5. Economic Outlook

The outlook for the global economy has improved since the November *Statement on Monetary Policy*. While the global recovery lost a little momentum late last year after a resurgence of COVID-19 infections in some economies, a number of vaccines have been approved and vaccinations have begun. Fiscal and monetary policy also remain very expansionary and, in some economies, fiscal support may increase further in the period ahead. The pace of the recovery will continue to vary across economies and, in many, the recovery will remain incomplete over the forecast period. Underlying inflationary pressures are likely to remain subdued globally for some time given considerable spare capacity.

Growth in Australia's major trading partners is expected to be a little stronger than at the time of the November *Statement* (see 'The International Environment' chapter). Part of this upgrade stems from a better starting point: activity in Australia's major trading partners was generally stronger than expected in the September quarter and recent virus outbreaks do not appear to have fully offset this. The outlook for Australia's major trading partners is a little stronger than for the rest of the world because some large trading partners – China and a few advanced east Asian economies – have been successful in suppressing infections and are benefiting from a strong recovery in their merchandise exports.

The recovery in the domestic economy has been sustained over recent months, supported by better health outcomes and a further expansion in monetary and fiscal policy in the second half of last year. In the baseline scenario, forecasts for GDP and employment growth have been upgraded relative to the November *Statement*, largely reflecting a stronger starting point for the forecasts. As a result, GDP and employment are expected to reach their pre-pandemic levels over the course of 2021, around 6–12 months earlier than previously expected. The unemployment rate is likely to have already peaked and is now expected to decline steadily to around 5¼ per cent by mid 2023.

Although these are materially better outcomes than previously expected, the level of GDP is still expected to remain below that forecast at the time of the February 2020 *Statement*. This partly reflects a smaller population; in per capita terms, the shortfall in GDP is less pronounced but still material. Spare capacity in the labour market is expected to remain elevated over the forecast period, and both wages growth and underlying inflation are expected to remain below 2 per cent.

The economy is now transitioning beyond the initial 'snapback' phase, which was underpinned by favourable health outcomes, the faster-than-expected lifting of activity restrictions and very substantial policy support. The nature and speed of the next phase of the domestic recovery remains uncertain and is expected to be uneven for some time yet. Beyond the risks associated with the virus, a key uncertainty is how Australian households and businesses respond and adapt to the tapering of some fiscal and other temporary support measures in coming quarters following the extraordinary boost to cash flows they received last year.

The baseline scenario assumes that no further large outbreaks of COVID-19 and accompanying hard lockdowns occur within Australia and that restrictions, when imposed, are brief. The domestic vaccination program is assumed to proceed in line with government guidance, and the international border is assumed to remain closed until the end of 2021. Under this scenario, GDP is expected to have contracted by around 2 per cent over the year to December 2020, but then grow by around 3½ per cent over both 2021 and 2022. Inflation is expected to pick up a little alongside the gradual decline in the unemployment rate, to be 1¾ per cent by mid 2023.

Given the high degree of uncertainty around the outlook, 2 alternative scenarios (upside and downside) are considered to assess the potential economic impact of different health outcomes. In summary:

- A stronger economic recovery than the one outlined in the baseline scenario is possible if ongoing low case numbers in Australia and a sustained run of positive health outcomes enable a faster easing of domestic restrictions. These outcomes would boost consumer and business confidence and reduce uncertainty, leading to a stronger recovery in private consumption and investment. In this scenario, a stronger rebound in activity would see the unemployment rate decline at a faster pace, falling to around 4¾ per cent by the end of 2022.
- Alternatively, a plausible downside scenario is that Australia experiences further large outbreaks of the virus. It is assumed that this would require broad activity restrictions to be reimposed, though not the extended lockdowns assumed in previous downside scenarios. In this scenario, consumer and business confidence would be weaker and the recovery in household consumption and business investment would be slower than in the baseline scenario. As a result the unemployment rate would peak in this scenario at around 6¾ per cent in mid 2021 and decline only slowly in 2022.

The recovery in domestic activity is well under way, but substantial spare capacity remains

The stronger-than-expected recovery in the second half of last year is primarily responsible for lifting the forecast level of GDP by around 1½ per cent across the forecast period. GDP is now expected to return to pre-pandemic levels by the middle of this year. The faster-than-expected removal of social distancing restrictions and recent policy measures are assessed to have pulled forward GDP growth from 2021 into the latter part of 2020, although GDP growth in 2022 is still broadly unchanged (at a higher level) relative to the November *Statement* (Table 5.1; Graph 5.1).

The recovery in household spending and an increase in public demand led the initial rebound in activity and are expected to be the main contributors to GDP growth over coming quarters. A pick-up in business investment is anticipated to lag the recovery in other components of private demand. Many firms are expected to fully utilise their existing capacity

Graph 5.1

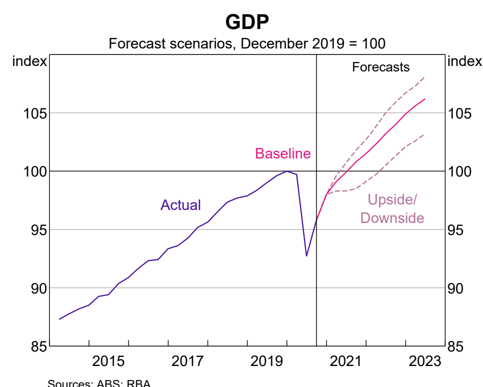


Table 5.1: Output Growth and Inflation Forecasts[(a)(b)]

Per cent

	Year-ended					
	Dec 2020	June 2021	Dec 2021	June 2022	Dec 2022	June 2023
GDP growth	−2	8	3½	3½	3½	3
(previous)	(−4½)	(6)	(4½)	(3½)	(3½)	(n/a)
Unemployment rate[(c)]	6.8	6½	6	5½	5½	5¼
(previous)	(7¾)	(7¼)	(6¾)	(6½)	(6¼)	(n/a)
CPI inflation	0.9	3	1½	1½	1½	1¾
(previous)	(½)	(2¼)	1	(1¼)	(1½)	(n/a)
Trimmed mean inflation	1.2	1¼	1¼	1½	1½	1¾
(previous)	(1)	(1¼)	(1)	(1¼)	(1½)	(n/a)
	Year-average					
	2020	**2020/21**	**2021**	**2021/22**	**2022**	**2022/23**
GDP growth	−2½	0	4	4	3½	3
(previous)	(−3½)	(−2)	(3)	(4½)	(3½)	(n/a)

(a) Forecasts finalised on 3 February. Forecast assumptions (November Statement in parenthesis): TWI at 63 (60), A$ at US$0.76 (US$0.70), Brent crude oil price at US$56/bbl (US$42/bbl); the cash rate remains around its current level and other elements of the Bank's monetary stimulus package are in line with the announcements made following the February 2021 Board meeting.

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

(c) Average rate in the quarter.

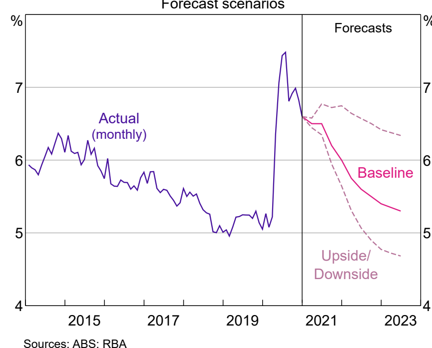
Sources: ABS; RBA

before embarking on large scale investments during a period of unusually high uncertainty.

Labour market

Labour market outcomes in the December quarter were much stronger than expected at the time of the November *Statement*. Employment and labour force participation have recovered more quickly than anticipated, and the unemployment rate declined further to 6.6 per cent in December. These outcomes suggest the peak in the unemployment rate has already occurred, and at a much lower level than expected earlier in the pandemic (Graph 5.2).

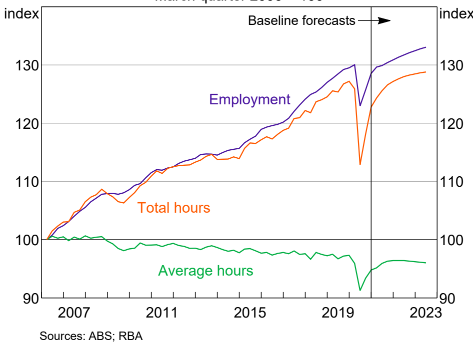
The improved near-term outlook means the expected recovery in employment and total hours has been front-loaded, with both of these aggregates returning to their pre-pandemic levels by late 2021 (Graph 5.3). The key driver of the faster recovery in the labour market has been the stronger-than-expected rebound in activity over the second half of 2020. The return to employment of people who had temporarily exited the workforce has also occurred more rapidly than expected; industries most affected



by activity restrictions were those with typically higher turnover rates, meaning rehiring could happen faster. The quick rebound in participation suggests that there has been less labour market scarring and fewer search frictions than is typically seen in labour market downturns and recoveries. It also implies that there are fewer workers still out of the labour force waiting to rejoin, which reduces the likelihood of a material increase in the unemployment rate being driven by people returning to the labour force.

The JobKeeper program winds down at the end of March, which creates some uncertainty for the overall pace of employment growth in the first part of the year. Employment is then expected to continue growing over the forecast period, underpinned by the ongoing expansion, but at a slower pace than previously anticipated given much of the expected recovery has already occurred.

The decline in the unemployment rate is expected to slow in the next quarter or two as JobKeeper finishes. From mid 2021, and consistent with the outlook for employment growth, the unemployment rate continues to move gradually lower to reach around 5¼ per cent by the end of the forecast period in mid 2023. While the outlook for unemployment is materially better than expected a few months ago, this still represents a significant amount of spare capacity in the economy, with the unemployment and underemployment rates expected to remain elevated across the forecast period. Although average hours worked have rebounded quickly to date, there are still some workers (particularly full-time) who remain on reduced or zero hours.



Labour force participation has returned to historically high levels, as a large number of people who had temporarily left the workforce had already returned by December. Some further modest increase in participation is expected in the next few quarters, as the recent strength in employment encourages some people currently outside the workforce to enter or return. Further out, the participation rate is expected to ease back a little as the recovery matures, but longer-run structural drivers of increased participation (such as incremental increases in the pension eligibility age and better health outcomes for older people) are expected to remain in place.

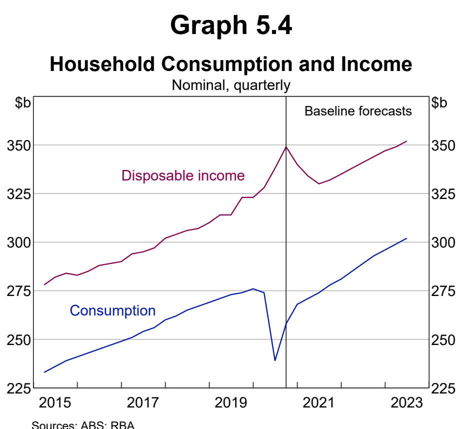
Public demand

Public demand is expected to make a larger contribution to domestic final demand growth over the year to June 2021 than was anticipated at the time of the November *Statement*. The upgrade reflects capital spending plans in state budgets that were released over recent months, which foreshadowed a larger and more rapid increase in public investment than previously indicated. Aggregate public investment is forecast to increase by around 25 per cent over the year to June 2021, a boost that is roughly comparable to the increase in public investment after the global financial crisis. Public consumption is expected to grow modestly over coming quarters and then decline a little as direct spending related to management of the pandemic is reduced.

Household consumption, income and saving

Consumption is expected to recover to pre-pandemic levels around the end of 2021 (Graph 5.4). The ongoing recovery in consumption is expected to be underpinned by the recovery in labour income, net household wealth and a gradual decline in uncertainty related to health and economic outcomes. Over recent months, the recovery in household spending was a little faster than expected at the time of the previous *Statement*, led by households in Victoria. The improvement in labour market conditions has supported household income and partly offset an expected decline in non-labour income as tighter eligibility requirements for income support measures have come into effect. Households who were affected by the tightening of containment measures over the summer are expected to have reduced their spending only modestly and for a short period.

The household saving rate is expected to decline from around 20 per cent in the September quarter 2020 to 5 per cent by the end of the forecast period, broadly in line with pre-pandemic levels. Household disposable income is expected to decline through the first half of 2021 as social assistance payments decline and the JobKeeper program is phased out, before income resumes a steady uptrend in line with the expected economic recovery. Consumption possibilities are expected to continue to broaden as restrictions ease further, which should be conducive to households spending a larger share of income received.



Dwelling investment

Dwelling investment is forecast to return to its pre-pandemic level by mid 2021. Building approvals for detached houses and alterations & additions increased sharply in the second half of 2020, indicating that a strong pick-up in lower-density residential construction is underway. A large share of the dwelling investment expected to occur over the coming year is assumed to be activity pulled forward by the HomeBuilder scheme (and to a lesser extent, some state-based support measures). Investment in higher-density residential construction is expected to remain weak, consistent with low levels of building approvals.

Business investment

Non-mining business investment is forecast to increase gradually off a very low base over the first half of 2021 and return to pre-pandemic levels by the end of 2022. Investment in machinery & equipment is expected to lead the moderate recovery over the forecast period, after declining by less than previously anticipated over 2020. The rebound in domestic activity, expanded tax incentives for investment announced in the Australian Government Budget in October and increased business profits over recent quarters should all help to support investment, particularly in goods-related industries where business conditions are well above average.

By contrast, non-residential construction is still expected to fall sharply in the near term as the pipeline of existing projects is worked through and recent weakness in building approvals suggests that few new projects will commence. Non-residential construction activity is not

expected to pick up until late 2021, in part because of the long lags in the approval and planning of projects. More broadly, these projections occur against a backdrop where non-mining business investment in a number of advanced economies, including Australia, was subdued for a long period prior to the pandemic, in part reflecting uncertainty about future demand conditions. Firms are likely to be faced with high uncertainty for some time.

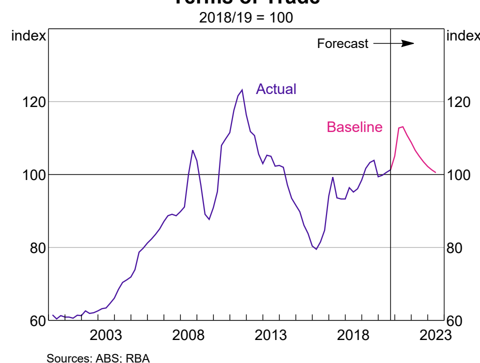
Mining investment is now expected to be little changed in the near term compared with expectations of modest growth at the time of the November *Statement*. Recent survey data suggest some firms have scaled back their investment intentions, despite increases in some commodities prices towards the end of 2020. Further out, maintenance and sustaining projects are expected to support mining investment at around its current level. As yet, there have been no indications by major miners of plans to expand investment in response to recent high iron ore prices. Iron ore projects take a number of years to deliver and market participants expect prices to ease as Brazilian supply recovers.[1] While higher iron ore prices may not have much direct effect on near-term mining investment, higher prices will support state and federal government revenues through increased mining royalties and company income tax receipts.

External sector

The outlook for exports is broadly similar to that in the November *Statement*, with exports gradually recovering and reaching pre-pandemic levels by the end of 2022. The forecast has been downgraded a little in the near term as recent weakness in coal exports is expected to persist, outweighing higher iron ore exports. Lower overseas student enrolments will also reduce education exports. That said, exports are expected to grow a little faster over 2022 as the availability of vaccines supports a quicker recovery in tourism and education once international travel restrictions ease. As in the November *Statement*, this easing is assumed to happen around the end of 2021.

Forecast import growth has been revised up due to stronger domestic demand and the appreciation of the exchange rate, even though the appreciation of the Australian dollar is assumed to affect trade by less than usual, because of the restrictions on international travel. Imports are expected to exceed their pre-pandemic level at the start of 2022.

The trade surplus is expected to be significantly wider than was anticipated in the November *Statement* as a near 15 per cent increase in the terms of trade across the forecast period more than outweighs higher import volumes. The terms of trade is boosted by higher profiles for iron ore, coal and LNG prices and a lower profile for import prices. As in the November *Statement*, iron ore prices are expected to decline over the forecast period, albeit from a significantly higher starting point that is near decade highs. As a result, the terms of trade are expected to decline over the second half of the forecast period but from a much higher level than previously anticipated (Graph 5.5).



Wages and inflation

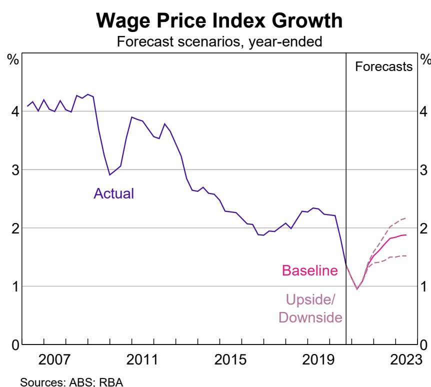
The outlook for wages growth is a little stronger than the baseline scenario in the November *Statement*, as absorption of spare capacity occurs at a slightly faster rate given the upgraded labour market outlook. However, even by mid 2023, the unemployment rate is still likely to be higher than is consistent with a tight labour market and a strong pick-up in wages growth. Year-ended growth in the Wage Price Index (WPI) is expected to remain below 2 per cent over the next few years, even slower than the low rates recorded prior to the pandemic (Graph 5.6).

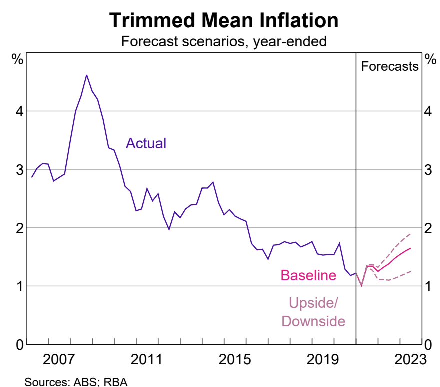
Despite the economic recovery getting underway in the September quarter, wages growth was weaker than in the June quarter, with the WPI increasing at its slowest rate since the series began 2 decades ago. Based on liaison reports, wages growth in the December quarter is expected to be weak again as private sector wage freezes remain widespread. As these wage freezes unwind, this will provide modest support to private sector wages growth over the year ahead, as will the strengthening labour market. Public sector wages will also pick up as some wage freezes and caps start to unwind. However, the broader outlook for public sector wages (which account for around one-quarter of the WPI) has been revised down slightly, as some state governments have announced measures to cap wage growth at lower rates than in recent years.

In line with the more positive outlook for the labour market, the outlook for underlying inflation has been revised up a little relative to the November *Statement*. Nonetheless, inflation is still expected to be subdued throughout the forecast period, consistent with some spare capacity remaining in the economy and wages growth remaining below 2 per cent in the baseline scenario (Graph 5.7).

Movements in headline inflation will continue to be choppy this year, reflecting the unwinding of rent reductions and various government support measures such as free child care and utilities rebates. Headline inflation is expected to increase to around 3 per cent over the year to June 2021, before dropping back to around 1½ per cent by the end of the year. Underlying inflation is expected to increase only gradually over the forecast period, reaching around 1¾ per cent by mid 2023.

At a compositional level, there are a number of cross-currents expected to affect inflation outcomes in the near term. Strong demand for detached housing construction is expected to boost new dwelling inflation. While rents are very weak at present, they are likely to pick up a little over the year ahead as negotiated rent





reductions unwind. Prices for consumer durables could increase further on the back of recent strong demand for cars and household items. Global supply chain disruptions had previously depleted inventories and generated some price pressures, but liaison reports suggest that this has now largely dissipated. Prices in other expenditure categories are expected to remain subdued; some government subsidies and rebates will remain in place for some time yet and a number of administered prices have been frozen. Utilities prices are also expected to continue to fall for some time, driven by low wholesale gas prices and increased electricity supply from renewables.

Risks and uncertainties

The momentum in activity and labour markets, the additional boost to the economy from state and Australian government budgets and the successful health response to the latest set of localised outbreaks have combined to reduce near-term downside risks. Internationally, a number of vaccines have been approved and vaccinations have begun, which reduces some of the downside risk to the global recovery.

Nevertheless, a higher-than-usual degree of uncertainty continues to surround the economic outlook. In recognition of this, plausible upside and downside scenarios for the domestic economy (based on different health assumptions) are outlined below, followed by a discussion of other risks and uncertainties.

Upside scenario: faster recovery

A stronger domestic recovery than the one set out in the baseline scenario is possible if a sustained run of positive health outcomes enables the remaining restrictions on activity to be eased more quickly. This would be expected to lead to a stronger rebound in consumer and business confidence, as well increased opportunities for services consumption, including interstate travel. A less uncertain environment would boost consumption in this scenario by households drawing down on savings accumulated over the past year; the scenario assumes that over the next year and a half, households consume around 40 per cent of the unplanned savings accumulated over the June and September quarters of 2020. In this scenario, higher confidence and increased activity also contributes to a faster rebound in business investment than in the baseline forecast.

The scenario also assumes faster-than-expected progress on overseas vaccination programs and more rapid control of virus outbreaks internationally. This underpins a faster recovery of tourism exports when international borders reopen, although the effect on GDP is almost entirely offset by stronger tourism imports in the scenario. Stronger activity and reduced uncertainty about the outlook support stronger labour demand and employment growth, which leads to a faster decline in the unemployment rate than in the baseline scenario; the unemployment rate declines to around 4¾ by the end of 2022 in this scenario. Better labour market outcomes lead to a stronger pick-up in wages growth and a slightly faster increase in inflation over the next couple of years.

Downside scenario: slower recovery

A plausible downside scenario would involve further large outbreaks that require broad activity restrictions to be reimposed. While these would be less severe than the extended lockdowns assumed in previous downside scenarios, an upswing in domestic case numbers would see activity restrictions tightened. This would negatively affect confidence and weigh on private consumption and investment. In this scenario, the combination of activity restrictions and weaker confidence induces households to consume less and add further to their stock of accumulated savings.

This scenario involves a longer and more damaging slowdown in activity than envisaged in the baseline scenario. Intermittent state border closures would be expected to prompt consumers to delay or reconsider interstate travel plans. Combined with temporary restrictions on activity and negative confidence effects this would reduce consumer spending and business investment. In this scenario, GDP increases more gradually over 2021, with growth only starting to pick up from early 2022. The slowing in activity and heightened uncertainty in this scenario would reduce momentum in the labour market recovery as firms put off hiring decisions and/or lay off extra workers. The unemployment rate peaks at a higher rate of 6¾ per cent in mid 2021 in this scenario, and declines only slowly thereafter. The larger degree of spare labour market capacity places further downward pressure on wages growth, which sees inflation trend lower until mid 2022.

Other risks and uncertainties

Beyond the uncertainty around health outcomes discussed in the scenarios above, there are other sources of risk and uncertainty clouding the domestic outlook, some of which have become more balanced in recent times.

One overarching issue will be how households and businesses respond to the tapering of fiscal and other temporary support measures following a period where household and business cash flows have been boosted by an extraordinary amount of policy support.

In the corporate sector, insolvencies could rise by more than expected as temporary support measures are withdrawn, reducing investment, slowing activity and placing upward pressure on the unemployment rate. There is also a risk that recent tax incentives that have supported business investment mostly pull forward demand, leading to a period of weak investment after the incentives expire. On the other hand, for some businesses that were able to build cash buffers and adapt their business models last year, stronger balance sheets and the opening of new opportunities as a result of the pandemic could provide a basis for a faster recovery. If elevated commodity prices persist longer than expected, it is also possible that this prompts mining firms to lift investment towards the end of the forecast period.

For the household sector, there are also risks to the baseline scenario forecasts in both directions. The expected decline in income through to mid year and a slowing in the recovery in labour markets could drag on the recovery in household consumption, as could a longer-lasting shift in risk preferences that results in the saving rate stabilising at a higher level. In the other direction, a stronger recovery in labour income, larger asset price gains and reduced economic uncertainty could prompt households to consume at a faster pace than currently envisaged in the baseline scenario, including by quickly drawing down on the large saving buffers accumulated over 2020. Higher housing prices could also support detached dwelling investment (alongside consumption) by more than expected, even as fiscal support measures unwind.

Turning to public investment, governments have collectively announced a large increase in capital spending over the year to June 2021. It is assumed that this spending occurs in a way that is broadly consistent with historical patterns of investment realisation and that capacity constraints are minimal. A more rapid rollout of public investment presents an upside risk to the forecasts given the intent of governments to ensure the timely rollout of capital spending programs. At the same time, there is a risk that the high level of budgeted capital spending could be slower to materialise due to capacity constraints, although subdued conditions in private non-residential construction means this is less likely than in the recent past.

The unusual nature of this downturn and recovery makes it difficult to judge the extent of spare capacity in the economy; any scarring effects would tend to damage the supply side of the economy and lower the growth rate of potential output. Although the improved outlook for the labour market suggests spare capacity will be absorbed faster than had been previously forecast, underutilisation is still expected to remain high for several years, which might delay the gradual pick-up in wages growth and inflation over the forecast period. It is also possible that if the unemployment rate were to decline more rapidly than expected, it might not be accompanied by stronger wage or price pressures if spare capacity is underestimated and wage and price inflation expectations become anchored at low levels. Given the extent of private and public sector wage freezes, as well as the likelihood that wages growth and underlying inflation remain below 2 per cent for an extended period, low inflation expectations may persist.

On the other hand, higher prices for some consumption goods and services, in part as a result of supply side bottlenecks, could lead to a sharper-than-expected increase in retail price inflation. Some firms will be better placed than others in passing through price pressures to consumers. More broadly, the speed of the labour market recovery so far, and possible changes in labour demand (such as for particular skills or in specific locations) combined with some labour supply constraints (such as border restrictions affecting the availability of skilled labour sourced overseas), could mean pockets of faster wages growth emerge more quickly, spilling over into broader measures of wage and price expectations. ✠

Endnotes

[1] See RBA (2019), 'Box B: The Recent Increase in Iron Ore Prices and Implications for the Australian Economy', *Statement on Monetary Policy*, August, pp 37–40. Available at <https://www.rba.gov.au/publications/smp/2019/aug/box-b-the-recent-increase-in-iron-ore-prices-and-implications-for-the-australian-economy.html>