

## Australia's Economic Outlook

- **COVID-19 resurgences risk Australia's nascent economic recovery.**
- **Domestic demand is set to remain soft while the external sector outlook is clouded by diplomatic tensions with China.**
- **Accommodative monetary policy is expected to remain in place for several years due to weak inflationary pressures.**

### ECONOMIC GROWTH OUTLOOK

Australia is set to join other advanced economies in recording a deep yet brief recession this year, for the first time in almost 30 years. In the first quarter of 2020, real GDP contracted by 0.3% q/q (+1.4% y/y); we estimate that the second quarter drop was significantly larger on the back of declining domestic demand that follows the curtailment of activity due to the COVID-19 pandemic. Australia's real GDP is forecasted to contract by 3.6% in 2020 as a whole. Growth will likely rebound to 2.7% in 2021 on the back of the lagged impact of monetary and fiscal stimulus measures, pent-up demand, and base effects. We note that there are substantial uncertainties regarding the forecast, with new waves of infections across the country posing notable downside risks to the outlook.

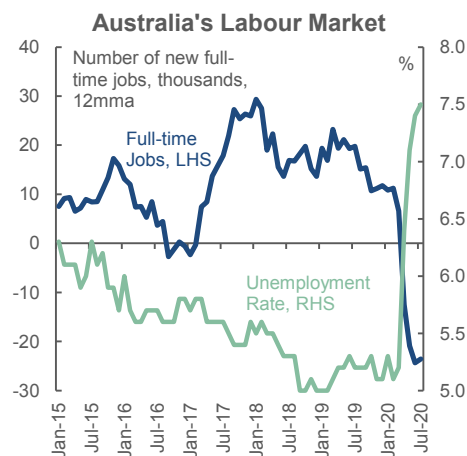
A recovery in household spending and investment will likely be somewhat delayed due to the newly imposed movement restrictions in Victoria. Consumer sentiment remains soft in line with weak labour market conditions (chart 1) and declining residential property prices (chart 2). Business confidence has rebounded, yet the sustainability of the recovery and its impact on real activity are highly dependent on the virus trajectory. Australia entered the COVID-19 crisis with healthy public finances; accordingly, it is in a solid position to support economic activity with higher public outlays until the recovery is well underway. Announced fiscal stimulus measures include direct payments to households, wage subsidies, incentives for private investment, and measures to support affected regions and communities. The Australian government unveiled a "mini-budget" on July 23, which laid out the nation's fiscal roadmap. The federal budget for the current fiscal year (July–June) was delayed until October due to the virus outbreak. The July update showed that the underlying cash deficit for fiscal year 2020–21 is expected to reach 9.7% of GDP vs. the government's pre-pandemic goal of reaching a small surplus.

Escalating tensions between Australia and China cloud Australia's external sector outlook; China is Australia's most important market, purchasing 42% of its total exports and 80% of its commodity exports. The bilateral relationship has been somewhat strained for some years already, yet it tensed up significantly in April following Australia's call for an international inquiry into the origins of the COVID-19 outbreak. Since then, China has slapped an 80% import tariff on Australian barley, banned beef imports from certain producers, and warned its citizens against travelling to Australia. Meanwhile, Australian authorities have advised that Australians may be at risk of arbitrary detention in China and have suspended the country's extradition treaty with Hong Kong after China imposed the National Security Law on the territory. As the latest move, China launched anti-dumping

### CONTACTS

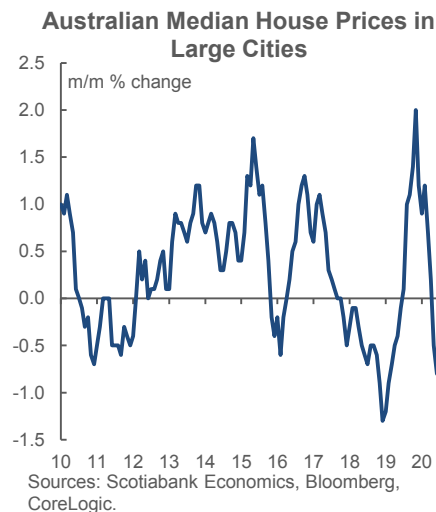
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Chart 1



Sources: Scotiabank Economics, Australian Bureau of Statistics.

Chart 2



investigations into Australian wine shipments to China. At this point, we assess that the direct economic harm for Australia caused by China's retaliatory measures remains manageable (barley and beef account for only slightly over 2% of Australian shipments to China, while international travel is limited due to the pandemic). However, if the dispute intensifies, other agricultural products, such as wine, dairy, or fruit, could be adversely impacted. The biggest risk related to the conflict is that China's retaliation spreads to mineral products/iron ore. Around 83% of Australia's iron ore shipments—the country's most important export—are destined to China. Nonetheless, we see such an escalation as a distant scenario given that Australia is a critical iron ore supplier to China; for now, the diplomatic dispute has not had a visible impact on the countries' iron ore trade (chart 3).

### INFLATION, MONETARY POLICY AND AUSTRALIAN DOLLAR OUTLOOK

Inflationary pressures will remain muted in Australia over the coming quarters due to significant spare capacity in the economy, high unemployment and low wage gains. Headline prices declined by 0.3% y/y in the second quarter (chart 4). While some of the underlying factors, such as dropping child care costs, are expected to reverse in the near future, we forecast headline inflation to climb only moderately, closing 2020 at 0.4% y/y. Inflation will likely accelerate gradually over the course of 2021 as the economy normalizes, yet we anticipate it to remain below the Reserve Bank of Australia's (RBA) target range of 2–3% y/y through 2021. Weak demand-driven price pressures will allow the RBA to maintain accommodative monetary conditions in the foreseeable future.

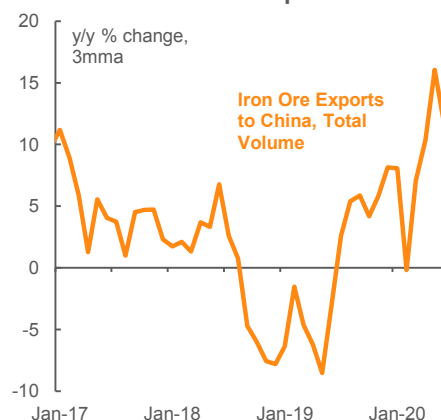
In March, the RBA responded to the COVID-19 shock with notable conventional and unconventional monetary policy measures. The benchmark cash rate has been lowered by a total of 50 basis points this year to 0.25%, following cuts of 75 bps in 2019 (chart 4). The RBA has also adopted yield targeting, aiming to keep the 3-year Australian government bond yield at around 0.25% by buying government bonds in the secondary market as needed. The RBA's government bond purchases total around AUD55 billion so far, with most of them conducted in April and May. Policymakers remain prepared to scale up the purchases when needed. In addition to the benchmark interest rate cuts and yield targeting, the RBA has also established a term funding facility for the banking system in order to lower funding costs and incentivize banks to provide credit to businesses.

According to the RBA, the yield target is set to remain in place until progress is being made towards the central bank's goals of full employment and annual inflation of 2–3%. Meanwhile, the monetary policymakers have pointed out that the yield target will be removed before the cash rate is raised. According to Governor Philip Lowe, the cash rate will likely remain at the current level for at least three years. As the economy is responding to the stimulus measures and starting to gather momentum, we do not expect any further monetary easing to be unveiled in the near future.

The Australian dollar (AUD) has strengthened against the US dollar (USD) since its low point in mid-March (chart 5), assisted by climbing iron ore prices and China's economic recovery. The reintroduced movement restrictions in Victoria seem to have had little impact on the AUD. Nevertheless, we assess that potentially escalating tensions between the US and China ahead of the US presidential election in November will limit the AUD's upside in the near future. We expect AUDUSD to close 2020 at 0.71.

Chart 3

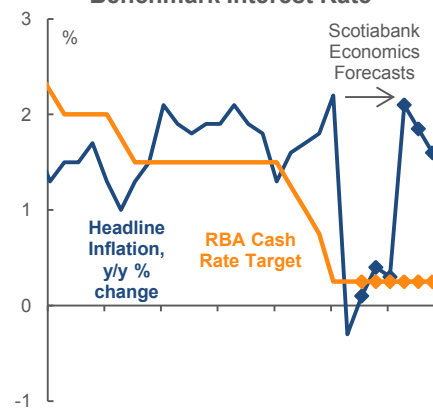
#### Australian Iron Ore Exports to China



Sources: Scotiabank Economics, Australian Bureau of Statistics.

Chart 4

#### Australia's Headline Inflation & Benchmark Interest Rate



Sources: Scotiabank Economics, Bloomberg.

Chart 5

#### AUD Performance



Sources: Scotiabank Economics, Bloomberg.

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