Australia's Economic Outlook 2021–2022

- **Australia's successful containment of COVID-19 and supportive policy environment play key roles in its economic recovery.**
- **Consumer spending is underpinned by rebounding labour and housing markets while the outlook for business investment remains more cautious. External sector prospects remain largely dependent on developments in China.**
- **Monetary policy is set to stay ultra-loose for an extended period of time as wage increases and inflationary pressures remain mild.**

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ECONOMIC GROWTH OUTLOOK

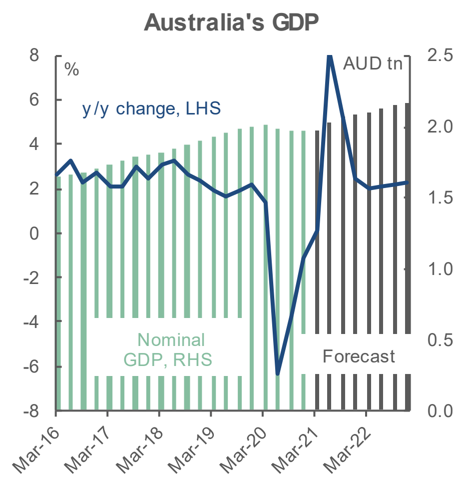
Australia's economic prospects continue to brighten, thanks to successful containment of COVID-19 combined with a supportive policy backdrop. The economy has been recovering since mid-2020 (chart 1) with the nation's output expected to reach pre-pandemic levels before mid-2021. Following a contraction of 2.4% in 2020, we expect Australia's real GDP to grow by 4.0% in 2021. In 2022, growth will likely decelerate to 2.2% as the recession-related base effect fades away.

Australia's domestic demand is rebounding along with strengthening consumer and business confidence. Consumer spending will remain an important driver of economic activity, yet the outlook is dampened by Australia's slow vaccination progress and the continued absence of international tourists. Nevertheless, recuperating labour and housing markets as well as pent-up demand will provide support to consumption. Indeed, the country's employment gains have been encouraging in recent months (chart 2), with the unemployment rate dropping to 5.6% in March from the July 2020 peak of 7.5%. Part-time jobs have returned to pre-pandemic levels, while full-time employment has yet to rebound fully. The Reserve Bank of Australia (RBA) estimates that the government's "JobKeeper" employment support program prevented 700,000 additional jobs from being lost during the pandemic. As the economy continues to recover, the labour market will likely solidify further over the medium term, though the expiration of the "JobKeeper" scheme at the end of March is set to temporarily halt the favourable progress.

Private sector investment will play a critical role in taking Australia's economic recovery onto a sustainable footing. Non-mining investment as a share of GDP was already trending downward before the pandemic; as such, recent muted gains in private sector outlays point to longer-term capital stock and productivity issues. While we expect business investment to pick up over the coming quarters on the back of a supportive policy environment and strengthening confidence, the rebound will likely only be gradual.

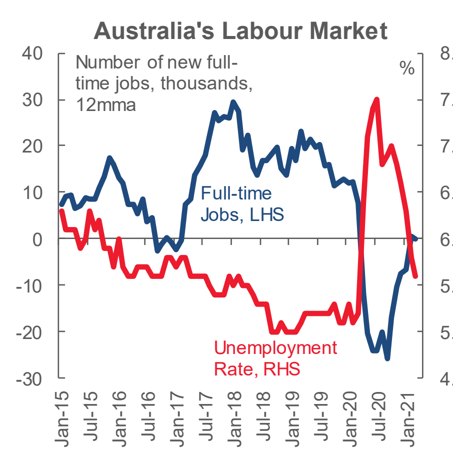
Public spending will continue to underpin Australia's economic activity. Treasurer Josh Frydenberg is expected to deliver the Federal Budget for Fiscal Year 2021–22 (July–June) on May 11. Australia entered the COVID-19 crisis with healthy public finances; despite significant fiscal measures unveiled during the pandemic (equivalent to over 19% of GDP), we assess that the country remains in a solid position to be able to continue to provide a supportive fiscal policy backdrop.

Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Australian Bureau of Statistics.

Forthcoming public outlays are expected to focus on supporting employment and the areas of the economy hit hard by the pandemic, with any significant fiscal consolidation pushed back until the economy is fully back on its feet.

Favourable terms of trade support the Australian external sector, yet a shift is expected in 2022 in line with our forecast for lower iron ore prices. Meanwhile, elevated diplomatic tensions with China—Australia's main export destination—will continue to adversely affect the country's exporters. While iron ore shipments to China remain underpinned by China's robust steel demand, the conflict has resulted in a dramatic drop in coal exports (chart 3). Meanwhile, pandemic-related travel restrictions continue to depress Australia's tourism and education services exports. Accordingly, we expect net exports to remain a drag on Australia's real GDP growth over the coming quarters.

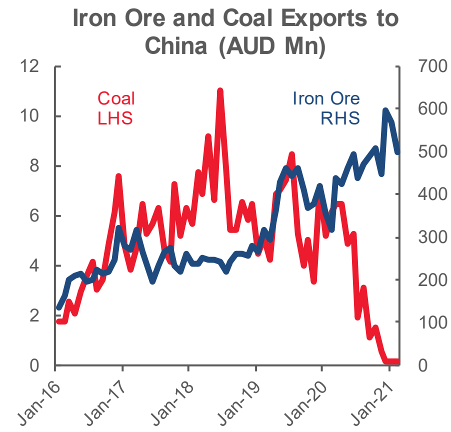
MONETARY POLICY, INFLATION AND AUSTRALIAN DOLLAR OUTLOOK

The RBA will maintain an accommodative monetary policy stance for an extended period, reflecting persisting slack in the Australian economy and muted inflationary pressures. In February 2021, the central bank announced an extension to its bond buying program. The RBA will buy an additional AUD 100 bn of bonds issued by the Australian government as well as by the states and territories following the mid-April completion of its previous program of AUD 100 bn (introduced in November 2020). Meanwhile, the RBA has left the benchmark cash rate and the target yield on the 3-year Australian Government bond unchanged at 0.10% since they were lowered to their current level last November. While we do not expect the bond purchase program to be extended beyond 2021, we do not foresee any changes to the cash rate and the target yield within the next few years. Nevertheless, the RBA's decision on whether to maintain the April 2024 bond as the target or switch to the November 2024 bond is still pending; the central bank has communicated that the decision is forthcoming later in the year and is dependent on economic data and evolving prospects for inflation and the labour market.

Despite the improving economic outlook, the RBA has repeatedly emphasized that for inflation to pick up in a sustainable way, wage growth would need to accelerate notably (wages rose by 1.3% y/y in Q4 2020; chart 4), which would require significant further gains in employment combined with a return to a tight labour market. The RBA expects such conditions to be met in 2024 at the earliest. We assess that inflation will remain muted in Australia through 2022, reflecting significant spare capacity in the economy and our expectation for continued low wage gains. We estimate that headline inflation remained close to 1.0% y/y in Q1, well below the RBA's 2–3% inflation target. While pandemic-related base effects are likely to push the Q2 inflation rate significantly higher, it will be a transitory phenomenon with headline inflation expected to close 2021 at 1.8% y/y and to hover at 2% y/y in 2022.

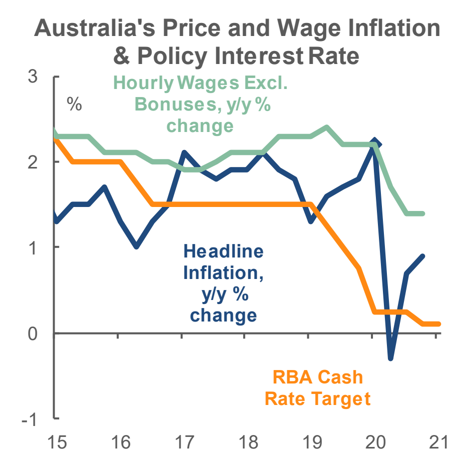
The Australian dollar (AUD) has steadily regained ground vis-à-vis the US dollar (USD) since the low point in March 2020 (chart 5), as the global economy has continued to recover. We expect AUDUSD to reach 0.80 by the third quarter of this year in keeping with a generally weaker USD tone, relatively steady bilateral relations between Canberra and Beijing, firm commodity prices as global output and trade rebound, and strengthening domestic real GDP growth that will increase the odds of a conclusion to the RBA's bond buying program by the end of 2021. Nevertheless, given our expectation of the RBA raising its benchmark interest rate later than the US Federal Reserve, the AUD will likely stabilize in the final months of 2021. The AUD is expected to face a mild weakening bias in 2022 as iron ore prices respond to rising Brazilian output. We expect AUDUSD to close 2022 at 0.78.

Chart 3



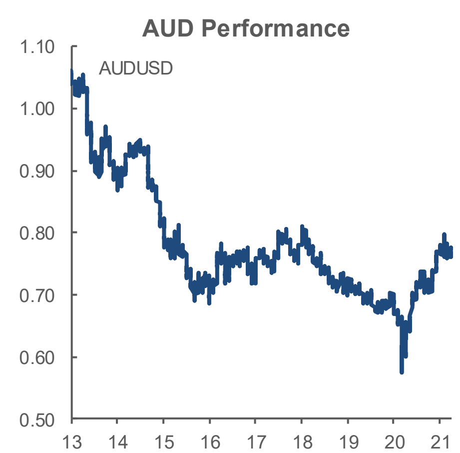
Sources: Scotiabank Economics, Australian Bureau of Statistics.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

Chart 5



Sources: Scotiabank Economics, Bloomberg.