The Scenarios: Outlook for the economy

Statement on Monetary Policy

- **Reserve Bank Statement: The Reserve Bank has continued to outline three economic scenarios, each dependent on assumptions on the course of COVID-19 containment.**
- **Baseline economic forecasts: The economy is expected to contract 6 per cent in the year to December 2020 and rebound 5 per cent in the year to December 2021.**
- **RBA Assistant Governor Lucy Ellis gave an address elaborating on the forecasts**
- **Performance of Services index (PSI): The AIGroup PSI rose from 31.5 to 44.0 - the biggest lift on record - in July. But the index was still below 50 for an eighth month, signifying contracting activity.**

The Statement on Monetary Policy can affect financial market pricing and it provides a roadmap for businesses.

RBA Economic Growth, Inflation and Unemployment Forecasts

Year-ended, percent	Jun 20	Dec 20	Jun 21	Dec 21	Jun 22	Dec 22
GDP - February 20	2.00	2.75	3.00	3.00	3.00	na
GDP - May 2020	-8.00	-6.00	7.00	6.00	5.00	na
GDP - August 2020	*-6.00*	*-6.00*	*4.00*	*5.00*	*4.00*	*4.00*
Underlying CPI - February 20*	1.75	1.75	1.75	2.00	2.00	na
Underlying CPI - May 2020*	1.50	1.25	1.25	1.25	1.50	na
*Underlying CPI - August 2020**	*1.20*	*1.00*	*1.25*	*1.00*	*1.25*	*1.50*
Unemployment - February 20	5.25	5.00	5.00	4.75	4.75	na
Unemployment - May 20	10.00	9.00	8.50	7.50	6.50	na
Unemployment - August 20	*7.00*	*10.00*	*9.00*	*8.50*	*7.50*	*7.00*

Source: Reserve Bank, CommSec. *Trimmed mean measure

What does it all mean?

- The report can be found here: https://www.rba.gov.au/publications/smp/2020/aug/pdf/statement-on-monetary-policy-2020-08.pdf
- Economic forecasting is always fraught with difficulties and that is even more the case in the current environment. The key factor is how well states, territories and countries manage to suppress the virus. To date, Australia has been travelling well on this path. Then came the second wave in Victoria unexpectedly arrived and economic forecasts had to be downgraded.
- Fiscal and monetary policy have been working in unison to support businesses and economies. The risk is that support measures may need to be left in place longer and/or that new measures need to be applied. Around $330 billion (16.2 per cent of GDP) has been outlaid by federal, state and territory governments to support the economy.

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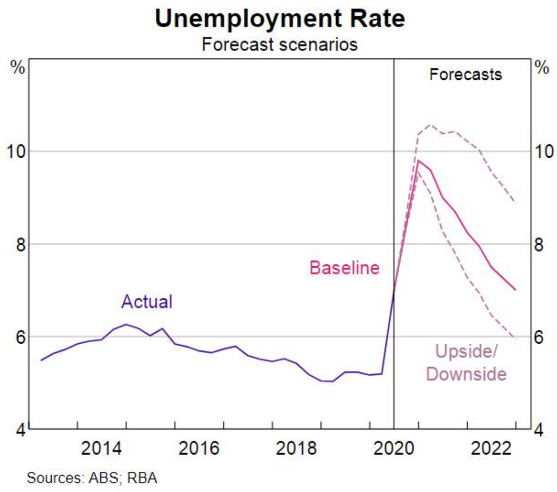
- The Reserve Bank is now expecting a lower-case 'v-shaped' economic recovery. And economic recovery is expected to be more protracted. Rather than rebounding at a 7 per cent annual pace in the year to June next year, the lift is expected to be more like 4 per cent. Unemployment is still tipped to top out near 10 per cent – but later this year, rather than earlier. Unemployment may still be around 8.5 per cent by the end of 2021, rather than 7.5 per cent.
- Interestingly the RBA indicated that the Board considered whether other measures should be considered to support the economy – notably intervening in foreign exchange markets to drive the Aussie dollar lower, and moving to negative interest rates. Both were rejected.
- Bottom-line is that the RBA Board believes that current monetary policy measures are sufficient. But inflation will be lower for longer and unemployment will be higher for longer. So interest rates will remain at current levels through to 2022.



The Scenarios
https://www.rba.gov.au/publications/smp/2020/aug/economic-outlook.html

Baseline scenario: Gradual recovery

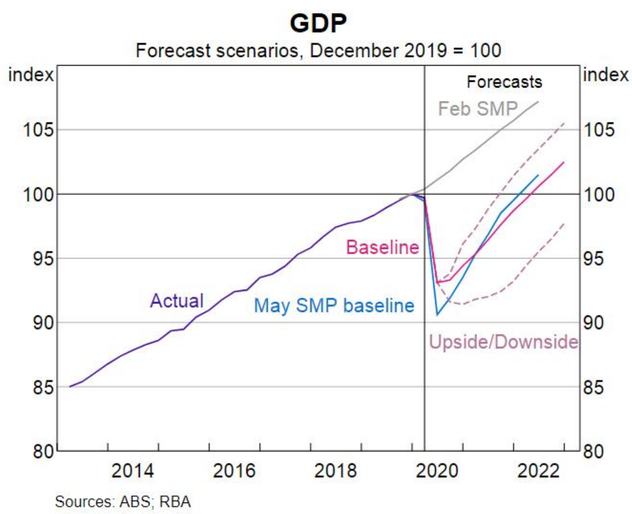
- *"In the baseline scenario, the Australian economy is expected to contract by about 6 per cent over 2020, before growing by around 5 per cent over 2021 and 4 per cent over 2022. This would still leave the level of output below where it would have been had the pandemic not occurred. Under the baseline scenario, the unemployment rate is expected to peak at around 10 per cent by the end of this year."*
- *"Under the assumptions for activity restrictions and border closures set out above in the baseline scenario, GDP grows modestly over the second half of 2020. Growth is driven by household consumption, as activity in much of the rest of the economy continues to contract. Household income is expected to decline over coming quarters as government support is tapered. How households and businesses adjust to this, after having increased savings over recent months, will be an important determinant of the outlook over the rest of the forecast period. Employment is expected to decline further over the second half of the year, as the job losses resulting from the heightened restrictions in Victoria as well as the tapering of the JobKeeper program more than offset the continued recovery in jobs elsewhere in the economy. The unemployment rate is expected to continue to increase over the second half of 2020, peaking at almost 10 per cent by the end of the year."*

Upside scenario: Faster recovery

- *"A stronger economic recovery is possible if faster progress in controlling the virus is achieved in the near term. In this scenario, a faster unwinding of activity restrictions and greater confidence lead to a faster recovery in consumption, investment and employment. The unemployment rate would peak at a lower level and decline faster than in the baseline scenario. "*

Downside scenario: Slower recovery

- *"However, a plausible downside scenario is where the world experiences a widespread resurgence in infections in the near term, and Australia itself faces further outbreaks and lockdowns in certain areas. Activity restrictions would weigh on household consumption and business investment decisions, despite continued policy stimulus and income support measures. Domestic activity would take much longer to recover in this scenario, resulting in the unemployment rate remaining close to its peak throughout 2021."*



Other key quotes:

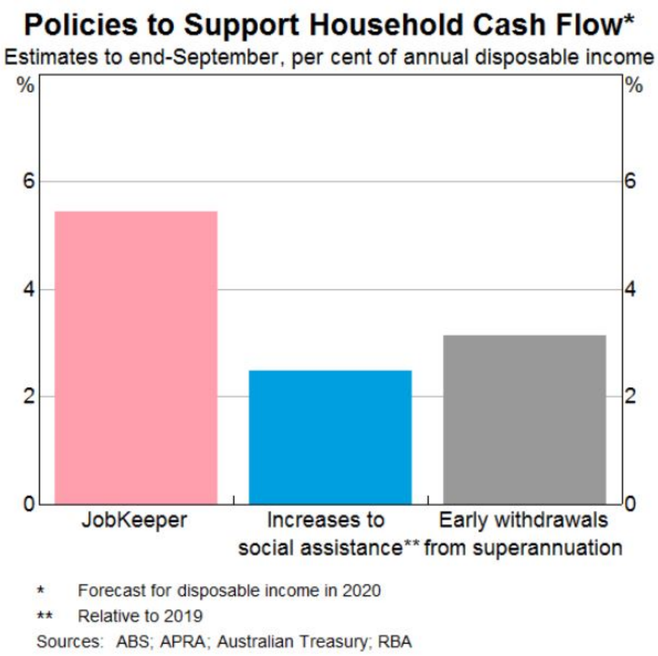
- **<u>Last Paragraph of 'Overview':</u>** *"The Board is committed to doing what it can to support jobs, incomes and businesses in Australia through this difficult period, and thereby help build the bridge to the* *recovery. The Board will not increase the cash rate target until progress is being made towards full employment and it is confident that inflation will be sustainably within the 2–3 per cent target band."*

- **Policy options:** *"As part of its review, the Board also discussed experience with a range of other possible monetary measures, including foreign exchange intervention and negative interest rates. It also reviewed historical experience of direct central bank financing of governments." Both were rejected.*
- The RBA Board *"concluded that, given the nature of the challenges posed by the pandemic, there was no need to adjust the mid-March package. The Board has, however, not ruled out adjusting this package in the future if circumstances warranted."*
- **Economic outlook:** *"The measures taken to address the current outbreak in Victoria will further delay the recovery. The most recently announced containment measures are expected to subtract at least 2 percentage points from national growth in the September quarter, relative to the counterfactual where the renewed outbreak had not occurred."*
- **Aussie dollar:** *"The Australian dollar is now in a range that is broadly consistent with its fundamental determinants, namely the terms of trade and the differential between interest rates in Australia and rates in major advanced* economies.*"*

Reserve Bank Assistant Governor (Economic) Luci Ellis spoke to the Australian Business Economists on *"The Economic Outlook"*

The speech is located here: https://www.rba.gov.au/speeches/2020/sp-ag-2020-08-07.html

- **Final paragraph on monetary policy outlook:** *"On Tuesday, the Board affirmed its commitment to do what it can to support jobs, incomes and businesses in Australia. It will maintain this accommodative approach for as long as this support is required, to help build the bridge to the recovery."*
- **On the economic outlook:** *"The [economic] recovery is expected to be slow and uneven, and GDP will probably take several years to return to the trend path expected prior to the virus outbreak."*
- **Labour market outlook:** *"We expect that employment and total hours worked will decline over the next few months, partly because of the increased activity restrictions in Victoria. Payroll data suggest that the recovery in employment began to falter in the second half of June and into July, even before the lockdown in Melbourne came into effect."*
- **'v'-shaped recovery?**: *"There are a number of reasons why activity is unlikely to bounce back completely after lockdowns end. Firstly, some activity restrictions usually remain even after the most stringent lockdown measures are lifted. Secondly, some people continue to engage in some social distancing beyond what is mandated. Thirdly, and probably most importantly, the deficiency in demand and a general increase in uncertainty induces people and firms to be more cautious in their spending decisions. So demand remains weak for some time."*
- **On the main driver of the economic contraction:** *"The main driver of the initial contraction has been consumption. Many categories of consumption were simply not permitted during the height of the lockdowns. Even now, some are still not permitted, such as overseas tourism. People substituted by spending on other things – in particular, they bought goods rather than services. But substitution can only go so far, so quickly. We estimate that household consumption declined over 10 per cent over the first half of the year."*
- **On household incomes:** *"Although many people lost their jobs over recent months, government support has meant that total household income has not fallen in aggregate. This has been a surprising outcome of the current episode. On top of the income transfers, many households have added to their available cash flow by withdrawing from their superannuation."*
- **On job losses and spare capacity:** *"...while the decline in total hours worked was smaller than we thought, it was tilted more to job losses rather than declines in average hours than expected. And more of the people who exited employment left the labour force entirely. This implies that there is more spare capacity in the labour market than a straight read of unemployment would suggest."*
- **On tourism and services exports**: *"Closure of international borders to most movements of people is affecting Australia's international trade and will continue to do so over the forecast period. International tourism will be infeasible until borders*



reopen, and will probably only recover slowly. This will affect both services exports and imports; before the pandemic, tourism imports – spending by Australians travelling overseas – substantially exceeded tourism exports."

- **On consumer prices (inflation):** *"Beyond the next quarter or so, we expect inflation to be low. Spare capacity in the economy and the resulting weak growth in labour costs are likely to put downward pressure on inflation for some time. We expect inflation to increase a little as the economy recovers."*
- **On cost of living pressures:** *"Governments could also decide to reduce pressures on the cost of living by freezing or lowering administered prices, as we have already seen for child care and preschool. It is uncertain how all these forces will play out."*
- **On the Reserve Bank's policy settings**: *"The package of measures introduced by the Reserve Bank Board in mid-March are intended to support the Australian economy by keeping funding costs low and credit available. The Board's assessment is that so far these measures are working as intended. Funding costs for banks, firms and households are all very low. Credit remains available and other policies have meant that borrowers in difficulty have been able to defer their repayments if needed."*
- **On fiscal policy:** *"Likewise the transfers to households and businesses coming from fiscal policy have supported incomes during this difficult period and provide a platform for the recovery. The JobKeeper program and various support for businesses have also ensured that employment relationships have been preserved to date and viable businesses can tide themselves over the period of disruption."*

What is the importance of the economic data?

- The Reserve Bank releases its **Statement on Monetary Policy** each quarter. The Statement is the Reserve Bank's assessment of economic and financial conditions and also contains the latest inflation views. The Statement is crucial in assessing the short-term outlook for interest rates.

What are the implications for investors?

- The RBA forecasts are broadly in line with CBA Group forecasts. The Reserve Bank expects inflation to peak near 10 per cent, whereas CBA Group are forecasting a peak closer to 9 per cent. But bottom-line is that unemployment will be at historically-high levels for a few years.
- Clearly the economic future is more uncertain than usual. We are in uncharted territory. But, notwithstanding issues in Victoria, Australia generally is in good shape compared with other countries. There is scope for more fiscal stimulus without the debt burden getting anywhere near the levels in the US, UK, Japan and China.
- The Reserve Bank believes there is still a role for monetary policy to provide more support if needed. But options seem to be limited. That said, in recent days the Bank has returned to the bond market, purchasing short-dated government bonds as part of its Yield Curve Control strategy. Should it need to, the Reserve Bank could purchase longer-dated maturities or state government (semi-government) - especially Treasury Corporation of Victorian (TCV) – bonds to keep borrowing costs low as governments issue more debt to fund stimulus spending.
- But overall, households and businesses aren't keen to take on debt at any interest rate. Apart from 'helicopter' money drops, reliance will be firmly focussed on fiscal stimulus.

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CBA forecasts

	Q1 20 (a)	Q2 20 (f)	Q3 20 (f)	Q4 20 (f)	2020*
Real GDP (qtr%ch)	-0.3	-6.1	-0.7	1.2	-4.2
Employment (qtr ch, '000)	54	-709	-125	160	-
Unemployment rate (%)	5.2	7.0	9.0	9.0	7.5

** Calendar year average*