April 2020

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

The global economy is in a deep recession due to the rapid and widespread escalation in Covid-19 containment measures since mid-March. While the driver of this recession is different to previous episodes, some of the longer-term consequences will be similar. Many businesses that have been forced to shut down will not re-open and the extra debt that households and businesses are being forced to take-on to address a severe cashflow squeeze will have to be worked off over time. As a result, activity is unlikely to return to its pre-virus trajectory for a while to come. The timing and strength of the recovery will depend on when, and to what extent, containment measures are eased. China was the first country to implement severe restrictions and has already eased restrictions. While some other countries are now flagging an easing, others are still debating whether to escalate measures further – so it is not clear that we are yet at peak containment globally.

- The rapid ramping up of Covid-19 containment measures globally, and the scale and speed of the resulting damage to economies, has severely stressed **financial markets** and seen major share markets fall by over 30%. There has been a partial recovery in share markets and indicators of financial stress such as credit spreads are off their peaks, helped by government and central bank policy measures. That said conditions remain tight, particularly for lower rated entities and capital outflows present a financial market risk for emerging markets.
- Not surprisingly, in an environment of collapsing activity, **commodity prices** have fallen. This has particularly been the case for oil prices due to a breakdown on OPEC+ production limits, although there has been a recent deal to curb output.
- **Central banks** have responded by cutting rates and moving to support financial markets to ensure market functioning and on-going credit provision. The Fed has launched a multitude of programs to address dislocations across various markets, including in the USD market, and is supporting lending to businesses (with Treasury backing). The ECB, BoJ and BoE have also initiated asset purchase programmes and funding support for banks. Regulatory requirements on banks have also been eased to ensure the flow of credit and early signs indicate that this is indeed happening (e.g. outstanding US commercial & industrial loans increased by 21% over a four-week period).
- Major **advanced economies** (AEs) have seen a rapid and severe reduction in activity due to Covid-19 containment measures. We expect double digit declines in some major advanced economies in Q2. The scale of the collapse in activity is already evident in labour market readings which have deteriorated with unprecedented speed. Some business surveys in March recorded exceptionally large falls, particularly for the services sector, where many of the initial containment measures (travel bans, closure of restaurants) were implemented. The scale and breadth of the fall in activity has been highlighted by estimates prepared by INSEE, the French statistical office, and point to a fall in activity of around 35% from the French lockdown. The impact on labour markets has been immediate, with indicators pointing to exceptionally large and rapid impacts on employment. We tentatively have some recovery in major AE GDP in Q3 but this will entirely depend on the timing and pace of easing in containment measures. We do not expect activity to return to its pre-virus level until well into 2021.
- Escalating containment measures across a wide range of countries (with the exception of China) slowed economic activity across **emerging market** (EM) economies in March. The EM PMIs remained negative (below 50) in March but less so than in February. The aggregate results mask some divergent trends across EMs. As China was the first economy to implement severe Covid-19 restrictions, it experienced the earliest downturn and is starting the earliest recovery. Stronger results for China – particularly in manufacturing – drove the less negative results in March, while most other countries deteriorated. EMs suffered dramatic capital outflows in the month, with these outflows risking a tightening in financial conditions for EM economies - countering the efforts of monetary authorities attempts to ease policy.
- We expect the **global economy** to contract by 2.8% in 2020 – with advanced economies seeing a sharper contraction than emerging markets. The impact is expected to spread across H1 2020 – with the China-led downturn in emerging markets more significant in Q1, while the advanced economy downturn is larger in Q2. This annual decline is the largest since at least the early 1950s and likely the Great Depression. Global growth is expected to rebound in 2021 as normal activity resumes – up by 6.6%. Apart from the timing and extent of the easing in containment measures, a key issue is how much ongoing economic fallout occurs. Prolonged unemployment, permanent business closures and lower consumer confidence (or greater caution) are a source of downside risk. Similarly, the increased debt burden – used to support businesses and households through the current downturn – could constrain demand and expansion activity going forward.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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Australia*: We have significantly downgraded our forecasts since mid-March. The domestic economy is now expected to see a contraction of an unprecedented speed and magnitude. GDP is expected to decline by around 8% in the first three quarters of 2020, before growth recovers in 2021. It is important to note the level of activity is not expected to be fully recovered until early 2022. Given the nature of coronavirus containment measures and the magnitude of the downturn, we will also see a significant deterioration in the labour market. The unemployment rate is expected to rise sharply and quickly to 11.7% in the next few months and stay there until the end of the year. With the recovery in growth from Q4 the unemployment rate is expected to partially recover in 2021 – but remain above 7% by end-2021. Policy makers have responded quickly and significantly, but this will be unlikely to offset the extent of the pain in the near-term. However, it will help significantly in the recovery phase. There are likely to be implications for wage growth and inflation growth with the build-up of spare capacity in the economy, meaning rates will remain at very low levels for an extended period. There are also risks to specific sectors such as an ongoing adjustment in commercial property and a delayed recovery in tourism and education sectors will lower exports with non-resident movements likely to be restricted for some time. While official data are lagged and yet to show signs of the coronavirus impact, the NAB Monthly business survey showed a collapse in both confidence and conditions in March.

- The **RBA** cut rates by 0.25% to a record low of 0.25% at an out-of-cycle meeting in mid-March and moved to yield curve control in the form of a target for 3-year bond yields of 0.25%. Simultaneously the bank announced a term funding facility for banks who extend business credit as well as narrowing the cash rate corridor by lifting the effective floor for commercial bank deposits at the RBA to 0.1%. The latter measures have the intent of ensuring bank profitability and the flow of credit in the economy. From here we expect the RBA to leave the cash rate unchanged for an extended period, with an easing in the target for 3-year yields occur first. This unwind will not occur until "the bank makes progress on full-employment and inflation" which on our outlook does not occur until beyond 2021. We expect unemployment to remain elevated and inflation to fall.
- The **unemployment rate** ticked up from 5.1% to 5.2% in March with a 5.9k rise in employment offset by a 20.3k rise in unemployed. The participation rate was unchanged at 66% and remains near its record high. From here we expect a material deterioration in the labour market, with the unemployment rate rising to 11.7% by mid-year and staying there until end-2020. We expect the unemployment rate to partially recover in 2021 but not completely – with the rate reaching 7.2% by end-2021. In this shock it is likely that the unemployment rate will not show the usual lag to activity with a fast and sharp deterioration seeing an instantaneous increase in unemployment. Indeed, the employment index in the March monthly business survey saw a sharp fall in the month, and implies a significant reduction in headcount by business.
- We expect **consumption** to fall significantly this year. Retail sales for February showed a 0.5% increase, with a notable increase in segments supported by household hoarding. However, from here we expect retail sales (and consumption to slow - and fall sharply in Q2 &Q3 2020). With households already constrained by slow wage growth and high debt levels, the deterioration in the labour market will see a further pull-back in household spending. The recent boost to spending from household hoarding is expected to fade while services spending has already softened on the back of containment measures. In the recovery phase we are likely to see a similar pattern in consumption to recent years, with restraint in discretionary spending.
- **Business investment** will likely see a significant fall in 2020 following weaker than expected outcomes in recent years. With activity seeing a sharp decline and uncertainty high, it is unlikely that firms will seek to expand operations while the unfolding recession plays out. Indeed, the NAB monthly business survey saw a sharp deterioration in the month. Both business conditions and confidence saw their largest monthly declines on record, with confidence now well below its trough in the 1990s recession. While business conditions fell by a smaller amount, they have already surpassed the trough seen in the global financial crisis. Reported capex and employment declined sharply in the month, in line with a decline in capacity utilisation to very low levels.
- **The Housing market** is also likely to weaken over the next year or so. We see house prices declining by 10-15% as the economy contracts. This follows the sharp recovery seen over the past year or so. Auction clearance rates have declined sharply in recent weeks, and house price growth has already slowed. We expect further declines in new construction with building approvals having remained low. There is some additional risk around this should an escalation in coronavirus containment measures see a shutdown in the construction sector. Further out, disruptions to planning and design phases of new construction may also see further softness in the pipeline.
- The **trade balance** has narrowed slightly for 3 consecutive months. Going forward the contribution net exports has made to growth in recent years is expected to fade. The last of the mega-LNG projects are now reaching full capacity and it is unlikely we will see significant investment in the resources sector in the near term. Services exports are expected to be impacted significantly through 2020 while containment measures remain in place.
- The downturn driven by Covid-19 containment measures has weakened global demand prospects and weighed on **commodity markets**. This has seen a softening in capex intensions in Australia, particularly in the LNG sector.
- The **AUD** has depreciated by around 8% since the beginning of 2020 in trade weighted terms, and by around 12% against the USD. The recent sequence of central bank policy actions and bouts of risk aversion have seen significant volatility. We have slightly lowered our currency forecast to around US0.63c by end 2020 and US0.71c by end-2021.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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