Statement on Monetary Policy

NOVEMBER 2020

RESERVE BANK OF AUSTRALIA

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Contents

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Overview

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

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

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

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

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

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

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

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

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

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

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

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

The availability of finance at low rates has been one factor supporting demand for housing in Australia. Consistent with this, new commitments for housing finance have recovered significantly, and housing credit growth has also picked up, most notably to owner-occupiers. Housing prices have increased in most cities and regional Australia over recent months, but have declined in Sydney and Melbourne. The HomeBuilder subsidy from the Australian Government and some state government subsidies have also supported demand for new housing, despite the lower near-term outlook for population growth. Rental markets, however, remain soft, with advertised rents, especially for apartments, declining in Sydney and Melbourne.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

1. International Economic Conditions

The global economy is recovering from the initial COVID-19 shock. Monetary and fiscal policies have provided substantial support to households and businesses, and further sizable fiscal stimulus for the recovery phase has recently been announced in some economies. Among the major economies, the recovery in China is more advanced than elsewhere.

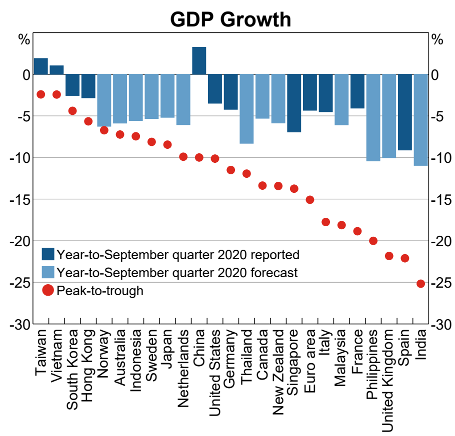
The pace of the global recovery has slowed and become more uneven in recent months. Goods consumption and production has led the global recovery, while activity in services industries remains curtailed by ongoing social distancing requirements. Resurgences in COVID-19 infection rates and the reintroduction of lockdown measures will reduce economic activity in many European economies over coming months.

Labour market conditions in most economies have improved over recent months, but significant spare capacity is expected to remain for some time. This will keep inflation low. As set out in the 'Economic Outlook' chapter, the nature of the pandemic means that the global outlook will remain uncertain and fragile in the period ahead, with the level of GDP in most economies likely to be below pre-pandemic forecasts for some years.

The global economy rebounded strongly

Global economic activity has picked up from its April low and labour market conditions have generally improved as public health restrictions were eased across most economies. After the June quarter recorded the biggest contraction in global GDP since the Second World War, global GDP growth in the September quarter was the strongest since at least this period (Graph 1.1). But the rebound in activity in the September quarter still left GDP well below pre-pandemic levels in the major economies, with China the notable exception. Goods consumption led the recovery, with retail sales above pre-pandemic levels in many economies. Global merchandise trade has bounced back quickly alongside the recovery in goods consumption, and new export orders suggest merchandise trade should continue to recover in coming months (Graph 1.2). In contrast, services trade has remained depressed because most international travel continues to be severely constrained.

Graph 1.1



Sources: CEIC Data; Consensus Economics; RBA; Refinitiv

The pace of recovery has slowed more recently due to the constraints from remaining social distancing requirements, behavioural changes and a resurgence in infections, particularly in Europe and the United States. The recent upswing in new cases of the virus in the northern hemisphere has increased risks to the outlook and highlighted that containment of the pandemic and ongoing policy support will be crucial to sustain the recovery.

New waves of COVID-19 infections have resulted in tighter restrictions in some economies

COVID-19 infections have increased rapidly in Europe since August, and are much higher than recorded earlier this year (Graph 1.3). Containment measures have been tightened in response, with many economies in the region imposing nationwide lockdowns in late October to stem the pressures on their health systems. As a result, population mobility, a high-frequency indicator, has started to decline (Graph 1.4).

Infection rates in the United States have started to increase again and are at elevated levels following a brief decline in July and August. They also remain high in some large emerging market economies such as Indonesia and Russia. Infection rates have started to decline in India, and remain low in most high-income east Asian economies.

Economic activity in China has continued to normalise

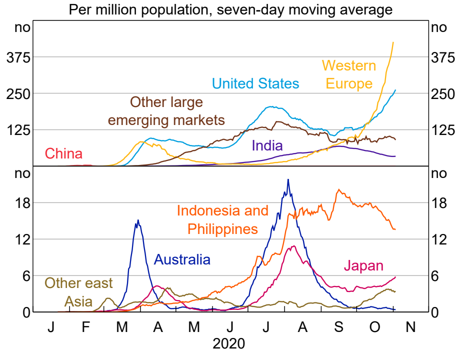
China has so far managed to avoid a major second wave of infections and this has allowed most restrictions on domestic economic activity to be lifted. Economic activity is now at or above pre-pandemic levels in many sectors.

The economic rebound continues to be led by construction-related investment and production. In particular, real estate and infras-tructure investment recovered quickly and monthly growth rates remain higher than prior

Graph 1.3

COVID-19 – New Cases per Capita

Per million population, seven-day moving average

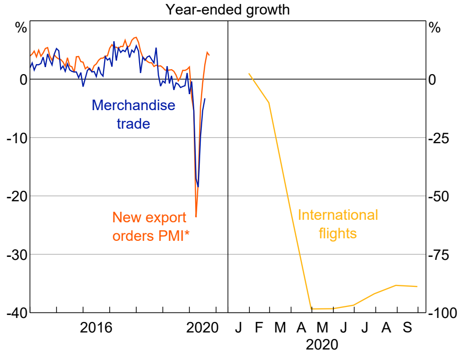


Sources: Johns Hopkins CSSE; RBA

Graph 1.2

Global Trade Indicators

Year-ended growth



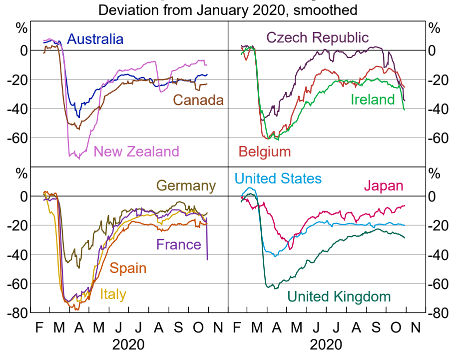
* Purchasing Managers' Index; mapped to merchandise trade growth

Sources: IATA; IHS Markit; RBA; Refinitiv

Graph 1.4

Population Mobility

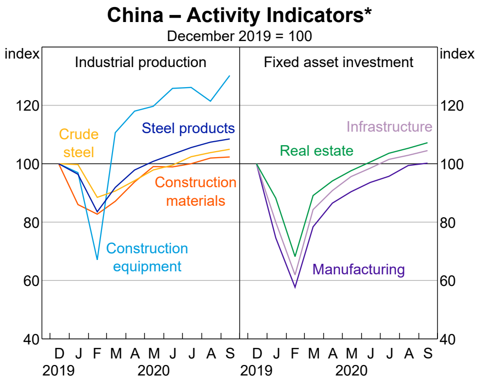
Deviation from January 2020, smoothed



Sources: Google LLC (2020), 'Google COVID-19 Community Mobility Reports', available at https://www.google.com/covid19/mobility/ viewed on 4 November 2020; RBA to the pandemic, reflecting the relatively fast normalisation in property market conditions and the focus on public infrastructure as part of the stimulus program (Graph 1.5). Consistent with this, production of construction-related products, such as steel, has remained robust. A sustained rebound in exports has also supported the recovery. This has reflected increased demand for Personal Protective Equipment (PPE) and medical supplies, and the global shift to remote working has supported demand for goods such as home office equipment and household furniture (Graph 1.6).

Consumer demand has generally been slower to recover. However, there have been some more encouraging developments recently: public confidence around the health situation appears to have improved following months of low COVID-19 case numbers in China; most of the remaining public health restrictions have been removed; and household incomes have largely recovered after declining sharply at the onset of the pandemic. Recent data suggest that consumer demand continues to improve, although demand for some consumer services remains below pre-COVID levels.

Graph 1.5



* Seasonally adjusted by the RBA
Sources: CEIC Data; RBA

Graph 1.6

* Seasonally adjusted by the RBA
Sources: CEIC Data; RBA

Policymakers have indicated that they have been broadly satisfied with the speed of the economic recovery to date, which has lessened the case for additional policy support. The fiscal stimulus announced in the early stages of the recovery has also been deployed more slowly than projected, reflecting weaker-than-expected expenditure (Graph 1.7). Significant government bond issuance in recent months should support a pick-up in fiscal expenditure over the remainder of the year and provide further support to infrastructure investment. With the economic recovery well underway, authorities have turned their attention to the longer-run policy agenda. While details are yet to be finalised, authorities have noted that this policy agenda will focus on measures to increase domestic consumption, support innovation, improve supply chain self-sufficiency and attract foreign investment.

Geopolitical and trade tensions remain elevated between the United States and China. The US Government has sought in recent months to restrict the global supply to China of semiconductors made with US equipment or designs. This could significantly curtail such exports from the rest of Asia to China.

Elsewhere, trade disputes between the United Kingdom and European Union, and China and other economies including Australia, have continued in recent months.

External demand has supported the recovery in east Asia while domestic demand conditions have varied

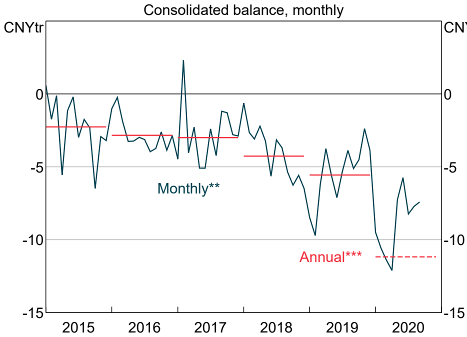
East Asian exports have rebounded in recent months, driven by the economic recovery in China, and the rebound in global goods consumption (Graph 1.8). Strong demand for electronics has boosted semiconductor production in key suppliers such as South Korea. Some economies in the region faced sluggish demand for their automotive exports for a number of months as global car sales fell sharply in the height of the pandemic. More recently though, global car sales have rebounded, returning to around pre-COVID levels in September.

Domestic demand has been more resilient in east Asian economies such as South Korea and Vietnam that successfully contained both the early outbreaks of COVID-19 and small resurgences in infections (Graph 1.9). In contrast, domestic demand has been weak or slower to recover in economies that experienced significant second waves of infections, notably Singapore, or where the pandemic has not yet been successfully contained, such as Indonesia and the Philippines.

Graph 1.7

China – General Government Budget*

Consolidated balance, monthly



* Government budget balance including government-managed funds; special government bonds are treated as deficit financing

** Seasonally adjusted by the RBA and annualised

*** Value for 2020 is a projection

Sources: CEIC Data; MoF; RBA

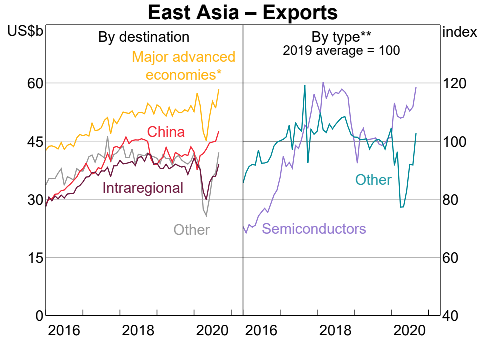
India's recovery has been impeded by elevated COVID-19 cases and a lack of policy space

Economic activity in India contracted sharply in the June quarter, due to the stringent nationwide lockdown between March and May. Activity was heavily restricted in many industrial sectors that were deemed non-essential, which resulted in a notable decline in steel demand and production. This led to a sharp fall in Australian coking coal exports to India, which fell to an eight-year low in June.

While activity has recovered somewhat since May, the pace of recovery slowed in July and August amid persistent increases in COVID-19 cases and the reintroduction of restrictions in

Graph 1.8

East Asia – Exports



* Includes the United States, the European Union and Japan

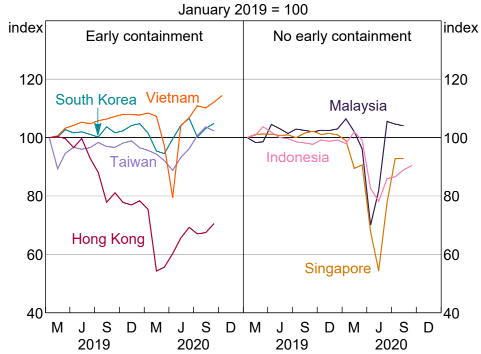
** South Korea and Taiwan

Sources: CEIC Data; RBA; Refinitiv

Graph 1.9

East Asia – Retail Sales

January 2019 = 100



Sources: CEIC Data; RBA

some states. More recently, activity and mobility indicators suggest that the pace of recovery has picked up again alongside concerted efforts by authorities to encourage the re-opening of the economy, although activity still remains some way below pre-COVID-19 levels (Graph 1.10).

In recent weeks, COVID-19 cases in India have begun to decline meaningfully for the first time since the onset of the pandemic. If sustained, this could support a further recovery in activity. Nonetheless, policy settings have not been as accommodative as elsewhere. Concerns about fiscal space have limited the amount of direct fiscal support provided so far, while stubbornly high headline inflation has limited the degree of monetary policy support that the Reserve Bank of India has been willing to provide.

The recovery in advanced economies has slowed from the initial rebound and will rely significantly on further fiscal support

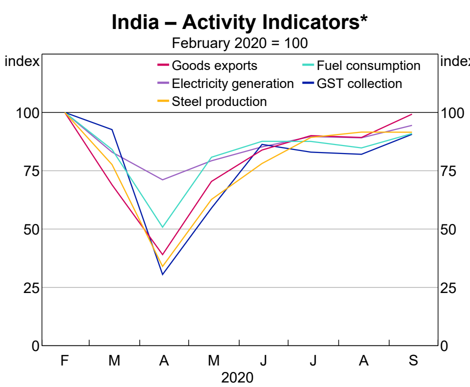
Strong fiscal and monetary policy responses have cushioned the impact of the pandemic on household and business incomes (see 'Box A: Income Support Policies in Advanced Economies during the COVID-19 Pandemic'). The government support has enabled a sharper recovery in some forms of consumption than would otherwise have been the case. In particular, the recovery has been led by goods consumption (Graph 1.11). As a result, conditions in the manufacturing sector have recovered quickly and industrial production has picked up strongly, although in most advanced economies manufacturing output remains below pre-pandemic levels (Graph 1.12).

Activity in many services industries remains constrained by ongoing social distancing. The resurgence in infections and the tightening of containment measures, particularly in Western Europe, has further weighed on services sector activity in recent times.

The recovery in business investment has been much less pronounced than in household consumption. Firms have reacted to reduced demand and heightened uncertainty about the outlook. Residential investment activity also contracted sharply, but has been more resilient, supported by historically low interest rates and increased demand for housing outside major cities.

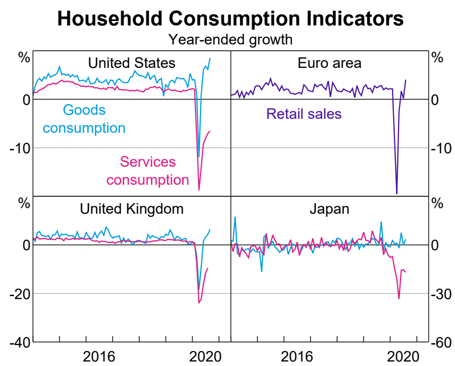
The fiscal response to the initial COVID-19 shock was rapid and exceeded the fiscal response to economic contractions provided in any earlier peacetime episode. Fiscal support for labour markets and household incomes has been extended in most advanced economies, and European governments have announced

Graph 1.10



* Seasonally adjusted by the RBA, except for GST collection
Sources: CEIC Data; RBA

Graph 1.11



Sources: RBA; Refinitiv

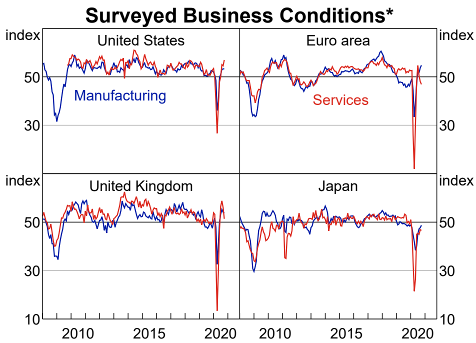
additional fiscal support as containment measures have been tightened. In contrast, the US authorities are still to reach an agreement on a new fiscal package (Graph 1.13). Continued fiscal support will be required to sustain the global recovery in the period ahead.

Labour market conditions have been improving slowly although significant spare capacity remains

Labour markets in advanced economies have been recovering alongside the pick-up in activity, but the recent tightening of containment measures in the northern hemisphere will slow progress in reducing the significant amount of spare capacity remaining. Total hours worked have increased since the June quarter but remain well below pre-pandemic levels (Graph 1.14). In the United States, most of the adjustment to total hours since the onset of the pandemic has occurred via large changes to employment. In most other advanced economies, the adjustment has occurred via changes to average hours worked by employees. Participation rates have also fallen sharply this year, as mobility restrictions, weak labour market conditions, health concerns and carer responsibilities have discouraged participation.

The share of the labour force supported by wage subsidies has trended down since the peaks in May, as people have returned to work or increased their hours after the nationwide lockdowns were lifted (Graph 1.15). The subsequent tightening in containment measures have so far modestly increased the take-up of wage subsidies, including in New Zealand in late August, and is expected to do so in Western Europe. Wage subsidy schemes have been extended in most economies as the recovery has progressed slowly and infections have increased again.

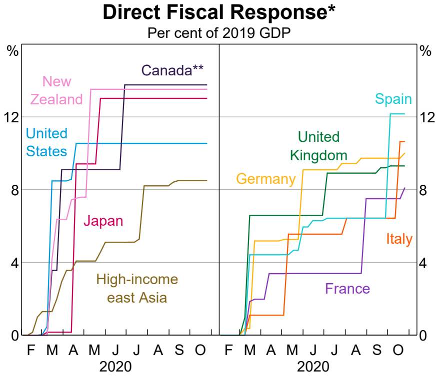
Graph 1.12



* Purchasing Managers' Index; below 50 indicates that activity is contracting

Sources: IHS Markit; RBA

Graph 1.13

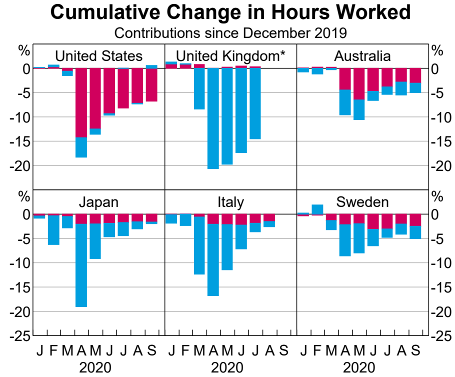


* Excludes subnational governments, loan guarantees and unallocated funds

** July increase represents budget changes to previously announced measures

Sources: IMF; national sources; RBA; Refinitiv

Graph 1.14



* United Kingdom data are derived from the weekly Labour Force Survey

Sources: CEIC Data; Office for National Statistics; RBA; Refinitiv

Inflation is likely to remain low but there have been large relative price changes

Inflation has declined since the start of the pandemic and is expected to remain low because of significant spare capacity. Core goods inflation has increased in many economies since the onset of the pandemic, consistent with the rebound in goods consumption. Food inflation has been quite high in a number of economies due to supply disruptions from the pandemic (Graph 1.16). However, services inflation (which has a relatively large weight in advanced economy consumer price indices) has been subdued alongside weaker demand from social distancing restrictions; in some economies, temporary consumption tax reductions or consumption incentives have also weighed on services prices.

The level of global economic activity is expected to remain below pre-pandemic forecasts for many years

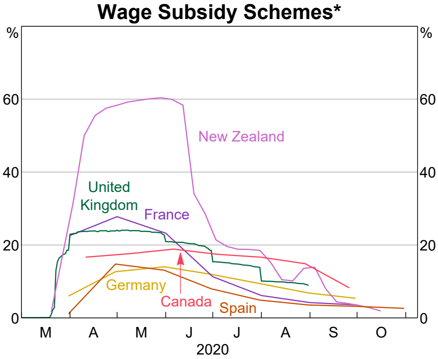
Economic activity in Australia's major trading partners is forecast to contract by 3 per cent in 2020, and gradually recover in coming years – with growth of 6 per cent in 2021 and 4 per cent in 2022 (Graph 1.17). Overall, the level of GDP in most economies outside China is expected to remain below pre-pandemic forecasts over the next couple of years because of the effect of continued social distancing restrictions and behavioural changes on business investment as well as consumption. Consumption of many services, including international travel, will be constrained at least until an effective vaccine has become widely available.

There is a high degree of uncertainty about the outlook for the global economy (see 'Economic Outlook' chapter). Risks are skewed to the downside and include: more countries introducing or extending lockdown measures as a result of a resurgence in infections; setbacks in the development and distribution of vaccines and medical treatments; and fiscal policy support that is withdrawn prematurely. Outside of the pandemic, geopolitical and trade tensions also pose downside risks to the global outlook.

The recovery is expected to be uneven across economies. In China, activity has returned to pre-pandemic levels in many sectors, and the level of Chinese GDP is now expected to return to pre-pandemic forecasts in early 2021. In the near term, China's success in containing COVID-19 should support a further normalisation in activity. Public infrastructure investment will also provide a boost as local governments spend the proceeds from the significant bond issuance that has occurred in

Graph 1.15

Share of Labour Force on Wage Subsidy Schemes*



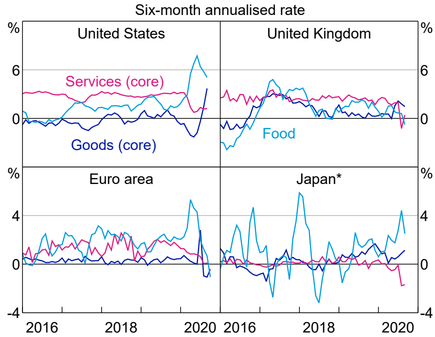
* Share of average labour force size over 2019; data may not yet be complete as in some economies claims can be retroactively submitted; data in some economies refer to number of jobs rather than heads

Sources: ifo Institute; national sources; RBA; Refinitiv

Graph 1.16

CPI Inflation

Six-month annualised rate



* Adjusted for consumption tax changes

Sources: RBA; Refinitiv

recent months. There remains uncertainty around the outlook for consumer demand in China, which has experienced a slower recovery than other areas of the economy, and whether the recent strength in exports can be sustained.

In the United States, most commentators are anticipating further fiscal stimulus, which will boost growth in 2021 and bring the level of GDP closer to pre-pandemic forecasts by 2023. The large fiscal support already announced for the euro area will support activity in the region over the next couple of years, although the recent resurgence in infection rates has slowed the recovery there and introduces a high degree of uncertainty for the outlook. Activity in advanced economies in east Asia should be supported by a sizable fiscal policy response, relative success to date in keeping infection rates low and continued strong global demand for technology products. The outlook for some emerging economies, including in east Asia, is more subdued because of higher infection rates, more limited fiscal support and the expected slow recovery in international tourism. The level of GDP in many of these emerging economies is expected to remain significantly below its pre-pandemic path for many years.

Bulk commodity prices have been mixed

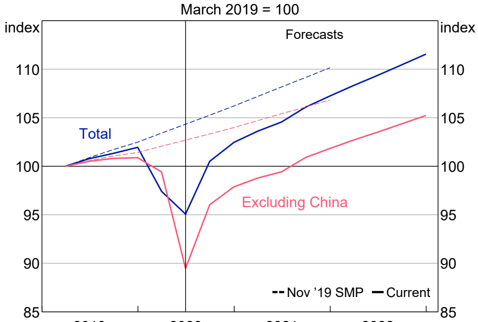
The benchmark iron ore price has remained elevated since the previous *Statement*, briefly reaching its highest level since 2014 in early September (Graph 1.18, Table 1.1). The iron ore price has been supported by continued strength in Chinese steel production, underpinned by public infrastructure and real estate construction. Port congestion in China has also supported prices, although this has eased more recently. The supply of iron ore from Brazil has increased following various disruptions earlier in the year, which has recently dampened the upward pressure on prices.

Coal prices have declined substantially this year. Coking coal prices are not far from their lows for the year. Recent reports that some Chinese utilities and steel mills have been instructed to stop importing Australian coal have led to increased uncertainty about the demand outlook for seaborne coal. By contrast, thermal coal prices have rebounded a bit of late, underpinned by gradually improving global demand and earlier supply cutbacks from producers. Some analysts have suggested that coking and thermal coal prices have also been supported by concerns that predicted increased rainfall over Australia – as a result of the La Niña weather pattern – will disrupt supply in coming

Graph 1.17

Australia's Major Trading Partner GDP

March 2019 = 100

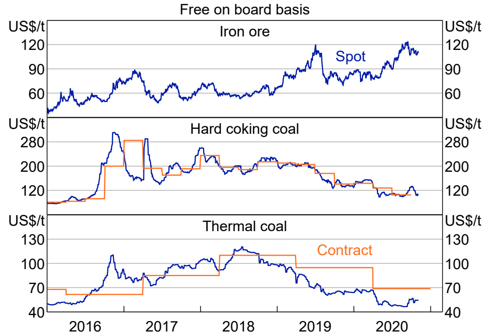


Sources: ABS; CEIC Data; Consensus Economics; RBA; Refinitiv

Graph 1.18

Bulk Commodity Prices

Free on board basis



Sources: Bloomberg; Department of Industry, Science, Energy and Resources; IHS Markit; RBA

Table 1.1: Commodity Price Changes[a]

Per cent

	Since previous *Statement*	Since start of year
Bulk commodities	–1	12
– Iron ore	–3	27
– Coking coal	–1	–22
– Thermal coal	14	–17
Rural	9	–2
Base metals	6	6
Gold	–8	23
Brent crude oil[b]	–9	–39
RBA ICP	3	0
– Using spot prices for bulk commodities	–1	0

(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

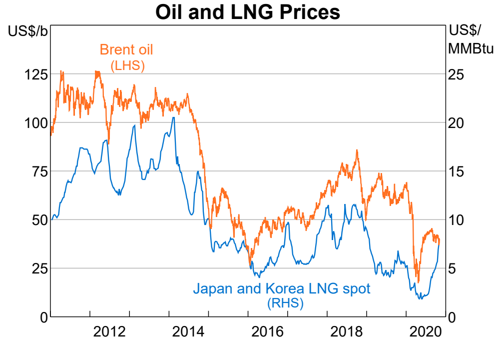
months; heavy flooding during Australia's last La Niña period led to a 20 per cent fall in Queensland's coal production in the March quarter of 2011.

The price of Brent crude oil has decreased since the previous *Statement* and is around 40 per cent lower than at the start of the year (Graph 1.19). The recent decline in the oil price has reflected concerns about a stalling in the recovery in global oil demand. As the oil price remains well above the record low levels in April, this will result in an increase in the average price received by Australian LNG exporters in the December quarter; the majority of Australia's LNG exports are sold via long-term contracts linked to oil prices at a 1–2 quarter lag. The Asian LNG spot price has also recovered over the past few months because of extended maintenance at some Australian LNG facilities and disruptions to US supply, while demand has also picked up.

Most base metal prices have increased since the previous *Statement* and are now above their levels at the start of the year (Graph 1.20). The price of gold has decreased, but remains around its record high. Gold does not offer a yield, so it is has become relatively more attractive in an environment where some measures of real yields, such as inflation-linked Treasuries, have become negative. The prices of rural commodities have increased since the previous *Statement*. Lamb prices have increased because of flock rebuilding and robust global demand for sheep meat. Wool prices have also increased of late, but remain around multi-year lows. ✠

Graph 1.19

Oil and LNG Prices

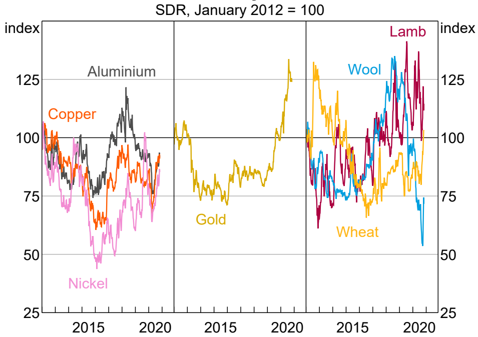


Sources: Bloomberg; RBA; Refinitiv

Graph 1.20

Commodity Prices

SDR, January 2012 = 100



Sources: Bloomberg; Landmark; MLA; RBA

Box A

Income Support Policies in Advanced Economies During the COVID-19 Pandemic

Government income support for households and businesses limited the contraction in economic activity in the first half of 2020 in many advanced economies. These policies, including wage subsidies and transfers to households, helped to support the cash flows of households and firms, and underpinned private sector demand. Indeed, household and business incomes in many advanced economies have fared much better during the first half of the year compared with previous recessions despite a larger contraction in GDP. This should support these economies in the next stage of the recovery, even as some forms of income support are scaled back in the period ahead.

Household incomes have been supported through a range of measures

Household incomes have been supported by a range of measures through the government-mandated lockdowns and subsequent shock to private demand. Wage subsidies have been used extensively in advanced economies to protect jobs and support employee incomes.[1] Expanded social benefits were provided to people who lost their jobs or were unable to work. Some fiscal authorities made sizeable one-off cash transfers. Other measures, such as early access to superannuation in Australia, also supported household cash flows.

In some economies, such as Australia, Canada and the United States, aggregate household disposable income rose strongly over the first half of the year as increased unemployment benefits and other transfer payments more than offset the decline in labour and other types of income (Graph A.1). In Australia, social assistance benefits in the June quarter were 50 per cent higher than the previous year. In Canada, government transfer payments to households doubled over the year to the June quarter. In the United States, transfers to households, including direct cash payments and increased unemployment benefits, doubled between March and April; in fact, the increase was so large that two-thirds of those unemployed earned more than in their previous employment.[2] In contrast, social assistance benefits did not increase significantly in most European economies as they mainly relied on enhancing existing wage subsidy schemes.

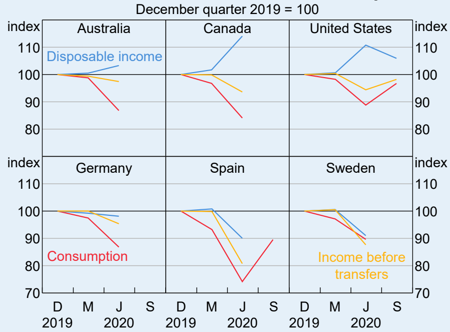
Wage subsidies have been critical to supporting household incomes and employment. Participation in wage subsidy schemes has been significant; in some economies, up to 60 per cent of the labour force have received these subsidies at some point. In Europe, while wage subsidies have supported household incomes by keeping workers attached to their employers, they have not prevented a decline in income. In Australia and New Zealand, wage subsidies have involved a minimum payment to workers and, in some cases, this exceeded the original earnings for some participants.[3] Importantly, beyond directly supporting incomes, wage subsidy schemes have limited the initial increase in unemployment, reduced income uncertainty and supported household confidence. By helping to maintain relationships between employees and their employers, wage subsidy programs will also limit longer-term scarring effects in the labour market that can result from unemployment.

The significant support to household incomes has enabled a shallower downturn and faster rebound in some forms of consumption, especially for goods, and has boosted household savings. Some of this increase in savings has been forced: activity restrictions prevented the purchase of many services.[4] The increases in incomes in the United States and Canada in the early stage of the pandemic were so large that it is unlikely households would have spent them immediately even if consumption opportunities were unconstrained. The boost to household savings should support consumption in the period ahead as some income support measures are scaled back.

Graph A.1

Real Household Income and Consumption

December quarter 2019 = 100



Sources: national sources; OECD; RBA; Refinitiv

Policy support for business has so far prevented a large increase in insolvencies

Government support for businesses has been important in directly offsetting large declines in revenue, thereby limiting job losses and business closures. In most advanced economies, this support has come principally in the form of wage subsidies, and to a lesser extent from other business subsidies and measures such as tax deferrals and loan guarantees (Graph A.2). Wage subsidies have supported business viability by sharply reducing the effective wage bill and thereby firms' operating costs.

Other direct business subsidies have also been important in some economies. In Australia, the value of non-wage subsidies in the June quarter was equivalent to just under one-third of the total value of government assistance for businesses; in Canada, the comparable figure was around 15 per cent. In the United States, effectively one-quarter of government business subsidies were non-wage subsidies because the small businesses using the Paycheck Protection Program could use up to one-quarter of their loans for eligible non-wage expenses and still qualify for loan forgiveness.

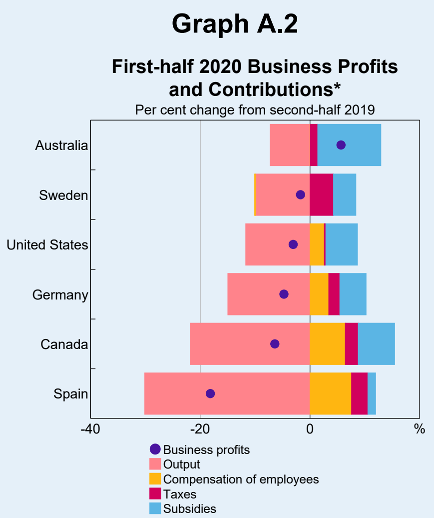
Private sector incomes during the COVID-19 shock have so far held up better than in past recessions

The increase in net government transfers to households and business subsidies to date have far exceeded the increases seen in past recessions (Graph A.3).

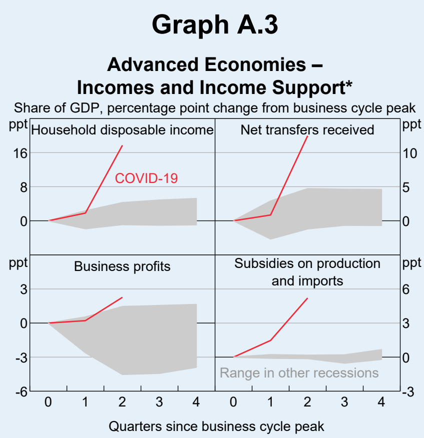
Net transfers to households generally increase during a recession because less tax is collected and government payments increase as people lose their jobs (reflecting the effect of 'automatic stabilisers'), but the unprecedented policy measures have boosted this effect. As a result, recent trends in private sector incomes have been atypical compared with other economic contractions.

The unusually strong support to household incomes and business viability has contributed to a stronger and quicker recovery in a number of economies than was widely anticipated before lockdowns were lifted. The recovery has been especially rapid in sectors that have been less constrained by remaining social distancing requirements, such as goods consumption and production. Moreover, consumer and business confidence have also been supported, and business failures and personal defaults have been limited so far.

The fragility of the recovery has led many governments to extend their wage subsidy schemes into 2021. At the same time, there has been an effort to make them more targeted (by narrowing the schemes' scope through tightened eligibility) and to reduce the value of the benefits paid. Some governments have also announced substantial further fiscal support, including for labour markets beyond the initial wage subsidies and investment initiatives to boost the recovery phase.[5] ✠



* Business profits include gross operating surplus and mixed income
Sources: ABS; OECD; RBA



* Sample includes Australia, Canada, Germany, Spain, Sweden and the United States; median change shown for COVID-19
Sources: national sources; NBER; OECD; RBA; Refinitiv; The Conference Board

Endnotes

[1] For more information on wage subsidies, see RBA (2020), 'Box A: Using Wage Subsidies to Support Labour Markets Through the COVID-19 Shock', *Statement on Monetary Policy*, August, pp 19–22. Available at <https://www.rba.gov.au/publications/smp/2020/aug/box-a-using-wage-subsidies-to-support-labour-markets-through-the-covid-19-shock.html>

[2] Ganong P, P Noel and J Vavra (2020), 'US Unemployment Insurance Replacement Rates During the Pandemic', BFI Working Paper No 2020-62 .

[3] New Zealand's wage subsidy scheme paid a fixed amount for full-time and part-time workers, whereas Australia's JobKeeper payment was a single rate for all eligible workers until late

September. New Zealand is not included in the sample of comparison economies due to lack of timely income data.

[4] Dossche M and S Zlatanos (2020), 'COVID-19 and the Increase in Household Savings: Precautionary or Forced?', ECB *Economic Bulletin*, Issue 6/20, viewed 2 October. Available at <https://www.ecb.europa.eu/pub/economic-bulletin/focus/2020/html/ecb.ebbox202006_05~d36f12a192.en.html>.

[5] For further discussion, see RBA (2020), 'Box B: Fiscal Policy Support for the Recovery Phase in Advanced Economies', *Statement on Monetary Policy*, August, pp 23–26. Available at <https://www.rba.gov.au/publications/smp/2020/aug/box-b-fiscal-policy-support-for-the-recovery-phase-in-advanced-economies.html>

2. International Financial Conditions

Global financial conditions continue to support economic growth. Monetary policy settings remain very accommodative and some central banks are expected to provide additional stimulus in the months ahead. Sovereign bond yields remain low and stable, reflecting the subdued economic and inflation outlook and the effects of central bank purchases. Corporate bond yields are very low and equity prices remain substantially higher than their March lows. Corporate earnings improved in the September quarter, but remain significantly lower than a year ago. The exchange rates of major advanced economies have been little changed since the previous *Statement*. The Australian dollar has depreciated from its recent peak in late August; much of this reflects the increase in market expectations, and then the introduction of further policy easing by the Reserve Bank at its November meeting. Financial conditions have been stable in recent months in most emerging markets, while in China, bond yields have risen further alongside the economic recovery and the Chinese renminbi has appreciated.

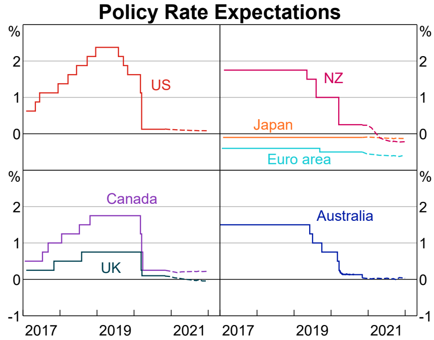
The policy settings of central banks in advanced economies will remain accommodative for a prolonged period

Central banks in advanced economies continue to provide monetary stimulus to support the economic recovery. Market analysts also expect some central banks to provide additional monetary stimulus in the coming months in response to shortfalls in demand and low inflation. An increase in COVID-19 cases in Europe and the United States is also expected to weigh on economic activity in the near term.

Central banks have given strong guidance that policy rates will remain at current or lower levels for several years, because inflation is expected to remain below target and unemployment rates elevated for an extended period (Graph 2.1). Some central banks continue to indicate that lower or negative policy rates are under consideration. The Reserve Bank of New Zealand (RBNZ) noted that banks' systems and processes are expected to be ready for negative interest rates by the end of the year. Also, the Bank of England (BoE) has begun consulting financial institutions on their operational readiness to deal with a zero or negative policy rate, should it be warranted by the economic outlook at some stage. Meanwhile, other central banks – including the Federal Reserve (Fed) and the Bank of Canada (BoC) – have indicated that their policy rates have reached the effective lower bound and are expected to remain above zero.

Graph 2.1

Policy Rate Expectations



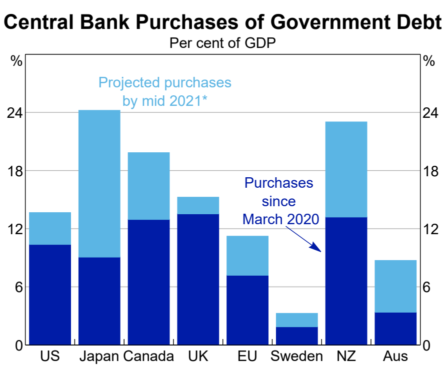
Sources: Bloomberg; RBA

Central banks continue to provide substantial stimulus via asset purchase programs, and are expected to do so for some time yet (Graph 2.2). Purchases of government bonds or other assets by some central banks, such as the Fed, have slowed as market conditions have improved. The BoC also announced that it would reduce the volume of weekly purchases, while simultaneously shifting its purchases towards longer-maturity bonds to maintain the level of stimulus provided by the program. At the same time, other central banks, including the Reserve Bank of Australia, RBNZ and the Swedish Riksbank, have recently expanded their purchase programs to support economic activity. A few central banks, including the European Central Bank (ECB) and the BoE, are expected to extend or expand their programs in the coming months. The ECB has indicated that it will 'recalibrate' its instruments in December to support the economic recovery and counteract the negative impact of the pandemic and the reintroduction of restrictions on the projected inflation path.

A number of central banks continue to support the flow of funding to businesses through lending facilities that provide long-term, low-cost funding for banks, often with incentives to increase lending to the private sector (Graph 2.3). In the euro area, banks borrowed a further €175 billion in the latest round of the ECB's targeted longer-term refinancing operations (TLTRO III), taking the total outstanding amount of loans under the TLTROs to around €1.7 trillion (17 per cent of GDP). Take-up of the Bank of Japan's lending facilities has also increased steadily in recent months, with loans outstanding reaching around ¥48 trillion (9 per cent of GDP) at the end of October. In the United Kingdom, the BoE's Term Funding Scheme With Additional Incentives for Small and Medium-sized Enterprises (TFSME) has made around £49 billion in loans (3 per cent of GDP). The BoE noted that lending under the TFSME was expected to exceed £100 billion over the coming year based on provisional plans submitted by participating firms. Elsewhere, the RBNZ highlighted its intention to deploy a Funding for Lending Programme before the end of the year to provide additional stimulus ahead of a possible policy rate reduction in 2021. Finally, the Fed eased the terms of its Main Street Lending Program, which purchases loans made by banks to small and medium-sized enterprises. The Fed lowered the minimum size of eligible loans from US$250 000 to US$100 000, and adjusted the fees associated with the program to encourage the provision of smaller loans.

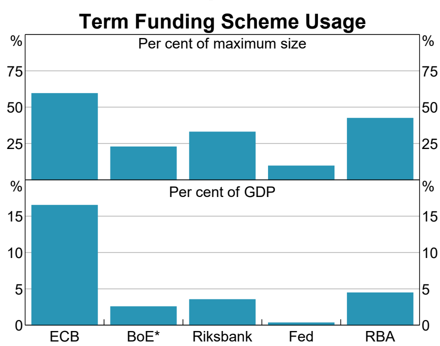
In the United States, the Fed revised its monetary policy framework after completing a comprehensive review. The key changes to the

Graph 2.2



* Projections are based on purchase targets and recent rate of purchases
Sources: Central banks; RBA; Refinitiv

Graph 2.3



* Maximum size refers to initial allowance only
Sources: Central banks; Refinitiv

statement on its longer-run goals and strategy were:

- **The introduction of an 'average inflation target'.** To anchor inflation expectations around 2 per cent the Fed will seek to achieve inflation that averages 2 per cent over time. To achieve this, the Fed will allow inflation to increase moderately above 2 per cent for some time following periods of persistently below-target inflation.
- **Re-characterisation of the maximum employment goal.** The Fed's policy decisions will be based on assessments of the 'shortfall' of employment from its maximum level, rather than 'deviations'. This implies an asymmetric approach, whereby an unemployment rate below the estimated longer-run rate alone would not be a sufficient reason to tighten policy. The Fed also emphasised the importance of the employment objective by moving it ahead of the inflation goal in the statement, and by describing the maximum level of employment as a 'broad-based and inclusive goal'.
- **Placing more emphasis on financial stability.** The revised statement notes that 'sustainably achieving maximum employment and price stability depends on a stable financial system'.

The Fed updated its forward guidance following the release of the new statement, indicating that the policy rate will not be increased until the labour market has reached maximum employment and inflation has risen to 2 per cent and is on track to moderately exceed 2 per cent for some time.

The ECB is conducting a review of its monetary policy strategy that will consider the definition of its price stability objective, including the level of the inflation target and the usefulness of strategies to respond to long periods of low inflation, the effect of structural forces on the relationship between inflation and the real economy, and the monetary policy toolkit. The ECB will also consider how issues such as social inclusion, climate change and financial stability are relevant to their mandate.

Government bond yields remain historically low

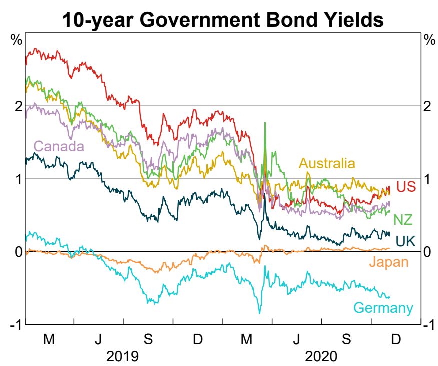
Government bond yields in advanced economies remain very low despite substantial issuance by fiscal authorities (Graph 2.4). This is consistent with expectations that economic activity and inflationary pressures will remain subdued for an extended period, and guidance from central banks that policy rates will stay low for several years and that asset purchase programs will continue.

Since March, most major central banks have purchased the equivalent of more than half of net government debt issuance, while purchases by the BoE have been the equivalent of around 95 per cent of issuance (Graph 2.5). In contrast, government debt purchases by the RBA and the Riksbank in the secondary market have been closer to 25 per cent of issuance (Graph 2.6).

Funding conditions remain favourable for most corporate borrowers

Corporate funding conditions have eased significantly since March. Bond yields are at historically low levels and credit spreads are

Graph 2.4

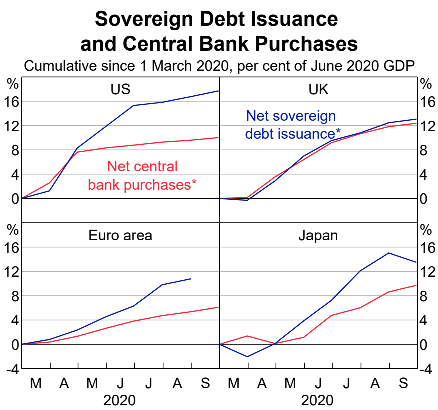


Sources: Bloomberg; Yieldbroker

around their long-run averages (Graph 2.7). Investor confidence has been supported by the significant easing in fiscal and monetary policies, including measures specifically aimed at supporting credit markets. This, in turn, has facilitated an increase in borrowing by firms in response to the pandemic: the pace of bond issuance and growth in business credit has been robust this year, although it has eased recently because firms already have substantial amounts of funding (Graph 2.8). At the same time, bank lending standards have tightened in many jurisdictions. To support the supply of credit through the banking system, fiscal and monetary authorities implemented loan guarantee programs and funding for lending schemes, while also encouraging banks to draw on their capital buffers to extend credit to households and businesses.

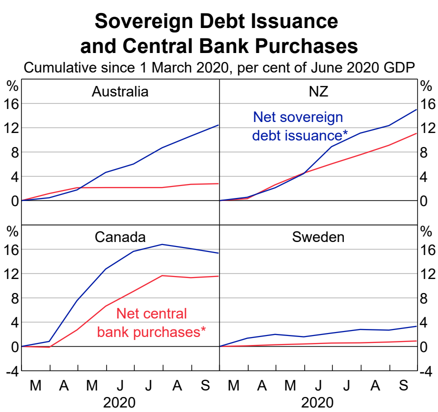
Although financial conditions have eased, the impact of the pandemic on economic activity has seen a rise in the number of companies that have defaulted on their debt. In the United States and Europe, defaults in the June quarter increased to levels last seen during the global financial crisis, before easing slightly in the September quarter (Graph 2.9). So far, defaulting firms have been largely concentrated in sectors most affected by the pandemic, including the retail, leisure, entertainment and energy sectors. The number of corporate defaults is expected to

Graph 2.5



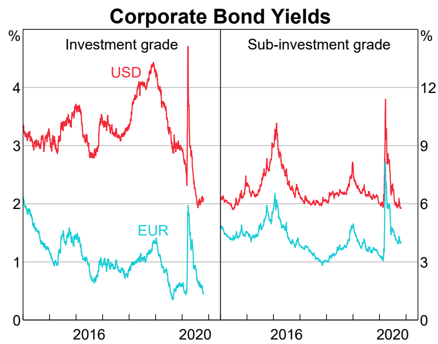
* Net of maturities
Sources: BoE; BoJ; ECB; Fed; Refinitiv; UK Debt Management Office

Graph 2.6



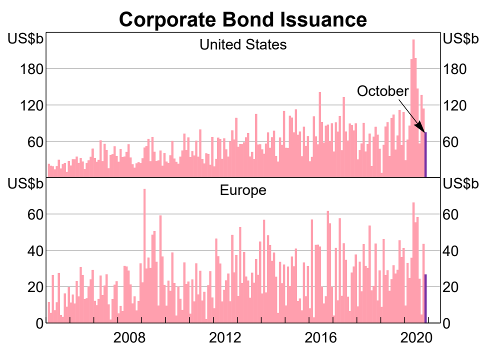
* Net of maturities
Sources: BoC; RBA; RBNZ; Refinitiv; Riksbank

Graph 2.7



Source: ICE Data is used with permission

Graph 2.8



Source: Dealogic

Table 2.1: Changes in International Share Prices

Per cent

	Since previous *Statement*	Since recent trough	Since pre-COVID-19 peak
United States	3	54	2
Euro area	0	35	–16
United Kingdom	–2	18	–22
Japan	6	43	–1
Australia	0	33	–15
China	1	36	14
World	**0**	**43**	**–4**

Source: Bloomberg

remain elevated over the remainder of the year, consistent with reduced levels of economic activity. Credit spreads have nonetheless declined to around their longer-run averages, because investors expect that public sector support will continue.

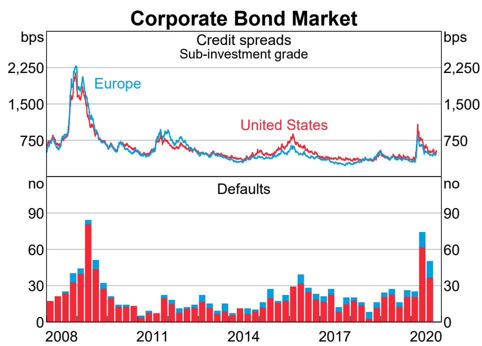
Equity prices have been volatile but remain substantially above their March lows

Global equity prices are generally little changed since the previous *Statement*, and they remain around 40 per cent higher than their trough in March (Graph 2.10). Equity prices temporarily fell sharply in parts of Europe after a number of countries reintroduced strict lockdowns to contain rising COVID-19 cases. In the United States and Japan, equity prices remain around their peaks prior to the pandemic; most other indices are around 15–20 per cent below their pre-pandemic levels (Table 2.1).

Higher global equity prices have been supported by a nascent recovery in corporate earnings. While profitability remains much lower than a year ago, corporate earnings in the United States and Europe are estimated to have risen over the September quarter and are expected to increase further in the months ahead. Corporate earnings have been aided by the significant easing of fiscal and monetary policies, which has supported economic activity while helping to reduce uncertainty and increase risk appetites. However, the volatility of equity prices has remained above long-run averages, in part reflecting rising COVID-19 infections in some parts of the world and uncertainty in the United States over the outcome of the US election and prospects for further fiscal stimulus (Graph 2.11).

A decline in equity prices in September reflected concerns about elevated valuations in equity markets, especially of technology stocks in the United States. The US technology sector has rallied by 65 per cent since its trough in March, and is 15 per cent higher than its pre-pandemic level (Graph 2.12). While the increase in technology stocks is consistent with greater demand for digital goods and services during

Graph 2.9

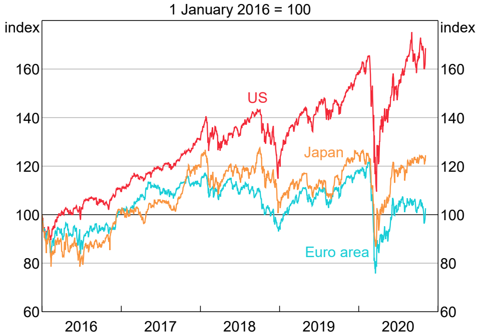


Sources: ICE Data is used with permission; S&P Global Market Intelligence the pandemic, the increase in US technology equity prices has significantly outpaced growth in forward earnings estimates for the sector.

Graph 2.10

Equity Prices

1 January 2016 = 100

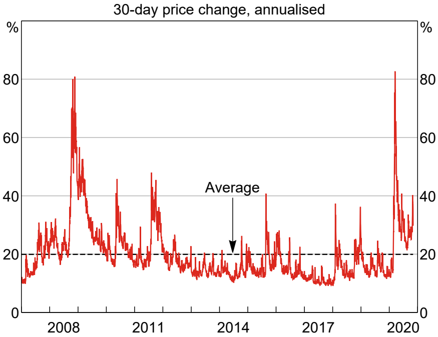


Source: Bloomberg

Graph 2.11

Implied Volatility for US Equity Prices

30-day price change, annualised



Source: Bloomberg

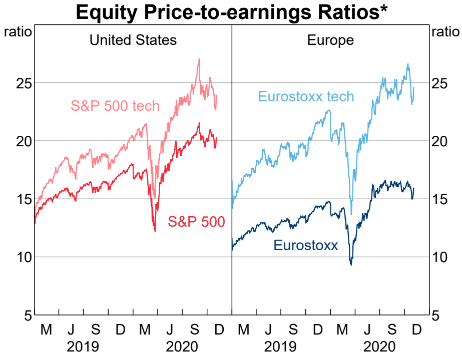
Bank share prices have continued to underperform broader equity markets because the economic impact of the pandemic is expected to reduce banks' profitability for some time (Graph 2.13). Provisions for future loan losses increased significantly over the first half of the year, contributing to sharp falls in earnings, before returning to pre-COVID-19 levels in the September quarter (Graph 2.14). Lower interest rates have also weighed on bank profitability by reducing net interest margins. In contrast, banks' investment banking revenues have been buoyed by higher market volatility and increased debt and equity issuance. Overall, banks remain highly capitalised, and continue to support the economic recovery by extending credit to households and businesses.

The US dollar has depreciated significantly over a number of months

After having appreciated sharply in March, the US dollar has depreciated significantly on a trade-weighted (TWI) basis and is around levels observed prior to the onset of the pandemic (Graph 2.15). The depreciation has been consistent with the easing in global risk aversion since March as well as US interest rates having fallen by more than those in other major advanced economies. The US dollar is little

Graph 2.12

Equity Price-to-earnings Ratios*



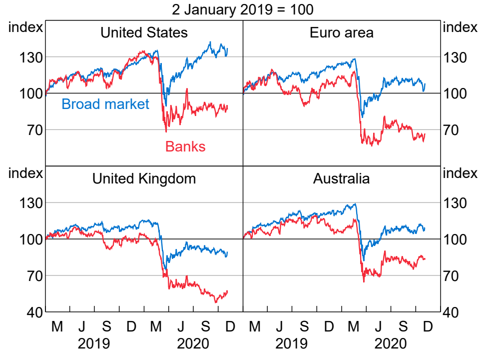
* Calculated using consensus forecasts for next calendar year earnings

Source: Bloomberg

Graph 2.13

Bank Equity Prices

2 January 2019 = 100



Source: Bloomberg

changed from where it was at the time of the previous *Statement*.

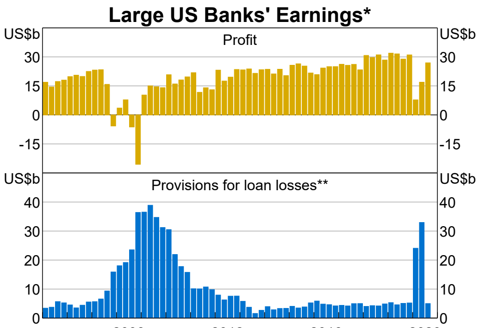
The euro has appreciated over a number of months and remains around its highest level since 2014, supported by the agreement on the EU recovery fund earlier in the year. In response to the appreciation of the euro, the ECB has reiterated that it would carefully assess developments in the exchange rate and its implications for inflation, but that it does not target the exchange rate. The Japanese yen also remains at a relatively high level, despite drifting lower over recent months. The currencies of a number of advanced economies have continued to track US equity markets relatively closely. This could reflect equity markets capturing information about changes in risk and the economic outlook at a time when sovereign bond yields are anchored at very low levels.

The Australian dollar has depreciated alongside a further easing in domestic monetary policies

The Australian dollar has experienced a broad-based depreciation since the start of September, depreciating by 3½ per cent on a TWI basis (Graph 2.16). It is now back around levels observed at the start of the year.

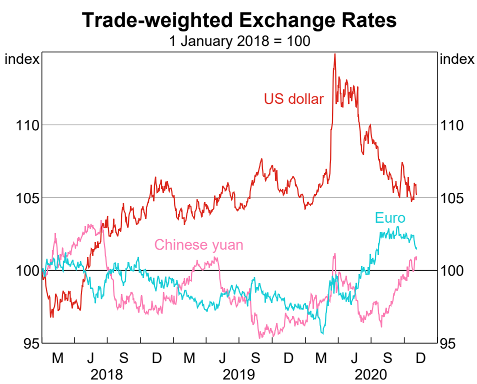
The depreciation of the Australian dollar over the past two months was associated with declines in interest rates in Australia relative to those of other major advanced economies. This occurred as market participants increasingly anticipated further policy easing by the Reserve Bank at the November Board meeting (see Domestic Financial Conditions). Commodity prices have also decreased in the past couple of months (Graph 2.17). Following this recent depreciation, the level of the Australian dollar is a touch lower than historical relationships with the terms of trade and interest rate differentials would suggest.

Graph 2.14



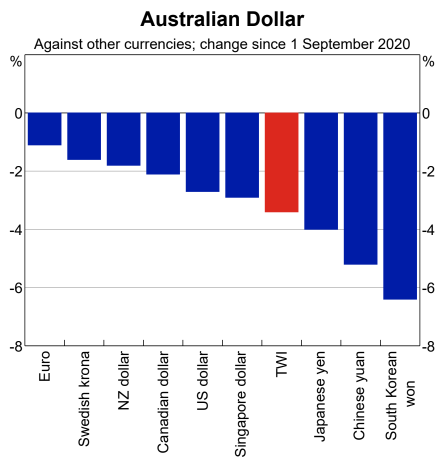
* Includes the 6 largest US banks
** Commercial banks only
Source: Bloomberg

Graph 2.15



Sources: BIS; Bloomberg; Board of Governors of the Federal Reserve System

Graph 2.16



Sources: Bloomberg; RBA

Australia experienced a net capital outflow in the June quarter

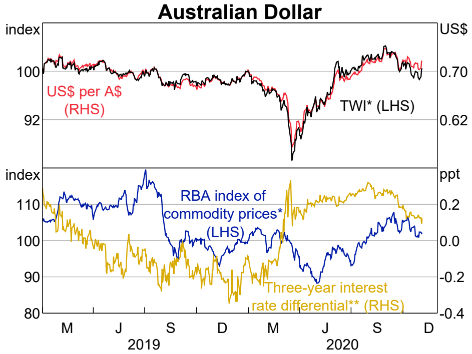
Australia recorded a net capital outflow in the June quarter, mirroring the current account surplus (Graph 2.18). Net outflows were consistent with the decline in outstanding issuance of debt abroad by Australian banks (see Domestic Financial Conditions). In contrast, there were inflows related to foreign purchases of Australian Government securities and Australian superannuation and investment funds selling foreign equities for liquidity purposes.

Australia's net foreign liability position remains around its lowest level as a per cent of GDP since the early 1990s (Graph 2.19). A small increase in the June quarter was driven by a narrowing in Australia's net foreign equity asset position. This in turn owed mostly to valuation effects associated with the appreciation of the Australian dollar, which reduces the Australian dollar value of foreign equity portfolios. This follows a number of years over which Australian equity investment abroad exceeded foreign equity investment in Australia and the net foreign equity position widened.

Financial conditions have been stable for most, but not all, emerging markets

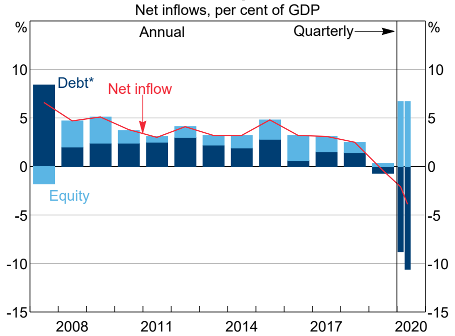
With a few notable exceptions, financial conditions in emerging market economies (EMEs) have been stable in recent months, aided by accommodative domestic policy settings and very accommodative global financial conditions. Government bond yields remain around record lows for most EMEs, equity prices have for the most part been steady and there have been modest portfolio inflows into most regions since June (Graph 2.20). Spreads on US dollar-denominated government and corporate bonds have narrowed further over recent months, although they remain above their pre-COVID levels. The currencies of some EMEs in Asia have appreciated against the US dollar, alongside the economic recovery in China, while exchange rates of most other EMEs have depreciated. In

Graph 2.17
Australian Dollar



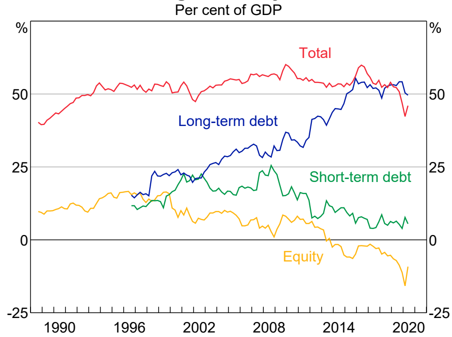
* Indexed to 1 January 2020 = 100
** Spread to the United States, Japan and Germany, weighted by GDP
Sources: Bloomberg; RBA

Graph 2.18
Australian Capital Flows
Net inflows, per cent of GDP



* Adjusted for US dollar swap facility in 2008-09 & 2020; includes reserve assets, other central bank flows and derivatives
Sources: ABS; RBA

Graph 2.19
Net Foreign Liability Position
Per cent of GDP



Sources: ABS; RBA

particular, the Turkish lira has depreciated significantly, reflecting concerns about rising geopolitical tensions and macrofinancial vulnerabilities.

Though financial conditions have improved substantially since the onset of the pandemic, EMEs remain vulnerable to the ongoing health and economic crisis. This is particularly the case for those EMEs that entered the pandemic with weak economic growth, large fiscal deficits and substantial external financing. A few EMEs that are particularly vulnerable continue to face financial conditions that are noticeably tighter than at the start of the year, in particular South Africa and Turkey.

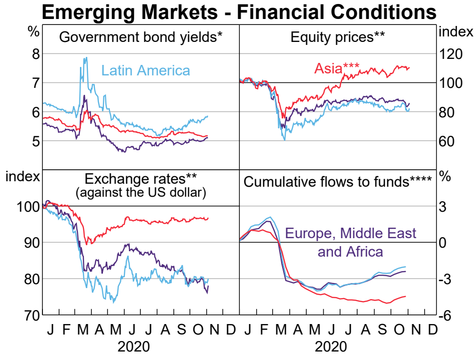
Emerging market central banks have maintained accommodative policy settings (see 'Box B: The Policy Response of Central Banks in Emerging Market Economies to COVID-19'). Policy rates have generally been unchanged at low levels since August (Graph 2.21). Indeed, a number of EME central banks have indicated that the scope for further policy easing is limited, noting concerns about the effect of further reductions in interest rates on exchange rate stability, inflation and financial stability. Central bank purchases of government bonds have generally been modest in recent months. Most EME's appear to have largely scaled back foreign exchange intervention to support their currencies, while some central banks in Asia have actually been accumulating reserves to limit exchange rate appreciation.

Multilateral measures have continued to support low-income countries and EMEs during the crisis. The International Monetary Fund (IMF) is providing financing to low-income countries and EMEs, and has extended to April 2021 a temporary increase in its limits on emergency lending; this will enable members to apply for further emergency financing if needed (Graph 2.22). In addition, over 40 low-income countries will continue to receive debt forbearance through the G20's Debt Service Suspension Initiative, which has been extended until mid 2021.

Given the scale of the crisis, there is widespread acknowledgement of the need to transition from emergency support to larger and longer-term assistance. As part of this process, the IMF is considering how to adapt its longer-term conditional lending programs to the specific challenges of this crisis; for example, by temporarily front-loading payments and introducing more focus on short-term economic stabilisation. The international community has also recognised that in some cases debt restructuring may be necessary, particularly for

Graph 2.20

Emerging Markets - Financial Conditions

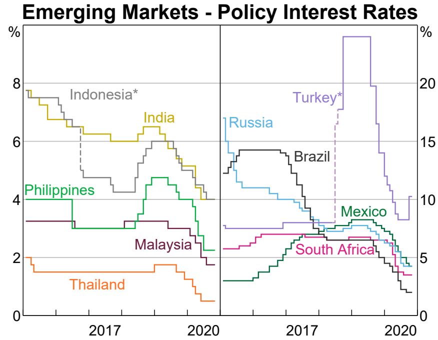


* Local currency bonds, weighted by market value
** 1 Jan 2020 = 100
*** Excluding China
**** Per cent of assets under management; includes flows to bond and equity funds

Sources: Bloomberg; EPFR Global; IMF; JPMorgan; MSCI; RBA

Graph 2.21

Emerging Markets - Policy Interest Rates



* Dashed lines indicate a change in the monetary policy framework and/or to the rate used as the official policy rate

Source: Central banks

low-income countries. Efforts are already underway to improve the sovereign debt restructuring process, including the development of a shared framework among G20 countries that is intended to enhance creditor cooperation.

China's monetary policy remains accommodative but financial conditions have tightened as the economy recovers

Policymakers in China continue to support economic growth and employment at the same time as limiting the build-up of financial stability risks. To that end, policymakers have overseen a tightening of conditions in financial markets since May. Government and corporate bond yields have risen to around pre-pandemic levels, interest rates in money markets have increased, and the People's Bank of China (PBC) has reduced its provision of liquidity (Graph 2.23).

Nevertheless, financial conditions more broadly remain accommodative. In particular, equity prices have risen substantially this year and bank lending rates remain low, reflecting reductions in the PBC's medium-term lending facility rate earlier this year, which flowed through to declines in the Loan Prime Rate (the reference rate for most bank loans in China). Local banks have also been instructed to reduce their interest margins to keep lending rates low.

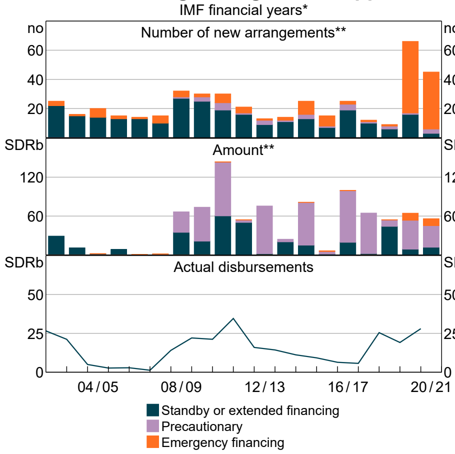
Growth in total social financing (TSF) has increased in year-ended terms despite some moderation in recent monthly growth rates (Graph 2.24). This remains consistent with the stated goal of authorities that TSF growth in 2020 be 'notably higher than in 2019'. The faster pace of growth this year partly reflects stronger growth in business loans, equity issuance and corporate bond issuance. In addition, government bond issuance has been strong at both the local government and central government levels this year consistent with the scale of China's government deficit.

Credit supply continues to be targeted towards the private sector and smaller enterprises, and away from the riskier and more highly leveraged sectors such as real estate. Policymakers also continue to focus on ensuring that credit is flowing through the less opaque and better regulated parts of the financial system (the banks and financial markets), and less through shadow financing channels. In addition, authorities remain mindful of the potential

Graph 2.22

IMF Financing Arrangements Approved

IMF financial years*



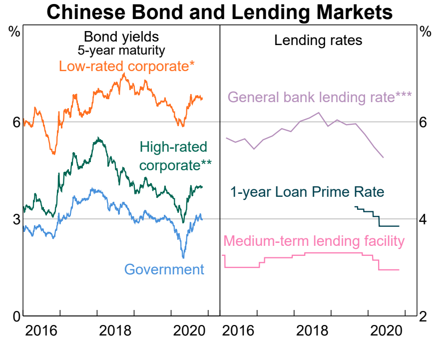
* IMF financial year runs from May to April; the observation for 2020/21 is for May to September 2020

** Excludes augmentation of existing arrangements

Sources: IMF; RBA

Graph 2.23

Chinese Bond and Lending Markets



* Based on domestically rated AA- corporate bonds

** Based on domestically rated AAA corporate bonds

*** Business rate proxy

Sources: Bloomberg; CEIC data; RBA

build-up of risks in the banking sector (see RBA (2020), *Financial Stability Review*, October).

The Chinese renminbi has appreciated

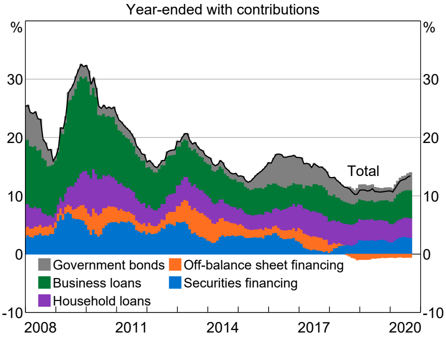
The Chinese renminbi has appreciated over recent months and is around 5 per cent higher than at the start of the year (Graph 2.25). The appreciation has occurred alongside the broad-based depreciation in the US dollar, the rebound in Chinese economic activity, and continued inflows to Chinese bond markets. These inflows are likely to have been supported by Chinese interest rates rising relative to those of advanced economies. Inflows related to China's inclusion in some global fixed income benchmarks also appear to have provided support to the value of the renminbi. Geopolitical and trade tensions remain key factors that could influence the currency.

In October, the PBC removed the requirement for holding reserves against some foreign exchange derivatives that would benefit from a depreciation in the renminbi. Some market reports suggested that the change signalled some concern about the recent pace of appreciation, while others highlighted it was consistent with the ongoing liberalisation of the currency. ✠

Graph 2.24

China – Total Social Financing Growth*

Year-ended with contributions

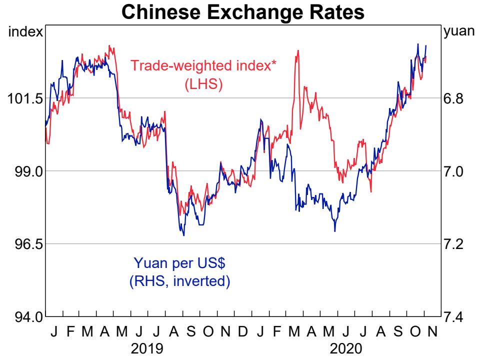


* Net government bond issuance includes local government bond issuance to pay off debt previously included in TSF, and uses RBA estimates prior to 2016

Sources: CEIC Data; RBA

Graph 2.25

Chinese Exchange Rates



* Indexed to 1 January 2019=100

Sources: Bloomberg; China Foreign Exchange Trade System; RBA

Box B

The Policy Response of Central Banks in Emerging Market Economies to COVID-19

Global financial conditions tightened noticeably at the onset of the COVID-19 crisis, placing significant strain on emerging market economies (EMEs). Government and corporate bond yields rose sharply, and exchange rates depreciated alongside substantial portfolio outflows. In response, and in contrast to some previous crisis periods, central banks in these economies implemented a broad range of easing measures. Together with the fiscal response of EME governments and the actions of governments and central banks globally, these measures contributed to the stabilisation of many, though not all, emerging financial markets and improved economic conditions more broadly.[1] This box outlines the key features of the monetary policy response of EMEs outside China to the COVID-19 crisis, acknowledging that there has been a diversity of experience and in many countries long-term challenges related to health outcomes, economic growth and financial stability remain.

Reducing policy rates

Central banks in EMEs lowered their policy rates substantially between March and July this year to ease financial conditions and support economic growth. As a result of the reductions in policy rates, as well as expectations that rates will remain low for some time, local currency government bond yields have declined to historic lows in many EMEs, thereby reducing borrowing costs more broadly. In contrast, a few EMEs such as South Africa and Turkey continue to face borrowing costs that are substantially higher than at the start of the year, reflecting elevated concerns about their economic outlooks and the capacity of policy makers in those economies to respond to any further significant shocks.

Historically, many EME central banks have not lowered their interest rates by as much as current economic conditions by themselves would warrant because of the potential for a large exchange rate depreciation and adverse consequences that could follow from that. While a depreciation typically supports the economy through net exports it can also lead to large and persistent increases in inflation when inflation is not well-anchored. Higher inflation can reverse some or all of the benefits of a nominal depreciation for the price competitiveness of an EME's domestically produced goods. Moreover, for economies with substantial foreign currency borrowing, a depreciation in the exchange rate can increase the cost of servicing and repaying debt that is unhedged. Similarly, a decline in interest rates and depreciation of the exchange rate can encourage large-scale portfolio outflows, making it difficult to roll over external funding.

Over recent decades in many EMEs central bank independence has increased and central banks have improved their policy frameworks, which has in turn helped to contain inflation and anchor inflation expectations. Local currency financial markets have also developed in many EMEs and central banks have accumulated substantial foreign exchange reserves. These developments have reduced the difficult trade-offs that many EME central banks have faced in the past and increased their scope to ease monetary policy this year. Indeed, the scale of the declines in EME policy rates this year is in sharp contrast to the Asian Financial Crisis and some more recent periods when EME policy rates were generally *increased* at times of tightening financial conditions for emerging markets (Graph B.1 and Graph B.2).

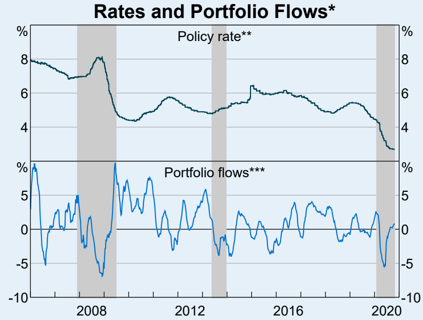
Large declines in inflation this year for many EMEs have also reduced the trade-offs EME central banks have faced, as has the large easing of monetary policy in advanced economies, which reduced currency depreciation and capital outflow pressures on EMEs. However, a few EMEs have not had benign inflation outcomes this year, and this has posed challenges for monetary policy. Turkey has experienced a large depreciation of the exchange rate and high inflation, and the central bank has responded recently by increasing policy interest rates. Argentina has also experienced continued high inflation and exchange rate depreciation. In India, recent high inflation is expected to be temporary, but the central bank has indicated it is an obstacle to the provision of further monetary stimulus.

Foreign exchange market intervention

EME central banks intervened extensively in the foreign exchange market during the most acute phase of the COVID-19 crisis to support their currencies. These interventions dampened financial stability risks that can arise from sudden increases in the value of foreign currency obligations. Estimates from the International Monetary Fund (IMF) suggest that while the scale of intervention in March was the largest in US dollar terms since the global financial crisis, the accumulation of reserves over the past decade meant that it was a less significant event when measured relative to the total stock of available reserves.[2] As conditions in emerging markets have stabilised of late, intervention to support currencies has been

Graph B.1

Emerging Market Policy Rates and Portfolio Flows*



* Shaded areas show approximate periods of the Global Financial Crisis, Taper Tantrum, COVID-19

** Average of India, Indonesia, Malaysia, Philippines, Thailand, Brazil, Chile, Mexico, Russia, South Africa

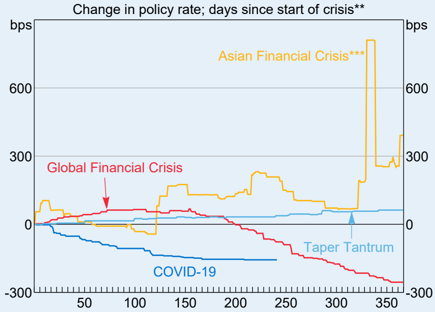
*** One-quarter rolling sum of net inflows to emerging market investment funds; per cent of assets under management

Sources: BIS; EPFR Global; RBA

Graph B.2

Emerging Market Policy Rate Responses to Crises*

Change in policy rate; days since start of crisis**



* Average of India, Indonesia, Malaysia, Philippines, Thailand, Brazil, Chile, Mexico, Russia, South Africa

** Approximate start dates of Asian Financial Crisis 2 July 1997; Global Financial Crisis 1 July 2008; Taper Tantrum 22 May 2013; COVID-19 1 March 2020

*** Average of India, Malaysia and Philippines only

Sources: BIS; RBA

scaled back and some countries, particularly in the Asian region, have been accumulating foreign exchange reserves.

EME governments did not rely heavily on measures to restrict capital flows during the COVID-19 crisis. In the past, some EMEs have placed restrictions on capital outflows to reduce currency depreciation pressures but these measures can also reduce the availability of external financing over the longer term.

Supporting government bond market functioning

Most EME central banks have purchased local currency government bonds this year to address disruptions to market functioning; many purchased government bonds in secondary markets for the first time. Central bank purchases have contributed to a normalisation of conditions, helping to offset the sudden and large retreat of foreign investors from EME local currency government bonds, which had contributed to declines in liquidity and sharp increases in yields.[3]

In most cases, bond purchases by EME central banks have been equivalent to 0.5–1.5 per cent of GDP, which is much less than the case of central banks in advanced economies. The EME purchases have been focused on addressing market dysfunction, whereas asset purchases in advanced economies have also sought to provide a broader easing of financial conditions by lowering longer-term risk-free interest rates. Government bond markets are also generally smaller as a share of GDP in emerging economies than in advanced economies. Notably, government bond purchases by EME central banks have been generally modest even though fiscal deficits in EMEs have increased substantially and government bond issuance has increased accordingly.

Many EMEs with US dollar obligations were also exposed to the dysfunction in US dollar markets in the early period of the crisis. The US Federal Reserve established temporary US dollar liquidity arrangements with a group of central banks including Brazil, Mexico and South Korea, allowing them to provide US dollar funding to their local markets. Other EMEs also benefited because the swap lines reduced some of the excess demand for US dollars. The broader monetary policy easing in advanced economies also reduced US dollar funding pressures for all EMEs.

Purchases of government debt at issuance

A couple of emerging market central banks have purchased government bonds directly from the government fiscal authority. In contrast to other purchases by central banks, these direct purchases have been made in the primary market: at the fiscal authority's auctions or by direct non-competitive transactions between the fiscal authority and the central bank.

In addition to its existing bond buying program, Bank Indonesia announced a deficit burden-sharing arrangement with the Indonesian Ministry of Finance in July under which Bank Indonesia will purchase government bonds in the primary market. The value of bonds purchased will be between 2½ and 6 per cent of GDP depending on the final implementation of the program and demand for the bonds from investors. The central bank's purchases have been split into three parts and directly linked to components of the government's fiscal response to the COVID-19 crisis including health and social security spending, and support for businesses. The government and central bank have indicated that two of the three parts of the central bank's purchases are limited to purchases in the current fiscal year.

In the Philippines, the central bank has purchased government bonds equivalent to 3 per cent of GDP directly from the Philippines Treasury through a provisional advance facility. The limit on the size of this facility was increased this year to 30 per cent of average government revenues over the previous three years (from 20 per cent), and will remain at the higher level for two years.

While the direct purchases of government bonds by Indonesia and the Philippines have raised some concerns about central bank independence, the response in financial markets has been muted thus far. To the extent that these programs are temporary measures, this should reduce concerns regarding central bank independence.

Supporting the flow of funding to businesses

EME central banks have generally focused their monetary policy operations on lowering funding rates for governments and financial institutions. In some emerging markets, central banks have also offered term funding facilities, refinancing programs or loan guarantee schemes, often targeted towards small and medium enterprises. However, these programs have generally been modest. Corporate asset purchase programs have been established by a limited number of EMEs. ✠

Endnotes

[1] An alternative discussion of EME's policy response including comparisons to the advanced economy response is available in Bank for International Settlements (2020), 'Annual Economic Report 2020'. Available at <bis.org/publ/arpdf/ar2020e.htm>.

[2] For more information on foreign exchange reserve operations by EMEs, see IMF (2020), 'GMM Box: Update on EM Reserve Operations', *Global Markets Monitor*, 9 July. Available at <https://www.imfconnect.org/content/dam/imf/News%20and%20Generic%20Content/GMM/archive/GMM%20July%209,%202020.pdf>.

[3] For a discussion of the nature and impacts of EME central bank purchases of government bonds, see IMF (2020), 'Global Financial Stability Report', October, Chapter 2. Available at <imf.org/en/Publications/GFSR/Issues/2020/10/13/global-financial-stability-report-october-2020#Chapter2>.

3. Domestic Economic Conditions

A recovery in economic activity is underway across the country, but is proceeding at an uneven pace. Some industries remain constrained by mandated and voluntary social distancing, particularly in hospitality and tourism, while some other industries are feeling the effects of the broader economic downturn. The recovery has also varied across the country. The recent outbreak in Victoria and the associated strict lockdown measures induced a temporary setback there, but the economic recovery has continued elsewhere. Nationally, more than half of the employment lost in the initial downturn has been regained, but significant spare capacity remains in the labour market.

This recovery follows the biggest peacetime contraction in the Australian economy since the early 1930s. The national accounts confirmed that the Australian economy contracted by 7 per cent in the June quarter, the largest decline since the quarterly accounts began in 1959. The decline in GDP was immense, but less severe than in many other advanced economies because health outcomes here were less severe and policy support was substantial.

The near-term economic outlook will depend significantly on health outcomes, the prevention of the spread of the virus, and advances in medical treatment. The substantial policy stimulus implemented by the Australian and state governments and the Bank has played an important role in supporting the economy and will continue to do so. Policy measures introduced since the start of the pandemic have helped to keep employment relationships intact and have also increased the financial buffers of many households and businesses; an increase in financial buffers is an unusual outcome during an economic downturn. Measures introduced by the Bank have supported financial market functioning and the flow of credit, and reduced interest rates for borrowers. All these measures will encourage a swifter recovery. While earlier fiscal measures were centred on supporting incomes and retaining jobs, recent announcements have been more targeted towards stimulating private demand, which had taken a significant hit because of the pandemic. It is also likely that the disruption to how businesses and households operate, work and consume will lead to some structural change in the economy and entail a period of adjustment. More generally, and as set out in the 'Economic Outlook' chapter, a high degree of uncertainty will be a feature of the outlook for some time.

Domestic COVID-19 cases have fallen significantly

Most states have recorded a small number of new daily COVID-19 cases over recent months, but many of these have been returned travellers in hotel quarantine and there have been few instances of local transmission that are not linked to known contacts. The number of daily domestic COVID-19 cases over recent months has largely reflected case numbers in Victoria; these have declined significantly, from an average of around 270 in July to below 5 in late October, and local transmission has fallen to a few cases per fortnight (Graph 3.1).

Since August, state governments outside of Victoria have generally made targeted adjustments to social distancing restrictions in response to local outbreaks, and have also announced plans to ease restrictions further if health outcomes allow it. Even so, some restrictions are likely to remain in place for some time, possibly until a vaccine becomes widely distributed.

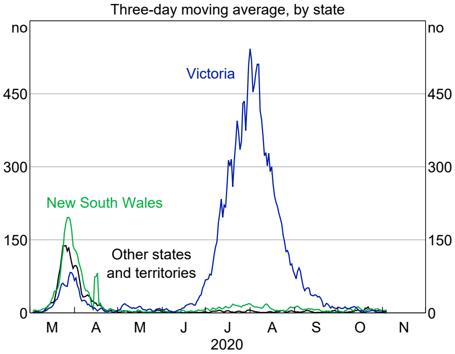
Restrictions in Melbourne have begun to be lifted under the Victorian Government's 'roadmap' for reopening the economy in steps, which seeks to balance reopening the economy and containing the virus. The first target was met in late September, a touch ahead of schedule, and restrictions were relaxed slightly. The next, more substantive, step of reopening started in late October. The last step of the plan, which would bring restrictions on activity in the state broadly in line with other parts of the country, is conditional on reaching a target of no new locally acquired cases in a 14-day period.

Over recent months, individuals have also voluntarily adjusted their behaviour in response to concerns about the spread of the virus. Reflecting a combination of mandated and voluntary responses, indicators of mobility dipped around July and August (Graph 3.2). Given the lockdown measures in Victoria, there was a marked fall in mobility in Melbourne; there was a shallower but still noticeable dip in Sydney, while the other capital cities appeared to have been less affected. Indicators of mobility, outside of Melbourne, have been relatively steady or declined a little over the past month or so and remain below their level at the start of the year in all states. Survey measures of business sentiment have continued to pick up over recent months, while measures of consumer sentiment increased sharply following the release of the Australian Government Budget (Graph 3.3).

Graph 3.1

Confirmed COVID-19 Cases in Australia

Three-day moving average, by state

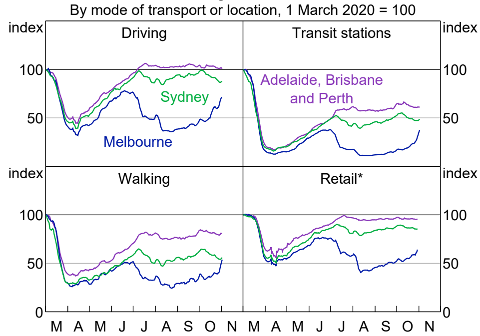


Sources: covidlive.com.au; government health departments; RBA

Graph 3.2

Mobility Indicators

By mode of transport or location, 1 March 2020 = 100



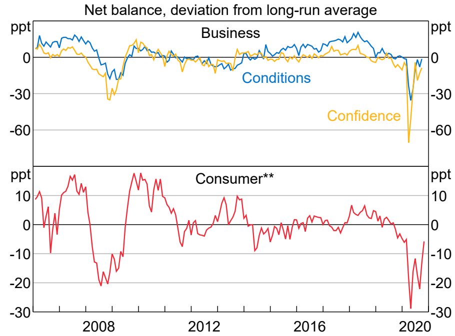
* Retail data are state based

Sources: Apple; Google LLC (2020), 'Google COVID-19 Community Mobility Reports', available at https://www.google.com/covid19/mobility/ viewed on 4 November 2020; RBA

Graph 3.3

Business and Consumer Sentiment*

Net balance, deviation from long-run average



* Latest observations are September 2020 for business confidence and conditions and October 2020 for consumer confidence

** Average of Westpac–Melbourne Institute and ANZ–Roy Morgan surveys

Sources: ANZ–Roy Morgan; NAB; RBA; Westpac–Melbourne Institute

Employment was quick to rebound initially, but the improvement has slowed more recently

Employment and hours worked remain well below their pre-pandemic levels, as does activity. The initial recovery in employment was faster than had been earlier expected, but the pace of improvement has slowed since August. This slowing at the national level has been partly driven by developments in Victoria; between July and September employment there decreased by 2.2 per cent while increasing by 1.9 per cent in the rest of Australia (Graph 3.4). Timelier payroll data indicate that the number of payroll jobs nationally are a bit lower than they were in August.

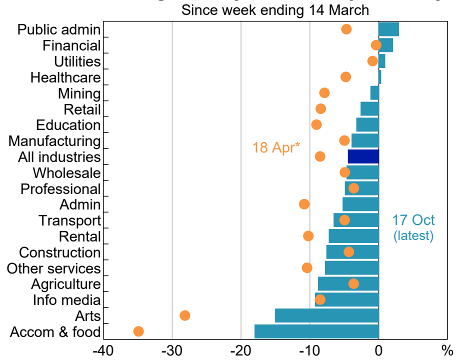
Labour market conditions initially improved quickly once health-related restrictions started to be eased from May. Of the 870,000 employment losses between March and May, about half have since been recovered, but employment in September was still 3.3 per cent lower than in March. Increases in employment have been broad based across industries, although the number of payroll jobs remains below pre-pandemic levels in most cases (Graph 3.5).

Consistent with the increase in employment, total hours worked nationally have recovered about half of their initial fall; the recovery has been stronger outside of Victoria but hours worked remain well below their previous level (Graph 3.4). Average hours worked have almost fully recovered for part-time workers, as activity has picked up in industries that employ a relatively large share of part-time workers, such as hospitality. However, average full-time hours have recovered only about half of their initial fall (Graph 3.6). In September, around 900,000 employees were working reduced hours for economic reasons, over half of whom were full-time workers. The number of people working reduced hours has steadily fallen in recent months in most states and is around half the number in April, but has remained elevated in Victoria.

Graph 3.5

Change in Payroll Jobs by Industry

Since week ending 14 March



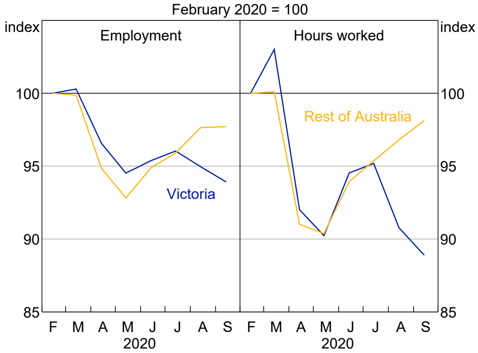
* The lowest weekly value of the aggregate payroll jobs index

Sources: ABS; RBA

Graph 3.4

Employment and Hours Worked

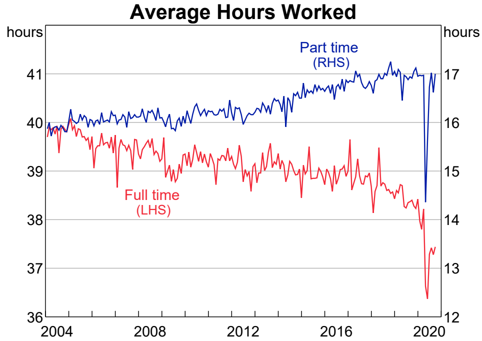
February 2020 = 100



Sources: ABS; RBA

Graph 3.6

Average Hours Worked



Sources: ABS; RBA

Unemployment and other measures of underutilisation remain high

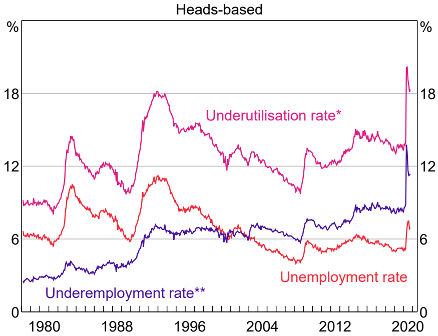
The unemployment rate increased from 5.2 per cent in March to 6.9 per cent in September (Graph 3.7). The rise in unemployment has been smaller than initially expected, in part because much of the labour market adjustment to the downturn was through employees working fewer hours while retaining their jobs, rather than becoming unemployed. The retention of employees during this period has been strongly underpinned by the JobKeeper program. Consistent with many employees working fewer hours, broader indicators of spare capacity in the labour market remain high. The heads-based underemployment rate was around 11½ per cent in September, having declined a little from its highest ever rate in April. Hours-based measures of underutilisation – which reflect the additional hours that unemployed and underemployed people would like to work – have also declined from their recent peaks, but remain elevated. The number of people working zero hours for economic reasons in September 2020 was still around four times as high as in September 2019.

Another key driver of the smaller-than-expected increase in the measured unemployment rate since the pandemic began has been a sharp decline in labour market participation. In particular, of those people who lost employment, a large share exited the labour force (at least temporarily); in many cases these people were able to access government income support programs (such as JobSeeker) that were expanded in response to the pandemic. Although the number of people outside the labour market has been steadily declining over recent months, there are still more than 200,000 people who left the labour force early in the pandemic and are yet to return, most of whom are in Victoria. As restrictions continue to ease, it is likely that more people will look to re-enter the labour force, encouraged by increasing employment opportunities and tighter JobSeeker eligibility criteria (JobSeeker mutual obligation requirements for recipients outside of Victoria were reinstated in August). To help gauge the effect of these various factors, the ABS provides some alternative measures of unemployment that include employees working zero hours and those employees who moved out of the labour force in March and are yet to return; these measures have declined in recent months but remain elevated (Graph 3.8).

Graph 3.7

Labour Underutilisation Rates

Heads-based



* Sum of the unemployment and underemployment rates

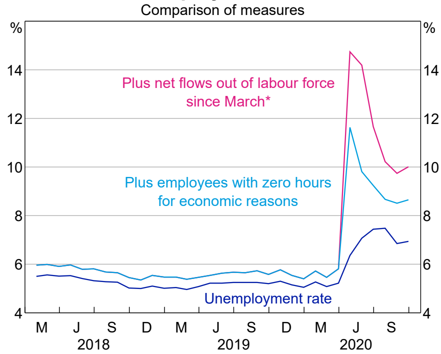
** Full-time workers on reduced hours for economic reasons and part-time workers who would like, and are available, to work more hours

Sources: ABS; RBA

Graph 3.8

Unemployment Rate

Comparison of measures



* 'Effective unemployment rate' used by government

Sources: ABS; RBA

The jobs outlook remains subdued, but is improving

Forward-looking indicators of employment such as job advertisements and vacancies have picked up since May, but remain lower than their pre-pandemic levels (Graph 3.9). Surveys and information from business liaison indicate that employment intentions have improved but remain subdued, and are mixed across industries. An elevated share of firms still expect to reduce headcount over the year ahead, but an increasing number of firms report that they expect to lift headcount or reinstate regular hours, contingent on continued improvement in business conditions. Contacts expecting to remain eligible for the JobKeeper extension tend to be exposed to travel or tourism, or have experienced significant revenue loss because of the restrictions in Melbourne.

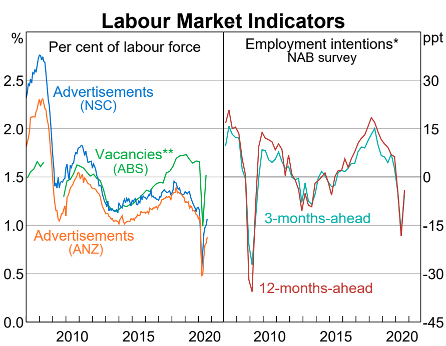
The Australian Government Budget contained further substantial fiscal support for the economy …

Following the outbreak of the pandemic, the Australian and state governments announced fiscal policy measures aimed at limiting the contraction in activity and large-scale losses of employment. The initial packages of fiscal support from the Australian Government were centred on the JobKeeper program, cash flow support for businesses and increased social assistance payments. State and territory governments also provided support to households and businesses, mainly in the form of relief from taxes and fees and increased funding of public services.

More recent policies announced in the 2020/21 Australian Government Budget, released in early October, were targeted at supporting the recovery. The measures included bringing forward tax cuts to households and expanding and extending depreciation allowances to encourage business investment (Graph 3.10). Additional expenditure on infrastructure was also announced.

The net fiscal impact of the Australian Government Budget on the economy is equivalent to around 7 per cent of GDP in 2020/21. This is mostly reversed over subsequent years. The fiscal deficit of the Australian Government is expected to increase to 11 per cent of GDP in 2020/21, as a result of the significant fiscal support provided by COVID-19 stimulus policies and the decline in revenue alongside the decline in activity. This represents the largest

Graph 3.9

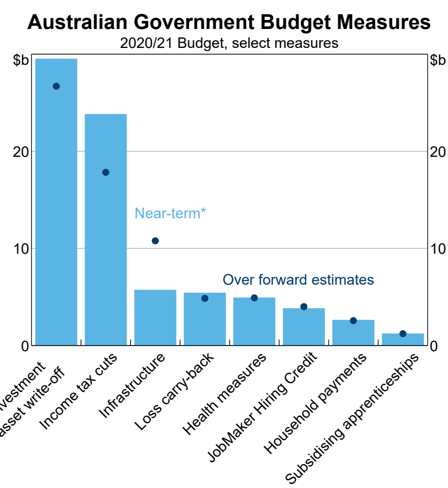


* Net balance for the following period; deviation from average; 12-months-ahead measure seasonally adjusted by the RBA

** Survey was suspended between May 2008 and November 2009

Sources: ABS; ANZ; NAB; National Skills Commission (NSC); RBA

Graph 3.10



* Cost over the next two financial years, except for the investment asset write-off and loss carry-back, which shows the cost over 2021/22 and 2022/23

Source: Australian Treasury

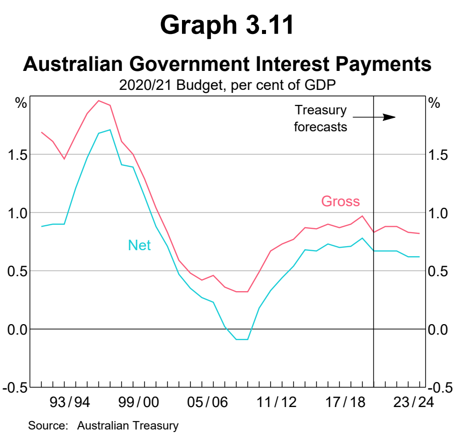
peacetime Australian Government fiscal deficit observed in Australia. By 2023/24, the deficit is expected to have declined to 3 per cent of GDP; at that time, new policy measures would no longer be contributing to the deficit, which would be driven instead by general government spending and automatic stabilisers such as ongoing elevated unemployment benefit payments and reduced taxation revenues. While Australian Government debt has increased due to spending measures and lower revenue, interest payments are still expected to decline as a share of GDP over the forecast period, reflecting the decline in interest rates to historically low levels (Graph 3.11).

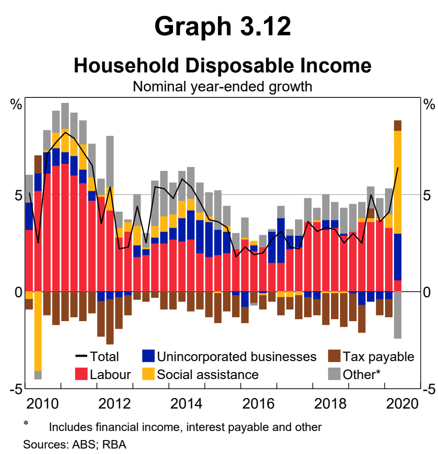
As well as supporting households and businesses by adjusting taxes and transfers, the Australian and state governments have added to demand directly by the provision of public goods and services. Public consumption increased by 3 per cent in the June quarter, and was the main source of expenditure growth in the economy, led by state and local government spending. Public investment is likely to increase over coming quarters as 'shovel ready' projects get underway.

… and policy measures have continued to support household cash flow

Policy measures have provided significant support to household cash flow. As a result, household disposable income increased in the June quarter, despite the large contraction in economic activity, and is expected to have increased further in the September quarter (Graph 3.12). Income support has mostly come from the JobKeeper program, which increased unincorporated business income and supported labour income, and from the temporary increase in social assistance payments. Eligibility for JobKeeper was tightened in late September and payments were reduced, in particular for part-time workers. (For a discussion of income support policies in other economies, see 'Box A: Income Support Policies for Advanced Economies during the COVID-19 Pandemic'.)

Household cash flow has been further boosted for those households who made early withdrawals from superannuation since April; these withdrawals have totalled $35 billion, equivalent to around 10 per cent of quarterly household disposable income. In aggregate, the increase in cash flow from these sources has been partly offset by a decline in other income, partly driven by a fall in financial income alongside steep declines in equity prices earlier in the year.





The Australian Government Budget included policies that will provide additional support to many households in 2020/21. In addition to bringing forward tax cuts, the low and middle income tax offset will continue to be available for this financial year. These measures are expected to reduce household income tax by around $24 billion over the next two years, mostly concentrated in 2021/22. Pensioners and some other households will also receive two $250 payments, to be paid from November 2020 and early 2021, in addition to the two payments of $750 received earlier this year.

Income support has enabled a swift rebound in spending since restrictions were lifted

A range of partial indicators suggest household spending has partly recovered over the past six months, supported by the easing in restrictions on activity and policies to support household cash flow. After declining by 13 per cent over the first half of the year, household consumption is forecast to increase by close to 10 per cent over the second half.

Consumption patterns have shifted considerably as households and retailers have adjusted to restrictions. Sales of household goods and food remained elevated in September. Spending at cafes & restaurants improved but remained below its pre-COVID level (Graph 3.13). Online retail sales continued to grow strongly in recent months, to account for more than 10 per cent of total retail sales. Sales of motor vehicles also increased strongly in many states.

Spending on discretionary services has remained weak compared with other types of consumption, although there are signs of improvement in some areas as restrictions ease. For example, payments data and information from the Bank's liaison program point to an increase in domestic travel spending from its trough in the June quarter. Some of this expenditure is likely to be instead of overseas travel, as spending by Australians travelling overseas typically accounts for around 5 per cent of consumption.

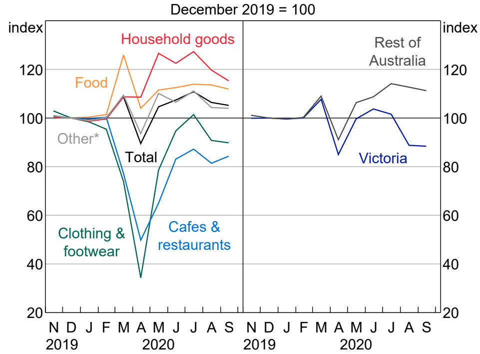
The prevalence of the virus and the accompanying activity restrictions weighed heavily on household spending in Victoria in the September quarter. Retail sales fell sharply in August, and information from the Bank's liaison program indicates that store closures severely impacted sales growth in Melbourne. Retailers anticipate that conditions will improve substantially alongside health outcomes and as trading restrictions are eased over coming months.

The increase in household income and contraction in consumption in the June quarter meant the household saving rate increased sharply to 20 per cent, the highest it has been since 1974 (Graph 3.14). Much of the increase in the saving rate was due to restrictions on household activity and reduced opportunity to consume in the quarter, but precautionary savings by some households concerned about future income would also have contributed. Some survey indicators suggest that households in most income brackets had a higher rate of saving over recent quarters; but that is likely to obscure some significant variation within each group. Households are expected to consume a

Graph 3.13

Retail Sales Values

December 2019 = 100



* Includes department stores and other retailing

Sources: ABS; RBA

larger share of their income as opportunities to spend increase and household income declines alongside the tapering in fiscal policy support.

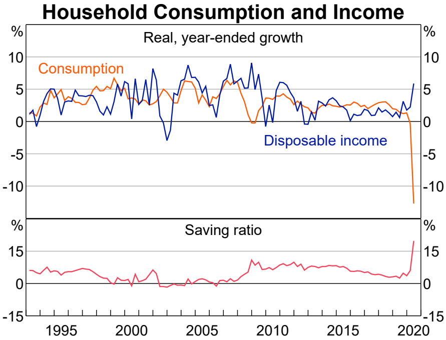
Housing market conditions across the country are uneven

Housing prices in Melbourne and Sydney have declined since the August *Statement*, while prices have increased in the other capital cities and regional Australia (Graph 3.15). New listings have increased in most cities since August, but remain a little below average for this time of year (Graph 3.16). The exception was Melbourne, where new residential property listings fell sharply because of the restrictions that were in place, but rebounded strongly in October as restrictions on in-person auctions and inspections were lifted. Auction clearance rates declined in September to below 40 per cent in Melbourne, and many scheduled auctions were withdrawn, but recovered to around 60 per cent in October. Auction clearance rates in Sydney have increased to around 70 per cent over the same period, and auction volumes have been around average.

Rental vacancy rates remain elevated in Sydney, and have increased further in Melbourne (Graph 3.17). Advertised rents in Sydney and Melbourne have declined, driven by apartment rents. By contrast, vacancy rates have declined and rents have increased strongly in Perth,

Graph 3.14

Household Consumption and Income



Sources: ABS; RBA

where lower dwelling investment in previous years has limited the supply of new rental stock. More generally, lower rental income could present cash flow challenges for some property investors if weak rental market conditions continue, and may also weigh on investor demand for new properties.

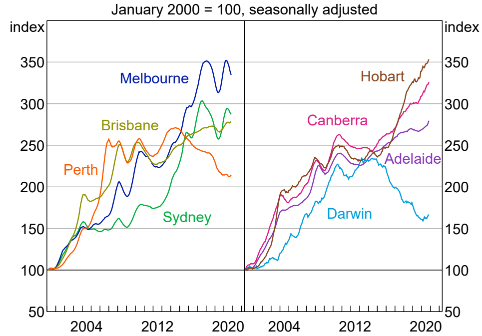
Policy is supporting detached housing construction

Fiscal and monetary policy measures are supporting conditions for detached residential construction in the near term. Building approvals for detached dwellings rose strongly over the September quarter (Graph 3.18). Survey measures of new orders for detached homes

Graph 3.15

Housing Prices

January 2000 = 100, seasonally adjusted

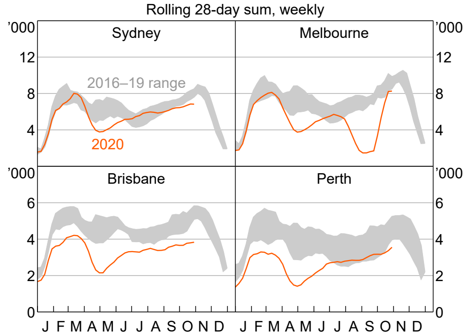


Sources: CoreLogic; RBA

Graph 3.16

New Residential Property Listings*

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

Sources: CoreLogic; RBA

have increased, although liaison has suggested that sales of greenfield land and new homes have moderated a little following a period of strong demand driven by policy measures, including the Australian Government's HomeBuilder scheme. Liaison indicated that the time limits to qualify for HomeBuilder have caused some builders to reach capacity for the remainder of the year. State government policies are also supporting demand, particularly in Western Australia. The value of large alterations & additions has also increased strongly in recent months.

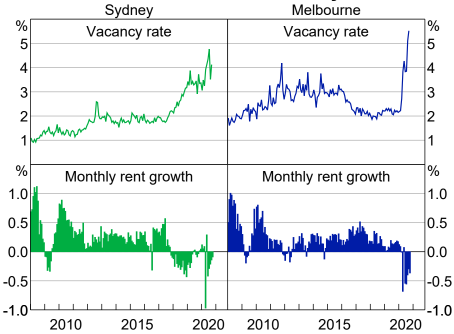
Construction activity in Melbourne was curtailed by limits on the number of workers allowed on construction sites and restrictions on movements between construction sites in August and September, and to a lesser extent in October. Victoria typically accounts for around one-third of national construction activity, so these restrictions weighed on dwelling and non-residential building investment in the September quarter.

Approvals for higher-density dwellings remain very low nationally. The strict timelines on the HomeBuilder scheme mean that higher-density construction projects are unlikely to qualify. Developers have reported that sales of off-the-plan apartments remained weak, with some developers delaying commencements of planned projects.

Forward-looking indicators for non-residential construction activity have weakened further; private non-residential building approvals have fallen significantly, and commencements of new private building projects fell in the June quarter (Graph 3.19). As the existing pipeline of commenced projects is worked through in coming quarters, non-residential construction activity is expected to fall. The pipeline of non-mining infrastructure work also eased further in the June quarter, led by renewable electricity projects.

Graph 3.17

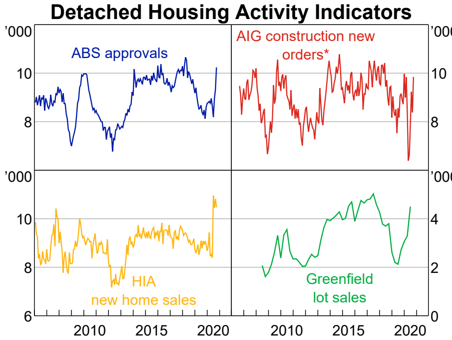
Advertised Rents and Vacancy Rates*



* Seasonally adjusted
Sources: CoreLogic; RBA; REINSW; REIV

Graph 3.18

Detached Housing Activity Indicators

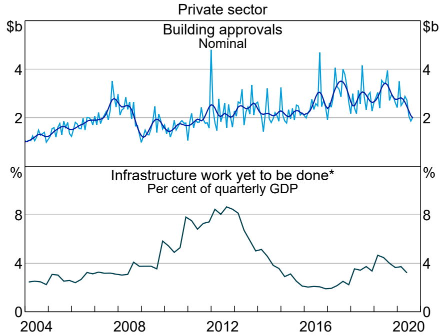


* Rescaled to have the same mean and variance as ABS approvals
Sources: ABS; AIG; HIA; RBA; Research4

Graph 3.19

Non-residential Construction Indicators

Private sector



* Excludes resources and other heavy industry
Sources: ABS; RBA

Policy has also cushioned the decline in business investment

Non-mining business investment, including non-residential construction, fell by 5 per cent in the June quarter, to be 9 per cent lower over the year. While sharp, the fall in investment was smaller than had been expected. This was largely because the fall in machinery & equipment investment was moderated by a significant take-up of tax incentives for investment that were announced in March, such as the expanded instant asset write-off. Investment in computer software and research & development also fell in the quarter.

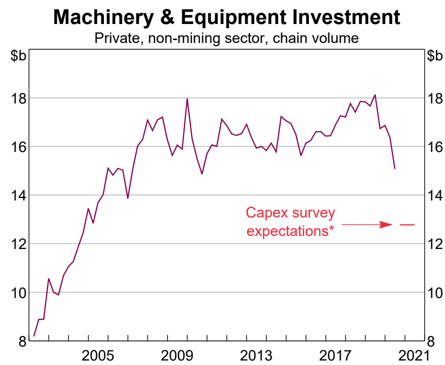
Firms' expectations for investment were little changed in the most recent ABS Capital Expenditure (Capex) survey, which was conducted in July and August. Firms continue to report that they will substantially reduce investment this financial year, including in machinery & equipment (Graph 3.20). All industries expect to reduce investment over the coming year (Graph 3.21). However, the Capex survey was conducted prior to the October Australian Government Budget, which expanded and extended tax incentives for business investment. These policies are expected to reduce the fall in machinery & equipment investment over the next two years by easing cash flow constraints (especially for small businesses) and encouraging firms to bring forward spending. Take-up of the policies is also expected to increase as the economic recovery continues and firms become more confident about future demand.

Mining sector investment increased by 1 per cent in the June quarter as work on replacement iron ore projects continued. Investment expectations from liaison and the Capex survey continue to suggest a modest increase in spending in the year ahead, driven by further work on iron ore and coal projects (Graph 3.22).

The pandemic has interrupted Australia's trade

Australia's trade in goods and services has fallen sharply since the outbreak of COVID-19 (Graph 3.23). Restrictions on international travel resulted in a collapse in exports and imports of tourism, education and passenger transport services. These are unlikely to recover until international travel restrictions are eased, which is assumed to take place around the end of 2021 (see 'Economic Outlook' chapter). At the same time, exports of resources and rural goods have

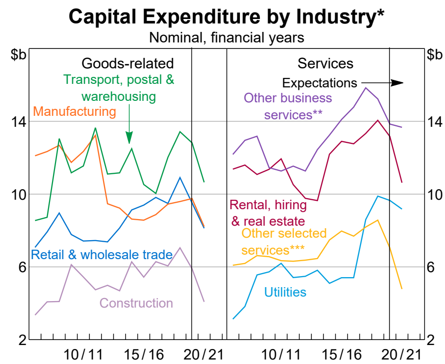
Graph 3.20



* Average real quarterly spending implied by firms' expectations; adjusted for past average differences between expected and realised spending, and deflated using RBA forecast for the implicit price deflator

Sources: ABS; RBA

Graph 3.21



* Non-mining industries included in the ABS capital expenditure (Capex) survey; expectations are firms' estimates of capital expenditure; adjusted for past average differences between expected and realised spending

** Includes information media & telecommunications, finance & insurance, and professional, scientific & technical services

*** Includes accommodation & food, administrative & support services, arts & recreation, and other services

Sources: ABS; RBA

declined, and imports of consumption and investment goods have fallen in line with weaker domestic demand. The decline in imports was larger than in exports over the first half of the year, so the trade surplus was higher on average. That said, the surplus has been generally narrower in recent months, driven by a pick-up in goods imports, which reflects the recovery in domestic demand.

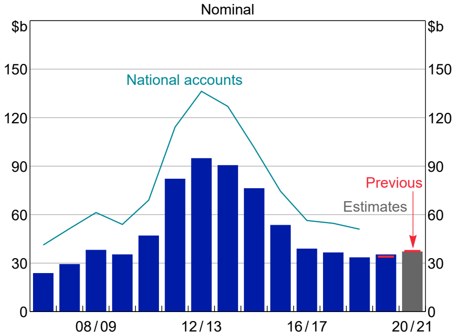
Resource exports declined by around 2 per cent over the first half of the year. The decline was led by lower coal exports because global demand for coal has been weak and some producers scaled back production in response to lower prices (Graph 3.24). By contrast, iron ore export volumes increased further and reached a record level in the June quarter; producers sought to capitalise on higher iron ore prices. However, partial trade data and information from the Bank's liaison program suggest that iron ore export volumes declined in the September quarter as Australian firms undertook maintenance, and liquefied natural gas (LNG) export volumes were affected by extended maintenance at some LNG facilities and weak global demand. Coal exports also look to have declined further in recent months.

Goods imports were very weak in the June quarter, but have picked up more recently in line with the recovery in domestic demand. Imports of motor vehicles have recovered particularly strongly, following a pick-up in vehicle sales as a result of the significant take-up of tax incentives for investment in the June quarter.

Graph 3.22

Mining Capital Expenditure*

Nominal



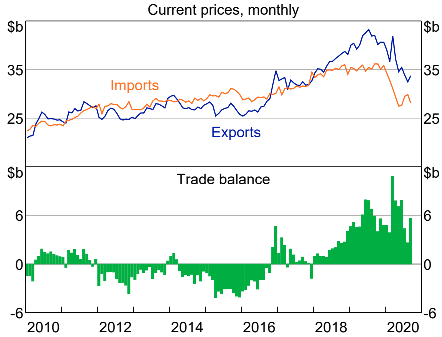
* Estimates are firms' expected capital expenditure; adjusted for past average differences between expected and realised spending

Sources: ABS; RBA

Graph 3.23

Trade in Goods and Services

Current prices, monthly



Sources: ABS; RBA

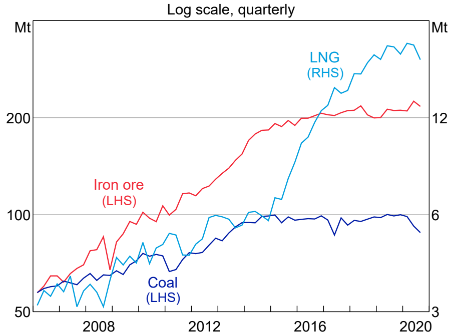
The outlook for the rural sector remains favourable

The Bureau of Meteorology has declared that La Niña is underway. This weather pattern typically results in above-average rainfall across eastern Australia during spring and summer; this generally provides favourable growing conditions for cereals, although it also increases the risk of flooding (Figure 3.1). At the same time, improved pasture conditions will continue to support farmers to further rebuild herds and

Graph 3.24

Resource Exports*

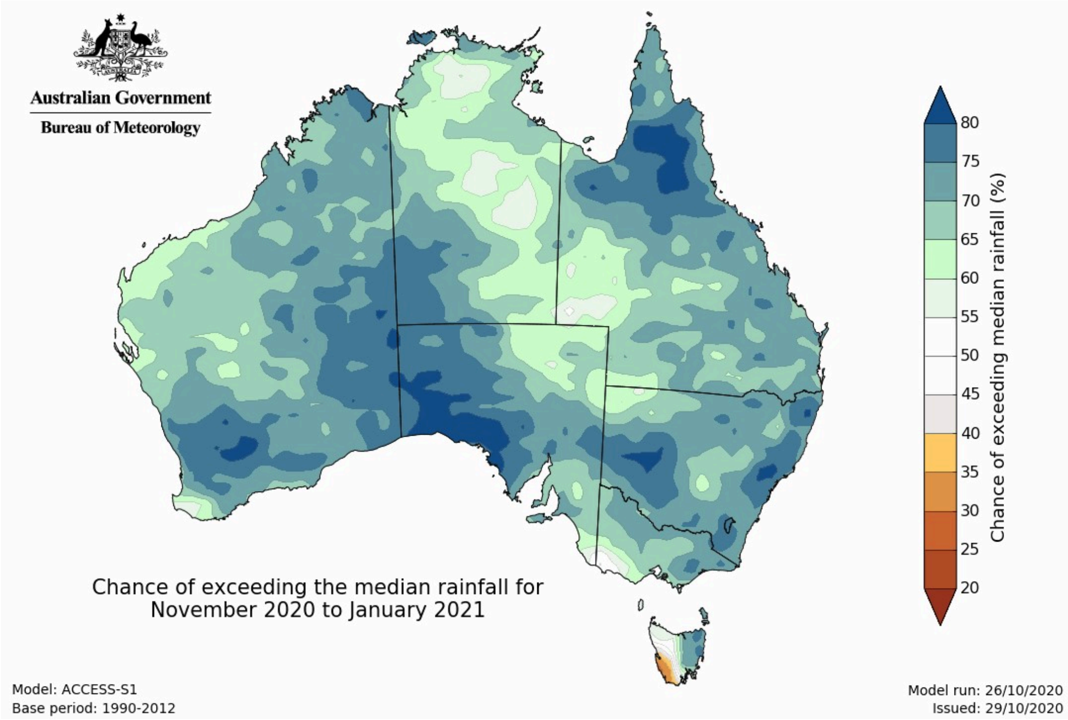
Log scale, quarterly



* Seasonally adjusted by the RBA

Sources: ABS; RBA

Figure 3.1 : Chance of Exceeding Median Rainfall



flocks, after the drought left the number of sheep and cattle in Australia at record lows. Accordingly, the Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) expects crop production to increase strongly in 2020/21, while meat production is expected to decline (Graph 3.25).

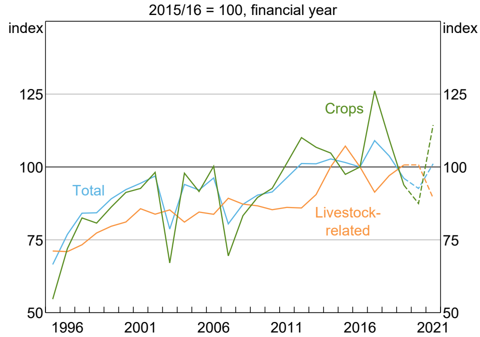
Note: This figure is licenced under the Creative Commons Attribution Australia Licence <https://creativecommons.org/licenses/by/3.0/au/legalcode>

The pandemic has had a limited impact on agricultural production to date, although weaker demand has weighed on prices for some higher-value agricultural goods. Horticultural harvests later in the year could be affected by international and domestic border restrictions, which could disrupt the supply of labour, even with government exemptions to travel restrictions that would allow the movement of some agricultural workers across borders. Since the start of the year, Chinese authorities have

Graph 3.25

Farm Production Volumes*

2015/16 = 100, financial year



* Dotted lines represent ABARES' preliminary estimates for 2019/20 and forecasts for 2020/21

Sources: ABARES; RBA

introduced import restrictions and tariffs on certain agricultural exports from Australia; these will materially affect some sectors directly targeted by the measures. ✠

4. Domestic Financial Conditions

The Reserve Bank's package of policy measures announced in March – including the reduction in the cash rate, the target for the yield on the 3-year Australian Government bond, the Term Funding Facility (TFF) and open market operations – has lowered funding costs and contributed to a plentiful supply of liquidity in the Australian financial system. This has flowed through to historically low interest rates on housing and business loans and supported the availability of credit to households and businesses. Financial markets have also continued to function smoothly after the period of dislocation in March and April. Banks drew down most of their initial allowances from the TFF ahead of the end-September deadline for accessing this allowance. Nonetheless, demand for new business loans remains subdued, consistent with the uncertain economic outlook. Australian equity prices have increased in recent months, but remain well below their mid-February peak.

In September, the TFF was expanded and extended, and in early November, a further package of policy measures was announced comprising: a reduction in the cash rate target, the 3-year Australian Government bond yield target and the interest rate on new drawings under the TFF to 0.1 per cent; a reduction in the interest rate paid on Exchange Settlement balances held with the Reserve Bank to zero; and the introduction of a $100 billion government bond purchase program. Together, these measures will further lower the structure of interest rates in Australia. This will support the economy by lowering borrowing costs, delivering a lower exchange rate than otherwise, and supporting asset prices and balance sheets.

The 3-year government bond yield has declined recently

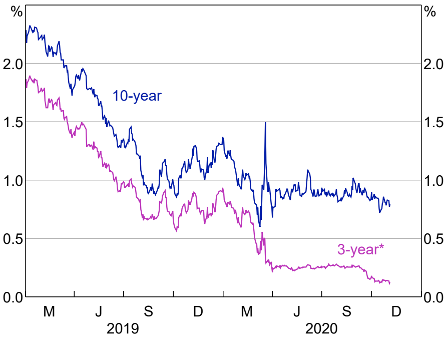
The yield on the 3-year Australian Government Securities (AGS) bond remained consistent with the target of around 0.25 per cent from late March until mid September, supported by the Bank's purchases of government bonds in the secondary market (Graph 4.1). Since late September, the 3-year AGS yield had declined, reflecting market participants' expectations of further easing in monetary policies. Following the reduction in the 3-year yield target in early November, the 3-year AGS yield declined further, consistent with the new target of around 10 basis points. Over the past couple of months, yields on 10-year AGS also declined noticeably, reflecting market expectations for a further reduction in short-term interest rates as well as expectations that the Reserve Bank would announce a bond buying program targeting longer-maturity bonds. The announcement in November of a further package of policy measures saw 10-year AGS yields decline further. At the same time, US Treasury yields have moved higher, so 10-year AGS yields are now broadly in line with 10-year US Treasury bond yields (Graph 4.2).

From March to May this year, the Bank purchased around $50 billion of AGS and bonds issued by the state and territory borrowing authorities (known as semi-government securities, or semis), to support smooth market functioning and achievement of the target for the 3-year AGS yield. In August and early September, the Bank purchased a further $12 billion of AGS in the secondary market in support of the 3-year yield target. These purchases were concentrated in the April 2023 and April 2024 bonds. The 3-year yield target applies to the bond with residual maturity closest to three years, which changed from the April 2023 to the April 2024 bond in mid October.

On 5 November, the Reserve Bank commenced purchases of AGS under the $100 billion bond purchase program announced as part of the package of further measures at the November Board meeting. Under the program, $100 billion of government bonds will be purchased over a period of approximately six months, with weekly purchases of around $5 billion. The allocation of bond purchases is planned to be around 80 per cent AGS and around 20 per cent semis. The focus of purchases will be bonds with residual maturity of around 5 to 10 years, but may also include bonds outside of this range, depending on market conditions; any purchases related to achieving the 3-year bond yield target will be separate from the $100 billion bond purchase program. The Bank will closely monitor the impact of its bond purchases on market functioning and will adjust auctions if necessary, including their size, composition and timing.

Graph 4.1

Australian Government Bond Yields



* 3-year yield target bond is the April 2023 Treasury bond until 20 October 2020, and the April 2024 Treasury bond thereafter

Sources: RBA; Yieldbroker

Government bond markets are functioning well and continued to absorb large volumes of issuance

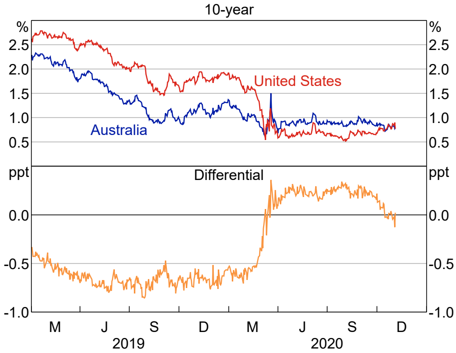
AGS and semis markets have continued to function smoothly in recent months, with bid-offer spreads remaining around average levels, and well below the elevated levels seen during the market dislocation in March and April. Spreads between yields on semis and AGS fell by around 5 basis points following the November Board announcement, to be at historically low levels (Graph 4.3).

Funding conditions remained favourable for the Australian and the state and territory govern-

Graph 4.2

Government Bond Yields

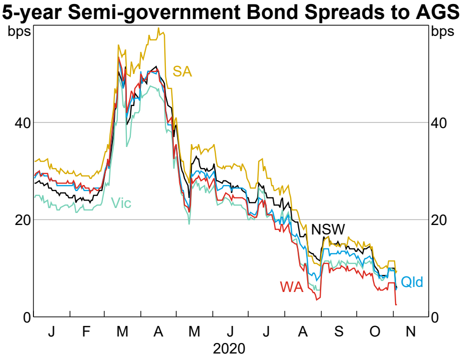
10-year



Sources: Bloomberg; RBA; Yieldbroker

Graph 4.3

5-year Semi-government Bond Spreads to AGS



Sources: RBA; Yieldbroker

ments. Government bond yields are at record lows and markets have absorbed large volumes of issuance. The Australian Office of Financial Management (AOFM) has issued $88 billion of Treasury Bonds and $38 billion of Treasury Notes since the start of August, in addition to the $103 billion of AGS and $45 billion of Treasury Notes issued in the preceding three months (Graph 4.4). This pace of issuance is well above the issuance in recent years. Demand at AOFM tenders has been consistently strong, including for the two largest AOFM syndications on record, which raised $25 billion and $21 billion of the new 2026 and 2031 bonds, respectively. The next three largest AOFM syndications occurred in the preceding three months and were also met with strong demand. These syndications also put the AOFM well ahead of schedule on its funding requirements. Accordingly, following the handing down of the 2020/21 federal budget in early October, the AOFM announced that it plans to scale back the weekly pace of issuance. While the projected increase in government debt for 2020/21 and the associated stock of debt outstanding are the largest as a share of GDP in decades, they are not unprecedented (Graph 4.5). Moreover, the stock of debt as a share of GDP remains low compared with other advanced countries.

Take-up of the TFF ahead of the initial allowance deadline was strong …

The TFF provides low-cost term funding to authorised deposit-taking institutions (ADIs) and an incentive for ADIs to increase lending to businesses, particularly small- and medium-sized enterprises (SMEs). Under the TFF announced in March 2020, ADIs have had access to three-year funding at an interest rate of 0.25 per cent. Take-up of the TFF accelerated ahead of the 30 September 2020 deadline for ADIs to draw down on their initial allowance. Almost all of the funding available under the $84 billion TFF initial allowance was drawn down (Graph 4.6); the large Australian banks, regional banks and smaller ADIs drew down close to all of their initial allowances, while foreign ADIs used nearly three-quarters of their allowances.

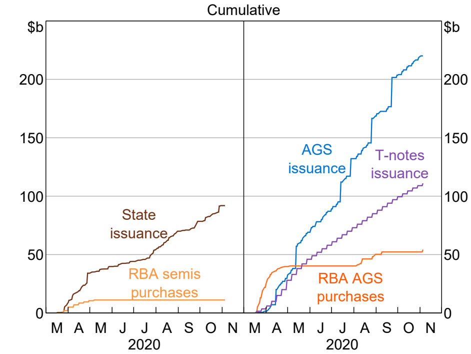
… and the TFF has been expanded and extended, and the interest rate on new drawings has been reduced

Following the Board's decision at the September Board meeting, a new TFF supplementary allowance has been available to all ADIs since 1 October 2020 (Graph 4.7). The supplementary allowance is fixed at 2 per cent of an ADI's overall credit over the three months to July 2020 ($57 billion in aggregate for all ADIs) and can be

Graph 4.4

Government Issuance and RBA Purchases

Cumulative

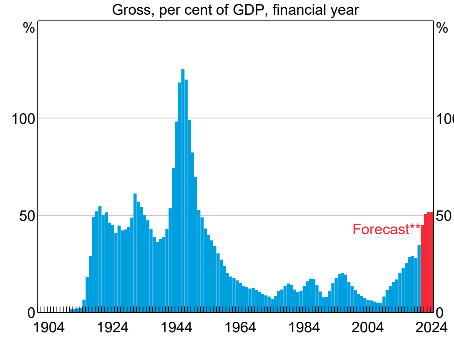


Sources: Bloomberg; RBA; Yieldbroker

Graph 4.5

Australian Government Debt*

Gross, per cent of GDP, financial year



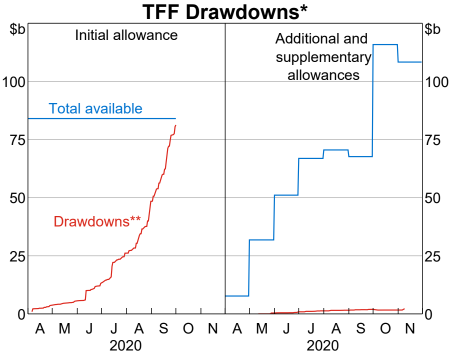
* Historical series contain structural breaks and adjustments

** 2020/21 Budget

Sources: ABS; Australian Treasury; Barnard (1986); Butlin (1985) accessed until 30 June 2021. Furthermore, the drawdown period for the additional allowance based on ADIs' new lending to businesses has been extended by three months until 30 June 2021. The introduction of the supplementary allowance brings the total funding allowance under the TFF to around $190 billion as of November, compared with $150 billion in August and $90 billion at the program's inception. At the November Board meeting, the Board decided to reduce the interest rate on new drawings under the TFF to 0.1 per cent.

Graph 4.6

TFF Drawdowns*



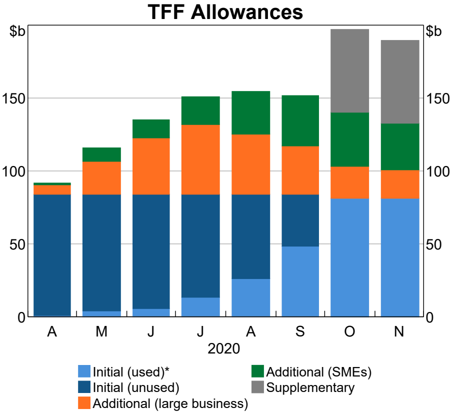
* Until 30 September, repos were applied against initial allowance until fully drawn, then against additional allowance. From 1 October, repos applied against additional and supplementary allowances

** Includes all settled, contracted and pre-processed repos to date

Sources: APRA; RBA

Graph 4.7

TFF Allowances



* Initial allowance use for April to September represents use at the beginning of the month; initial allowance use from October onwards represents final initial allowance use

Sources: APRA; RBA

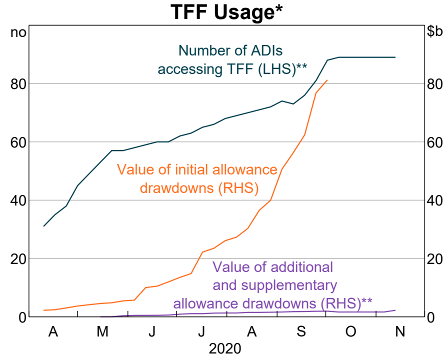
To date, 89 ADIs have accessed the TFF (around two-thirds of eligible ADIs). Take-up of the additional allowance has been modest since the inception of the scheme, because ADIs were required to draw their full initial allowance before accessing their additional allowance and because the deadline for accessing the additional allowance is some time away (Graph 4.8). ADIs have indicated that they are well funded and are considering how they will use their supplementary allowances. Similar to the approach taken by ADIs to the initial allowances, liaison with ADIs suggests that further TFF drawings are likely to be spread out across the remaining allowance period, but weighted towards the end. Consistent with this, drawdowns since the 30 September initial allowance deadline have so far been infrequent and relatively small. The TFF continues to support low funding costs across the economy by providing the banking sector with low-cost term funding.

Liquidity in the banking system remains high

The level of liquidity in the banking system – as measured by banks' exchange settlement (ES) balances held at the Reserve Bank – remains high as a result of the Reserve Bank's package of

Graph 4.8

TFF Usage*



* Initial allowance was available up to 30 September 2020 and supplementary allowance was available from 1 October 2020

** Final observation includes partial data for trades settling in the week beginning 9 November 2020

Sources: APRA; RBA

policy measures (Graph 4.9). In recent months, increased use of the TFF and, to a lesser extent, purchases of government bonds by the Reserve Bank have added to liquidity in the system (Graph 4.10).[1] Offsetting this, liquidity obtained by banks via daily open market operations has continued to decline, as in aggregate banks have replaced this shorter-term repurchase agreement (repo) funding with longer-term funding provided by the TFF.

The Bank's balance sheet has expanded

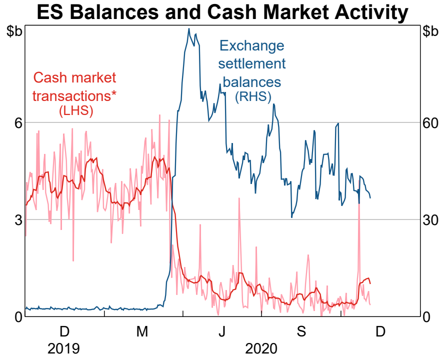
The package of policy measures is also reflected in a very large increase in the Reserve Bank's balance sheet. The balance sheet is around $110 billion larger than it was prior to the onset of COVID-19. The increase in assets held by the Reserve Bank has been driven by the Bank's increased holdings of long-dated government bonds as a result of bond purchases as well as an increase in securities provided as collateral by ADIs accessing the TFF (Graph 4.11). On the liabilities side, this has been mirrored by an increase in ES balances as the policy measures have substantially increased liquidity in the banking system (Graph 4.12). There has also been an increase in government deposits held at the Reserve Bank to around $100 billion from around $20 billion before the pandemic. This reflects the fact that, to date, proceeds from government bond issuance have exceeded net government outlays. By mid 2021, the size of the Bank's balance sheet is expected to have nearly tripled since the beginning of 2020, reflecting the comprehensive set of policy measures to support the economy in the wake of the COVID-19 crisis.

The cash rate declined further

Over recent months the cash rate had remained around 13 basis points, a little above the rate of remuneration on ES balances of 10 basis points

Graph 4.9

ES Balances and Cash Market Activity



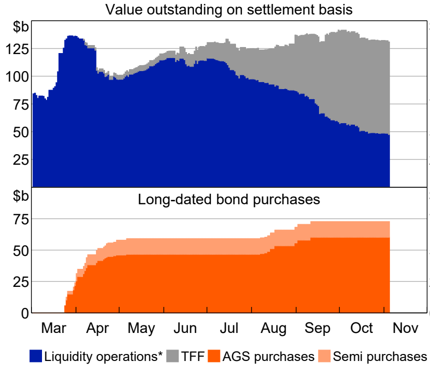
* 10-business-day moving average; pink line shows actual transaction volumes

Source: RBA

Graph 4.10

Monetary Policy Operations

Value outstanding on settlement basis

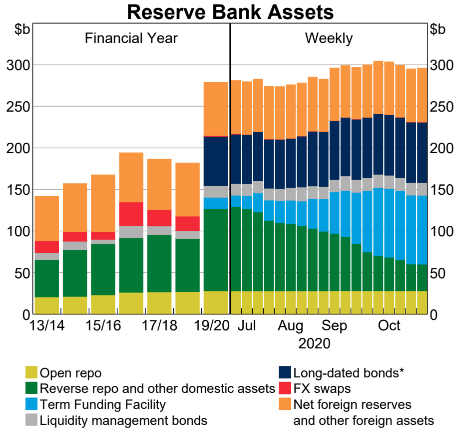


* Liquidity injections net of drains and maturities; contracted in OMOs, FX swaps and short-dated bond purchases

Source: RBA

Graph 4.11

Reserve Bank Assets



* Purchased under program announced March 2020

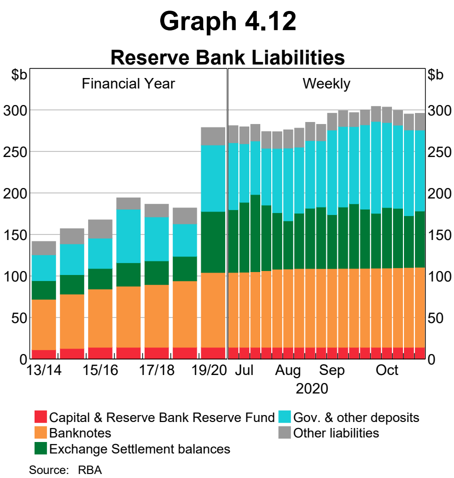
Source: RBA

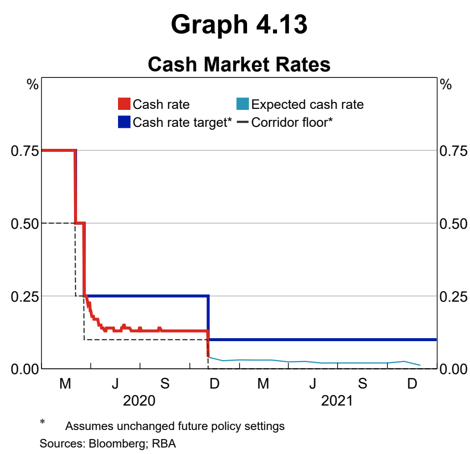
(Graph 4.13). Following the reduction of the cash rate target to 10 basis points at the Reserve Bank Board meeting in early November, the cash rate declined further, to 4 basis points in early November. Financial market prices imply that investors expect the cash rate to remain around its current level. The fact that the traded cash rate has been below the cash rate target was expected and is consistent with the experience of other countries that have significantly increased cash reserves in the banking system. The traded cash rate has remained a bit above the rate of remuneration on ES balances held with the Reserve Bank (which was 10 basis points from March until early November, and was reduced to zero at the November Board meeting). This difference reflects the compensation banks generally require to cover the transaction costs and credit risks associated with lending their excess balances in the overnight cash market, rather than holding them at the Reserve Bank.

Activity in the overnight cash market has also continued to be subdued as a result of the plentiful supply of ES balances (Graph 4.9). Indeed, on multiple occasions since March, transaction volumes in the overnight cash market have been below the thresholds required to calculate the cash rate based on actual transactions. In these instances, the published cash rate has been determined on the basis of the robust fall-back arrangements built into the cash rate procedures. Under these arrangements, the cash rate was published based on the last published cash rate based on sufficient transactions, except for two instances where the published cash rate was set at a different rate that, in the expert judgement of the Bank as the cash rate administrator, better reflected current market conditions.[2]

Money market rates remain very low

Short-term money market rates are at historically low levels owing to the low level of the cash rate and the large amount of liquidity in the banking system (Graph 4.14). The rates on 3-month bank bills (BBSW) have recently edged lower to be around 3 basis points, broadly in line with the overnight indexed swap rate (OIS). Prior to the new policy measures announced at the November Board meeting, repo rates at the Bank's daily open market operations had been held steady at 18 basis points, while repo rates in the private interbank market had been reported to have moved lower to be around 13 basis points for 3-to-6-month terms. Following the reduction in the cash rate target and the remuneration on ES balances in November, repo rates at the Bank's daily market operations





declined to 10 basis points. The implied cost of borrowing Australian dollars via the foreign exchange swap market has continued to decline in recent months, to be around –6 basis points.

Banks' funding costs are at historic lows

The Reserve Bank's package of policy measures has worked to lower banks' funding costs to historically low levels (Graph 4.15). Banks' non-equity funding costs are estimated to have declined by around 60 basis points between end February and end September. Much of the banks' wholesale debt and deposit costs are ultimately linked (either directly or via hedging) to BBSW rates, which have declined by around 75 basis points since the end of February. Low-cost funding from the TFF and deposit inflows have reduced banks' need to seek new wholesale funding, with the cost of new 3-year bank bonds remaining higher than the rate on TFF borrowing. The policy measures announced by the Reserve Bank in September and November are expected to further lower banks' funding costs over the period ahead.

Large deposit inflows in recent months have seen the deposit share of banks' total funding (including equity) increase by around 4 percentage points since the end of February (Graph 4.16). Government bond purchases by the Reserve Bank and the banking sector have contributed to deposit growth, for instance as payments for bonds purchased from the private (non-bank) sector are credited to the deposit accounts of the sellers.[3] The increase in deposits also reflects a decline in short- and long-term bank debt outstanding.

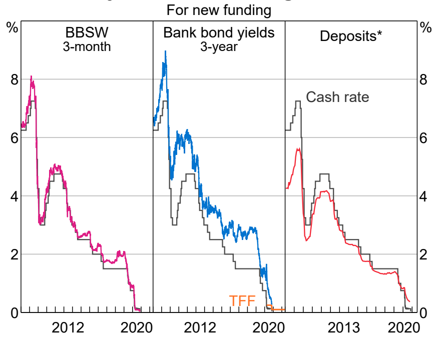
Australian bank bond issuance has been low

Most of the decline in the outstanding stock of bank bonds reflects maturities of bonds issued in offshore markets by the major banks (Graph 4.17). Australian banks have engaged in less bond issuance recently. This is because they

Graph 4.15

Major Banks' Funding Costs

For new funding

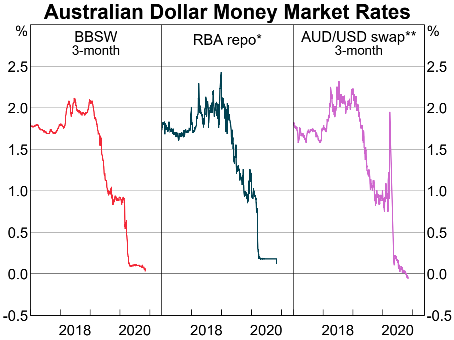


* RBA estimates; excludes deposits in housing loan offset accounts

Sources: AFMA; APRA; ASX; Bloomberg; major banks' websites; RBA; Refinitiv

Graph 4.14

Australian Dollar Money Market Rates



* Weighted average rate for morning open market operation repos

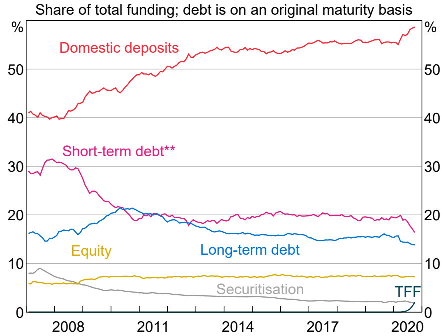
** Implied AUD cost via commercial paper issuance and a cross-currency swap

Sources: ASX; Bloomberg; RBA; Tullet Prebon; US Federal Reserve

Graph 4.16

Banks' Funding Composition*

Share of total funding; debt is on an original maturity basis



* Adjusted for movements in foreign exchange rates

** Includes deposits and intragroup funding from non-residents

Sources: ABS; APRA; Bloomberg; RBA; Refinitiv can instead access low-cost funding from the TFF – $83 billion of which had been drawn by early November – and because of the slow pace of asset growth compared with earlier years. Nonetheless, major banks issued around $5 billion worth of Tier 2 hybrids in August, with the spreads on these securities similar to those achieved in 2019. Hybrid securities have both equity and debt features and can be used to fulfil a part of regulatory capital requirements.

Non-banks continued to issue residential mortgage-backed securities

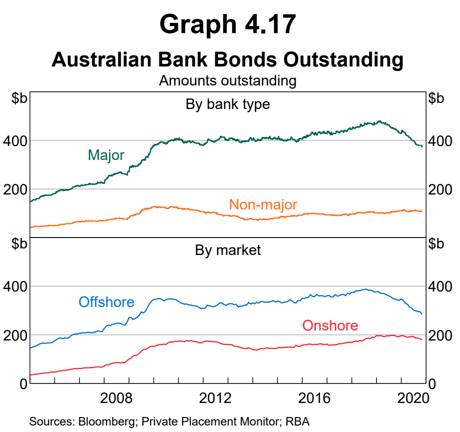
Issuance of residential mortgage-backed securities (RMBS) increased in the September quarter, driven by $7 billion issued by non-ADIs (Graph 4.18). Several of these deals were 'non-conforming' RMBS, consisting of mortgages made to traditionally riskier borrowers. Spreads on deals issued by non-ADIs remain elevated compared with pre-COVID levels, but have declined from their peak earlier this year.

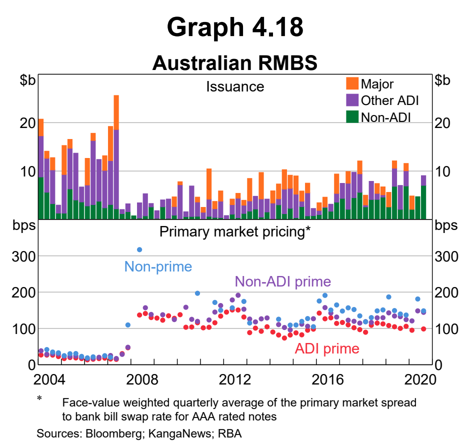
Since the March announcement of the Structured Finance Support Fund (SFSF), the AOFM has provided funding to securitisation warehouses and invested directly in the primary and secondary asset-backed securities (ABS) market. These measures supported the improvement of conditions in the ABS market around the middle of the year. The AOFM has not participated in primary or secondary markets since July, but continues to support the warehouse market.

Deposit rates have declined further

Banks have continued to respond to the plentiful supply of funding at low rates by reducing deposit rates. Interest rates for new term deposits declined by around 95 basis points between end February and end September, while rates for new at-call deposits declined by around 40 basis points over the same period. The decline in the spread between interest rates on term and other deposit rates is supporting a shift from term to at-call deposits by customers.

These changes have led to a rise in the share of bank deposits paying low interest rates (between zero and 25 basis points) (Graph 4.19). A little over one quarter of the debt funding of the major banks is in the form of deposits paying interest of 25 basis points or less. This compares with around 15 per cent a year ago. On average, the share of low-rate deposits in total debt funding of the other banks is estimated to be a little lower than that of the major banks. However, most deposits are still paying rates above 25 basis points, reflecting a sizeable share of deposits at interest rates greater than 100 basis points.





Interest rates on business loans are at historic lows

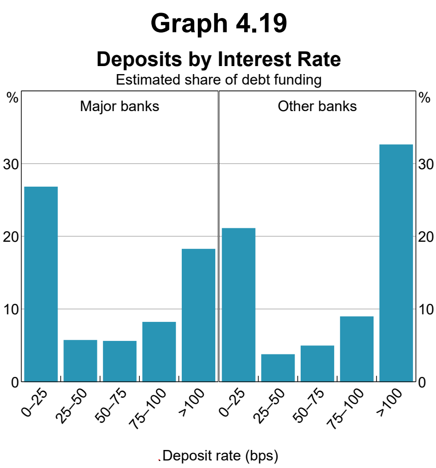
The cash rate reductions and other policy measures announced in March have also flowed through to lower interest rates on outstanding business loans. Interest rates on variable-rate loans to large businesses declined by 80 basis points between end February and end September (Graph 4.20). Interest rates on variable-rate loans to small and medium-sized businesses declined by 70–75 basis points over the same period. Following the Reserve Bank Board's decision to ease monetary policy further in early November, a number of the major banks announced interest rate reductions for loans to small businesses; many of the reductions apply to loans under the Australian Government's $40 billion SME loan guarantee scheme.

Housing interest rates are at historic lows

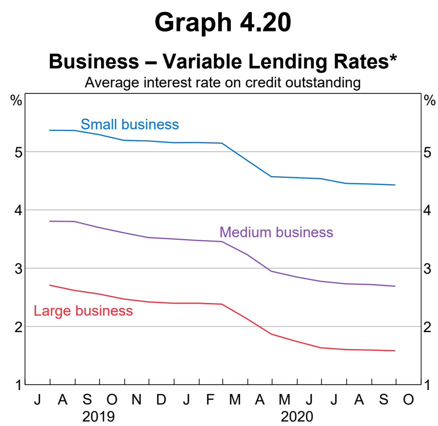
A large share of the decline in funding costs since March 2020 has flowed through to housing interest rates paid by borrowers. While SVRs declined by an average of 29 basis points between end February and end September, the average rate paid on outstanding variable-rate loans declined by around 40 basis points. This decline in the average actual rates paid reflects both the decline in lenders' SVRs and ongoing competition for high-quality borrowers, with lenders offering particularly low interest rates to new and refinancing borrowers (Table 4.1; Graph 4.21). A few small lenders announced a reduction to standard variable rates (SVRs) in the days immediately following the Board's decision to further ease monetary policy in early November.

Refinancing has been a significant driver of the downward drift in housing rates over the past year or so. While the demand for new housing loans initially declined with the onset of the pandemic, external refinancing activity has been very strong. Since March, the major banks have captured a larger-than-usual share of refinancing by offering very low rates on fixed-rate loans and offers of cash rebates to refinance from another lender. While refinancing activity has declined since its peak in May, competition for borrowers is ongoing, with some lenders continuing to offer cash rebates to refinance from another lender. This competition for high-quality borrowers has also meant that some households with existing loans have been able to negotiate a lower interest rate with their current lender.

Rates for new fixed-rate housing loans declined by around 70 basis points between end February and end September, alongside a



Sources: APRA; Bank liaison; Bloomberg; RBA; Refinitiv



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

Table 4.1: Average Outstanding Housing Rates
September 2020

	Interest rate Per cent	Change since February 2020 Basis points
Variable-rate loans		
– Owner-occupier	3.20	–38
– Investor	3.56	–40
All variable-rate loans	3.32	–39
Fixed-rate loans		
– Owner-occupier	3.01	–71
– Investor	3.39	–62
By repayment type(a)		
– Principal-and-interest	3.18	–44
– Interest-only	3.80	–43

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

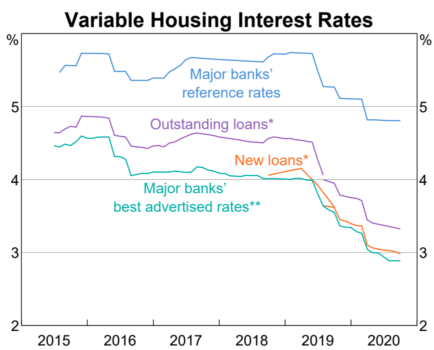
Sources: APRA; RBA

decline in the fixed interest rates derived from interest rate swaps (the benchmark for pricing fixed-rate loans) (Graph 4.22). The interest rates on new fixed-rate loans were around 55–65 basis points below new variable interest rates at the end of September. The proportion of loans at fixed interest rates has increased sharply since March and the stock of fixed-rate housing loans has risen accordingly, to around 25 per cent of housing credit outstanding. A number of banks lowered fixed-rates on a number of home loan products following the Board's decision to further ease monetary policy in early November.

Total credit growth has slowed sharply

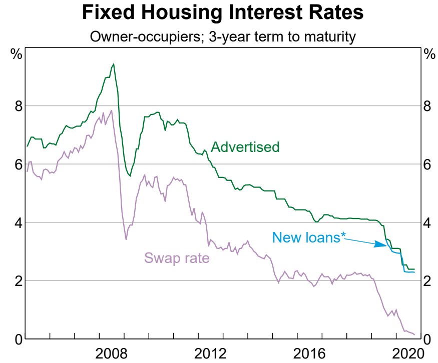
Despite the reductions in interest rates, total credit growth has slowed since earlier in the year, largely reflecting reduced demand for business and personal credit (Table 4.2; Graph 4.23). In monthly terms, the stock of total credit outstanding was little changed over August and September, following a few months of small declines. Business credit outstanding

Graph 4.21



* Series break in July 2019; thereafter, data based on EFS collection
** Including low-cost brands
Sources: APRA; banks' websites; CANSTAR; RBA; Securitisation System

Graph 4.22



* Data based on the EFS collection
Sources: APRA; Banks' websites; CANSTAR; RBA; Refinitiv

Table 4.2: Growth in Financial Aggregates

Percentage change[(a)]

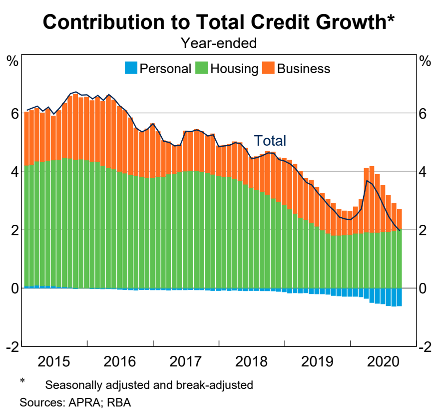
	Jun 2020	Three-month annualised Sep 2020	Mar 2020	Six-month annualised Sep 2020
Total credit	–1.2	–0.5	4.8	–0.8
– Household	1.0	1.9	2.4	1.4
– Housing	2.8	3.3	3.6	3.0
– Owner-occupier	5.3	5.0	5.7	5.2
– Investor	–1.4	0.4	–0.2	–0.5
– Personal	–19.1	–13.3	–8.6	–16.3
– Business	–5.0	–5.2	9.7	–5.1
Broad money	16.9	11.1	10.1	14.0

(a) Seasonally-adjusted and break-adjusted

Sources: ABS; APRA; RBA

declined in recent months, retracing the sharp increase seen over March and April (discussed further below). Meanwhile, growth in total housing credit increased slightly in recent months, as demand for housing has picked up a little (discussed further below). Credit supply by some ADIs had tightened slightly early in the pandemic, mostly reflecting the application of existing lending standards in an environment of weaker economic conditions and considerable uncertainty. More recently, though, some of the tightening in credit supply has eased.

Graph 4.23



The stock of personal credit outstanding continued to decline, although the pace of decline has slowed in recent months. Around half of the decline in personal credit since March was due to a decrease in outstanding credit card debt. Some of this decline owed to lower credit card spending by households early in the pandemic. Spending on credit cards has increased a little over recent months, as measures to contain the virus have been eased. Borrowers' capacity to repay this debt has also reportedly been boosted by superannuation withdrawals and government assistance payments.

Demand for new business loans remains subdued …

Lending to large business decreased further in recent months, as large businesses continued to repay revolving credit facilities (Graph 4.24). Businesses overall have now repaid the lines of credit that they drew down over March and April to shore up liquidity positions in response to the pandemic. Even so, the size of unused credit limits available is significantly higher than before the pandemic. This reflects repayment of existing credit lines as well as an increase in overall credit limits (Graph 4.25). The volume of lending to SMEs has remained little changed over this time.

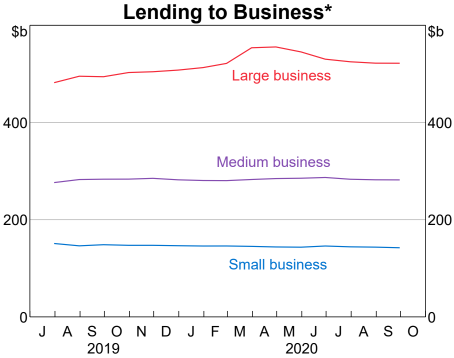
Despite historically low interest rates, demand for new loans appears to be low. Survey data and liaison with businesses and banks suggest that businesses are reluctant to take on debt given considerable uncertainty about the economic outlook, and have instead sought to shore up their liquidity positions. Consistent with this, about 60 per cent of businesses surveyed by the ABS in August identified uncertainty about the future state of the economy as a significant factor influencing investment decisions. In contrast, about half as many businesses indicated that access to external finance significantly influenced their investment decisions. A survey in October showed that around three quarters of businesses had not sought any additional funds over the prior six months. The most commonly cited reason for not seeking funds was that the business had sufficient funds. Businesses have made use of a range of temporary government and loan payment deferral initiatives to build up liquidity buffers in response to the pandemic, which has lessened the immediate need for new loans.

Commitments for new fixed-term loans to SMEs have declined since June in non-seasonally adjusted terms, particularly for plant and equipment (Graph 4.26). Lending activity for this category was likely to have been boosted before the end of the financial year by the Australian Government's instant asset write-off scheme. The Australian Government recently announced an expansion of this scheme in its 2020/21 budget, which should support business investment and lending activity.

Take-up of the Australian Government's $40 billion SME loan guarantee scheme has remained low to date, with about $1.9 billion of loan commitments having been made to around 21,000 businesses under the scheme. Changes to the scheme came into effect in

Graph 4.24

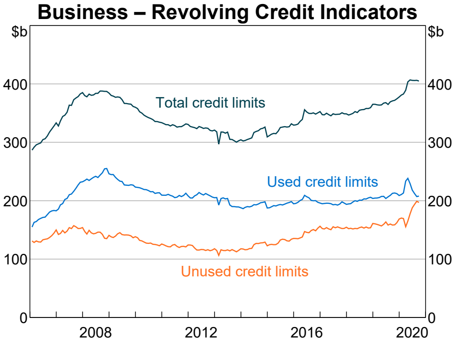
Lending to Business*



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

Graph 4.25

Business – Revolving Credit Indicators

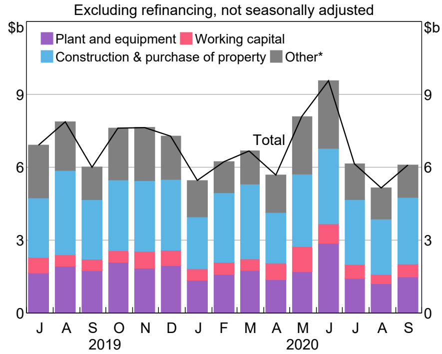


Sources: ABS; APRA; RBA

Graph 4.26

SMEs – Fixed-term Loan Commitments

Excluding refinancing, not seasonally adjusted



* Wholesale finance, acquisitions and general business purposes
Sources: APRA; RBA

October that make it more flexible and so take-up could pick up in the period ahead. From October, businesses were able to borrow under the scheme for a wider range of purposes including investment (rather than being limited to working capital). Lenders can take security (but not against residential property) for loans under the scheme and SMEs will be able to borrow up to $1 million for up to five years (up from $250,000 and three years previously). Overall, the low take-up to date is consistent with a lack of demand for credit in general. A number of banks announced reductions to business loan rates under the SME loan guarantee scheme, following the Reserve Bank Board's decision to ease monetary policy further in early November. The quantity of funds potentially available at low cost through the scheme remains supportive of new lending should demand from businesses pick up.

About 11 per cent of small business loans were subject to loan repayment deferrals as of September, down from around 20 per cent in June, with four-month extensions being made available on a case-by-case basis.

… and the supply of business credit has tightened a little in response to the pandemic

Although the weakness in business credit growth appears to be driven mostly by demand, the availability of credit to businesses has tightened in response to the pandemic. Banks have indicated in liaison that much of the tightening reflects the application of existing lending standards in the weaker economic environment. Banks are also requiring a greater degree of verification of borrowers' information to better understand whether it is reasonable to extend a loan. Banks have noted the challenge of making assessments in an uncertain environment, and are providing more guidance to frontline staff on when it is appropriate to look through current weak financial positions of firms when assessing new loans. Some banks are also cautious about lending to particular sectors – such as tourism, retail and commercial property – and to businesses that are new to the bank.

Consistent with this, recent surveys and liaison with small businesses indicate that access to finance has become a bit more difficult due to the pandemic, and that fewer businesses have tried to access finance in recent months. In late September, the Australian Government announced changes to responsible lending obligations intended to simplify the loan application process and reduce the need for extensive verification procedures, and clarified again that consumer lending laws do not apply to small business lending.[4]

The Australian Government announced in October that the $540 million Australian Business Growth Fund had been formally established to provide longer-term equity funding to SMEs. The fund is expected to shortly begin engaging with SMEs that are seeking equity funding. The fund will take a minority interest in selected businesses, providing each between $5 million and $15 million of funding. To be eligible, businesses must have revenue between $2 million and $100 million and a good track record of revenue growth and profitability.

Meanwhile, Australian corporate bond issuance remained high in recent months

While demand for business credit remains subdued, demand for non-intermediated debt has been robust. Non-financial corporate bond issuance remained high in the September quarter, following an increase in the June quarter (Graph 4.27). Bond issuance has been particularly high among firms outside the resource sector. A diverse range of firms issued bonds in recent months, including from the infrastructure, automotive, grocery and transportation sectors.

Corporate bond spreads in secondary markets declined over recent months (Graph 4.28). For A rated non-financial corporations, spreads to AGS returned to levels seen before the COVID-19 outbreak. Spreads for BBB rated corporations declined, but remained somewhat higher than levels seen at the beginning of the year. Nonetheless, with government bond yields at record lows, corporate bond yields are very low by historical standards.

Demand for housing loans has picked up recently …

After slowing earlier in the year, growth in owner-occupier housing credit picked up a little and investor housing credit stopped falling in recent months (Graph 4.29). This is consistent with other indicators of increased demand for housing.

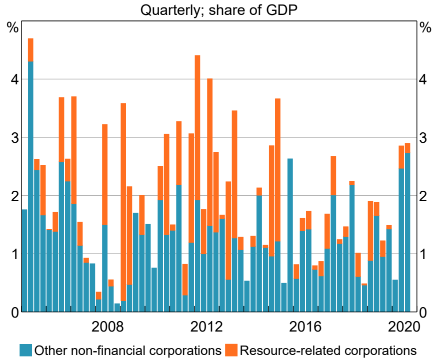
Commitments for new housing loans increased over the September quarter to be above the levels seen in March (Graph 4.30). This largely reflected a sharp increase in owner-occupier commitments; investor commitments for new loans have also increased, but to a lesser extent. The increase in commitments is consistent with the improvement in some housing market activity indicators such as auction clearance rates, turnover and new listings. Banks have indicated in liaison that the recent increase in housing market activity is, in part, likely to reflect pent up demand, as borrowers who found it difficult to purchase a property when restrictions were in place have now been able to do so. Lower interest rates, government measures targeted at first home buyers, and the HomeBuilder program are also supporting the demand for housing finance. A further 10,000 places for the First Home Loan Deposit Scheme and an increase in property price caps announced as part of the Australian Government 2020/21 budget will provide further support to demand for housing.

Although demand for investor credit strengthened a little towards the end of the

Graph 4.27

Australian Corporate Bond Issuance

Quarterly; share of GDP

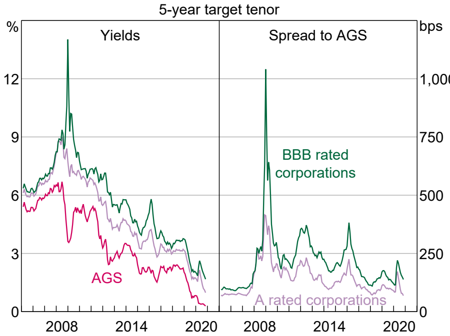


Sources: Bloomberg; Private Placement Monitor; RBA

Graph 4.28

Australian Corporate Bond Pricing

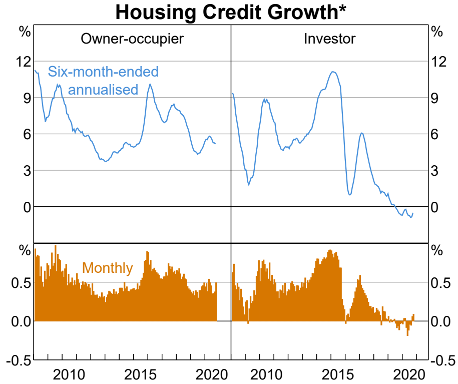
5-year target tenor



Sources: Bloomberg; RBA; S&P Capital IQ

Graph 4.29

Housing Credit Growth*



* Seasonally adjusted and break-adjusted

Sources: APRA; RBA

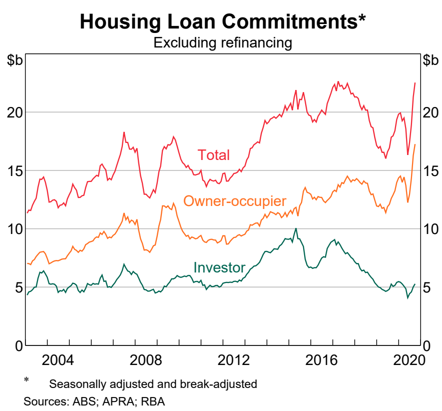
September quarter, it remained weak by historical standards. This is likely to reflect investors' sensitivity to the uncertain outlook for housing prices, as well as the decline in advertised rents and high vacancy rates in Sydney and Melbourne.

… and following an earlier tightening, the supply of housing finance has eased a little

The availability of housing credit tightened in response to the pandemic, mostly reflecting the effect of applying existing credit standards to the weaker and uncertain environment. Lenders required more recent verification of income and were a bit more cautious about lending to borrowers with high loan-to-valuation ratios (LVRs), or to those employed in sectors most adversely affected by the pandemic.

However, recently, some banks have begun to ease some requirements regarding additional information. They have also reduced the discounts they apply to highly variable sources of income (such as bonuses and commissions) when assessing a borrower's capacity to service a loan. Banks have also indicated a bit more appetite for higher LVR loans. Approval rates for housing loans are said to have remained high and banks report in liaison that the slight easing in lending requirements has resulted in some additional loan approvals. In addition, the Federal Government's recently proposed changes to responsible lending obligations will simplify and speed up the loan application process, but banks will still be required to comply with APRA's lending standards of 'sound credit assessment and approval criteria'.

Graph 4.30



Payments into housing loan offset and redraw accounts remained at a high level in the September quarter

Mortgage borrowers continued to make large payments into offset and redraw accounts in the September quarter (Graph 4.31). Since March, these payments have amounted to around 5 per cent of disposable income. The bulk of these funds have been placed into offset accounts (a type of deposit account linked to mortgages) and so do not reduce the measure of housing credit outstanding. The increase in payments is likely to reflect a combination of reduced opportunities for spending, mortgage holders saving for precautionary reasons, and some borrowers depositing cash received from early release superannuation and social assistance payments. Further restrictions in Victoria to contain the spread of the virus, including the move to Stage 4 restrictions in August, may have contributed to borrowers that were still employed placing additional funds into offset and redraw accounts as spending opportunities were significantly curtailed.

At the same time, reductions in housing loan interest rates have continued to flow through to borrowers in the form of lower interest payments. Since March, interest payments have declined by around 0.75 per cent of disposable income, mostly reflecting pass-through of the Bank's policy easing in March and borrowers refinancing to lower interest rates, but also the strong growth of disposable income (Graph 4.32).

The share of mortgage holders with a repayment deferral arrangement in place declined from 8 per cent at the end of the June quarter to 5½ per cent at the end of the September quarter. Moreover, one in five of those borrowers had continued to make partial or full mortgage payments.

Australian equity prices remain lower than at the start of the year

The ASX 200 has increased over recent months. Taking into account dividend payments, the Australian equity market has performed broadly in line with other overseas markets and remains around 15 per cent below its mid-February peak (Graph 4.33). By contrast, the US market reached a new high in September before retracing some of these gains to return to around its mid-February peak. Option-implied volatility for the ASX 200 has declined to be well below its peak in March, but above its average of the past few years.

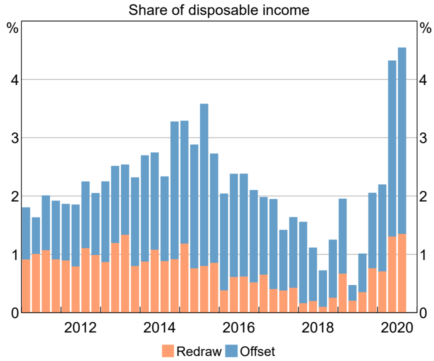
Equity prices outside the resources and financial sectors increased by around 5 per cent since the start of August (Graph 4.34). The information technology sector rallied by around 20 per cent, as companies continued to benefit from the shift to many people working from home, and some of these IT firms announced intentions to expand globally. The consumer discretionary, real estate, and health care sectors were also strong performers over recent months, buoyed by a gradual reopening of the economy. Share prices of financial companies decreased over the two months to October but have increased over recent weeks. Prices in the resources sector decreased by around 5 per cent, alongside a decline in oil and iron ore prices.

Issuance of new equity by listed companies has slowed in recent months compared with issuance during the height of the pandemic. In total, listed entities raised around $13 billion from July to September, down from $29 billion in the previous quarter (Graph 4.35).

Graph 4.31

Flows into Offset and Redraw Accounts*

Share of disposable income



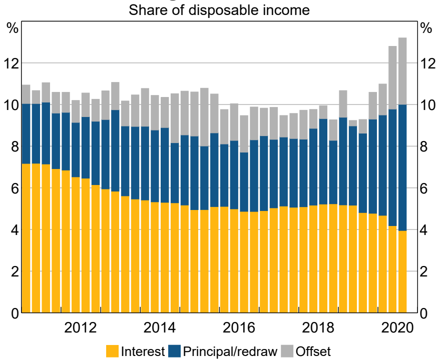
* Seasonally adjusted and break-adjusted

Sources: ABS; APRA; RBA

Graph 4.32

Flows into Housing Loan and Offset Accounts*

Share of disposable income



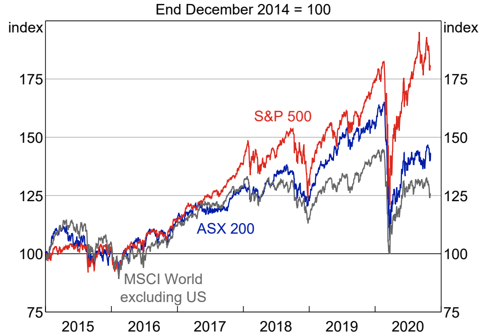
* Seasonally adjusted and break-adjusted

Sources: ABS; APRA; RBA

Graph 4.33

Total Return Indices

End December 2014 = 100



Source: Refinitiv

Profits of Australian listed companies fell

Profits of ASX 200 companies in the first half of 2020 declined significantly from a year ago, owing to the economic effects of COVID-19 (although national accounts data suggest that the profits of Australian businesses increased in aggregate). Dividends declared by non-resource firms fell significantly, while dividends declared by resources firms declined less sharply.

Listed companies outside the resources and financial sectors were the most sensitive to the economic effects of COVID-19, and these firms recorded losses in aggregate (Graph 4.36). A few companies in the industrials sector, including toll road operators and aviation companies, reported substantial losses as COVID-19-related restrictions led to reduced demand for their services. The real estate sector reported significantly lower profits, reflecting the effect of adverse property revaluations, rental waivers and deferrals. However, some real estate firms noted that foot traffic at shopping centres had returned to pre-COVID-19 levels by the end of June. Underlying profits of healthcare companies were slightly lower, as elective surgeries were postponed to prioritise the treatment of COVID-19 patients.

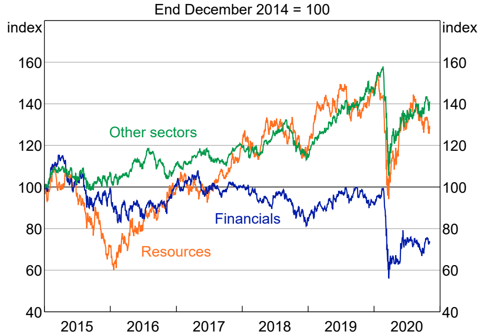
Underlying profits for the energy and materials sector decreased relative to the same period last year. The profits of energy firms declined owing to the lower level of oil prices in the half. Profits in the materials sector declined due to lower copper, coal and aluminium prices. Nonetheless, some firms in the materials sector benefited from robust Chinese demand for many commodities and strong demand for gold more broadly.

Underlying profits for companies in the financial sector were lower relative to the same period last year. Banks reported lower profits, partly reflecting provisions for expected credit losses arising from the economic effects of the COVID-19 pandemic and narrower net interest margins, while insurers were affected by increased claims and investment losses. ✠

Graph 4.34

Australian Share Prices

End December 2014 = 100

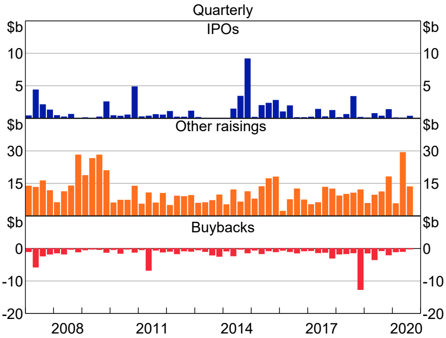


Source: Bloomberg

Graph 4.35

Australian Equity Raisings*

Quarterly



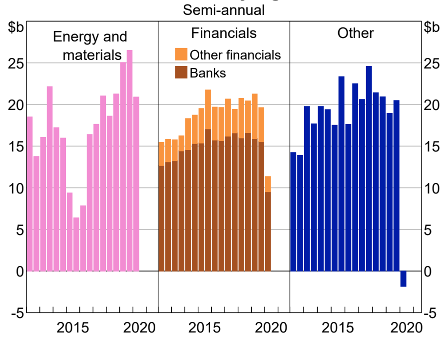
* All listed companies

Sources: ASX; RBA

Graph 4.36

ASX 200 Underlying Profits*

Semi-annual



* Results for companies with reporting dates in the half are rolled forward

Sources: Bloomberg; company reports; Morningstar; RBA

Endnotes

[1] Graph 4.10 is shown on a settlement basis as of 5 November so it does not include the Bank's AGS purchases (under the $100 billion government bond purchase program) made on 5 November 2020, which will settle on 7 November 2020.

[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>

[3] For more information, see RBA (2020), 'Box D: Recent Growth in the Money Supply and Deposits', *Statement on Monetary Policy*, August, pp 75–77. Available at <https://www.rba.gov.au/publications/smp/2020/aug/box-d-recent-growth-in-the-money-supply-and-deposits.html>

[4] The proposed changes to responsible lending obligations would, in most cases, allow lenders to rely on the information provided by borrowers, replacing the current practice of 'lender beware' with a 'borrower responsibility' principle. Notwithstanding these changes, lenders will still be required to comply with APRA's lending standards of 'sound credit assessment and approval criteria'. Responsible lending obligations will remain in place and be heightened for small value credit contracts (for example, payday loans) and consumer leases. The Government will consult publicly with stakeholders before finalising any legislation required to implement the reforms.

5. Inflation

Recent consumer price movements have been dominated by the impact of government policy responses to the COVID-19 pandemic, as well as movements in world oil prices. Examples of policy-driven price changes include the temporary introduction of free child care nationwide, free preschool in some states and a number of price freezes for administered services. Further, there have been large declines in rents since March as border closures have contributed to an increase in rental vacancy rates and state governments have required landlords to negotiate rent reductions for tenants in financial difficulty. More broadly, social distancing restrictions have led to substantial changes in consumption patterns – most notably, a shift away from services expenditure in favour of spending on household goods and grocery food – and this has affected pricing decisions. The sharp decline in economic activity and increase in spare capacity has also contributed to subdued underlying inflation over the past two quarters.

Responses to the pandemic have also affected wage movements. Many firms have responded to the effects of the pandemic by freezing wages, and in some cases by imposing temporary wage cuts for some, mostly senior, staff. Some planned wage increases have been deferred or reduced, including as a result of decisions by the Fair Work Commission (FWC) and some government employers. Some measures of wages growth, such as average earnings per hour (AENA), have been temporarily boosted by the JobKeeper wage subsidy as well as large compositional effects due to greater employment losses in lower paid jobs.

The effects on prices and wages of many of these responses to the pandemic are expected to unwind over the coming year. However, elevated spare capacity in the economy means it is likely that wage and price inflation pressures will be subdued for a considerable period.

CPI inflation picked up strongly in the September quarter as some earlier large price falls were unwound

Recent inflation outcomes have been unusually volatile as a result of the pandemic. The seasonally adjusted Consumer Price Index (CPI) rose by 1.5 per cent in the September quarter as a number of large price increases reversed earlier declines that had stemmed from the pandemic and related policy responses (Graph 5.1; Table 5.1). The increase in September was the largest quarterly increase in CPI inflation (excluding interest charges) since 2006, and followed a decline in June that was the largest since 1931. Headline inflation was 0.7 per cent over the year to September.

The main driver of the increase in the September quarter was prices for child care and some preschool services returning to more typical levels, after these had been fully subsidised by governments for much of the June quarter. Automotive fuel prices also rose, retracing some of the sharp decline earlier in 2020. Together, these price increases

Table 5.1: Measures of Consumer Price Inflation

Per cent

	Quarterly(a)		Year-ended(b)	
	September quarter 2020	June quarter 2020	September quarter 2020	June quarter 2020
Consumer Price Index	1.6	–1.9	0.7	–0.3
Seasonally adjusted CPI	1.5	–1.8	--	--
Selected underlying measures				
Trimmed mean	0.4	–0.1	1.2	1.2
Trimmed mean excl. imputed items (c)	0.3	0.1	1.4	1.5
Weighted median	0.3	0.1	1.3	1.3
CPI excl volatile items (d)	1.3	–1.3	1.0	0.4
CPI excl volatile items, child care, preschool & primary education and imputed items (c) (d)	0.2	0.3	1.7	2.0

(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) Imputed items are those that were imputed using headline CPI for all capital cities in the June or September quarter 2020

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

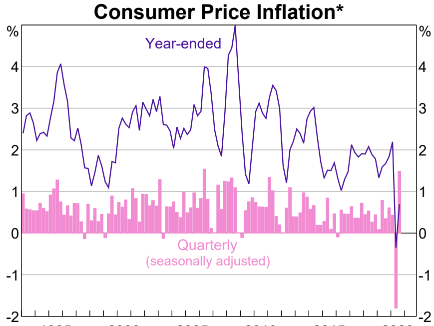
Sources: ABS; RBA

contributed 1¼ percentage points to CPI inflation in the quarter (Graph 5.2). Prices continued to rise for a number of retail items, including household goods and motor vehicles, reflecting ongoing strong demand. Housing-related prices (excluding utilities) rose a little in the September quarter, with further falls in rents more than offset by a rise in prices for newly built dwellings.

The Australian Bureau of Statistics (ABS) has been able to return to normal price collection in most capital cities as social distancing restrictions have eased over recent months.[1] Imputed items comprised around 8 per cent of the basket in the quarter (compared with 12 per cent in the June quarter).

Graph 5.1

Consumer Price Inflation*



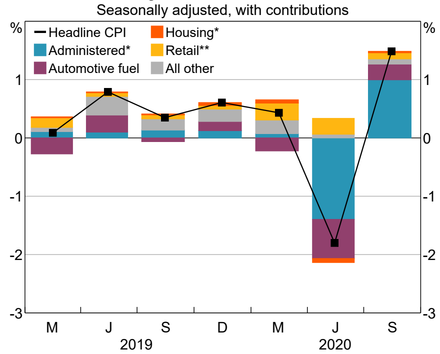
* Excludes interest charges prior to the September quarter 1998; adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

Graph 5.2

Quarterly Headline CPI Inflation

Seasonally adjusted, with contributions



* Excludes utilities

** Includes fruit and vegetables

Sources: ABS; RBA

Trimmed mean inflation increased to 0.4 per cent in the September quarter and was 1.2 per cent over the year (Graph 5.3). Part of this increase was because of the unusual pattern of component-level price movements, as several prices bounced back after sharp falls in the June quarter. In particular, price rises for child care and automotive fuel, as well as the imputed price increases for unavailable items, accounted for much of the increase in trimmed mean inflation in the quarter. Abstracting from these temporary shifts, underlying inflationary pressures in the economy remain subdued; CPI inflation excluding volatile items, child care, preschool and imputed items was around 0.2 per cent in the quarter.

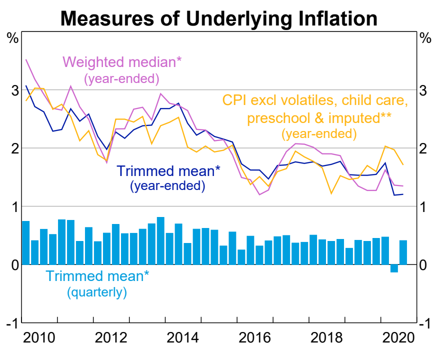
Government policies have driven large movements in some administered prices

Administered price inflation increased sharply in the September quarter as several government subsidies implemented in response to the COVID-19 pandemic ended. The Australian Government had fully subsidised child care and before- and after-school care services from 6 April to 12 July 2020, which meant prices fell to zero during this period. Prices returned to more normal levels in the September quarter in all cities except Melbourne, where child care centres remained closed for much of the quarter in accordance with public health restrictions. In addition, preschool fees returned to full price in Queensland after being waived for the second term of the school year. The end of these subsidies meant child care prices increased sharply in the quarter, and to a lesser extent preschool & primary education prices. Together, the end of these policies contributed almost 1 percentage point to the increase in headline CPI in the September quarter. However, the price levels for these categories remain well below their pre-COVID-19 levels (Graph 5.4). Preschool fee waivers in New South Wales and Victoria have been extended until the end of the year – headline inflation will be boosted in early 2021 as these waivers are lifted.

Automotive fuel prices increased following earlier falls

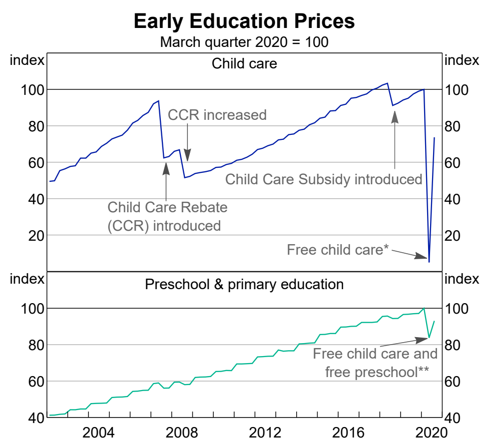
Fuel prices increased in the September quarter following a sharp fall over the first half of 2020 (Graph 5.5). The 9 per cent increase in the quarter contributed ¼ percentage point to quarterly headline inflation. Fuel prices declined slightly in the month of October. At current

Graph 5.3



* Seasonally adjusted
** Not seasonally adjusted; excludes fruit, vegetables, automotive fuel, child care, preschool & primary education and items that were imputed using headline CPI for all capital cities in the June or September quarter 2020
Sources: ABS; RBA

Graph 5.4



* Nationwide from 5 April to 12 July 2020
** Nationwide from 5 April to 12 July 2020 for child care; term two in Queensland and terms two to four in New South Wales and Victoria for preschool
Sources: ABS; RBA

levels, automotive fuel prices are expected to have little impact on headline CPI in the December quarter.

Price rises for other administered prices were generally smaller than is typical in the September quarter

A number of other administered prices were reset in July. Property rates & charges increased by less than is typical in the September quarter, largely because of price freezes in Brisbane, Canberra, Darwin and Hobart. This led to a seasonally adjusted price decline for these items (Graph 5.6). Other motor vehicle-related prices, which had declined earlier in the year due to the introduction of temporary free parking offers in some cities, increased a little in the September quarter. The CPI measure of urban transport fares declined further, reflecting the temporary introduction of discounted off-peak transport prices in Sydney.

Prices for utilities, which account for around 5 per cent of the consumption basket, declined in the September quarter. In July, the Australian Energy Regulator's Default Market Offers – which are effectively caps on standing offer electricity prices in New South Wales, South Australia and southeast Queensland – were reduced, and the number of offers covered by the caps was expanded. These price reductions were partly offset by prices normalising in Brisbane, Canberra and Perth as one-off government rebates applied in the previous quarter expired. Gas prices declined, driven by a reduction in distribution charges in Sydney. Water & sewerage prices declined due to changes in water authorities' pricing approaches in Adelaide and Sydney.

Utilities inflation has been subdued for the past two years and is likely to remain low for some time. Wholesale gas prices have fallen in recent months alongside lower international prices. Lower wholesale gas prices and increased generation capacity from renewable energy projects continue to exert downward pressure on wholesale electricity prices (Graph 5.7). Additionally, retail utilities prices in Canberra, Darwin, Hobart and Perth are expected to remain broadly unchanged until 2021 due to state government price freezes.

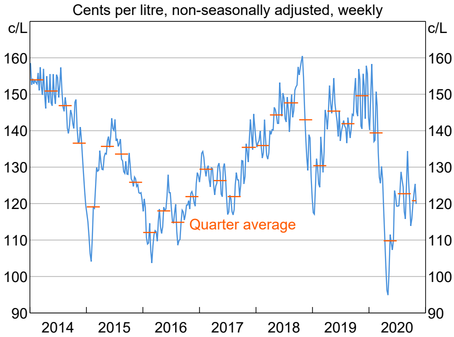
Retail prices increased in the quarter

Retail prices, which comprise just over a quarter of the CPI, rose a little in the September quarter, to be 2.2 per cent higher over the year. Higher prices for consumer durable items accounted for much of this increase. The pick-up in consumer durables inflation was broad based, but was again especially marked for furniture &

Graph 5.5

Unleaded Petrol Prices

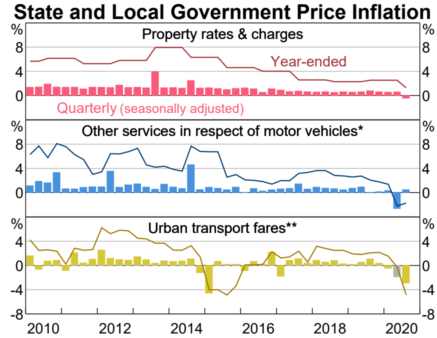
Cents per litre, non-seasonally adjusted, weekly



Sources: Australian Institute of Petroleum; RBA

Graph 5.6

State and Local Government Price Inflation



* Includes motor vehicle registration, roadworthiness tests, driver licence fees, parking fees, driving lessons and toll road charges

** Imputed using headline CPI in the June quarter 2020

Sources: ABS; RBA

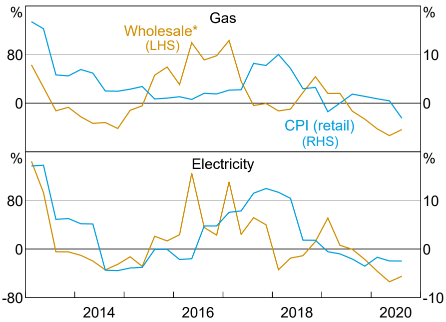
household appliances, which have seen strong demand related to a large share of people spending more time at home (Graph 5.8). Global supply disruptions affecting stock levels have also tended to boost prices for consumer durables. Motor vehicle price inflation also picked up due to price pressures from reduced domestic inventory and the introduction of new models at higher price points. These increases were partly offset by price declines for clothing & footwear, as demand for clothing has been weak and supply chain disruptions have affected clothing less than other consumer durables.

Food prices fell in the September quarter, but were 3.3 per cent higher over the year

Graph 5.7

Energy Price Inflation

Year-ended



* Quarter-average spot prices weighted according to state generation capacity

Sources: ABS; AEMO; AER; RBA

(Graph 5.9). Liaison reports suggest that supermarket discounting behaviour has returned to pre-pandemic patterns, following a reduction in discounting during periods of heightened demand earlier in the year. Price declines were most notable for packaged foods and bread & cereal products. In contrast, meat prices increased further as recent rainfall has induced some farmers to rebuild herds and flocks, reducing the supply of meat.

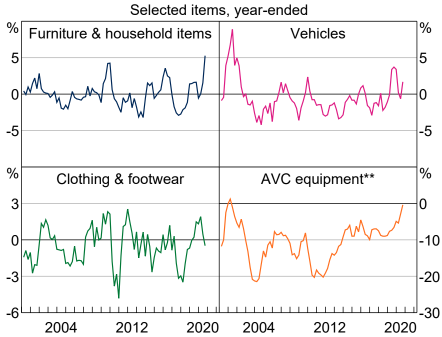
Housing inflation remains subdued as rents continue to fall

Housing-related inflation rose slightly in the September quarter, after slowing sharply in the first half of 2020 mainly because of declines in rental prices. As a result, housing-related prices, which comprise around one-sixth of the CPI basket, contributed only a little to headline CPI in the quarter. Prices for newly constructed dwellings increased by 0.5 per cent in the September quarter. Strong price rises in Perth drove this increase as state government grants supported demand for dwellings in the September quarter and led builders to reduce bonus offers (Graph 5.10). In contrast, prices for new dwellings fell in all other capital cities except Melbourne and Canberra. Future price increases will depend on the outlook for

Graph 5.8

Consumer Durables Price Inflation*

Selected items, year-ended



* Adjusted for the tax changes of 1999–2000

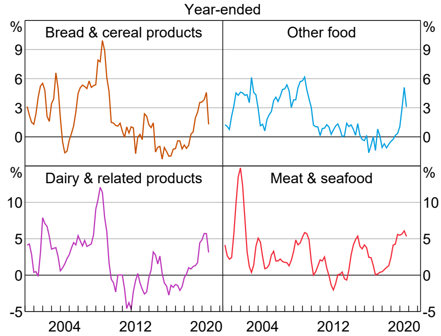
** Audio, visual & computing equipment

Sources: ABS; RBA

Graph 5.9

Food Price Inflation*

Year-ended



* Adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

dwelling construction and how quickly housing demand recovers following the COVID-19 shock.

Rents were 1.4 per cent lower over the year to September, the largest year-ended decline in the 47 years since the quarterly series began (Graph 5.11). In part this is because of an increase in the stock of properties available for long-term rental, as some short-term holiday rental properties have been converted to long-term rentals following the introduction of travel restrictions. Declines in rental prices have also followed the introduction of state government policies that enable tenants to negotiate rent reductions if they are experiencing financial stress due to COVID-19. Information from liaison contacts suggests that, nationally, up to 8 per cent of residential tenants have successfully negotiated rent reductions since the end of March, although some of these were only temporary and have already been reversed. Rent reductions for ongoing tenancies directly affect measured rent inflation because the CPI captures rents paid on the stock of existing rental properties. Public housing rent reductions and rent relief as part of land tax rebate schemes have also contributed to rent price falls in some states.

Market services inflation remains weak

Prices for market services were unchanged in the September quarter (Graph 5.12). These prices include household services such as hairdressing and house cleaning, as well as financial services and meals out & takeaway, and comprise a little under a quarter of the CPI. The activity restrictions in Melbourne during much of the September quarter resulted in the ABS imputing prices for a number of items in that city. Elsewhere, the easing of restrictions allowed the ABS to return to normal price collection for most items, after imputed prices were used in the June quarter for a number of categories. This resulted in a measured increase in recreation, sport & culture prices, as the return to normal price collection unwound the imputed June quarter price decline for the sports participation and other sporting & cultural services expenditure classes. Offsetting this, strong competition between restaurants and takeaway food businesses led to lower prices for meals out & takeaway.

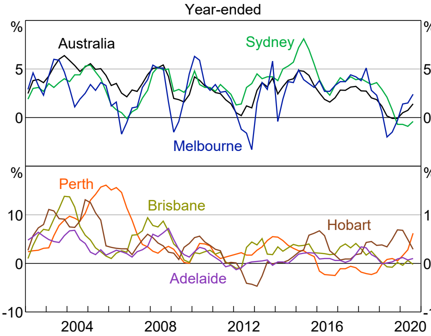
Survey-based measures of inflation expectations remain low

Wage- and price-setting behaviour can be affected by expectations about the future rate of inflation. Market economists' year-ahead inflation expectations have been revised down a

Graph 5.10

New Dwelling Inflation

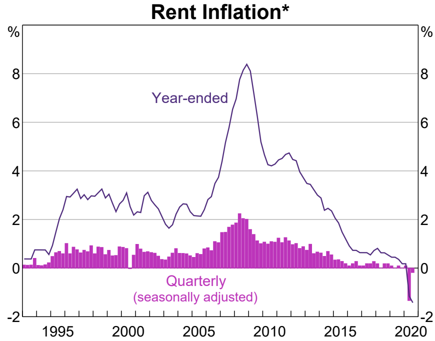
Year-ended



Source: ABS

Graph 5.11

Rent Inflation*



* Adjusted for the tax changes of 1999–2000

Sources: ABS; RBA

little recently. In part this is because recent large anticipated changes in some price components (such as the effects of oil prices and government subsidies) are no longer influencing year-ahead expectations (Graph 5.13). In contrast, unions' short-term inflation expectations have picked up a little but remain relatively subdued. Long-term survey-based measures of inflation expectations are around 2–2½ per cent and remain consistent with the Bank's medium-term inflation target.

Wages growth declined in the June quarter

Growth in the Wage Price Index (WPI) slowed to 0.2 per cent in the June quarter, to be 1.8 per cent higher in year-ended terms (Graph 5.14). These quarterly and year-ended growth rates were the slowest in the history of the series. Private sector wages growth slowed to 0.1 per cent in the quarter as employers made significant adjustments to wages in response to the effects of COVID-19. In contrast, public sector wages growth was stable at 0.6 per cent in the quarter.

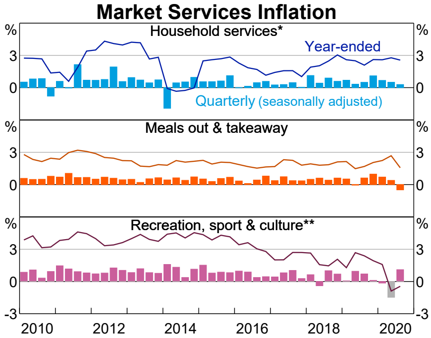
A small number of wage reductions weighed on growth in the June quarter. These were largest in professional, scientific & technical services, other services and construction; liaison evidence suggests that these cuts were largely temporary. Although wage increases are typically less common in the June quarter than in other quarters, the ABS noted that wage increases in the June quarter 2020 were even less common than usual.

Other measures of earnings have been boosted by JobKeeper, but this effect will fade over coming quarters

In contrast to the very low growth in the WPI in June, average earnings per hour were 8.2 per cent higher in the quarter (Graph 5.15). This spike was driven by the effects of the JobKeeper program on this measure of earnings, as well as compositional changes in the labour market in the quarter.

Graph 5.12

Market Services Inflation



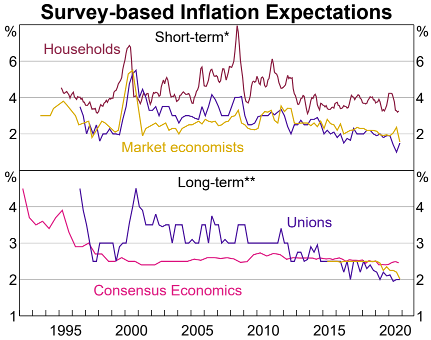
* Includes house cleaning, vehicle and home repairs, hairdressing and veterinary services

** Partly imputed using headline CPI in the June quarter 2020

Sources: ABS; RBA

Graph 5.13

Survey-based Inflation Expectations



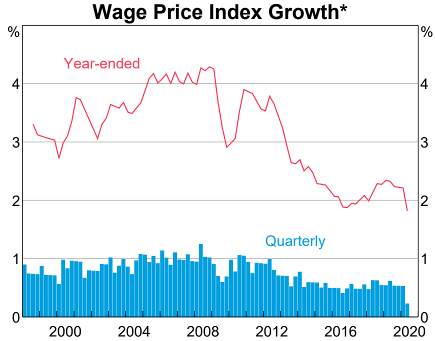
* Over the year ahead

** Average over the next five to ten years for market economists and unions; average over six to ten years in the future for Consensus

Sources: Australian Council of Trade Unions; Consensus Economics; RBA; Workplace Research Centre

Graph 5.14

Wage Price Index Growth*



* Total hourly rates of pay excluding bonuses and commissions

Source: ABS

- The JobKeeper program increased employees' average hourly earnings above their ordinary payments in cases where employees would otherwise have earned less per fortnight than the minimum JobKeeper payment of $1,500.
- The overall composition of jobs worked also shifted significantly in the June quarter; responses to the pandemic resulted in relatively more job losses in lower paid jobs. This compositional change lifted the average level of hourly earnings in the quarter. (In contrast, compositional change did not affect the WPI, which measures ordinary time rates of pay for a sample of jobs that is held fixed from quarter to quarter.)

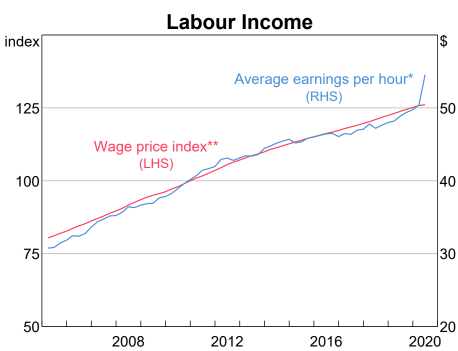
The spike in measured average earnings per hour is expected to be reversed over coming quarters as the JobKeeper program tapers and as employment in lower paid occupations continues to recover.

The changes to the JobKeeper program effective from 28 September are likely to see business eligibility decrease and fewer employees benefit from the minimum payment. In addition, the minimum fortnightly payment was reduced from $1,500 to either $1,200, or $750 for workers who had worked fewer than 20 hours per week prior to the pandemic. The lower payment rates that apply over the December quarter would fully cover wages costs for around 10 per cent of employees if they are eligible (Graph 5.16). This coverage is lower than that provided by the initial JobKeeper program; the original – higher – payment was a larger amount than that earned by around one-fifth of employees prior to the effects of COVID-19 (for instance, including some part-time workers). Although the changes from late September will reduce the boost to average earnings received by employees, JobKeeper will continue to provide a substantial subsidy to labour costs until the program's scheduled expiry in March 2021.[2]

Government decisions have affected the timing and size of some wage increases

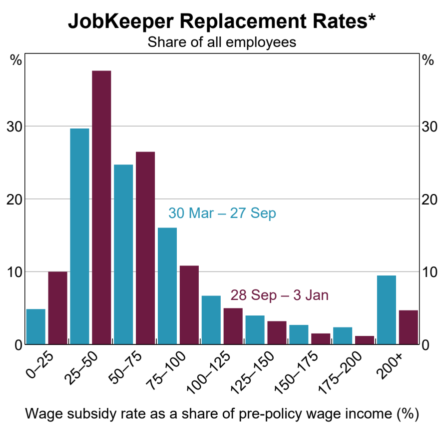
The FWC awarded a 1.75 per cent increase to award wages this year. This was lower than in recent years, and the increase was delayed for most affected employees from July to November or February. The deferred increase has also affected many employees covered by enterprise bargaining agreements given a growing number of these agreements have pay increases linked to the award wage outcome.

Graph 5.15



* Non-farm
** Excludes bonuses and commissions; December 2010 = 100
Source: ABS

Graph 5.16



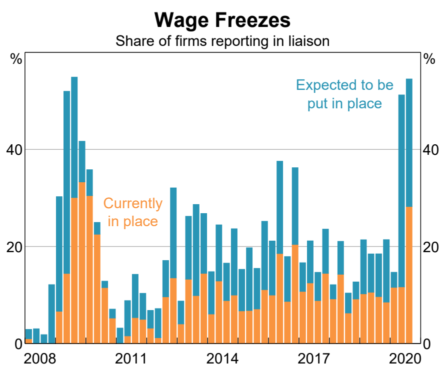
* Based on the distribution of wages in 2018, grossed up to 2020 by average earnings growth; data are replacement rates of the prevailing JobKeeper amount given weekly hours worked for all employees; JobKeeper eligibility is not taken into account
Sources: ABS; HILDA 18; RBA

Public sector wages growth was little changed in the June quarter, but wage freezes and deferrals will weigh on wages growth for the next few quarters. Some previously agreed wage increases have been deferred for up to 12 months, notably for Commonwealth and Queensland government employees. The NSW Industrial Relations Commission recently decided that pay rises in the current financial year for NSW government employees would be 0.3 per cent. The NSW Government has also announced plans to cap future wage increases to 1.5 per cent, lower than the 2.5 per cent increases applying in recent years.

Liaison suggests wage freezes became more widespread in the September quarter

Evidence from the Bank's liaison program suggests that wage freezes have been a common response by firms to the impact of the pandemic on business conditions. In the September quarter, more than half of reporting firms in this program indicated they either had a wage freeze in place or expected to implement one in the year ahead (Graph 5.17). Many firms have delayed remuneration reviews, which will weigh on wages growth in the near term, but may provide some catch up if delayed increases subsequently occur. In addition, most reported wage cuts put in place earlier in the year remain in place, although most firms expect these to be temporary.

Graph 5.17



Source: RBA

Endnotes

[1] The only items that continued to be imputed using headline CPI in the September quarter for all capital cities were domestic and international holiday travel. However, activity restrictions in Melbourne during much of the September quarter meant that the ABS had to impute prices for a number of items in the Melbourne CPI. The ABS released a note setting out its approach to imputation of unavailable prices in the September quarter 2020, available at <abs.gov.au/articles/methods-changes-during-covid-19-period#measuring-the-consumer-price-index-september-quarter-update>.

[2] To assist with understanding the impacts on employing businesses' labour costs of the JobKeeper subsidy (and from payroll tax changes) the ABS reconstructed the previously discontinued Labour Price Index (LPI) for the March and June quarter 2020, available at <abs.gov.au/statistics/economy/price-indexes-and-inflation/wage-price-index-australia/jun-2020#spotlight-labour-price-index>.

6. Economic Outlook

Following the largest contraction in decades, the global economy is in the early stages of recovery, as is Australia. However, the level of GDP in a number of major economies is expected to remain below pre-pandemic forecasts for the next couple of years, and a high degree of uncertainty continues to surround the outlook. The main source of uncertainty relates to the evolution of the pandemic, and the policy and behavioural responses to it.

The initial phase of the recovery in the global economy was enabled by improving health outcomes, which in turn allowed containment measures to be eased. Substantial policy stimulus also contributed. Even still, the global recovery remains fragile and uneven, with differences in health outcomes and relative positions in global supply chains largely accounting for the wide variation in economic outcomes. Economic activity in Australia's major trading partners is forecast to contract by 3 per cent in 2020 (in year-average terms) and then grow by 6 per cent in 2021 and 4 per cent in 2022. These forecasts are broadly similar to those presented in the August *Statement on Monetary Policy*; however, a recent resurgence in COVID-19 infections in a number of key economies has increased near-term risks to this outlook. Underlying inflationary pressures are likely to remain subdued globally for some time given considerable spare capacity.

In Australia, the recovery in activity has been underway for several months after the economy experienced the deepest peacetime contraction since the Great Depression in the first half of the year. The domestic recovery is set to be supported by the further easing in activity restrictions and substantial monetary and fiscal policy stimulus. The baseline scenario for GDP growth has been upgraded a little relative to the August *Statement*. This reflects stronger-than-expected household consumption and additional policy support (including that announced in the Australian Government Budget), though a downward revision to resource exports has partly offset the firmer outlook for domestic demand. Even after the GDP forecast upgrade, the severity of the downturn in the first half of the year means that GDP is not expected to return to its pre-pandemic level until the end of 2021.

Conditions in the labour market have improved a bit faster than expected at the time of the August *Statement* but remain soft overall. Employment remains well below its pre-pandemic level and measures of labour market underutilisation are high. Growth in employment is expected to be subdued over the next few months, as policy support measures, such as JobKeeper, are tapered. The unemployment rate is anticipated to peak at a little below 8 per cent, above current levels but lower than the 10 per cent peak that was previously expected. The unemployment rate is then expected to gradually decline, with employment expected to grow steadily and more people expected to be drawn back into the labour market; the unemployment rate is expected to remain above pre-pandemic levels at the end of the forecast period. Substantial spare capacity, including high underemployment, is likely to keep wages growth and inflation low for a considerable period.

Given the high degree of uncertainty about the outlook, two scenarios are considered in addition to the baseline. These represent two out of a range of plausible outcomes around the baseline projections (upside and downside), and are largely based on different assumptions about health outcomes and activity restrictions. Alternative outcomes, including outside the ranges discussed here, are also possible, some of which are addressed later in the 'risks and uncertainties' discussion. In summary:

- The baseline scenario assumes that no additional large outbreaks and accompanying strict containment measures occur within Australia and that restrictions continue to be gradually lifted nationally (or are only tightened modestly for a limited time). Some restrictions on international departures and arrivals are assumed to be in place until around the end of 2021. Under this scenario, GDP is expected to contract by around 4 per cent over the year to December 2020, but then grow by 5 per cent over 2021 and 4 per cent over 2022. The unemployment rate peaks at a little below 8 per cent in coming months, before gradually declining in 2021 and 2022 to just above 6 per cent at the end of the forecast period. Inflation is expected to pick up a little alongside a modest reduction in spare capacity, to be around 1½ per cent by the end of 2022.
- A plausible downside scenario is that Australia experiences further major outbreaks and there is a loss of control of the virus in other economies. In this scenario a substantial share of the population faces renewed distancing restrictions and curbs on business activities, and the opening of international borders is delayed further. The reimposition of restrictions domestically is assumed to weigh heavily on confidence and significantly slow the recovery in consumption and business investment, with the unemployment rate peaking at around 9 per cent in late 2021 and declining only a little in 2022.
- A stronger economic recovery than envisaged in the baseline scenario is also possible, especially if additional progress in the medical treatment and control of the virus is achieved in the near term, resulting in a faster withdrawal of containment measures. A sustained improvement in health outcomes domestically and abroad would boost confidence and support private consumption, investment and services exports. In this scenario, the unemployment rate peaks at 7½ per cent before declining to 5½ per cent by the end of 2021.

The recovery in domestic activity is underway, but spare capacity is expected to remain high for an extended period

In the baseline forecasts, GDP is expected to recover over coming quarters at a faster pace than expected at the time of the August *Statement*. But the pandemic will have long-lasting effects on the Australian economy, with GDP unlikely to return to its pre-pandemic level until the end of 2021 (Table 6; Graph 6.1). Overall, the economy is expected to be noticeably smaller at the end of the forecast period than anticipated prior to the pandemic, partially because of a sharp slowing in population growth.

In the near term, growth is driven by household consumption and public demand. Households are expected to consume a larger share of their income than they did over the June and September quarters, when the savings ratio was unusually high. Household income, which has been boosted by COVID-19 policy support measures, is expected to decline over coming quarters as these measures come to an end. But

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	–6.3	–4	6	5	4	4
(previous)	(–6)	(–6)	(4)	(5)	(4)	(4)
Unemployment rate[(c)]	7.0	8	7½	6½	6½	6
(previous)	(7.0)	(10)	(9)	(8½)	(7½)	(7)
CPI inflation	–0.3	½	2¼	1	1¼	1½
(previous)	(–0.3)	(1¼)	(3)	(1)	(1¼)	(1½)
Trimmed mean inflation	1.2	1	1¼	1	1¼	1½
(previous)	(1.2)	(1)	(1¼)	(1)	(1¼)	(1½)
	Year-average					
	2019/20	**2020**	**2020/21**	**2021**	**2021/22**	**2022**
GDP growth	0	–4	–2	3	4	4
(previous)	(0)	(–4)	(–3)	(2)	(5)	(4)

(a) Forecast assumptions (August Statement in parenthesis): TWI at 60 (61), A$ at US$0.70 (US$0.72), Brent crude oil price at US$42/bbl (US$46/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 November Board meeting.

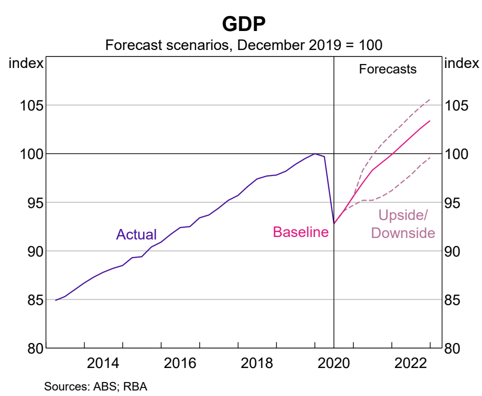
(b) Rounding varies: GDP growth to the nearest whole number; unemployment rate to the nearest half point; inflation rates to the nearest quarter point. Shaded regions are historical data and are shown to one decimal place. Figures in parentheses show the corresponding baseline scenario forecasts in the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

(c) Average rate in the quarter

Sources: ABS; RBA

the easing of restrictions on the consumption of some services and the previously accumulated savings will support household consumption through this period of lower income. The contribution of business investment to growth is also expected to increase across the forecast period. Exports are set to contribute to growth over coming years, but by less than expected at the time of the August *Statement*.

Graph 6.1



The forecasts incorporate a material downward revision to the outlook for population growth, in line with updated estimates prepared by the Australian Treasury. These updated projections are for population growth of around 0.2 per cent in 2020/21 and 0.4 per cent in 2021/22; this is the slowest rate of population growth since the First World War.

Labour market

Labour market conditions in most of the country have improved since May, but total employment remains much lower than before the pandemic. In the near term there will be several cross-currents affecting the labour market; further easing of domestic activity restrictions will boost employment, but there will likely be some offsetting effects from changes to temporary support policies such as JobKeeper. From mid 2021 through to the end of the forecast period, employment is expected to increase steadily as activity picks up, returning to its pre-pandemic level by the end of 2022.

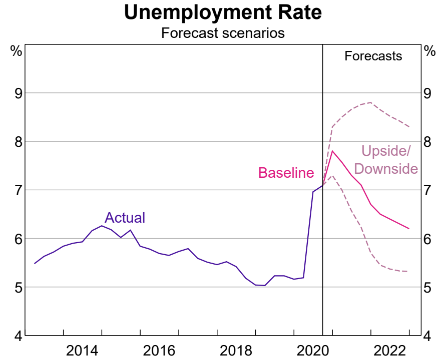
Employment recovered more strongly in the September quarter than was expected at the time of the August *Statement*. The unemployment rate – which was 6.9 per cent in September – has also been held down as a large number of employees have remained attached to jobs through working reduced or zero hours; this is particularly the case in Victoria. In the next few months labour market participation is expected to increase as restrictions ease further, outpacing the expected growth in employment.

Under the baseline, the unemployment rate is expected to increase to a little below 8 per cent in coming months, lower than the 10 per cent peak expected a few months ago, and then gradually decline over 2021 and 2022 to be just above 6 per cent at the end of the forecast period (Graph 6.2).

- In the near term, employment is expected to be supported by further easing of activity restrictions, particularly in Victoria, as well as an ongoing improvement in general economic conditions. Average hours worked should also increase as fewer employed people work reduced (or zero) hours (Graph 6.3). This improvement in conditions is also likely to encourage more people to return to searching for work, as will tighter eligibility tests for JobSeeker recipients.
- Labour market outcomes in coming months will also be shaped by changes to Australian Government employment subsidy programs. The JobKeeper program extension commenced at the end of September, and is due to expire at the end of March 2021. However, several new labour market subsidy and training programs were announced in the October Budget, including a JobMaker Hiring Credit to support new jobs for people under 35, and subsidies for apprenticeships and traineeships. Take-up of these programs is expected to increase gradually over the coming period, which should lend some support to employment.

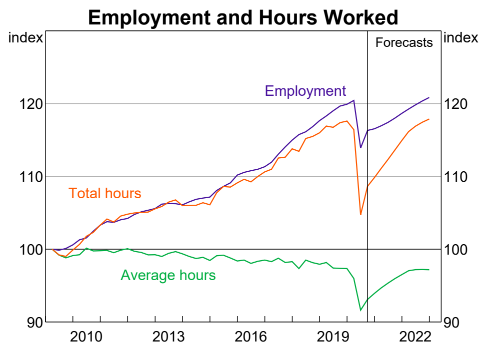
The participation rate is expected to increase gradually over the forecast period, as improving conditions encourage workers back into the labour market; longer-run structural drivers of increased participation (such as incremental increases in the pension eligibility age) also remain in place. Employment is expected to grow faster than both its long-term average

Graph 6.2



Sources: ABS; RBA

Graph 6.3



Sources: ABS; RBA

pace and population growth over 2021 and 2022.

Given the divergent forces shaping the near-term outlook for employment and the participation rate, there is considerable uncertainty over unemployment rate outcomes over coming months. The expected pace of decline in the unemployment rate is similar to that seen in most other economic recoveries in Australia since the 1980s. That said, a key difference between the current downturn and previous episodes is the much higher degree of underemployment at present. Average hours worked by existing employees remain well below their pre-pandemic levels, and it is possible that more of the anticipated increase in labour demand could be met by existing employees working more hours in the first instance, rather than hiring additional employees. If this were to occur, it would slow the pace of decline in the unemployment rate. More generally, measures of labour market underutilisation are expected to remain high throughout the forecast period.

Public demand

Public demand is expected to make a steady contribution to domestic final demand growth over the next year. The 2020/21 Australian Government Budget points to growth in public consumption, driven by spending on health, aged care and the national disability insurance scheme. Infrastructure spending is expected to support strong growth in public investment in coming years.

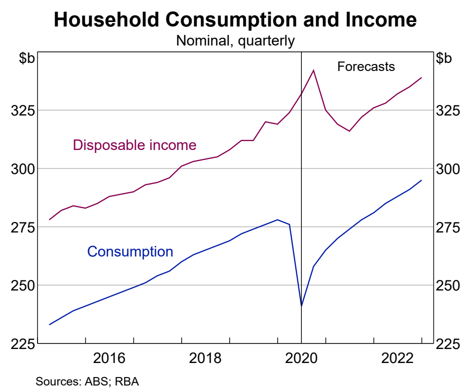
Household consumption, income and saving

After declining by 13 per cent over the first half of the year, household consumption is expected to have rebounded strongly in the September and December quarters, but will still be around 5 per cent below its pre-pandemic level at the end of 2020 (Graph 6.4). This forecast recovery is stronger than that published in the August *Statement* and is underpinned by the easing of restrictions and substantial income support. Growth in consumption is expected to remain robust over the second half of the forecast period, supported by the improvement in labour market outcomes and moderate growth in household wealth.

Household income is forecast to have increased further in the September quarter, reflecting increased social assistance payments and improved labour market outcomes. Income is still expected to decline over subsequent quarters, but the level in the first half of 2021 is expected to be a little above projections in the August *Statement*, partly due to tax cuts having been brought forward as announced in the Budget.

With consumption constrained in the June quarter by activity restrictions and a desire to build precautionary buffers, and income supported by fiscal transfers, the implied saving ratio increased to around 20 per cent. Households are expected to consume a larger share of their income over coming quarters as consumption possibilities broaden and confidence improves. To the extent that households also spend a portion of savings accumulated in prior quarters, this will further support consumption growth as households

Graph 6.4



smooth through the drop in income expected over coming quarters.

Dwelling investment

Following an anticipated decline in the September quarter, dwelling investment is expected to increase over coming quarters as the construction industry in Victoria resumes normal levels of activity and the HomeBuilder program supports detached building activity in most states. Growth over the latter part of the forecast period is expected to slow because the HomeBuilder program will have pulled some activity forward, particularly in the detached housing market, and because the protracted period of low approvals has diminished the pipeline of higher-density activity.

Business investment

Non-mining business investment is expected to be very weak over the next year or so, but not quite as weak as expected at the time of the August *Statement*. While disruptions to construction activity have been less severe than previously expected, non-residential construction investment is still anticipated to decline as the current pipeline of work yet to be done is completed and few new projects commence. The easing in restrictions in Melbourne will support construction activity in the near term as firms attempt to catch up on work that had been postponed in the September quarter.

A gradual recovery in non-mining business investment is expected to get underway in the first half of 2021 as the domestic recovery continues, led by investment in machinery & equipment. Tax incentives, which include the accelerated depreciation allowances over the next two years that were introduced in the Australian Government Budget, are expected to encourage some firms to bring forward investment plans and enable others to invest by easing cash flow constraints. A sustainable pick-up in non-residential construction activity is not expected until late 2021 because of the typical long lags in the planning and approval of construction projects.

The outlook for mining investment is similar to the baseline forecast in the August *Statement*. Mining investment is expected to be a little higher in the near term, led by work on iron ore and coal projects. Further out, mining investment is expected to ease slightly as construction on these projects winds down.

External sector

Exports are expected to contribute to growth over the forecast period but the outlook for exports has been downgraded compared with the August *Statement*. In the next year or so, extended maintenance at some liquefied natural gas (LNG) facilities is expected to weigh on LNG exports, and coal exports are expected to be lower because of weak global demand for coal. By contrast, iron ore exports are expected to remain strong.

The recovery in tourism and education exports is also expected to begin later than previously expected because international travel restrictions are assumed to ease around the end of 2021 – two quarters later than assumed at the time of the August *Statement*. The take-up of online study by international students and, to a lesser extent, pilot programs that allow some international students to enter Australia are expected to provide modest support to education exports. Forecast import volumes have been revised up over the next year or so, in line with upward revisions to domestic demand. Further out, the assumption that outbound international travel restrictions will remain in place for an additional two quarters weighs on the forecast for imports.

The trade surplus is expected to be lower over the forecast horizon than was previously anticipated; lower export and higher import volumes more than offset the effect of a higher terms of trade. The forecast for the terms of trade has been revised up over the next year or so, largely driven by higher prices for bulk commodities (Graph 6.5).

Wages and inflation

The outlook for wages growth is little changed compared with the baseline scenario in the August *Statement*. Although the unemployment rate is expected to peak at a lower level than previously forecast, labour market underutilisation remains very high throughout the period, suggesting limited upward pressure on wages. Year-ended growth in the wage price index (WPI) is expected to remain below 2 per cent over the next few years.

Wages growth was exceptionally weak in the June quarter, in part because some workers took temporary pay cuts. Wages growth is also expected to remain very weak in the near term. Liaison evidence suggests that around a quarter of surveyed firms intend to implement wage freezes in the year ahead, while around 30 per cent of surveyed firms already have a wage freeze in place. In addition, most wage cuts implemented in the June quarter remain in place; however, these will provide some modest support to wages growth as they unwind over coming quarters. Year-ended growth in the WPI is expected to trough at around 1 per cent in mid 2021, and then pick up only gradually to around 1¾ per cent by end 2022. As wage freezes unwind, it is possible that patterns of wage increases return to the '2–2½ per cent' norm seen in recent years. However, it is also possible that the widespread imposition of wage freezes, combined with a prolonged period of labour market slack, embeds a norm for wage increases that is below 2 per cent.

The outlook for underlying inflation in the baseline scenario is also little changed compared with the August *Statement* (Graph 6.6). Inflation remains very subdued at the end of the forecast period, reflecting the ample spare capacity that remains in the economy.

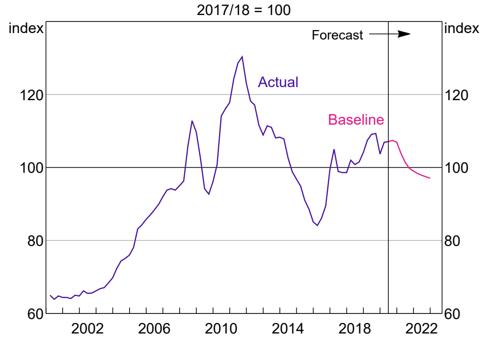
The near-term outlook for headline inflation has been revised down, reflecting the extension of several government subsidies until the end of the December quarter and the announcement of additional rebates in some states. Headline inflation is now expected to be around ½ per cent over the year to December 2020 (down from 1¼ per cent expected in August). Further out, both underlying and headline inflation are expected to increase gradually, reaching 1½ per cent by end 2022.

Compositionally, prices for some goods (such as consumer durables) are expected to continue

Graph 6.5

Terms of Trade

2017/18 = 100

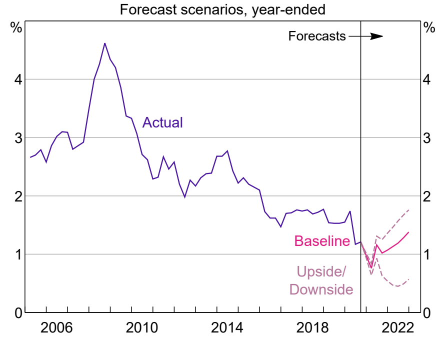


Sources: ABS; RBA

Graph 6.6

Trimmed Mean Inflation

Forecast scenarios, year-ended



Sources: ABS; RBA

increasing in the near term. Liaison information suggests there is strong ongoing demand for household goods; this has been compounded by depleted inventories early on in the pandemic and ongoing freight disruptions, putting upward pressure on prices. However, overall these effects are expected to be more than offset by weak demand more broadly and the deflationary effects of ongoing rental price declines driven by the increased stock of rental properties and slower population growth. The outlook for administered prices and government subsidies is a source of uncertainty; this may become a bit clearer over the course of November as various state budgets are announced.

Upside scenario: faster recovery

A stronger economic recovery than shown under the baseline forecasts is possible, especially if low virus case numbers are sustained, prompting domestic activity restrictions to be lifted more quickly and confidence to rebound strongly (this scenario does not presuppose the introduction of a vaccine, only enhanced control and management of the virus). A boost to consumer confidence could lift household consumption above its level in the baseline scenario. It is also likely that households would be more willing to draw down on savings accumulated over 2020, supporting a recovery in private demand; the scenario assumes that households consume around half of their accumulated unplanned savings over the coming year. It also assumes that international virus outbreaks are rapidly brought under control, such that tourism exports return to pre-pandemic levels more quickly once borders reopen.

In this scenario, the unemployment rate peaks below the level in the baseline scenario, and then declines more quickly as stronger activity and reduced uncertainty about the outlook support stronger labour demand and employment growth. This would be expected to underpin a stronger pick-up in wages growth and a faster increase in inflation over the next couple of years.

Downside scenario: slower recovery

An alternative possibility is that there are additional major outbreaks of infection in Australia and a sustained lack of virus control in other countries. This scenario assumes that around one-quarter of the domestic population faces a reintroduction of distancing restrictions and curbs on selected business activities in the first half of 2021. This would be expected to weigh heavily on consumer and business confidence in late 2020 and the first half of 2021, reinforcing the direct effect of restrictions on activity. The resurgence of infections abroad is assumed to see the reopening of international borders postponed until at least mid 2022, further delaying the rebound in services exports.

This scenario involves a more protracted and damaging slowdown in activity than envisaged in the baseline scenario. The reintroduction of measures to contain the virus, and the shock to confidence, would sharply reduce consumer spending and business investment over late 2020 and early 2021 and significantly delay the recovery. GDP would increase sluggishly throughout 2021, with growth starting to pick up only from early 2022. The loss of momentum in activity in this scenario would slow the recovery in employment as firms postpone hiring decisions and lay off additional workers, and the unemployment rate would increase to a peak of around 9 per cent in late 2021. The larger degree of spare labour market capacity would place further downward pressure on wages growth and see inflation trend lower until mid 2022.

Other risks and uncertainties

Risks to the domestic economic outlook in the very near term have eased as a result of favourable health outcomes, continued signs of recovery in private demand and the additional boost to growth expected from measures announced in the Australian Government Budget. Nevertheless, the medium-term outlook remains highly uncertain and there are a number of risks and uncertainties in addition to those described earlier.

Consumer spending is a significant driver of the expected economic recovery. One source of uncertainty relates to the net effect from the boost to consumption by recent fiscal stimulus measures (such as tax cuts) and the dampening effect from the expiry of temporary cash flow support measures. The propensity of households to save out of income is a related source of uncertainty, and will depend on confidence about the outlook. Households could respond to heightened uncertainty by choosing to save more (including paying down debt more quickly), despite record low interest rates. On the other hand, some households have already built up significant financial buffers over recent quarters, and if economic conditions continue to improve, could choose to draw on these buffers to fund consumption.

The housing market poses risks to the outlook in both directions. Although the national decline in housing prices has been limited to date, it is possible that conditions could weaken if there is a sharp increase in households that are unable to meet their mortgage obligations. This could be the result of a higher incidence of business failures and a further large rise in unemployment. Further out, the slowing in population growth could weigh on housing demand by more than is expected, resulting in lower prices and weaker dwelling investment. In the other direction, substantial policy stimulus could lead to a sharper recovery in housing prices supporting a stronger outlook for private demand than currently forecast.

The health of firms, particularly small businesses, is another a source of uncertainty. Many businesses have increased financial buffers, which is unusual during a recession. However, the longer the economy remains weak, the greater the likelihood that more firms will encounter financial stress as liquidity buffers are run down. There is a risk that business insolvencies will rise by more than expected as government support programs are tapered, slowing the recovery in activity, reducing investment and placing upward pressure on the unemployment rate. By the same token, the unprecedented government interventions to support businesses and enable them to build cash buffers could cushion firms as support is unwound and provide the basis for a faster recovery than currently forecast.

The amount of spare capacity in the labour market, and the speed at which this spare capacity is absorbed, are both significant sources of uncertainty. Average hours worked remain well below pre-pandemic levels, which means that as activity in the economy picks up, many firms could meet the demand for labour by increasing the hours of existing employees before taking on new workers. The degree of confidence about the economic outlook will also affect hiring decisions, with firms often tending to delay hiring decisions during an economic downturn. Participation in the labour market could rise more or less quickly than expected. This reflects that a large number of people who lost their jobs earlier in the year have not been actively looking for work and therefore are not currently considered as part of the labour force; it is difficult to assess how quickly these workers will return to the labour force, which will have implications for the unemployment rate. Structural change in the economy, the supply of skilled labour to match employment opportunities (including from immigrants), and 'scarring effects' on the long-term unemployed could all affect the amount of spare capacity in the labour market.

The combination of high labour market underutilisation and the extent of wage freezes at present mean that wage and price pressures are expected to remain subdued in the baseline scenario. It is possible that this results in nominal wage-setting norms and inflation expectations becoming anchored at lower levels than was observed before the pandemic. In the other direction, shortages in skilled labour and supply constraints in some parts of the economy could add more to wage and price pressures than currently expected.

The timing and pace of recovery in service exports once international travel restrictions are eased remain highly uncertain. Australia's relative success in managing the virus could make Australia a more attractive destination for international students and tourists. There is also likely to be some pent-up demand of people who wish to return to their home country, move country or visit family abroad. However, it is also plausible that the appetite for long-haul international travel could remain depressed for a long time, even after borders reopen.

Turning to global developments, a resurgence in infections in major economies and the measures taken to control them are the main factors shaping the outlook. It is unclear how long it will take to bring the virus back under control in parts of Europe and North America, and how much the recovery could be set back in the meantime. The global recovery will also depend on the scale and effectiveness of fiscal policy measures. US authorities have not yet agreed an extension of the fiscal support that lapsed in July or to new fiscal measures in support of the recovery; the longer the fiscal impasse, the more it will weigh on the recovery.

Finally, geopolitical and trade tensions remain elevated. The pandemic has heightened many of these pre-existing tensions and a worsening of the pandemic could increase them further, derailing the recovery. This includes US–China trade and technology tensions and the future of trade relations between the United Kingdom and the European Union. ✠

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