ per cent from March to May, before recovering somewhat in June. A large part of this decline is because full-time workers worked fewer hours on average in recent months – only around half of the initial decline in full-time workers’ average hours has been recovered. Part-time workers’ average hours had declined sharply in April, but have now mostly recovered (Graph 3.10). In June around 1 in every 10 workers remained on reduced hours for economic reasons. Of these, around 230,000 workers worked zero hours; in the absence of the JobKeeper program, some of these workers would have lost their job. The underemployment rate was around 12 per cent in June, after spiking in April to its highest rate since the labour force survey series began in 1978. Measures of underutilisation remain around record high rates.



... while the near-term outlook for jobs remains uncertain

Forward-looking indicators of labour demand suggest that labour market conditions will remain subdued for some time. Job advertisements have picked up modestly since May, but remain around 30 per cent lower than earlier in the year (Graph 3.11). Increases in advertisements have been strongest in industries that had been most directly affected by social distancing restrictions and for which restrictions have begun to ease, such as accommodation & food and retail/wholesale trade. Surveys indicate that firms' hiring intentions remain weak, and information from business liaison suggests that hiring decisions are highly dependent on how activity restrictions and policy support measures evolve, as well as the outlook for demand conditions more broadly.

Policy measures have supported the labour market and household cash flow ...

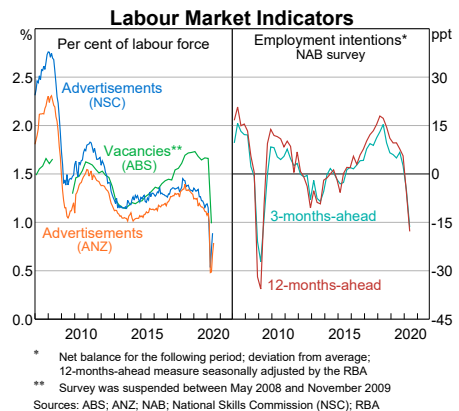
Declines in employment have reduced households' labour income, but much of this is being offset by policies that are providing substantial income support and aiding the recovery. Support for household cash flow has primarily come from the JobKeeper program, increased social assistance payments and early

withdrawals from superannuation accounts (Graph 3.12).

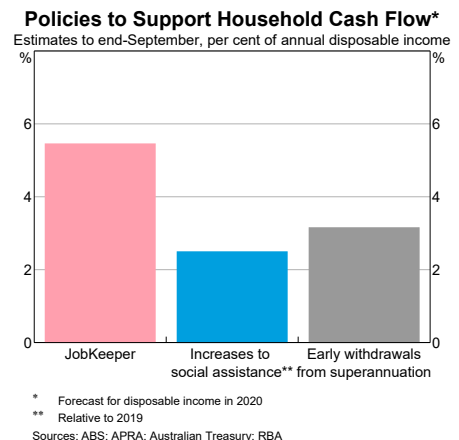
The Australian Government introduced the JobKeeper program in April. This has provided a fortnightly wage subsidy of \$1,500 per worker for a wide range of employers adversely affected by the COVID-19 outbreak. This program had been due to expire in September, but in July the government announced an extension until March 2021, with some downward adjustments to subsidy rates and changed eligibility criteria.

Other additional government payments have been supporting incomes of a large number of people over recent months. Since April,

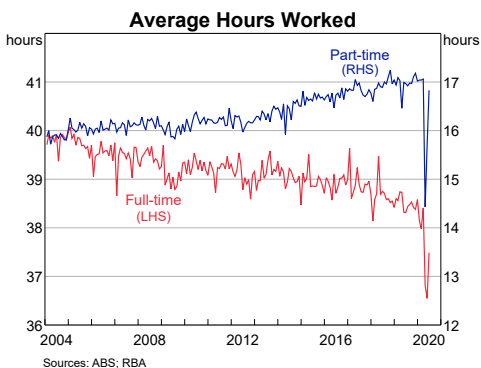
Graph 3.11



Graph 3.12



Graph 3.10



payments to recipients of JobSeeker and a range of other social assistance programs have been substantially boosted by a fortnightly \$550 Coronavirus Supplement. This supplement has also been extended beyond September, after which payments will be at a lower rate and subject to tighter eligibility criteria. Through April and May, around 6½ million existing recipients of social assistance payments received an Economic Support Payment of \$750, and around 5 million people received a second \$750 payment in July.

The combination of these newly introduced measures and existing fiscal policy settings has seen government payments as a share of GDP increase sharply. In the Australian Government's July economic and fiscal update, government payments were estimated to have been around 28 per cent of GDP in 2019/20 (compared to an average of around 25 per cent over the previous 30 years), and payments were forecast to increase further in 2020/21, to 34 per cent (Graph 3.13). Households and businesses have also paid less tax in recent months as their incomes have declined. The net positive fiscal impact of these increased outlays and reduced tax revenues set out in the July update were equivalent to around 4 per cent of GDP growth in 2019/20; a further 5 per cent change was expected in 2020/21.

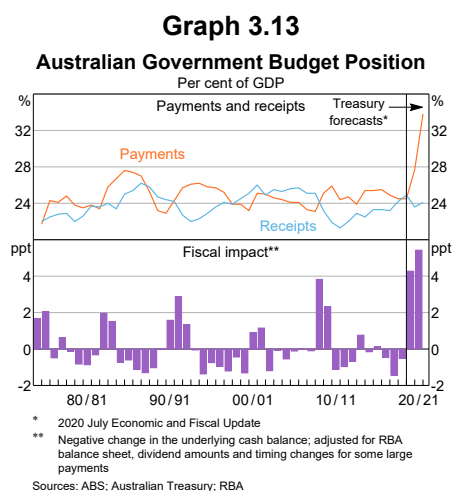
State and territory governments have also been providing support to households and businesses, mostly in the form of relief from taxes and fees and increased funding for public services. Following the stringent lockdowns in Victoria in early August, the Australian and Victorian governments introduced a pandemic leave disaster payment to support workers required to self-isolate. Government income support measures have been complemented by private sector measures, such as policies to allow mortgage holders to defer their regular payments, and rent deferrals and discounts by residential and commercial landlords.

Eligible households have also supplemented their income with early withdrawals from their superannuation accounts. In the June quarter, around 2½ million eligible individuals made an average early withdrawal of nearly \$8,000 from their superannuation. A second tranche of superannuation withdrawals became available after 1 July. Just under 40 per cent of those who applied in the first tranche have reapplied in the second. As at the end of July, around \$30 billion had been withdrawn under this policy.

... which has supported spending on some consumption items

A range of partial indicators suggest household spending (including on retail sales, purchases of motor vehicles and discretionary services) fell sharply in the month of April but has since rebounded. The turnaround in spending on these items was supported by the easing in restrictions on activity and policies to bolster household cash flow.

Consumption patterns have shifted considerably as households and retailers have adjusted to different types of restrictions over recent months. In March and April, spending at cafes, restaurants and takeaway outlets fell markedly as restrictions on public gatherings and eating out were imposed (Graph 3.14). This was more than



offset by a very large increase in spending on food and beverages as households increased consumption at home and stocked up. Growth in food sales has since slowed, but remains much higher than a year ago, in part because many people continue to work from home and eating out options remain restricted.

Sales of many types of household durables, including goods for home entertainment, appliances, furniture, and goods for home renovation, grew very strongly in May and June. Information from the Bank’s liaison program suggest sales of these categories remained strong in July. By contrast, clothing & footwear spending – much of which typically involves in-person and close-contact shopping – was very weak in April and May but has increased recently. Households have also adapted to restrictions by making more of their purchases online; online retail sales accounted for around 10 per cent of the total value of retail sales in the June quarter, up from an average of around 6 per cent in 2019. Motor vehicle sales to households were very strong in July.

Despite the recent pick-up in some categories of retail spending, overall household consumption is estimated to have declined by around 10 per cent in the June quarter (Graph 3.15). Activity restrictions heavily weighed on domestic spending on discretionary services,

such as recreation and personal care. However, a disproportionate share of the contraction came from reduced spending on overseas travel, given the restrictions on international travel. Spending by Australians travelling overseas typically accounts for around 5 per cent of nominal consumption, although the effect on overall GDP is offset by corresponding imports.

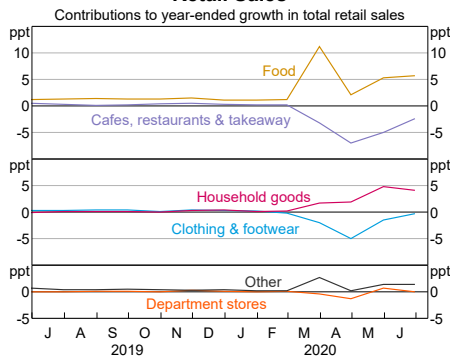
The lower overall level of household consumption, combined with the large boost to household cash flow from income support measures, led to a very large increase in the household saving rate in the June quarter. Reflecting this, household bank deposits have grown very strongly over recent months and credit card debt has declined (see the ‘Domestic Financial Conditions’ chapter and ‘Box D: Recent Growth in Money Supply and Deposits’).

Conditions in established housing markets have been mixed

Housing prices in most capital cities have declined a little since the *May Statement*, while Melbourne price declines in recent months have been larger (Graph 3.16). Prices in some smaller cities (Adelaide, Canberra and Hobart) have been resilient to the downturn observed elsewhere. New residential property listings declined markedly in April as activity restrictions and uncertainty weighed on the property

Graph 3.14

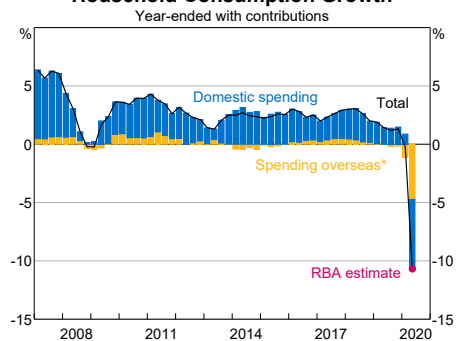
Retail Sales



Sources: ABS; RBA

Graph 3.15

Household Consumption Growth



* Personal travel and passenger transport services debits
Sources: ABS; RBA

market; listings in Sydney have since increased to be broadly in line with their average level for this time of year, but they remain below average elsewhere (Graph 3.17). The reinstatement of restrictions in Melbourne in early July, including restrictions on in-person auctions and open houses, weighed on new listings and resulted in auction clearance rates in Melbourne declining to 45 per cent in July, to be a bit above the level seen in April. The introduction of further restrictions in Melbourne in early August will further reduce activity in the housing market over coming weeks. By contrast, following a strong bounce-back, auction clearance rates in Sydney have remained relatively stable in the recent period, at a bit above 60 per cent.

The modest decline in established housing prices at the national level, and the partial recovery in financial asset prices such as equities since March, mean that household wealth was broadly unchanged in the June quarter and increased a little over the past year.

Rental markets remain challenging for landlords and favourable for tenants

Rental vacancy rates rose further in recent months in Melbourne and Sydney, and advertised rents continued to move lower (Graph 3.18). The increase in the vacancy rate in Sydney has been driven by a larger number of

vacant properties – primarily apartments – in the inner and middle ring suburbs. One important factor affecting rental market conditions has been the decline in international visitors and domestic business travel because of travel restrictions. This has encouraged some landlords to offer their short-term rental accommodation on the long-term market, increasing the available rental stock.

New residential bond lodgements rose sharply in May in Sydney, consistent with some tenants entering into new leases to realise lower rents. Nationally, around 5 per cent of residential tenants have obtained rental discounts over recent months. Instances of rent deferrals remain much higher than usual. Lower rental income could present cash flow challenges for some property investors if these conditions persist, and is also likely to weigh on investor demand for new properties.

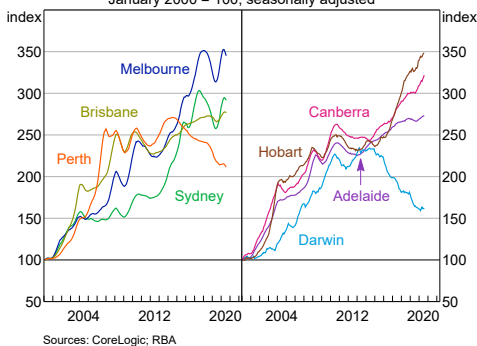
Policy measures are providing some support to residential construction, but overall conditions remain weak

In June, the Federal Government introduced the HomeBuilder scheme, which provides a grant of \$25,000 to owner-occupiers undertaking eligible new building work over the rest of the calendar year. Survey information and liaison with

Graph 3.16

Housing Prices

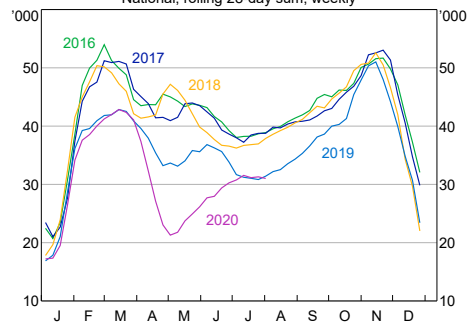
January 2000 = 100, seasonally adjusted



Graph 3.17

New Residential Property Listings*

National, rolling 28-day sum, weekly



* Properties advertised for sale across multiple sources or multiple times in the same 28-day period are only counted once

property developers indicated a large increase in enquiries for detached houses when this scheme was announced and sales of titled greenfield lots have increased to be around pre-outbreak levels (Graph 3.19). New home sales increased particularly strongly in Western Australia in June, following the announcement of HomeBuilder and the state government announcement of ‘building bonus grants’ of \$20,000.

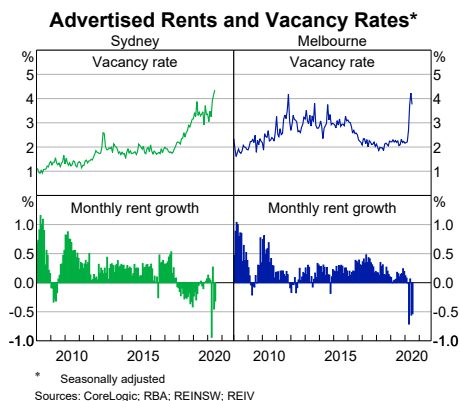
Despite this near-term boost to some parts of the new housing market, overall conditions remain weak. Construction activity in Melbourne will be significantly curtailed by restrictions on the number of workers allowed on residential construction sites in August and September. More broadly, residential building approvals for both detached and higher-density housing have declined over recent months. Furthermore, since the HomeBuilder scheme requires that work commences within three months of the contract date, higher-density construction projects are less likely to qualify. Developers have reported that sales of off-the-plan apartments have remained very soft, and some developers are delaying commencements of planned projects. The pipeline of residential work to be done declined over the past year because completions outpaced new approvals.

Non-mining investment intentions remain very weak ...

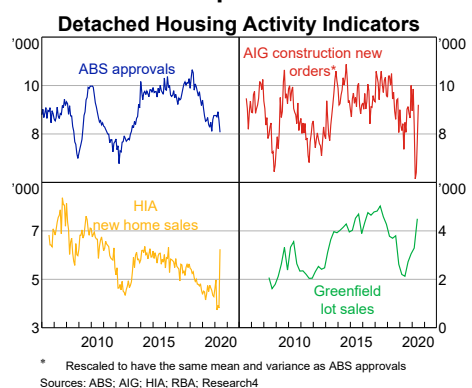
Non-mining investment declined by 6 per cent over the year to March, and is expected to fall further over the next year or so. Information from liaison suggests that firms have deferred or cancelled planned discretionary investment to preserve liquidity in response to weak current and expected demand. As well as near-term business conditions being highly uncertain, firms are also having to assess the implications of large shifts in consumer behaviour and economic activity (such as an elevated share of online retail expenditure, an increased prevalence of working from home, and a switch to domestic tourism over international travel). Should some of these shifts persist beyond the outbreak being contained, changes to the pattern and geographical distribution of activity will need to be incorporated into firms’ investment (and employment) decisions.

Survey measures of non-mining investment intentions were subdued prior to the pandemic and have been revised down further, consistent with weaker demand and heightened uncertainty. The ABS Capital Expenditure (Capex) survey, which was conducted in April and the first half of May, indicates that non-mining investment in both machinery & equipment and buildings will fall sharply over

Graph 3.18



Graph 3.19



the next year or so (Graph 3.20). That said, liaison indicates that the Australian Government’s expanded instant asset write-off scheme – which is available for assets up to \$150,000, and has been extended to December 2020 – supported a significant increase in commercial vehicle sales in June. In general, though, other survey indicators of expected business investment and capacity utilisation remain weak, and building approvals remain well below their levels in 2019 (Graph 3.21).

The near-term outlook for machinery & equipment investment is particularly weak, given this category of investment spending is sensitive to near-term demand conditions. Non-

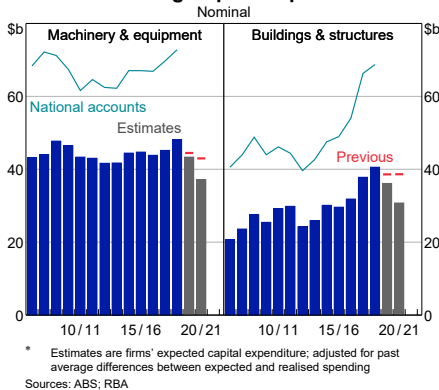
residential construction investment is expected to decline sharply over the second half of the year. In part, this reflects the introduction of limits on worker numbers at non-residential construction sites in Melbourne as part of the Victorian Government’s response to the COVID-19 outbreak. In other states, work on already commenced projects is expected to continue. However, liaison information suggests that many building projects that were scheduled to commence have been put on hold.

... but governments are planning to ‘fast-track’ infrastructure projects to support activity

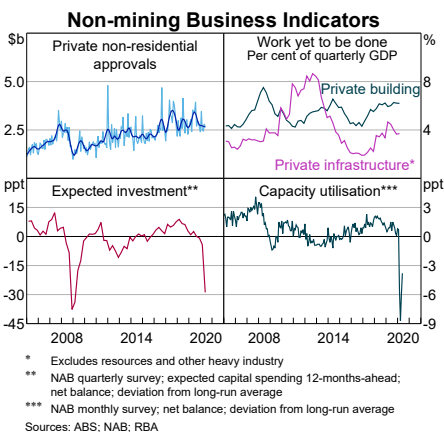
Over recent months, governments have announced plans to expedite approvals for both public and private construction projects. The Australian Government has announced that approvals for around \$70 billion of projects have been prioritised, to allow construction activity to commence sooner; these include a range of electricity, mining, rail, road and water infrastructure projects. Most states have also announced an intention to fast-track a number of smaller ‘shovel-ready’ projects.

The pipeline of infrastructure work yet to be done has been broadly steady as a share of GDP over the past couple of years, supported by public infrastructure projects (Graph 3.22). In contrast, the pipeline of private non-mining infrastructure work has declined a little over the past year, led by roads and renewables. Expedited approval times for select private construction investment, which would partly offset an expected decline in the pipeline of private infrastructure projects over the next few quarters. The accelerated spending could also provide a modest indirect boost to business investment; for example, if private contractors increase spending on machinery & equipment to facilitate work on these projects.

Graph 3.20
Non-mining Capital Expenditure



Graph 3.21



Mining investment is expected to increase a little over the next year

Mining investment increased by 10 per cent over the year to March, as replacement iron ore projects commenced and construction at the remaining LNG projects was completed. Information from the Capex survey and the Bank’s liaison program indicate that investment is expected to increase slightly over the year ahead as work on iron ore and coal projects ramps up, although growth is expected to be more moderate than was anticipated at the start of the year (Graph 3.23). Further out, mining investment is expected to ease as a result of less work on iron ore and coal projects, and the deferral of final investment decisions on some large LNG projects.

Resource exports were broadly unchanged over the year to March; strong growth in LNG exports was largely offset by lower export volumes of non-monetary gold and a range of metal ores. Partial trade data indicate that iron ore exports picked up in the June quarter as exporters sought to benefit from high iron ore prices, including by running down inventories that had been built up in previous months because of weather-related shipping disruptions (Graph 3.24). Disruptions to Brazilian iron ore production have supported demand for

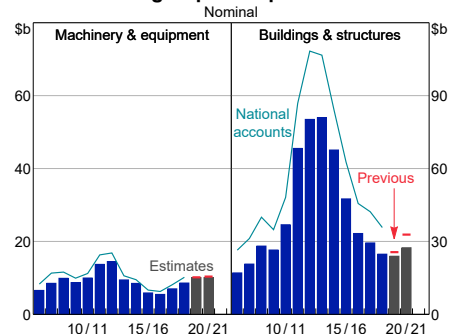
Australian iron ore, especially from China. However, coal exports declined; demand for coal has been particularly weak from India and Japan.

Service exports fell sharply in the June quarter

Travel and transport service exports collapsed over the first half of the year, following the introduction of international travel restrictions in February and March (Graph 3.25). Education travel exports declined sharply in the March quarter, as some students, mainly from China, were forced to delay their arrival, or were unable to commence their studies. However, the majority of international students who were in

Graph 3.23

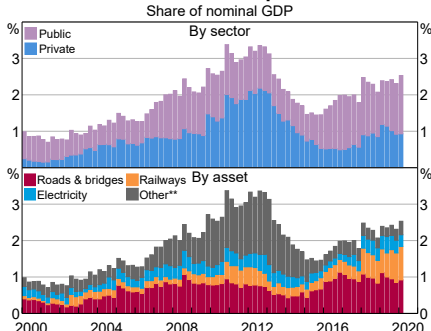
Mining Capital Expenditure*



* Estimates are firms' expected capital expenditure; adjusted for past average differences between expected and realised spending
Sources: ABS; RBA

Graph 3.22

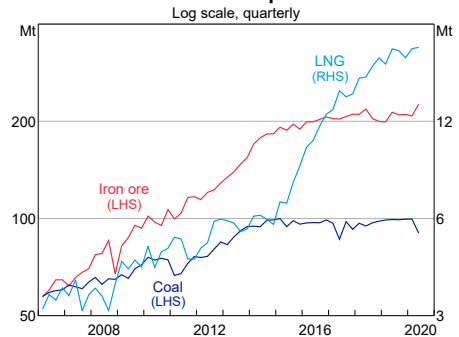
Infrastructure Pipeline*



* Includes some resource-related work (for example, some railways, harbours, and pipelines have been associated with resource projects)
** Includes harbours, pipelines, water, sewerage, telecommunications, recreation and other infrastructure projects
Sources: ABS; RBA

Graph 3.24

Resource Exports*



* Seasonally adjusted by the RBA
Sources: ABS; RBA

Australia when travel restrictions were introduced have remained in Australia, and this supported service exports in the June quarter. Tourism travel exports were close to zero in the June quarter because almost no foreign travellers were permitted to enter Australia. Service exports will not pick up materially until international travel restrictions begin to be lifted.

Likewise, reduced overseas travel by Australians resulted in a sharp fall in import volumes over the first half of the year. The fall in private domestic demand, particularly consumption and private business investment, also contributed to the decline in imports; the value of both consumer and capital goods fell in the June quarter.

The trade surplus increased further in the June quarter, to around \$25 billion or around 5 per cent of nominal GDP (its highest share since 1959 when quarterly data began), as import values fell by more than export values (Graph 3.26). The current account is therefore likely to have recorded its fifth consecutive quarterly surplus.

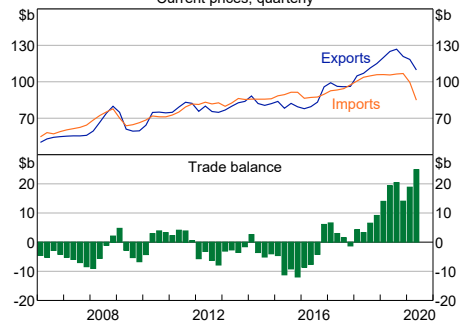
The outlook for the rural sector is favourable

After several years of severe drought, weather conditions have been mostly favourable since

the start of the year, particularly in New South Wales and Victoria. The latest climate outlook published by the Bureau of Meteorology indicates that favourable conditions are likely to continue, with higher-than-average rainfall expected across most of Australia until at least October. Consistent with this, the Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) expects farm production volumes to increase strongly in 2020/21, led by a strong recovery in the production of winter crops, such as wheat and canola (Graph 3.27; Graph 3.28). This is expected to more than offset a decline in livestock-related production as farmers rebuild herds and flocks following recent rainfall. ↗

Graph 3.26

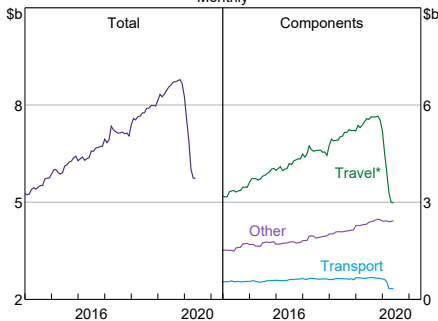
Trade in Goods and Services*
Current prices, quarterly



* Based on monthly data; seasonally adjusted by the RBA
Sources: ABS; RBA

Graph 3.25

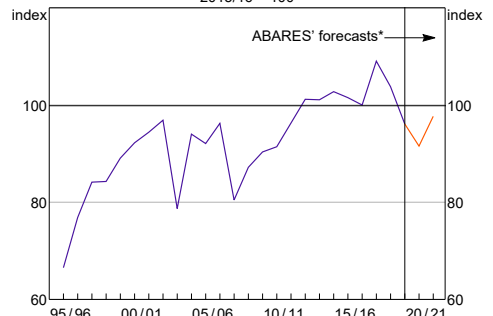
Service Export Values
Monthly



* Comprises mainly education-related travel and tourism; May and June 2020 are in original terms
Sources: ABS; RBA

Graph 3.27

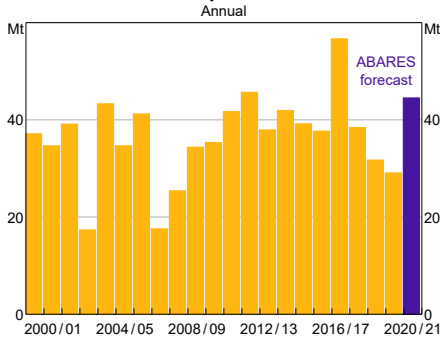
Farm Production Volumes
2015/16 = 100



* 2019/20 and 2020/21 forecasts
Source: ABARES

Graph 3.28

Winter Crop Production*



* Includes wheat, canola, barley, pulses, oats, safflower and triticale
Source: ABARES

4. Domestic Financial Conditions

In recent months, the Reserve Bank's comprehensive package of policy measures has kept funding costs low across the economy and continued to support the availability of credit for households and businesses. Financial market functioning remains much improved from the period of upheaval in March. Australian banks' funding costs have declined to historically low levels. This has flowed through to interest rates on housing and business loans, which are also at historic lows. Lenders have taken steps to ease loan payment obligations for households and businesses whose incomes have been adversely affected by the COVID-19 disruptions. About half of eligible authorised deposit-taking institutions (ADIs) have accessed the Bank's Term Funding Facility (TFF) and, on average, those ADIs have used around two-thirds of their initial allowance.

Conditions in government bond markets have normalised and yields on 3-year government bonds have been consistent with the target

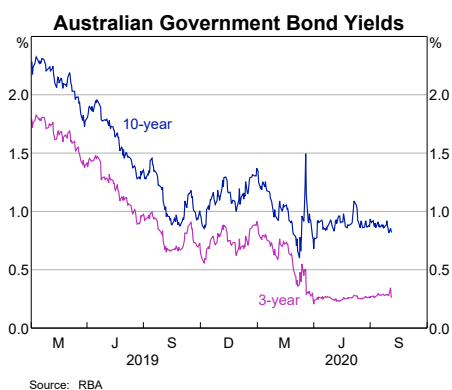
Following a large rise in volatility and severe impairment in market functioning in March, market conditions have improved noticeably in recent months. This improvement has been supported by the Bank's comprehensive policy actions, including the purchase of both Australian Government Securities (AGS) and bonds issued by the states and territory borrowing authorities (known as semi-government securities, or semis). Also, the yield on 3-year AGS has been consistent with the target of around 25 basis points. Meanwhile, yields on longer-term bonds have stabilised in a narrow range, alongside a reduction in volatility

in overseas financial markets (Graph 4.1). The differential between 10-year AGS yields and the yield on 10-year US Treasury bonds has been steady at around 20–30 basis points (Graph 4.2).

With government bond markets functioning well and the 3-year AGS yield consistent with the target of around 25 basis points, the Bank had not needed to purchase government bonds for much of May, June and July; this followed purchases of AGS and semis from March to early May that had amounted to around \$50 billion. However, the 3-year AGS yield had been a little higher than 25 basis points over recent weeks. Accordingly, in early August the Bank purchased AGS in the secondary market to ensure that the yield on 3-year bonds remains consistent with the target. Further purchases of AGS will be undertaken as necessary to meet the yield target. The Bank continues to stand ready to purchase AGS and semis to address dysfunction in government bond markets were it to reoccur.

The improvement in market conditions since March is evident in the narrowing in bid-offer

Graph 4.1



spreads on both AGS and semis, which have returned to their pre-crisis levels in recent months (Graph 4.3). Conditions in semis markets took a little longer than for AGS to return to a more normal state, reflecting a slower return of demand for semis (from longer term investors) and the usual approach of dealers to hold fewer semis on their balance sheet relative to AGS. Spreads between yields on semis and AGS are around or below the levels seen in late 2019 and early 2020 (Graph 4.4). Another indicator of the improvement in market conditions is the considerable narrowing in the bond-futures basis – the difference between the yield on a futures contract and the yield on the bonds underlying the contract, adjusted for the cost of financing the bonds (Graph 4.5). In addition, the ability to trade in bond futures without moving the price has recovered from the lows reached in mid March.

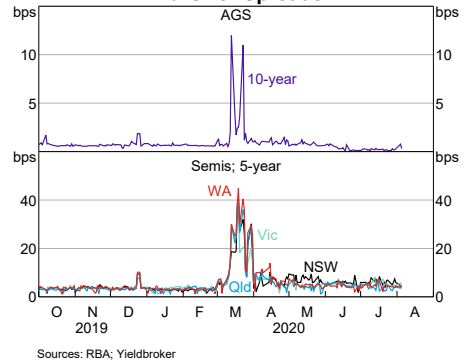
Financial markets have absorbed a large amount of government bond issuance

The improvement in market conditions has occurred amid significant issuance of government bonds (Graph 4.6). The Australian Office of Financial Management (AOFM) has issued around \$105 billion of AGS and \$48 billion of Treasury Notes since the beginning of May, a significant step-up in issuance reflecting the increased funding requirement for the COVID

19-related fiscal support. The increase in government debt expected for 2020/21 and the associated stock of debt outstanding are the

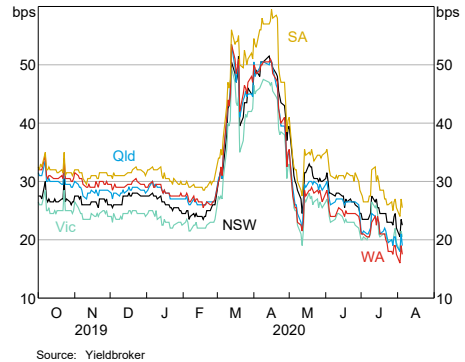
Graph 4.3

Bid-Offer Spreads



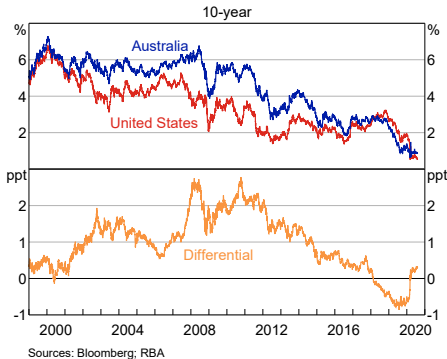
Graph 4.4

5-year Semi-government Bond Spreads to AGS



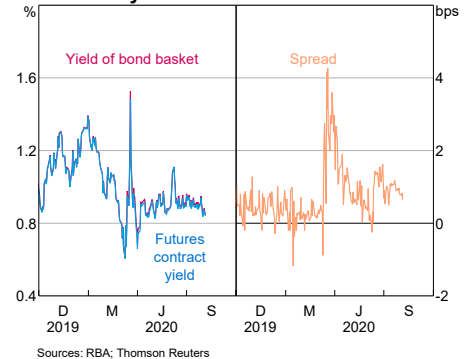
Graph 4.2

Government Bond Yields



Graph 4.5

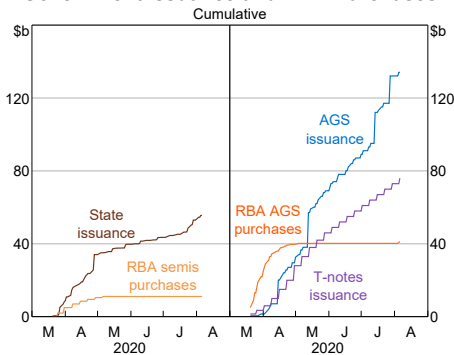
10-year Bond-Futures Basis



largest as a share of GDP in decades, although they are not unprecedented (Graph 4.7). The stock of debt as a share of GDP also remains low compared to other advanced countries. Demand at the AOFM's tenders has been consistently strong, including for the three largest AOFM syndications on record, which raised \$19 billion, \$17 billion and \$15 billion of the December 2030, November 2025 and June 2051 bonds, respectively. The pace of semi issuance has slowed in recent months, after having stepped up noticeably in April. Notwithstanding the marked increase in issuance, yields on AGS and semis are at historically low levels (Graph 4.8).

Graph 4.6

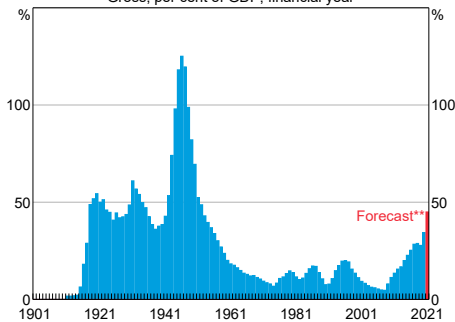
Government Issuance and RBA Purchases



Sources: RBA; Yieldbroker

Graph 4.7

Australian Government Debt*
Gross, per cent of GDP, financial year



* Historical series contain structural breaks and adjustments
** 2020 July Economic and Fiscal Update
Sources: ABS; Australian Treasury; Barnard (1986); Butlin (1985)

Liquidity in the banking system is high

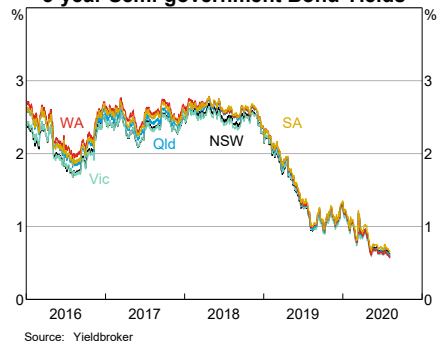
Liquidity in the banking system – as measured by banks’ exchange settlement (ES) balances held at the Reserve Bank – remains elevated. The substantial increase in liquidity in March and early April arose from the additional provision of liquidity via the Bank’s daily open market operations and purchases of government bonds. Since then, the Bank has changed how it conducts open market operations, moving from targeting a particular level of ES balances (and using price to allocate the funds), to meeting the demand of financial institutions at a steady repo rate. In doing so, the Bank has allowed ES balances to vary with changes in government spending and issuance, as well as financial institutions’ demand for liquidity (Graph 4.9). While bank demand for liquidity through open market operations has eased in recent months, use of the TFF has increased, with around \$30 billion drawn by early August (Graph 4.10). This has added to liquidity in the financial system in recent months and supported funding conditions.^[1]

The cash rate has remained low and market expectations are for this to continue

Reflecting the large increase in ES balances, the cash rate has remained below the 25 basis point target over recent months, at 13–14 basis points.

Graph 4.8

5-year Semi-government Bond Yields



Source: Yieldbroker

The decline in the traded cash rate below the target rate is consistent with the experience of other countries in which there has been a significant increase in cash reserves in the banking system, and was expected when the policies were implemented. Because of high system liquidity, activity in the overnight cash market remained low compared with historical norms (Graph 4.9). In recent months, on some days activity has dropped below the thresholds required to calculate a transaction-based value of the cash rate. The published cash rate on all but one of those days was set as the last cash rate published based on sufficient transactions, in accordance with the published fall-back

procedures.^[2] On one day, the published cash rate was set at a different rate that, in the expert judgement of the Bank, better reflected current market conditions. Financial market prices for the year ahead imply that participants expect the cash rate to remain little changed from current levels (Graph 4.11).

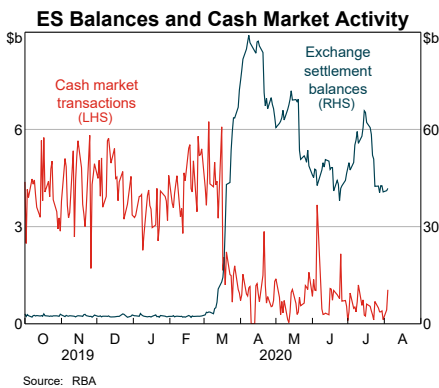
Money market rates are very low

The elevated liquidity in the system is ensuring that short-term money rates are at historically low levels. (Graph 4.12). The rates on three-month bank bills remain at around 10 basis points, a little below the cash rate. These very low rates reflect many alternative sources of funding for the large banks. Repo rates at the Bank's open market operations have been steady at 18 basis points, around 6 basis points above the overnight indexed swap rate. The implied cost of borrowing Australian dollars via the foreign exchange swap market has declined steadily, to be around 15 basis points. This largely reflects a decline in US dollar money market rates.

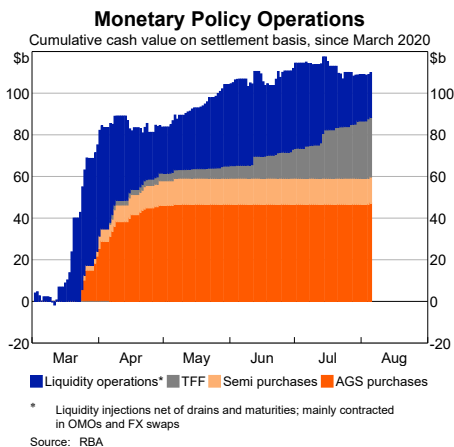
Banks' overall funding costs have declined to historically low levels

Banks' (non-equity) funding costs have declined further in recent months, as the Bank's package of policy measures has worked to lower

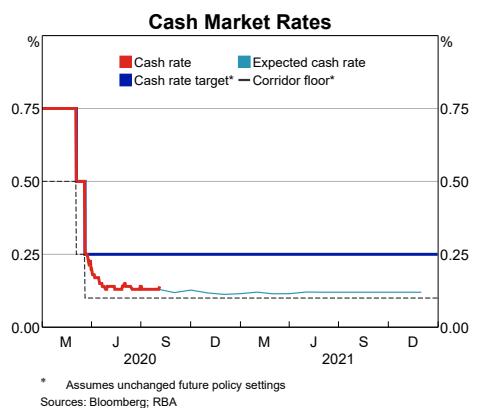
Graph 4.9



Graph 4.10



Graph 4.11



wholesale debt costs and wholesale and retail deposit rates (Graph 4.13). Much of the major banks' wholesale debt and deposit costs are ultimately linked (either directly or via hedging) to bank bill swap (BBSW) rates, which have declined by 65–70 basis points since the end of February.

In general, banks have good access to low-cost funding. The share of banks' overall funding from deposits has increased by 2 percentage points since the end of February this year, as the stock of deposits held at banks grew strongly over March and April (see 'Box D: Recent Growth in the Money Supply and Deposits'). Banks have also accessed low-cost funding under the TFF, and many have indicated that they will take up their allowances in full over time. The share of overall funding from wholesale debt has declined.

Deposit rates have fallen further and bank bond yields are at low levels

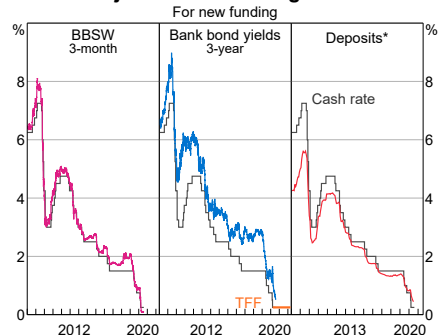
Banks have responded to the ready availability of low-cost funding by reducing deposit rates further. Interest rates for new deposits have declined by between 40–70 basis points since the end of February. Term deposit rates, which typically pay higher interest rates than at-call deposits, have declined by more than rates on other deposits (Graph 4.14). Lower deposit rates

have served to lower bank funding costs, with much of the recent increase in deposits flowing into transaction accounts that typically offer very low rates, often close to zero.

Yields on bank bonds are at historically low levels. This reflects low yields on AGS and swaps as well as low spreads to these reference rates. Indeed the spread of domestic bank bonds to AGS is the lowest it has been in at least the past 15 years (Graph 4.15).

Graph 4.13

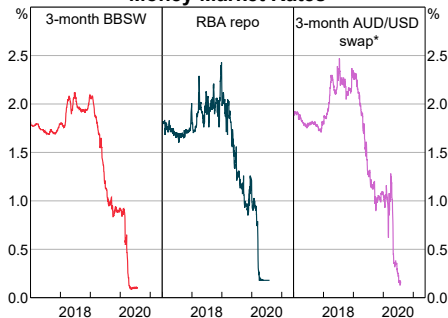
Major Banks' Funding Costs



* RBA estimates; excludes deposits in housing loan offset accounts
Sources: AFMA; APRA; ASX; Bloomberg; major banks' websites; RBA, Refinitiv

Graph 4.12

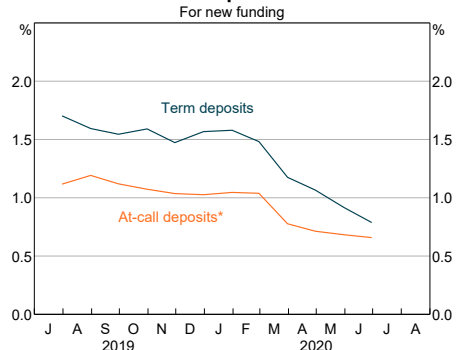
Money Market Rates



* Implied AUD cost via USD LIBOR funding and cross-currency swap
Sources: ASX; Bloomberg; RBA

Graph 4.14

Banks' Deposit Rates



* Includes deposits in housing loan offset accounts and non-interest-bearing deposits
Sources: APRA; RBA

Australian bank bond issuance has been low

Net issuance of bonds by the major banks has declined over the year thus far as maturities continue to exceed new issuance (Graph 4.16); this is consistent with strong liquidity positions, slow balance sheet growth, and access to lower-cost term funding through the TFF. By contrast, net issuance by non-major banks, which account for a much smaller share of the market, is within the range of previous years. Overall, Australian banks have issued around \$14 billion of senior bonds since March. In April, only covered bonds were issued, but there was some senior unsecured bond issuance after April. Australian non-major banks and local branches of non-resident banks accounted for most of this issuance.

Take-up of low-cost funding available from the TFF has increased

The TFF provides a guaranteed source of low-cost funding to ADIs, and an incentive to support lending to businesses, particularly to small- and medium-sized enterprises (SMEs) (Box E: The Reserve Bank's Term Funding Facility). Through the TFF, ADIs have access to three-year funding at a fixed interest rate of 0.25 per cent. The maximum size of the facility has increased from about \$90 billion at its inception to

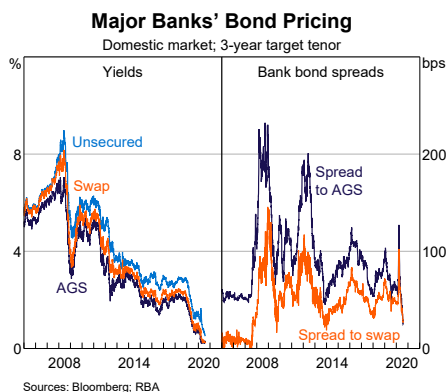
\$154 billion in August, reflecting business credit growth since the commencement of the scheme. The bulk of the allowance (the initial allowance of \$84 billion distributed across all ADIs) must be drawn by the end of September 2020, with the remainder (the additional allowance available to ADIs that have expanded lending to businesses) to be drawn by the end of March 2021.

In aggregate, the pace of drawdowns of the TFF has picked up in recent months (Graph 4.10). ADIs have drawn down around \$30 billion or 35 percent of initial allowances, up from around \$4 billion three months ago. Around half of eligible ADIs have accessed the TFF and, on average, those ADIs accessing the facility have used around two-thirds of their initial allowance.

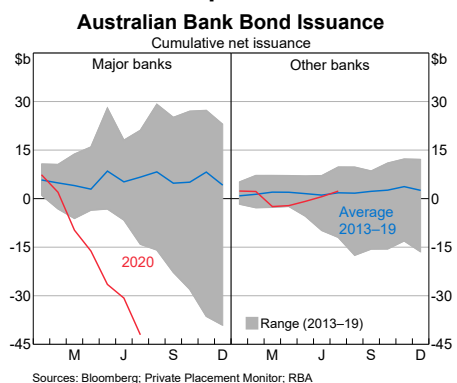
Interest rates on business loans have declined to historically low levels

The cash rate reductions and other policy measures announced in March have flowed through to interest rates on outstanding business loans. Interest rates on variable rate loans to large businesses have declined by 75 basis points since the end of February. For small and medium sized businesses, variable rates have declined by 60–70 basis points over the same period (Graph 4.17).

Graph 4.15



Graph 4.16



The average interest rate on unsecured loans extended through the government’s guarantee scheme to SMEs is close to the average interest rate on secured small business loans (most loans to SMEs are secured). Despite the generally low cost of these funds, take-up of the scheme-backed loans has remained low (see below).

Lending to businesses has decreased, largely reflecting weak demand for new loans

Lending to businesses decreased in recent months, unwinding about half of the substantial increase over March and April (Graph 4.18). The recent decline reflected large businesses repaying most of the lines of credit that had been drawn upon earlier as a precaution to shore up liquidity positions in response to the pandemic (Graph 4.19). Lending to SMEs was little changed over this time.

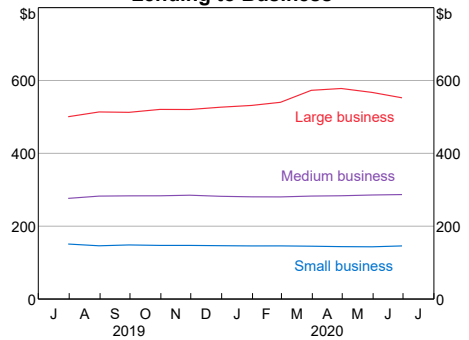
Demand for new loans appears to be low. This is likely to reflect businesses’ reluctance to take on debt, given considerable uncertainty about the economic outlook. Indeed, an ABS survey conducted in mid May showed that only 5 per cent of businesses identified access to credit as a requirement to return to normal trading conditions. A follow-up survey conducted in mid July showed that one in three businesses that received additional funds

through a tax credit reported using some of the funds to repay debt and a similar proportion reported putting funds into savings. The need for debt finance is likely to have been lessened by the various short-term initiatives that are helping many businesses (particularly SMEs) to cover operating costs. This includes the government’s income support measures, loan payment deferrals offered by banks and flexibility on rental payments for commercial tenants that have been significantly affected by COVID-19.

The supply of credit to businesses appears to have tightened a little but weakness in lending growth, particularly to SMEs, appears to be mostly driven by weak demand. To date, the tightening in supply mostly reflects a greater

Graph 4.18

Lending to Business*

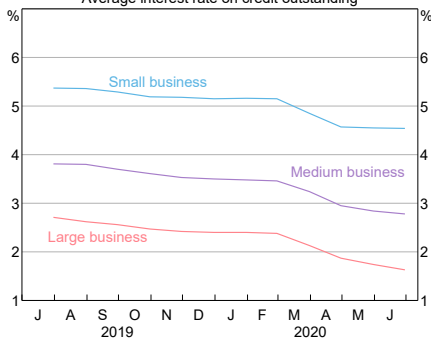


* Data covers financial institutions with \$2 billion or more in business credit
Sources: APRA; RBA

Graph 4.17

Business – Variable Lending Rates

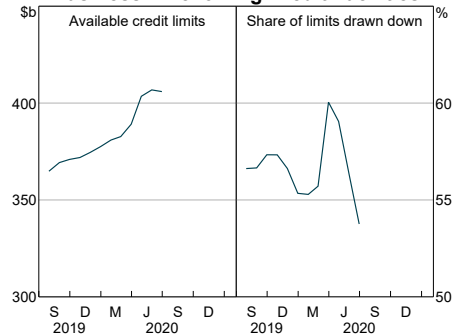
Average interest rate on credit outstanding



Sources: APRA; RBA

Graph 4.19

Business – Revolving Credit Facilities



Sources: APRA; RBA

degree of verification of borrowers' information rather than a tightening in lending criteria.

However, some banks have indicated in liaison that they are more cautious about lending to new customers and to sectors significantly affected by the pandemic, such as smaller retailers, tourism and commercial property.

Take-up of the government's \$40 billion SME loan guarantee scheme has remained low. Around \$1.6 billion of loan commitments have been made under the scheme, equivalent to around ½ per cent of SME lending outstanding. The low take-up is consistent with a lack of demand for credit in general. The government has announced changes to the scheme that will make it more flexible and extend its availability until June 2021 (it was previously due to end 30 September 2020). From October, under the new rules, the loans can be used for a variety of investment purposes (rather than limited to working capital), loans can be secured (but not against commercial or residential property) and SMEs will be able to borrow up to \$1 million for up to five years (up from \$250,000 and three years previously). In addition, a repayment deferral period will no longer be required. The quantity of funds potentially available at low cost through the scheme remains supportive of new lending should demand from businesses pick up.

About a fifth of SME loans (or around 10 per cent of all business loans) have been granted payment deferrals for up to six months. Banks recently announced that on a case-by-case basis, borrowers will be able to extend the deferral period by four months, but those businesses that have been severely impacted by the pandemic face the prospect of being placed on hardship programs.

In July, the Reserve Bank hosted the annual Small Business Finance Advisory Panel – drawn from small businesses across Australia – which provided valuable perspectives on the financial conditions small businesses currently face.

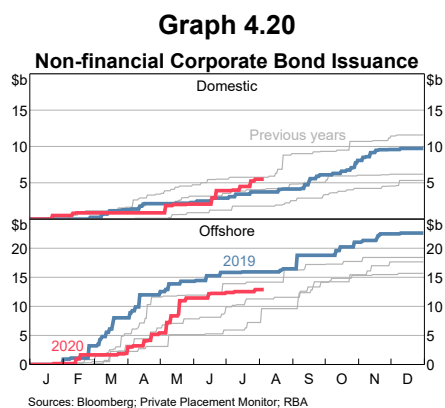
Conditions in the Australian corporate bond market have improved ...

The pace of non-financial corporate bond issuance picked up in the June quarter. Gross corporate bond issuance for the year to date is comparable to the average of recent years (Graph 4.20). At the peak of the market dislocation in March and April the only issuance by non-financial corporations was in the offshore market. In May, however, there was one large issuance into the domestic market, followed by further issuance more recently.

To assist with the smooth functioning of Australian capital markets, in May, the Reserve Bank broadened the range of corporate bonds eligible to be used as collateral in repurchase agreements (repos) with the Bank. Since the announcement, the Bank has had applications for more than 200 securities from around 75 issuers to be considered as eligible collateral. Over 120 applications have already been approved.

... and more Kangaroo bond issuers accessed the domestic market

Highly rated non-resident companies were the main issuers of bonds in the Australian non-government debt market during March and April. Around \$9.5 billion of Kangaroo bonds were issued in the June quarter of 2020, above the average quarterly issuance over the past few



years (Graph 4.21). Moreover, since mid May, more issuers (mostly non-resident banks) have been able to issue bonds with ratings below AAA in the Kangaroo bond market.

The market for asset-backed securities has benefited from ongoing government support

Since the March announcement of the Structured Finance Support Fund (SFSF), the AOFM has invested directly in the primary and secondary asset-backed securities (ABS) market and provided funding to securitisation warehouses. These measures contributed to the improvement of conditions in the ABS market. Accordingly, after low issuance of ABS in March and April, activity in the ABS market has increased more recently. This has been most noticeable for residential mortgage-backed securities (RMBS), with around \$8 billion of RMBS issued since the beginning of May (Graph 4.22). All these deals were issued by non-authorized deposit-taking institutions (non-ADIs) with varying degrees of support from the AOFM.

Housing interest rates have declined to new lows ...

Interest rates on variable- and fixed-rate housing loans have declined substantially in response to reductions in the cash rate and other measures

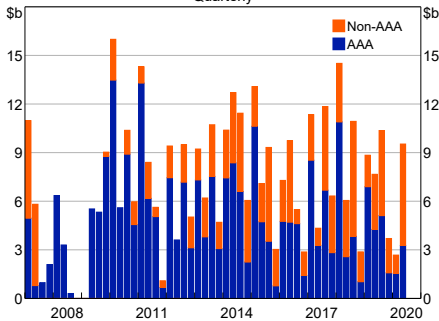
to ease financial conditions earlier this year. Standard variable rates (SVRs) have declined by an average of 28 basis points over that period (Graph 4.23; Table 4.1). While lenders have not made further changes to SVRs since the reduction in the cash rate target on 20 March, some have been offering lower variable rates on various products under promotion. Interest rates on outstanding variable-rate housing loans have declined by around 35 basis points since the end of February.

Rates for fixed-rate housing loans have declined sharply since the end of February this year, alongside a decline in the fixed interest rates derived from interest rate swaps (the benchmark for pricing fixed-rate loans; Graph 4.24). Most lenders have reduced their fixed interest rates across all maturities. Consistent with this, interest rates on new fixed-rate loans have declined by around 65 basis points over that period. The average outstanding fixed rate has declined by less than this, given the usual delays associated with the expiry of existing fixed-rate loan periods.

The interest rates on new fixed-rate loans are around 60–70 basis points below new variable interest rates. The recent decline in fixed rates relative to variable rates has contributed to an increase in the share of housing loan applications that are for fixed-rate loans, as

Graph 4.21

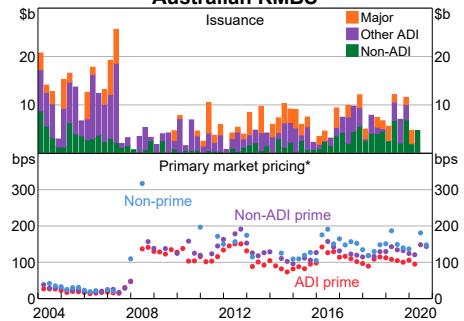
Kangaroo Bond Issuance
Quarterly



Sources: Bloomberg; RBA

Graph 4.22

Australian RMBS



* Face-value weighted quarterly average of the primary market spread to bank bill swap rate for AAA rated notes
Sources: Bloomberg; KangaNews; RBA

Table 4.1: Average Outstanding Housing Rates

June 2020

	Interest rate Per cent	Change since February 2020 Basis points
Variable-rate loans		
– Owner-occupier	3.24	–33
– Investor	3.61	–35
All variable-rate loans	3.37	–34
Fixed-rate loans		
– Owner-occupier	3.28	–45
– Investor	3.64	–37
By repayment type ^(a)		
– Principal-and-interest	3.28	–35
– Interest-only	3.88	–33

(a) Weighted average across fixed- and variable-rate loans

Sources: APRA; RBA

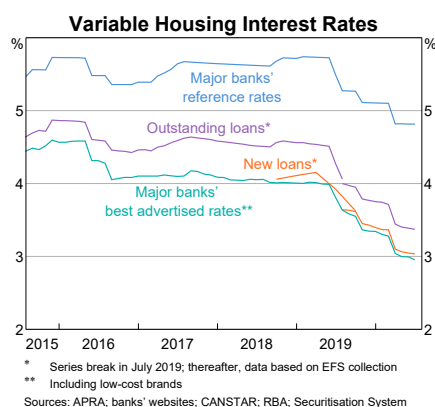
borrowers are refinancing from variable- to fixed-rate loans. As a result, there has been an increase in the share of the stock of outstanding loans that are fixed-rate, which now account for around 25 per cent of housing credit outstanding.

... partly reflecting strong competition and refinancing activity

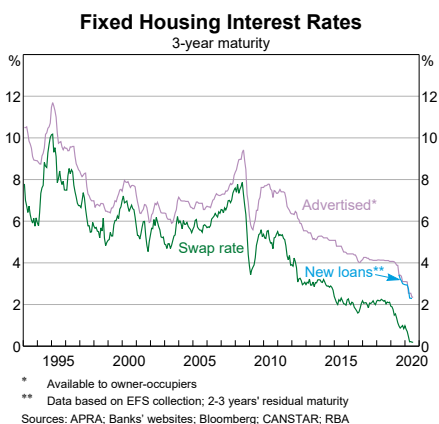
The continued drift down in interest rates paid on outstanding housing loans over the past few months partly reflects the effects of competition

for high-quality borrowers. This includes new customers and those willing to refinance their existing mortgages. External refinancing has risen sharply since March, consistent with the very low level of interest rates and offers of cash back to borrowers for refinancing an existing loan previously held with another lender (Graph 4.25).

Graph 4.23



Graph 4.24



Balances in housing loan offset accounts increased significantly in the June quarter

The reductions in housing loan interest rates following the reductions in the cash rate and the comprehensive policy package have been flowing through to borrowers by reducing interest payments on variable-rate mortgages (which account for around 80 per cent of the stock of outstanding housing credit; (Graph 4.26)). Reductions in interest payments in recent months are also consistent with the recent declines in fixed interest rates and an increasing share of borrowers refinancing to lower rate products.

By contrast, balances in mortgage offset and redraw accounts increased significantly in the June quarter. Over much of this period, most of the additional payments were into offset accounts (which are a type of deposit account and so do not reduce measured credit outstanding). This was consistent with many mortgage holders saving for precautionary reasons and reduced opportunities for spending as containment measures were introduced to limit the spread of the virus. Consistent with this, the increase in funds in offset accounts was particularly strong in April and May. Cash inflows from the early release of superannuation and

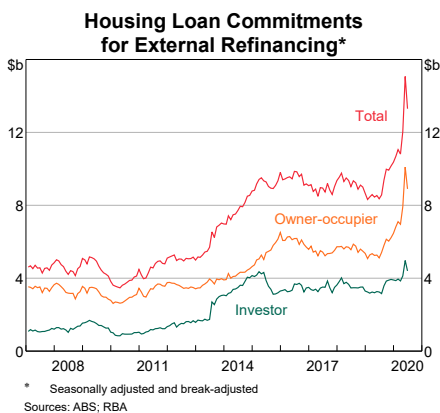
social assistance payments may also have contributed to more funds being placed in offset accounts.

Banks have announced that the six-month loan payment deferrals scheme, most of which were due to expire over the period September to October, can be extended by an additional four months on a case-by-case basis. As of June, 12 per cent of borrowers had been granted loan payment deferrals. However, one in five of those borrowers continued to make mortgage payments.

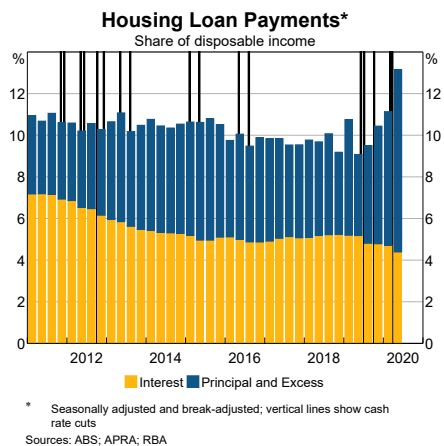
Commitments for new housing loans have declined and housing credit growth has slowed ...

In contrast to refinancing activity, new housing loan commitments have declined since the end of March this year (Graph 4.27). This follows the weaker housing market activity observed over that period. In liaison, some banks have indicated that demand for new housing finance has weakened. Uncertainty about the economic outlook associated with the pandemic, low turnover and the softer housing price outlook has reduced the demand for credit. In the month of June, housing loan commitments increased a little in most states (other than Victoria), alongside the easing of restrictions that

Graph 4.25



Graph 4.26



were put in place in response to COVID-19, as well as an improvement in some housing market activity indicators observed in May and June.

While the decline in loan commitments since March this year has been driven by a slowing in demand, lending standards have also tightened a little. Lenders are closely scrutinising the capacity to service loans for borrowers whose employment prospects or rental incomes have been impacted by COVID-19, and are requiring more recent verification of income than previously. Some banks have adjusted interest rates to make new loans with high loan-to-valuation ratios (LVRs) less attractive than new loans with low LVRs or lowered the maximum LVRs on new loans for customers that are self-employed and those residing in tourism-reliant regions. Overall, however, lenders have indicated in liaison that approval rates for housing loans remain high, even though the time to approve loans increased in recent months for some banks due to operational reasons amid high volumes of refinancing activity.

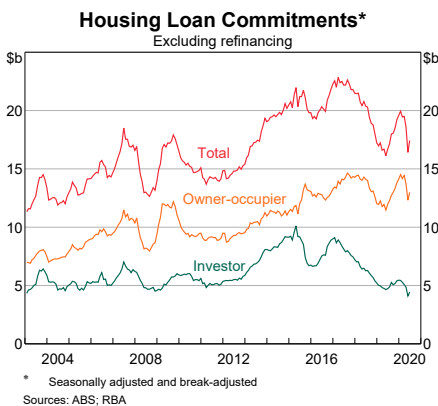
Growth in housing credit extended to owner-occupiers has slowed, reflecting the recent slowdown in housing market activity and the sharp decline in loan commitments (Graph 4.28). At the same time, owner-occupier credit has been boosted by loan payment deferrals and

increased refinancing activity that has seen some borrowers increase the size of their mortgages a little. Investor housing credit has continued to decline and the pace of decline is now $\frac{3}{4}$ per cent in six-month-ended annualised terms.

... contributing to a broad slowing in total credit growth

Growth in the stock of total credit outstanding has slowed in recent months (Graph 4.29; Table 4.2). This has largely reflected a decline in the stock of business credit outstanding, which fell by $4\frac{3}{4}$ per cent on a three-month annualised basis in June. Growth in total housing credit has slowed a little in recent months to $2\frac{3}{4}$ per cent on a three-month annualised basis. The stock of personal credit outstanding has fallen by $6\frac{1}{2}$ per cent since February, driven by declines in outstanding balances on credit cards and fixed-term loans. As discussed above, the slowing in credit growth for businesses and households mostly reflects softer demand for financing in the uncertain economic environment, although some ADIs have tightened lending standards for borrowers most adversely affected by COVID-19. Broad money growth rose sharply in March and April, reflecting strong growth in deposits (see

Graph 4.27



Graph 4.28

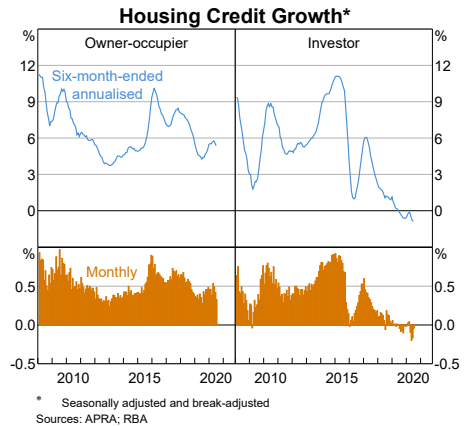


Table 4.2: Financial Aggregates

Percentage change^(a)

	Three-month annualised		Six-month annualised	
	Mar 2020	Jun 2020	Dec 2019	Jun 2020
Total credit	7.4	-1.1	2.7	3.1
– Household	2.3	0.9	2.3	1.6
– Housing	3.5	2.7	3.2	3.1
– Owner-occupier	5.6	5.1	5.5	5.4
– Investor	-0.1	-1.6	-0.6	-0.9
– Personal	-9.8	-18.5	-6.5	-14.3
– Business	18.5	-4.8	3.5	6.2
Broad money	14.8	17.2	4.7	16.0

(a) Seasonally-adjusted and break-adjusted

Sources: ABS; APRA; RBA

‘Box D: Recent Growth in the Money Supply and Deposits’).

Australian equity prices remain below the mid-February peak

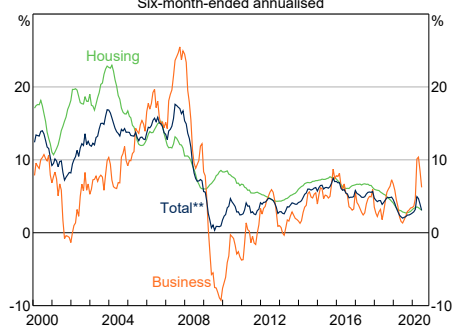
Australian equity prices have increased but remain around 15 per cent below the mid-February peak. This is broadly in line with overseas markets (other than the United States) when dividend payments are taken into account. The broad US equity index (S&P 500) has retraced most of its declines and is only a little below its mid-February peak, owing to the

strong growth in the equity prices of a range of IT related companies that have a large weight in the overall index (Graph 4.30).

Most sectors experienced a recovery in their share prices since the start of May, amid slightly more positive global sentiment buoyed by fiscal and monetary support, and positive news on the development of COVID-19 vaccines (Graph 4.31). Prices in the resources sector have increased by around 20 per cent, on the back of higher gold and iron ore prices. While share prices of energy companies have somewhat recovered following the stabilisation in oil prices, write-downs of properties and exploration

Graph 4.29

Credit Growth by Sector*
Six-month-ended annualised



* Seasonally adjusted and break-adjusted; including securitisation

** Includes housing, personal and business credit

Sources: ABS; APRA; RBA

Graph 4.30

Total Return Indices
End December 2014 = 100



Source: Refinitiv

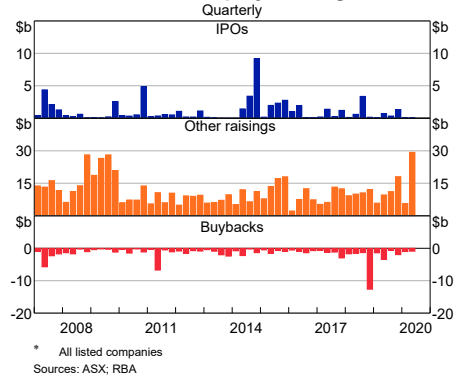
assets have accelerated, amid outlook uncertainty. Prices in the ‘other’ sector are around 5 per cent above their levels at the start of May. Within this sector, the information technology sector has outperformed, which is a common trend overseas, to be around 30 per cent higher.

The volume of equity raised by listed companies over recent months has been one of the highest globally. In total, listed entities have raised around \$29 billion from April to June 2020 (Graph 4.32). Sectors that were more heavily affected by the economic disruption due to COVID-19 raised the most capital as a proportion of their market capitalisation (Graph 4.33). Of note here were the industrial (e.g. airlines), consumer discretionary (e.g. travel services), and real estate (e.g. owners of commercial

properties) sectors. The information technology sector was the exception, with companies conducting raisings more so for strategic growth opportunities than for liquidity purposes. ↘

Graph 4.32

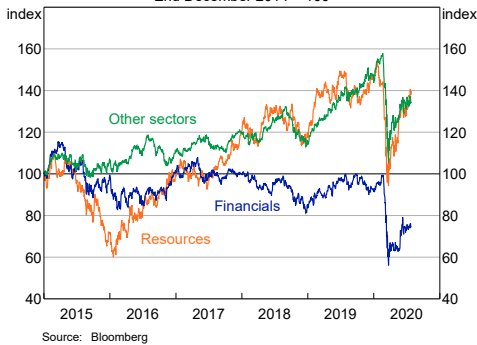
Australian Equity Raisings*



Graph 4.31

Australian Share Prices

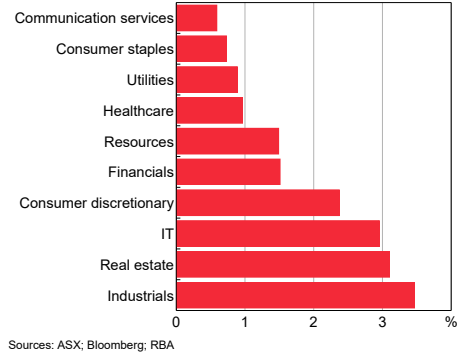
End December 2014 = 100



Graph 4.33

Capital Raising by Sector

Percentage of sector market capitalisation, April-June 2020



Endnotes

[1] Reserve Bank liquidity operations are described in more detail in Kent C (2020), ‘The Reserve Bank’s Operations – Liquidity, Market Function and Funding’, Online speech to KangaNews, Sydney 27 July. Available at <<https://www.rba.gov.au/speeches/2020/sp-ag-2020-07-27.html>>

[2] Kent C (2020), ‘The Reserve Bank’s Operations – Liquidity, Market Function and Funding’, Online speech to KangaNews, Sydney 27 July. Available at <<https://www.rba.gov.au/speeches/2020/sp-ag-2020-07-27.html>>

Box D: Recent Growth in the Money Supply and Deposits

There has been a significant increase in the money supply since February, reflecting strong growth in deposits. Large deposit inflows in March and April reflect the banking sector's provision of credit to the economy, changes to the composition of banks' funding related to changes in preferences of investors and a contribution from the Reserve Bank's purchases of government bonds. Deposit and money growth have slowed more recently.

Deposits and money are primarily born of credit

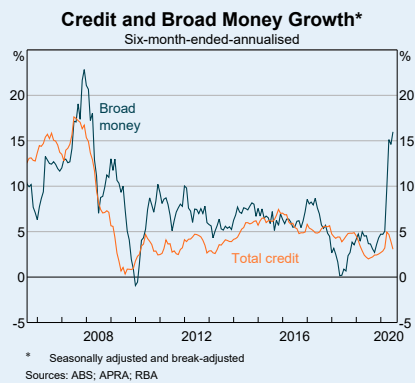
Measures of money grew strongly over March and April this year, reflecting growth in deposits at authorised deposit-taking institutions (ADIs; Graph D.1). Deposit and money growth are typically driven by new lending by the banking sector. Lending creates deposits as the funds made available to a borrower find their way into a deposit somewhere in the banking system, either as a deposit in the borrower's account, or in another account when the borrower uses those funds to make a purchase.^[1]

Business credit growth has created deposits

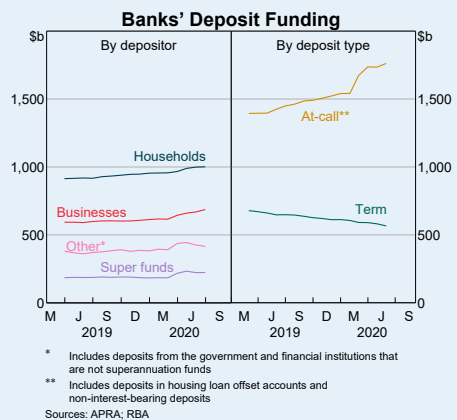
The banking sector recently extended more credit to the economy, which created new deposits in the banking system in the manner discussed above. Over March, much of this lending was to businesses, which in part reflected large companies drawing on lines of credit and holding these funds as deposits at the lending bank (Graph D.2). This borrowing was sizeable; new non-financial

business deposits accounted for around one-quarter of the total increase in deposits over March. It appeared to have been motivated by precautionary reasons, as businesses looked to shore up liquidity positions at the onset of the COVID-19 outbreak. A large part of the rise in credit to large businesses has since been repaid.

Graph D.1



Graph D.2



The increase in banks' holdings of government debt has created deposits

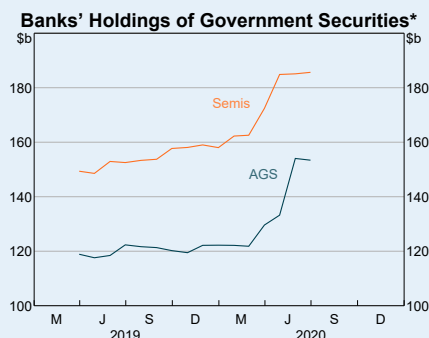
The purchase of government bonds by the banking sector can add to deposits in a similar way to the extension of credit to businesses and households.^[2] Banks have purchased some of the newly issued state government debt. In the first instance, those borrowed funds are held by the state governments as a deposit with a commercial bank until the funds are spent.^[3] In addition, when the banking sector purchases state government debt in the secondary market from the private (non-bank) sector, it credits the deposit account of the seller to pay for the transaction. In both cases, new deposits are created. Deposits have risen in recent months, as banks' holdings of state government debt have increased and as state governments have issued debt (Graph D.3).

Banks' holdings of Australian Government Securities have also risen recently, alongside an increase in Australian Government borrowing, which has contributed to the rise in bank deposits. However, the process of deposit creation is slightly different when the banking sector purchases debt issued by the Australian Government, since the Reserve Bank is the banker for the Commonwealth of Australia. When the Australian Government borrows from the banking sector, it holds the borrowed funds as a deposit at the Reserve Bank until the funds are spent. As the Australian Government spends these funds in the economy, such as in the form of JobKeeper payments to businesses, it adds to deposits held by businesses and, subsequently, to deposits of the household sector through employees of those businesses.

A decrease in the stock of bank bonds has contributed to bank deposits

The stock of outstanding bank debt has decreased since the end of February. Ample funding from other sources has meant that the banking sector has repaid more debt than it has issued. Some of that funding has come from the take-up of the Reserve Bank's Term Funding Facility. Some of the recent reduction in outstanding bank debt has also reflected the banking sector repaying debt held by superannuation funds, and the stock of deposits held by superannuation funds has risen accordingly. This occurred as superannuation funds sought to improve their liquidity positions through March and April, ahead of withdrawals related to the Government's scheme for early release of superannuation, and as part of their management of the liquidity impact from margin calls.^[4] These changes have added to the stock of deposits, as banks repaid debt by crediting the deposit account of the lender from which the funds are borrowed. These developments have seen the share of banks' overall funding from deposits increase since February this year, while the share of debt funding has declined (Graph D.4).

Graph D.3



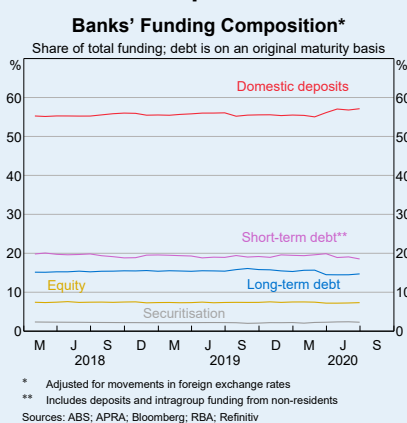
* Excluding holdings by banks' subsidiaries, foreign branches and other related entities
Sources: APRA; RBA

The Reserve Bank's purchases of government bonds have created deposits

As part of the package of monetary policy measures announced in mid March, the Reserve Bank began to purchase government debt from the private sector, to support the three-year yield target and address market dysfunction. Around \$50 billion of government bonds were bought from March

to early May, and around \$1 billion in early August. These bonds were purchased by the Reserve Bank from a panel of commercial banks via auction, and were paid for with newly created money credited into banks' Exchange Settlement Accounts (these balances do not count as deposits, as they are not held with the private banking sector). Some of these bonds sold by commercial banks would have been purchased from non-bank investors, generating a flow of funds into non-bank investors' deposit accounts.^[5]

Graph D.4



Deposit and money growth have slowed more recently

Large businesses have repaid a large part of the funding obtained by tapping into their lines of credit earlier in the year. This repayment has contributed to a slowing in deposit growth recently as well as a decline in business credit. In addition, since late April, the Reserve Bank's bond purchases have also been scaled back significantly. ❖

Endnotes

- [1] For more information, see Doherty E, B Jackman and E Perry (2018), 'Money in the Australian Economy', *RBA Bulletin*, September, and Kent C (2018), 'Money – Born of Credit?', Remarks at the Reserve Bank's Topical Talks Event for Educators, Sydney, 19 September. Available at <<https://www.rba.gov.au/publications/bulletin/2018/sep/money-in-the-australian-economy.html>> and <<https://www.rba.gov.au/speeches/2018/sp-ag-2018-09-19.html>>
- [2] This is not the case when a state or the federal government borrows money from the private (non-bank) sector. In this case, the funds are paid for using deposits from households and businesses, and, in time, government spending redistributes these deposits in the economy.
- [3] The Reserve Bank's monetary aggregates do not include deposits from government entities. However, these deposits are included in measures of banks' different types of funding.
- [4] This scheme allows for individuals to access up to \$10,000 tax-free in each of the 2019-2020 and 2020-2021 financial years. Around \$29 billion in withdrawals have been processed to-date.
- [5] In the case where the Reserve Bank buys bonds that were not on-sold to banks from non-bank investors, no new deposits are created.

Box E: The Reserve Bank's Term Funding Facility (TFF)

The TFF provides low-cost funding to the banking sector to support the supply of credit, particularly to businesses

The Reserve Bank's TFF was announced on 19 March 2020 as part of a comprehensive policy package to support the Australian economy in the face of economic and financial disruptions resulting from the COVID-19 pandemic. The TFF provides a guaranteed source of low-cost funding for the banking system, and so helps to support the supply of credit and lower interest rates for households and businesses. It also provides an incentive for authorised deposit-taking institutions (ADIs) to increase their lending to businesses, especially small and medium-sized enterprises (SMEs).

ADIs currently have access to over \$150 billion of TFF funding

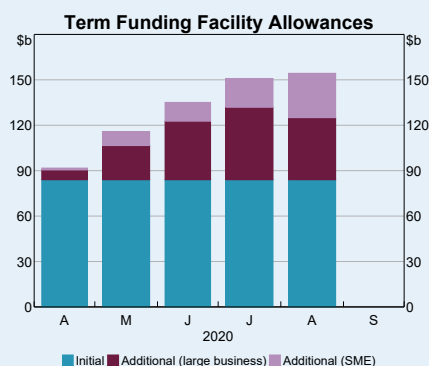
All ADIs that extend credit are eligible to participate in the TFF.^[1] This includes more than 130 Australian banks, credit unions and building societies, as well as foreign bank branches and subsidiaries operating in Australia. The amount that each ADI can borrow under the TFF is the sum of two allowances:

- *Initial allowance*: This was fixed at the start of the scheme to be equivalent to 3 per cent of each ADI's total credit outstanding. ADIs can access their initial allowance until 30 September 2020.
- *Additional allowance*: ADIs can access additional funding under the TFF if they expand their business credit, particularly for SMEs (those with turnover of less than

\$50 million). For every extra dollar of loans an ADI makes to large businesses, ADIs can access one additional dollar of funding from the Reserve Bank. For every extra dollar lent to SMEs, they have access to an additional five dollars of funding. ADIs are able to draw on their additional allowance, which is updated monthly, until 31 March 2021.

In total, ADIs currently have access to just over \$154 billion in secured three-year funding from the Reserve Bank (Graph E.1). This is equivalent to around 5 per cent of the stock of ADI credit outstanding. The initial allowance accounts for a little more than half (\$84 billion) of TFF funding currently available. The amount of funding available under the additional allowance – \$70 billion – has increased markedly since the scheme opened, reflecting an increase in business lending by various ADIs.

Graph E.1



* Initial allowance drawdown period ends 30 September 2020; additional allowance drawdown period ends 31 March 2021
Source: RBA

Around half of eligible ADIs have drawn on their TFF allowances to date

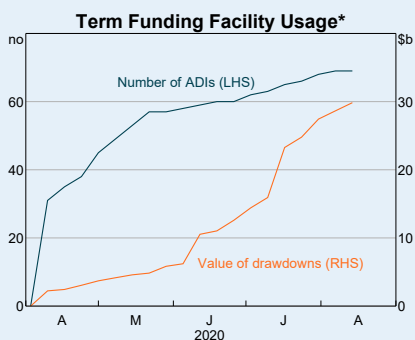
ADIs have drawn around \$30 billion of TFF funding since the scheme opened in April 2020 (Graph E.2). This consists of 34 per cent of the initial allowance and 2 per cent of the additional allowances currently available under the TFF. The 69 ADIs that have already drawn on the TFF have accessed, on average, around two-thirds of their initial allowance, although there is considerable variation across ADIs (Graph E.3).

TFF drawdowns increased gradually in the first months of the scheme. During this time

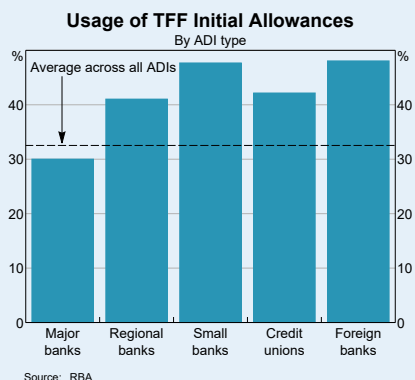
many ADIs experienced significant inflows of low-cost deposits (see Box D: Recent Growth in the Money Supply and Deposits), and they had also accessed low-cost short-term liquidity from the Reserve Bank's expanded open market operations, which had increased in size and maturity. Combined with expectations of modest credit growth, plentiful short-term liquidity meant that the demand for additional funds by many ADIs was modest.

Drawdowns of the TFF have picked up more recently as ADIs increasingly take up their initial allowance before the deadline of that part of the facility on 30 September. Many ADIs have indicated that they decided to spread out their drawings over the allowance period, which means that their TFF funding will mature in stages in three years' time. This suggests that drawings against the additional allowance may be spread out over the period to 31 March 2021. To date, the overall take-up of the TFF relative to the initial allowance has been consistent with the experience of similar term funding schemes overseas, such as the Bank of England's term funding facilities.

Graph E.2



Graph E.3



The TFF is helping to keep bank funding costs and lending rates low

The interest rate on TFF drawdowns – fixed at 25 basis points per year for three years – is substantially lower than other sources of ADI funding around the same term. The direct effect of the TFF on funding costs is relatively modest, as total TFF allowances account for a modest portion of ADIs' non-equity funding. However, the TFF also works through indirect channels to lower ADIs' funding costs and improve funding conditions. The availability of a low-cost funding alternative in an environment of modest additional funding

needs has lessened the demand by ADIs for other sources of funding. As a result, the TFF – jointly with the RBA's other policy measures – has contributed to the downward pressure on funding costs more broadly since February. This has helped to support credit

supply to the economy and has contributed to the decline in the borrowing rates faced by households and businesses to historically low levels in recent months. ↗

Endnotes

- [1] The Australian Government has a complementary program of support for the non-bank financial sector, small lenders and the securitisation market, which is being implemented by the Australian Office of Financial Management.

5. Inflation

As expected, there were large temporary price falls in the June quarter ...

The Consumer Price Index (CPI) declined by 2 per cent in the June quarter and 0.3 per cent over the year (Graph 5.1; Table 5.1). As anticipated, the fall in the CPI owed to unusually large temporary declines in a few price series. As a result, the June quarter saw the first decline in year-ended CPI inflation (excluding interest charges) since the early 1960s and the largest quarterly decline since 1931. Child care and some pre-school services were free for most of the quarter, and fuel prices also moved sharply lower; together, these price declines subtracted 2 percentage points from CPI inflation in the quarter. Rents also declined in the quarter as tenants have obtained discounts on existing rental agreements and travel restrictions led to increased supply in the longer-term rental market. In contrast, there were strong price increases for some food items and household goods that were in high demand under the social distancing measures. Looking ahead, CPI inflation will increase sharply in the September quarter as child care and pre-school prices progressively return to normal levels, and as fuel prices have rebounded from their May low.

Measurement challenges were prominent in the June quarter CPI. Headline CPI reflected price changes for 91 per cent of the CPI basket, as the remaining prices were unavailable to be collected in the quarter because of various containment measures. For the 9 per cent of items that were unavailable, which included for

example domestic and international holiday travel and sports participation, the ABS imputed prices using headline CPI.^[1]

The COVID-19 containment measures also led to large changes in consumption expenditure shares. For example, travel restrictions and social distancing requirements resulted in consumers spending more on home entertainment and groceries instead of going on international holidays and dining out (see 'Domestic Economic Conditions' chapter for more detail). However, the CPI measures price changes for a fixed basket of goods and services (representing the things that households typically buy).

Underlying inflation measures were around zero in the June quarter, although they too were affected by the price movements discussed above (Graph 5.2). Price falls for child care and automotive fuel, as well as the imputed price declines for unavailable items, account for much of the slowing in underlying inflation in the quarter. CPI inflation excluding imputed items, child care, pre-school and volatile items was positive but slowed to 0.2 per cent in the quarter. Overall, the large price changes resulting from changes to government policies and the measurement challenges during the quarter, make it more difficult to use the aggregate inflation measures to gauge the inflationary impulse in the economy.

Table 5.1: Measures of Consumer Price Inflation

Per cent

	Quarterly ^(a)		Year-ended ^(b)	
	June quarter 2020	March quarter 2020	June quarter 2020	March quarter 2020
Consumer Price Index	-1.9	0.3	-0.3	2.2
Seasonally adjusted CPI	-2.0	0.5	-	-
<i>Selected underlying measures</i>				
Trimmed mean	-0.1	0.5	1.2	1.8
Trimmed mean excl. imputed items	0.1	-	1.5	-
Weighted median	0.1	0.5	1.3	1.6
CPI excl. volatile items (c)	-1.3	0.6	0.4	2.1

(a) Except for the headline CPI, quarterly changes are based on seasonally adjusted data; those not published by the ABS are calculated by the RBA using seasonal factors published by the ABS

(b) Year-ended changes are based on non-seasonally adjusted data, except for the trimmed mean and weighted median

(c) Volatile items are fruit, vegetables and automotive fuel

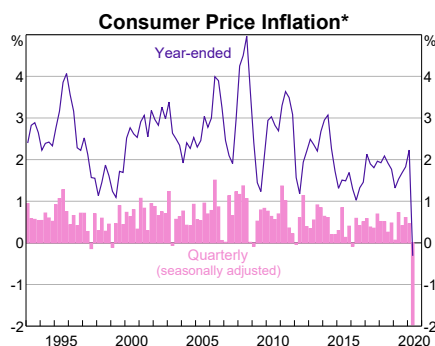
Sources: ABS; RBA

Government policies reduced administered prices

A number of government policies announced in response to the COVID-19 pandemic affected consumer prices significantly in the June quarter, most notably the introduction of free child care services from 6 April to 12 July 2020. The government subsidy, which also covered before and after school care services, led to a 95 per cent decline in child care prices in the June quarter (Graph 5.3). In addition, pre-school fees were waived for term two in New South

Wales, Victoria and Queensland. Together, these policies subtracted 1.2 percentage points from headline inflation in the June quarter (Graph 5.4). Inflation will rebound in the second half of 2020 as these subsidies are progressively removed. Child care fees resumed on 12 July, while pre-school remains free until after term 3 in NSW and Victoria. On 5 August, the Australian Government announced increased funding to allow Victorian child care facilities to re-introduce fee waivers.

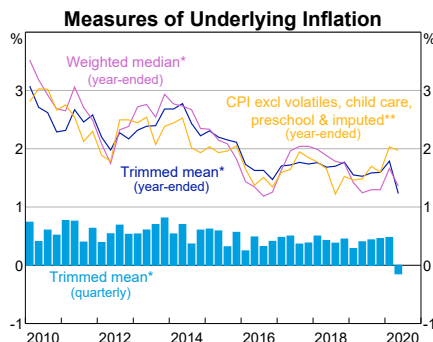
Graph 5.1



* Excludes interest charges prior to the September quarter 1998; adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

Graph 5.2



* Seasonally adjusted

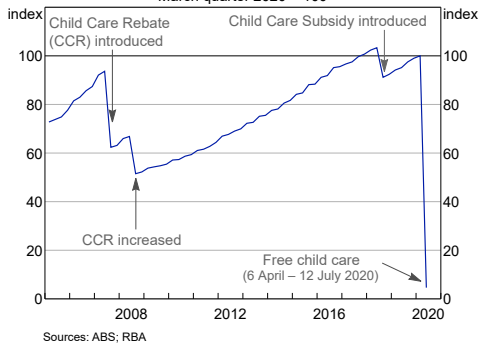
** Not seasonally adjusted; excludes fruit, vegetables & automotive fuel, child care, preschool & primary education and imputed items

Sources: ABS; RBA

There was also a decline in medical and hospital services prices in the quarter. The government increased bulk billing incentives during the pandemic, which reduced health costs. Private health insurance premiums had been scheduled to increase by 2.9 per cent in April; however, most private health insurers deferred the scheduled increase for at least six months. Scheduled increases in state government fees and charges typically occur at the start of July, but a number of state governments have announced price freezes for state-administered charges until 2021. These freezes, along with delays in the finalisation of government budgets, are likely to hold property rates, motor vehicle-related charges and public transport fares steady throughout most of the year.

Graph 5.3

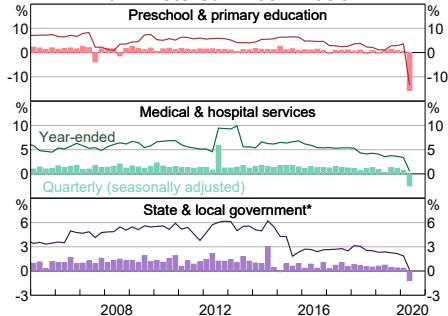
Child Care Prices
March quarter 2020 = 100



Sources: ABS; RBA

Graph 5.4

Administered Price Inflation



* Includes urban transport fares, property rates & charges and other services in respect of motor vehicles

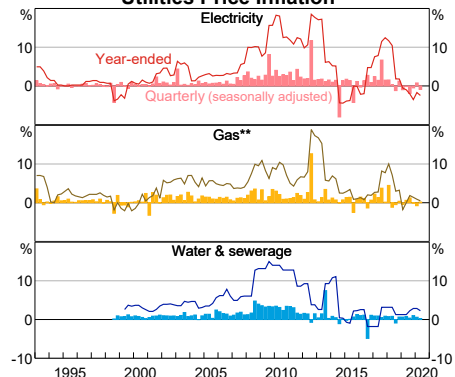
Sources: ABS; RBA

Utilities prices declined in the June quarter, reflecting the introduction of new rebates in several states (Graph 5.5). The Australian Capital Territory and Western Australian governments increased the rebates they offer to concession customers as part of their COVID-19 policy response. The Queensland Government quadrupled the size of the annual electricity asset ownership dividend that is applied to households' electricity bills, which led to a 15 per cent decline in Brisbane electricity prices in the quarter.

Utilities inflation has been subdued for the past 18 months and is likely to remain low for some time. Wholesale electricity prices have declined in most states since early 2019 because renewable energy projects have increased generation capacity. Wholesale gas prices have also fallen in recent months alongside lower international prices. The Default Market Offer, which places a cap on standing offer electricity prices in New South Wales, South Australia and southeast Queensland, was reduced in July. The Australian Capital Territory, Northern Territory, Tasmanian and Western Australian governments have also announced that they will freeze utilities prices until 2021.

Graph 5.5

Utilities Price Inflation*



* Adjusted for the tax changes of 1999–2000

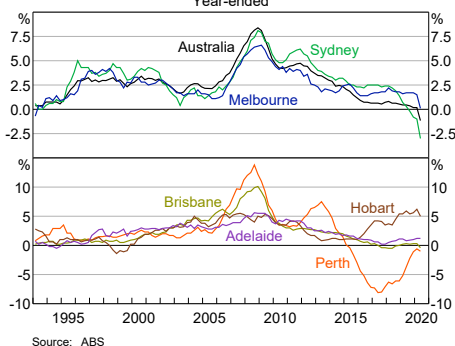
** Includes other household fuels

Sources: ABS; RBA

Rents also declined in the quarter

Housing-related inflation slowed sharply in the June quarter. Rents declined for the first time in the 45-year period for which quarterly rents data are available (Graph 5.6). The supply of properties available for long term rental has increased since the outbreak of COVID-19; the introduction of travel restrictions encouraged some landlords that were previously supplying short-term holiday accommodation to instead put their properties on the longer-term rental market. State governments have introduced mechanisms to enable tenants who have become unemployed or lost income due to COVID-19 to negotiate rent reductions. Information from liaison contacts suggests that around 5 per cent of residential tenants have successfully negotiated rent reductions since the end of March. Rent reductions for ongoing tenancies directly affect measured rent inflation because the CPI captures rents paid on the stock of existing rental properties. Rent relief as part of land tax rebate schemes and public housing rent reductions also contributed to rent price falls in some states in the quarter. Rent declines in the June quarter were largest in Sydney and Melbourne where renegotiations were most prevalent and where the international travel restrictions have led to the most pronounced increase in rental stock.

Graph 5.6
Rent Inflation
Year-ended



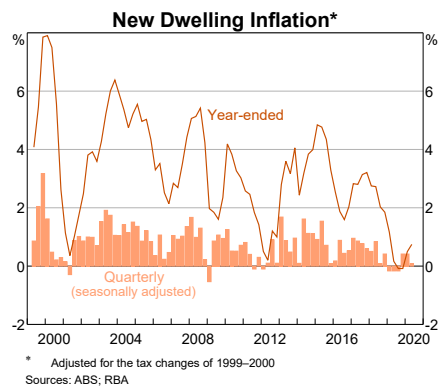
Source: ABS

New dwelling price inflation moderated in the June quarter (Graph 5.7). Increased demand for new housing in late 2019 and early 2020 had allowed some builders to raise base prices early in the year, while bonus offers and purchase incentives had become less prevalent. However, demand for new dwellings declined in the June quarter. Future price increases will depend on how fast housing demand recovers following the COVID-19 shock. Information from liaison suggests that the Australian Government's HomeBuilder package is boosting demand in the near term, particularly for new detached housing.

Market services inflation remains subdued

Market services inflation, which includes household services such as hairdressing, as well as financial services and meals out & takeaway, slowed in the June quarter (Graph 5.8). Social distancing measures resulted in a number of household services and their respective prices being unavailable for part or all of the June quarter. The ABS constructed price estimates for unavailable items using the price change for a similar or substitute product; for example, restaurant prices were imputed using takeaway food prices. For domestic and international holiday travel, sports participation and other

Graph 5.7



* Adjusted for the tax changes of 1999-2000
Sources: ABS; RBA

recreational, sporting and cultural services, the ABS imputed prices using headline CPI.

Some retail prices increased strongly in the quarter

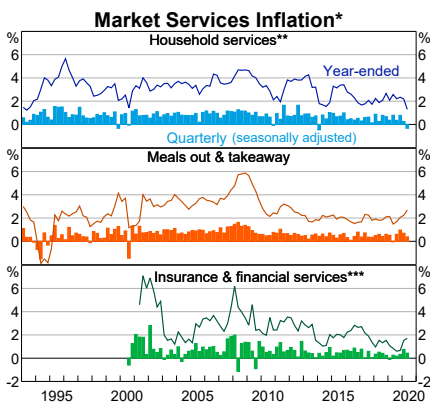
Retail prices increased in the June quarter. Prices for non-durable household goods such as personal hygiene and cleaning products rose as some supermarkets stopped discounting on the back of increased demand for these items. Strong demand alongside the introduction of lockdowns and working from home measures caused price rises for furniture and household appliances (Graph 5.9). In contrast, prices for clothing and footwear declined sharply as retailers offered significant discounts early in the quarter in an attempt to drive sales.

Food prices also increased strongly in the June quarter on the back of sustained demand. Some supermarkets stopped discounting in late March because of increased demand as households prepared for an anticipated period of social distancing. Strong demand for food items continued for the first half of the June quarter but, by the end of the quarter, discounting behaviour for some products had returned to normal. Price pressures were most evident for

longer-life supermarket items, such as pasta, tinned food and frozen meals (Graph 5.10). Meat prices increased further as improved rainfall conditions in Eastern Australia induced some farmers to restock, reducing the supply of meat.

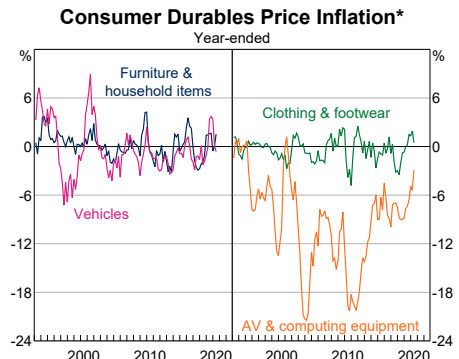
Fuel prices declined sharply over the first half of 2020 as activity restrictions suppressed global demand for oil (Graph 5.11). The 19 per cent decline in the June quarter subtracted 0.7 percentage points from quarterly headline CPI. Fuel prices rose a little in the month of June and the increase has been sustained throughout the first month of the September quarter; at current levels, automotive fuel prices are expected to boost headline CPI by close to ½ percentage points in the September quarter.

Graph 5.8



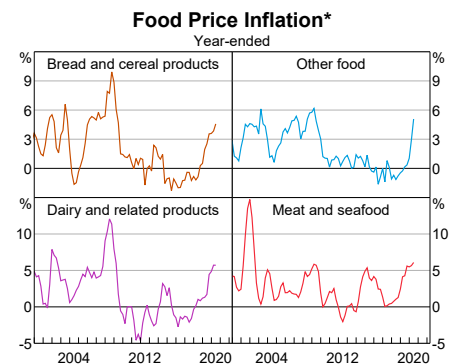
* Adjusted for the tax changes of 1999–2000
 ** Includes home cleaning, vehicle repairs, hairdressing, veterinary services, sports and leisure services
 *** Excludes deposit & loans to June quarter 2011
 Sources: ABS; RBA

Graph 5.9



* Adjusted for the tax changes of 1999–2000
 Sources: ABS; RBA

Graph 5.10



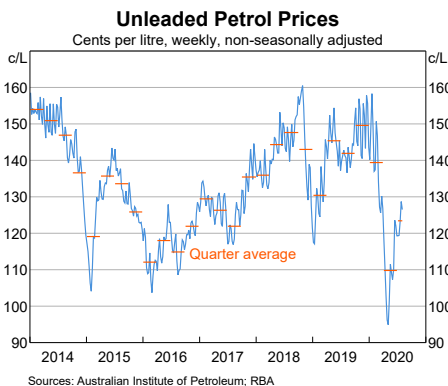
* Adjusted for the tax changes of 1999–2000
 Sources: ABS; RBA

Inflation expectations have declined since the outbreak of COVID-19

Wage- and price-setting behaviour can be affected by expectations about the future rate of inflation. Market economists have revised up their inflation expectations for the year ahead, likely due to the recovery in fuel prices and the rebound in child care prices over the remainder of 2020 (Graph 5.12). Unions expect inflation to remain well below 2 per cent in June 2021. Households' inflation expectations have also declined over the past six months; the share of households expecting prices to rise over the next year is now at a historical low. Long-term survey-based measures of inflation expectations are little changed at around 2–2½ per cent and remain consistent with the Bank's medium-term inflation target (Graph 5.13).

Short- and long-term market-based measures of inflation expectations have both declined since the outbreak of COVID-19 in early 2020. However, these measures have been significantly affected by dysfunction in these markets in the months following the initial COVID-19 shock. Since May, market functioning has improved and market-based measures have increased.

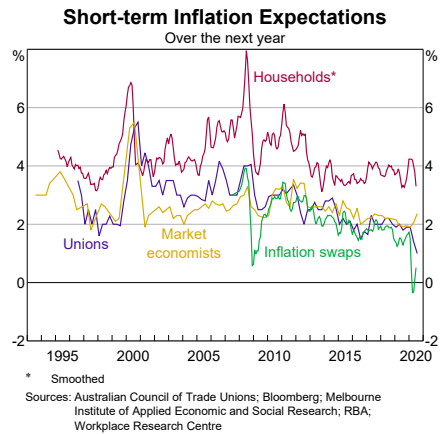
Graph 5.11



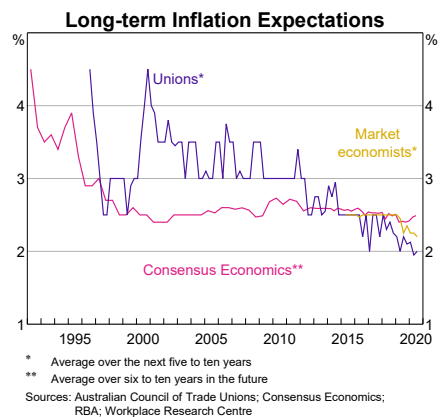
Liaison suggests there have been widespread wage freezes

The ABS payrolls data show that the wage bill has fallen 5 per cent between mid March and mid July (Graph 5.14). Employee earnings declined over April and May, as employment and average hours worked fell sharply, but have recovered a little since then. The JobKeeper wage subsidy program has provided substantive support for wages. Around one-quarter of JobKeeper-supported employees effectively received an increase in earnings as a result of the flat JobKeeper payment of \$1,500 per fortnight. In addition, job losses were more prevalent in lower-earnings industries and age groups, which

Graph 5.12



Graph 5.13



helps explain why the decline in jobs has been larger than the decline in the wage bill.

Information from liaison suggests that a sizeable share of employees had remuneration reviews delayed, wages frozen, or had wage cuts in recent months. More than 10 per cent of liaison contacts have reported COVID-related wage cuts; the wage cuts have typically been targeted towards senior management, but broader wage cuts for all staff have also been implemented by some firms. The vast majority of wage cuts are expected to be unwound as business conditions recover. The proportion of liaison contacts implementing wage cuts is significantly higher than during the Global Financial Crisis. Wage freezes have also been implemented for some employees in the public sector, notably Commonwealth and Queensland government employees. Under current policies, previously agreed wage increases have been deferred for up to 12 months.

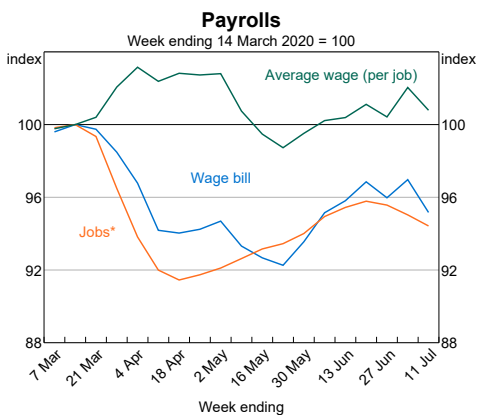
Wages growth is expected to slow in the year ahead

Looking ahead, wages growth is likely to remain weak. Around 35 per cent of firms in the liaison program expect to implement a wage freeze in the year ahead (Graph 5.15). Overall, around half

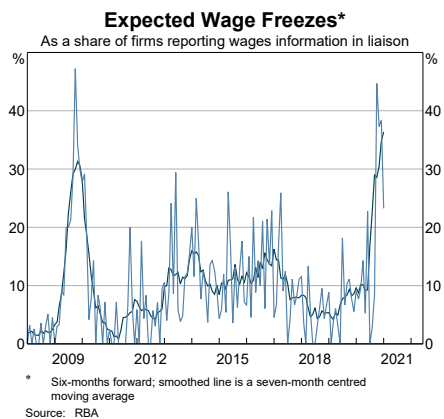
of the surveyed firms expect wages growth to be lower in the year ahead than the current rate of growth, as a result of wage freezes and smaller wage increases.

The Fair Work Commission (FWC) determined that the National Minimum Wage and all award wages will increase by 1.75 per cent, which is lower than the outcomes in recent years (Graph 5.16). The timing of the increase will be staggered across the economy in recognition of the uneven effects of the containment measures. From 1 July, around 25 per cent of award-reliant employees in areas like health care and primary and secondary education received the wage increase. Award rates covering a further 40 per cent of award-reliant employees in areas including construction and manufacturing, which have faced some adverse effects from the pandemic, will increase from 1 November. The remainder, including awards in accommodation & food services, arts & recreation, and aviation, were deemed to be the most affected by the pandemic and related restrictions, and award rate increases have been delayed until 1 February. The FWC decision directly affects around 13 per cent of the wage bill, while another 12–20 per cent of employees on collective or individual agreements have their pay set with reference to the decision or the relevant award.

Graph 5.14

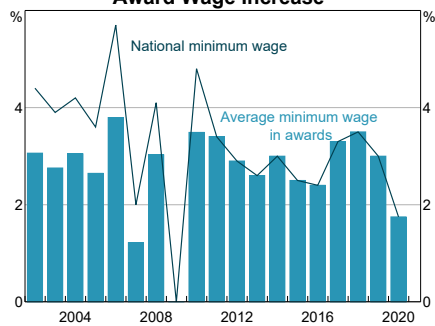


Graph 5.15



Graph 5.16

Award Wage Increase*



* RBA calculations; the time period over which each increase applies varies

Sources: AFPC; AIRC; FWC; RBA

The ABS has indicated that the JobKeeper payment will have no direct impact on the wage price index (WPI) as it is a wage subsidy. However, they will publish additional series to capture hourly income growth including the JobKeeper subsidy.^[2] It will be important to consider all measures of income growth in an assessment of changes to employee earnings over this period. ✎

Endnotes

- [1] The ABS released a paper which sets out its approach to imputation of unavailable prices: abs.gov.au/ausstats/abs@.nsf/Latestproducts/1359.0Main%20Features3Jun%202020?opendocument&tabname=Summary&prodno=1359.0&issue=Jun%202020&num=&view=>
- [2] The ABS released a paper which sets out its approach to measuring the WPI during the COVID-19 pandemic: abs.gov.au/ausstats/abs@.nsf/Latestproducts/1359.0Main%20Features15Jun%202020?opendocument&tabname=Summary&prodno=1359.0&issue=Jun%202020&num=&view=>

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).

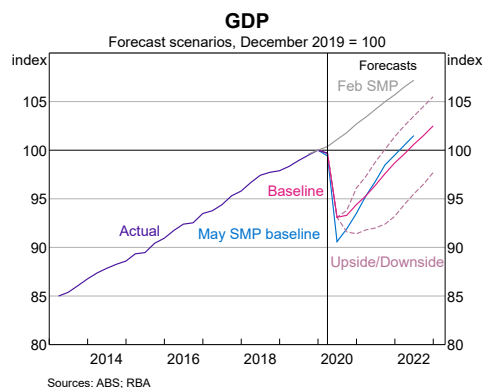
The profile for GDP over the second half of the forecast period is broadly similar to the baseline scenario presented in the *May Statement* (Table 6.1). However, the pace of recovery in the unemployment rate is now expected to be more gradual.

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,

Graph 6.1



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

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

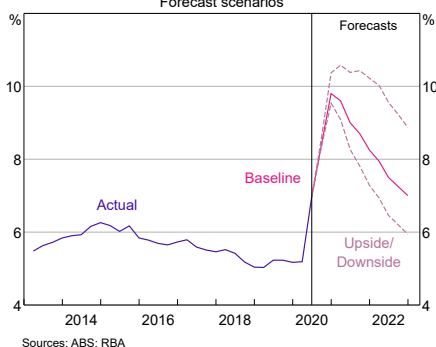
Overall, employment is expected to decline further over the second half of the year, as job losses from activity restrictions in Victoria and the tightening of the JobKeeper program more than offset a continued recovery in jobs elsewhere in the economy. Total hours are expected to decline a little further 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,

Graph 6.2
Unemployment Rate
Forecast scenarios



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.

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.

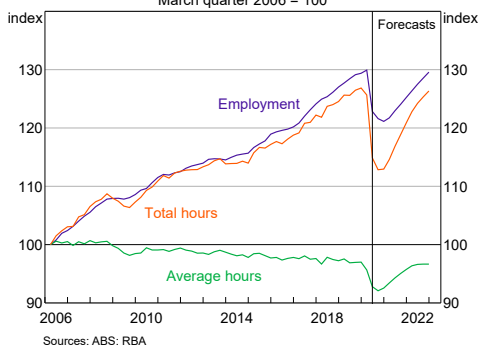
Business investment

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

Graph 6.3

Employment and Hours Worked

March quarter 2006 = 100



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.

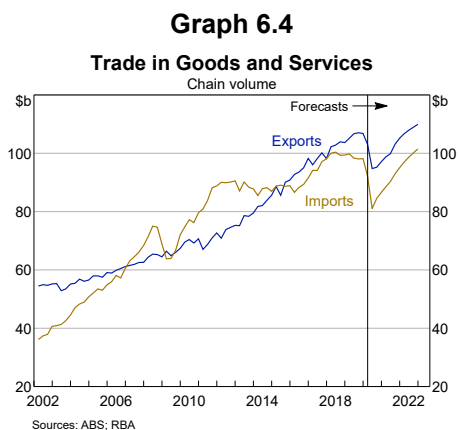
Consistent with the lower wages profile, inflation is also expected to be a little lower than expected in the baseline scenario of the May *Statement* (Graph 6.5). After a brief rebound in

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.

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.

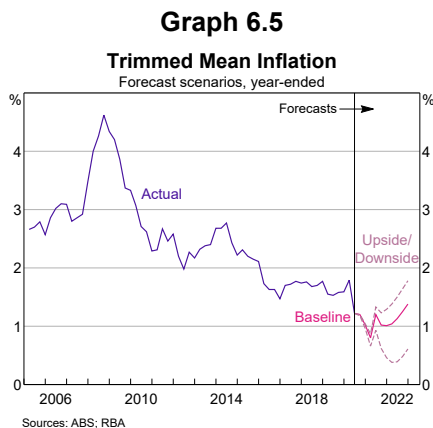
The upside scenario presented here assumes that, even if a vaccine is developed soon, it will

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.

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. ❖

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HILDA

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