Bank of Melbourne

Monday, 16 August 2021

Economy Hit by Delta Helter Skelter

The spread of the delta variant across NSW has accelerated over recent days. Case numbers have grown to over 400 a day and the state recorded 478 cases today, its highest since the beginning of the pandemic. The NSW government extended stay-at-home restrictions to include regional NSW from 5pm last Saturday. This requires that people across all of NSW only leave their homes for an approved reason. Movement restrictions were also tightened. Residents are required to stay within a 5 km radius of their home for shopping and exercise, down from the previous 10 km restriction. Moreover, the ACT and parts of the NT are in a snap lockdown and Victoria's lockdown has been extended alongside a tightening of restrictions.

Economic outlook

The recovery in 2021 has been interrupted by the current Delta outbreak. The size of this interruption has deepened with the tightening of restrictions in NSW, ACT, NT and Victoria.

In late July, we forecast the economy to contract by a little over 2% in the September quarter, before forecasting a strong recovery for the December quarter. We flagged these forecasts were predicated on the NSW lockdown lifting at the end of September and that other parts of the country avoided lengthy lockdowns.

However, since we prepared these forecasts, health outcomes have deteriorated significantly. And so, we expect these key assumptions will no longer hold up. Indeed, we see a risk that the lockdown in NSW could extend well into October, despite vaccinations ramping up.

As a result, we now expect the national economy will contract by 2.6% in the September quarter with a rebound of 2.6% in the December quarter. This will take growth over 2021 to 2.4%, down from our previous expectation of a little over 3%. This is a large reduction and means economic growth over 2021 will be slightly below the long-run average of around 2.6%.

Next year, we anticipate solid growth of 5.0%, as the risk of lockdowns reduce significantly due to a high share of the population being vaccinated.

The downgraded economic growth outlook has flow on implications to the labour market. We expect the unemployment rate to be at 5.0% at the end of December 2021, up from our previous estimate of 4.8%. The rate is then expected to fall to 4.1% at the end of 2022, up from our previous forecast of 4.0%.

The unemployment rate is likely to rise in the next few months, possibly to the high 5s. But this peak will be much lower than the peaks recorded last year through the national lockdowns and other state-based lockdowns. Notably, the labour market showed significant strength going into this outbreak. In June, the unemployment rate fell to a 10-year low of 4.9%.

The lockdowns are expected to largely result in a reduction in the hours worked, rather than a significant increase in the unemployment rate. In other words, employees are temporarily stood down but remain employed. Government support programs, such as JobSaver, also help incentivise businesses to retain employees.

There are a few key developments underlying these revisions.

First, we now expect the lockdown in NSW to be extended to the end of October, instead of lifting at the end of September. So far, there are no convincing signs that case numbers in NSW have reached a peak.

Second, the Greater Sydney lockdown has spread to impact all of NSW and the list of LGAs of concern has grown from 8 to 12, expanding the regions facing tighter restrictions. Further, the travel limit has been reduced from 10 km to 5 km from home.

Third, Victoria has been plunged back into lockdown (its sixth) and the Victorian Premier today announced this is being extended for two weeks. A curfew will also be imposed on residents. Cases are yet to show signs of slowing. We expect the Victorian lockdown will last at least a total of six weeks.

Elsewhere, the ACT entered a one-week lockdown, which has now been extended for a further two weeks, and Greater Darwin and the Katherine region has also entered a snap three-day lockdown today. These lockdowns will have a less material impact on national economic activity, particularly if they are not extended any further.

While not our base case, there is a growing risk of a contraction in the December quarter. This would mean two consecutive quarters of negative growth, meeting the definition of a technical recession. This is because there is a material risk that the virus spreads across more parts of the country and that restrictions are in place well into the December quarter, pushing out the expected bounce back in economy activity.

On the positive side, as we have noted many times before, the economy tends to rebound strongly once lockdowns lift. This is still our expectation. The key uncertainty is when lockdowns will lift and we expect that will be tied critically to the vaccination rollout.

The pace of vaccinations across NSW and the rest of Australia is encouraging. Currently, double dose vaccination rates range from around 23% to 32% of the eligible population (ages 16+) across the states and territories. In NSW, almost 27% of the eligible population is now fully vaccinated.

The supply of vaccines has also received a boost. Australia will receive an additional 1 million doses of the Pfizer vaccine from Poland, with around half of those to be distributed to young people in NSW across the 12 LGAs of concern. The supply of Pfizer vaccines is expected to increase over coming months. Additionally, Moderna recently received provisional approval by the Therapeutic Goods Administration and is expected to arrive in the country over the next few months.

This increased supply will be a literal 'shot in the arm' for Australia's vaccination program and help the country meet its vaccination target. We expect the nation will reach the national 70% target by November, and possibly even sooner, if vaccinations continue at the current pace.

These are positive signs and will help reduce the frequency and severity of future lockdowns. However, as global experience is showing, vaccination rates need to be quite high to effectively control the spread of the delta variant.

Economic calendar

Looking to the economic calendar this week, the RBA will publish the minutes from its August policy meeting on Tuesday. Despite the material deterioration in the near-term outlook, the RBA announced it would continue with its planned tapering of bond purchases from September. This will see the RBA reduce the rate of bond purchases from $5 billion per week to $4 billion per week. The RBA also reiterated that its central scenario is that the cash rate will not increase before 2024. The minutes will provide additional information on the thinking of the board in making those decisions.

On Thursday, there is the release of July's labour force statistics, which will provide an important read on how the employment market reacted to the early stages of the NSW lockdown. Our estimates based on partial data suggest employment increased by 20k jobs in July and the unemployment rate fell to 4.8%.

This somewhat counterintuitive result reflects our expectation that most of the adjustment in the labour market will come through hours worked, rather than changes in head count. The survey was also undertaken during the first two weeks of July, prior to the expansion of restrictions in NSW to include the construction sector. Other parts of Australia were not yet significantly impacted by lockdowns during the survey period.

The wage price index for the June quarter will be released on Wednesday. In recent months, contacts have reported increased pressures in finding the right skills in certain sectors. There are reports that these difficulties are flowing through into isolated wage pressures in those industries. However, this has not yet translated to a broad increase in wages. Annual wages growth in the March quarter was only slightly above the lowest pace on record. We expect wages to have increased by 0.7% in the June quarter, up from a 0.6% increase in the March quarter. Annually, this takes wages growth to 2.0%.

Forecasts

		2021		2022			
End Period:	**Close (13 August)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	0.10	0.10	0.10	0.10	0.10	0.10	0.10
90 Day BBSW, %	0.02	0.04	0.07	0.10	0.15	0.20	0.40
3 Year Swap, %	0.44	0.50	0.55	0.70	0.80	0.95	1.10
10 Year Bond, %	1.22	1.55	1.80	1.95	2.00	2.05	2.10
US Interest Rates:							
Fed Funds Rate, %	0.125	0.125	0.125	0.125	0.125	0.125	0.375
US 10 Year Bond, %	1.35	1.60	1.80	1.95	2.00	2.05	2.10
USD Exchange Rates:							
AUD-USD	0.7336	0.75	0.78	0.80	0.82	0.82	0.82
USD-JPY	110.40	111	111	112	112	112	113
EUR-USD	1.1735	1.21	1.22	1.23	1.22	1.21	1.21
GBP-USD	1.3806	1.41	1.42	1.43	1.44	1.45	1.44
NZD-USD	0.7001	0.71	0.74	0.76	0.77	0.77	0.77
AUD Exchange Rates:							
AUD-USD	0.7336	0.75	0.78	0.80	0.82	0.82	0.82
AUD-EUR	0.6242	0.62	0.64	0.65	0.67	0.68	0.68
AUD-JPY	80.80	83.3	86.6	89.6	91.8	91.8	92.7
AUD-GBP	0.5317	0.53	0.55	0.56	0.57	0.57	0.57
AUD-NZD	1.0478	1.06	1.05	1.05	1.06	1.06	1.06

	2019	**2020**	**2021 (f)**	**2022 (f)**
GDP, %	2.1	-1.0	2.4	5.0
CPI (Headline), %	1.8	0.9	2.6	2.4
CPI (Trimmed mean), %	1.6	1.2	1.9	2.6
Unemployment Rate, %	5.2	6.8	5.4	4.1
Wages Growth, %	2.2	1.4	2.4	2.7

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

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