Friday 20 March 2020

Navigating the Economy with COVID-19

- **The shock from the coronavirus is very different to some we have seen in recent times. In this crisis, part of the solution, the containment measures, is what is having the profound impact on the economy.**
- **We see a potentially deeper shock to Australian economic activity this time around in comparison to the GFC, but one in which economic activity could recover more quickly, provided containment measures have the desired effect.**
- **In the meantime, volatility in financial markets is likely to continue until we see some light at the end of the tunnel with the infection rate.**
- **This year, we expect a contraction of 1.0% over the first half of the year, but for the economy to return to growth in the second half. Growth is expected to rebound 2.5% over the second half of this year. Note these forecasts have downside risks attached to them and are fluid; they have a high degree of variability, as the situation is evolving and not yet fully quantifiable.**
- **A recovery later in the year depends on how well containment measures work and for confidence to return.**
- **We expect that the unemployment rate in Australia will lift above 7% later this year, from a current rate of 5.1%. This would be a more pronounced rise in comparison to the GFC period, but not as severe as the 1991 recession.**
- **The RBA has said that supporting small and medium-sized businesses is a priority. That is, trying to build a bridge to recovery so that otherwise viable firms survive. Managing cash flow at this time will be the key challenge. Some of the measures it announced yesterday are designed to support businesses and build this bridge.**
- **While we do not know how long the coronavirus will stay with us for, we do know that some sense of confidence will return at some point. While the containment measures are set to hit economic activity, these are there for a reason. If they prove successful, they will limit the number of new cases. Economic activity is cyclical, and recoveries always eventually follow a downturn.**

A few short weeks ago, the coronavirus was seen as something that was deeply impacting the rest of the world, but mostly constrained to a few select countries. There was no doubt that it was having a profound impact on the Chinese economy, which would have had flow-on effects to Australia. However, as cases have mounted in Australia and as containment measures have become more aggressive, the coronavirus impact has hit much closer to home, affecting all of our everyday lives.

Given the rapid pace of unfolding developments, we have yet to see much economic data to gauge the impact of the travel bans, social distancing and the broad sense of anxiety that has led consumers to empty supermarket shelves.

But what are we expecting? Below, we provide some key insights and considerations for the economic impact of COVID-19.

The current crisis is different to the Global Financial Crisis (GFC): The ructions in financial markets over recent weeks have been reminiscent of the GFC, including the large falls in equity markets and extreme risk aversion. Vast amounts of liquidity measures have been enacted by central banks to prevent dislocations in bond and money markets.

However, the current coronavirus crisis is a very different type of shock. The GFC reflected a range of issues built up in the financial system, which crippled the flow of money. This current shock is an entirely external shock, in which part of the solution, the containment measures, is what is having the profound impact on the economy.

We see a potentially deeper shock to Australian economic activity this time around in comparison to the GFC, but one in which economic activity could recover more quickly, provided containment measures have the desired effect. In the meantime, volatility in financial markets is likely to continue until we see some light at the end of the tunnel.

A recession is on the cards: While we did avoid a technical recession in the midst of the GFC, it seems very likely that one will occur over the first half of 2020. A technical recession is defined as two quarters or more of contraction in economic activity. Governments and central banks have deployed an extensive range of stimulus measures, but are unlikely to prevent a recession given containing the virus requires restricting the movement of society.

The last recession in Australia was in 1991 when the economy contracted by 1.3% in the March quarter, followed by a 0.1% decline in the June quarter, but economic activity was also very sluggish throughout the bulk of 1990. Over this period, annual growth troughed at -1.4% in the year to the June quarter of 1991.

This year, we currently expect a contraction of 1.0% over the first half of the year (falls of 0.7% in the March quarter and 0.3% in the June quarter), but for the economy to return to growth in the second half. Growth is expected to rebound 2.5% over the second half of this year. It would leave year ended GDP growth of 1.5% for 2020. While the economy was on weak footing in the lead up to the coronavirus escalating, a recovery is expected as activity begins to return to normal. Nonetheless, a recovery later in the year depends on how well containment measures work and for confidence to return. Furthermore, our forecasts contain downside risks and have a high degree of variability attached to them; they are very fluid, given the situation is very much still evolving and not fully quantifiable.

Jobs will be lost: With any recession or downturn in economic activity, jobs growth is expected to weaken and the unemployment rate to rise. In the GFC period, the unemployment rate rose from a cyclical low of 4.0% to peak at 5.9%. Meanwhile, in the 1990-91 downturn, the unemployment rate rose from a cyclical low of 5.8% to peak at 11.1%.

We expect that the unemployment rate in Australia will lift above 7%, from a current rate of 5.1%, thus delivering a more pronounced rise in comparison to the GFC period, but not as severe as the 1991 recession. The RBA is also anticipating significant job losses. In the questions-and-answers session yesterday, the RBA Governor said we need to "steel ourselves for a rise in the unemployment rate". He added that he hoped it was temporary and displaced workers will find jobs again when the recovery takes hold.

There is also reason to believe that the labour market could adjust more quickly in recovery than previous downturns, as labour mobility is more flexible than previously.

Business and retail spending will be hit: Many businesses will face substantial declines in revenue during this period, so the aim for policymakers is to make sure that they have support in this period prior to recovery. That is, trying to build a bridge to recovery so that otherwise viable firms survive. Managing cash flow at this time will be the key challenge.

Business confidence was already fragile before the wider outbreak in Australia.

Businesses linked to tourism and education are the most vulnerable, however, other services such as sport and recreational services, bars and restaurants are also hard hit. The RBA has said that supporting small and medium-sized businesses is a priority during this period. Some of the measures it announced yesterday are designed to support businesses.

While supermarkets, food retailing and healthcare spending will likely receive a boost, spending in some of these areas could be negatively affected if this crisis drags on for a lengthy period of time. Overall household spending is expected to be weaker as jobs and incomes become more constrained and as caution prevents spending on discretionary items and big-ticket items.

Panic always subsides: While we do not know how long the coronavirus will stay with us for, we do know that some sense of confidence will return at some point. Even if containment measures were to be in place for an extended period, people could end up adjusting to a new reality. While the containment measures are set to hit economic activity, they are there for a reason. If they prove successful, they will limit the number of new cases. Economic activity is cyclical, and recoveries always eventually follow a downturn.

The RBA yesterday said the record low cash rate of 0.25% will be maintained for “some years”, supporting the economic recovery when it comes. The RBA Governor yesterday stressed the temporary nature of this downturn.

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