19 March 2020

South Australian Economic Outlook

National Economic Outlook

The domestic and international economic outlook has been rocked by the global outbreak of the novel coronavirus. The situation is rapidly evolving, limiting the ability to quantify the economic impact at this stage. It is clear that the containment measures necessary to control the spread of the virus have already created enough disruption to activity to cause a technical recession in Australia during the first half of 2020. Beyond the first half, the impact is highly uncertain. Policymakers are responding, but are faced with the uncomfortable reality that the most effective measures to contain the virus are likely to cause considerable harm to the economy.

The latest available economic data show that the **Australian economy** was on fragile footing before the outbreak of the coronavirus. The economy remained stuck in a lower gear in the December quarter. GDP grew at a modest 0.5% over the quarter, leaving the annual rate for 2019 at 2.2%. Growth was slightly faster than expected, however it remains well below the estimate of trend growth (or potential) which is 2.75%. Softness in consumer spending and the downturn in residential construction have been the main drags on growth.

New **business investment** has been in the ICU ward over the past year, and remained there in the December quarter. New business investment fell 0.8% over the quarter. Spending on machinery and equipment rose 0.1% while spending on new engineering and construction fell by 3.6% and 3.0%, respectively. Investment is likely to remain weak in Q1 and Q2. Business confidence and supply chains faced first-round effects of the coronavirus outbreak in the Hubei province of China early in the year, and has weakened further following the rapid global spread of the virus.

As part of its $17.6 billion stimulus package to offset the economic impact of the coronavirus, the Federal government has offered investment incentives for businesses including instant write-offs and other cashflow support measures. These initiatives are aimed at supporting investment during Q2. They could encourage some investment, with companies encouraged to bring forward investments that they may have been planning in the future. However, the impact of the coronavirus is uncertain and businesses may still feel reticent to invest in the current climate no matter what incentives are provided.

Data from the latest capital expenditure survey included the first estimate of business investment intentions over the year ahead. Although these expectations were as of Q4, and are therefore outdated in light of the current coronavirus pandemic, they show that mining firms were optimistic about the coming 12 months and were planning on increasing investment. Non-mining investment was also expected to increase, albeit at a very modest pace.

The downturn in residential construction remains in place. **Building approvals** nationally are 44.1% lower than the peak recorded in late 2017. The downturn remains sharpest in the eastern seaboard states. A recent recovery in dwelling prices has yet to lead to any meaningful improvement in approvals, pointing to ongoing weakness in residential construction for the next 6-9 months at least. The coronavirus outbreak is showing early signs of having some impact on the construction sector. There have been anecdotes of delays in obtaining some materials (such as glass), which has disrupted timeframes. With reports of China returning to 60-70% capacity, these supply chain disruptions should be minimised. The global outbreak of the virus is likely to have ramifications on demand, which could further hamper construction investment.

Consumer spending has been soft due to slow wages growth and high household debt. It remains the key channel through which the coronavirus containment measures will negatively impact the economy.

Preliminary data for February show that **retail sales** recorded a modest 0.4% increase, as increased expenditure on food and other essential items offset declines in discretionary spending. The widespread adoption of social distancing and instances of stockpiling did not occur until March.

Retail sales are expected to be significantly impacted by changing consumer behaviour in the face of the coronavirus outbreak in Australia. We forecast substantial falls in sectors most exposed to the coronavirus outbreak. In light of the restrictions on travel and on large gatherings (including a ban on indoor congregations of more than 100 people), we expect a 40% decline over the March and June quarters in hotels; restaurants & cafes; recreational services and air travel. Consumer durables are expected to see a 7% decline in expenditure over the same period. Spending on big-ticket items will be impacted by confidence and quarantine effects, as well as due to the negative wealth effect from plunging asset prices.

The Federal Government's stimulus package includes cash payments to households receiving welfare. We assess that some of these payments will be spent and will support demand over the coming quarters. However, a significant portion is likely to be saved given the uncertain environment. The efficacy of cashflow support to small businesses as incentives to retain workers will also depend on the severity of the coronavirus outbreak in Australia. Most State and territory governments have also outlined initiatives to support their economies during the health crisis.

In addition to the fiscal support being provided by the Federal and State governments, the Reserve Bank (RBA) has taken a proactive approach. The RBA reacted to the US Fed's "call-to-arms" earlier in the month, cutting the cash rate to 0.50% and promising to provide further support as appropriate. Credit markets have shown signs of tightening, prompting the RBA to resume liquidity support measures last utilised in the GFC. The RBA has flagged further measures which are expected to be announced later today.

The RBA is expected to cut interest rates again by its next meeting. This would leave the cash rate at its effective lower bound of 0.25%. The RBA has repeatedly signalled that it will not implement negative rates as a form of unconventional monetary policy. The preferred approach is quantitative easing (QE) and would likely involve the purchasing of government bonds and would target specific rates on the yield curve. We expect the RBA to announce these measures by its next meeting.

The **Australian dollar** has fallen to a post-GFC low in recent days. It breached the 60 US cent level for the first time since 2003 on March 17. The Australian dollar is often traded as a proxy for global growth and commodity prices. Given the uncertain outlook amid the coronavirus outbreak, there is further downside risk for the AUD/USD over the coming quarters. A weaker AUD/USD exchange rate will boost the competitiveness of Australian exports, however, in the context of a global growth slump the trade sector is still likely to struggle.

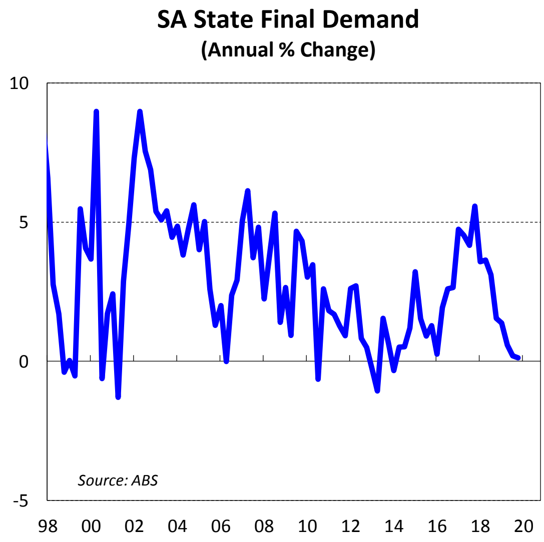
South Australian State Economic Outlook

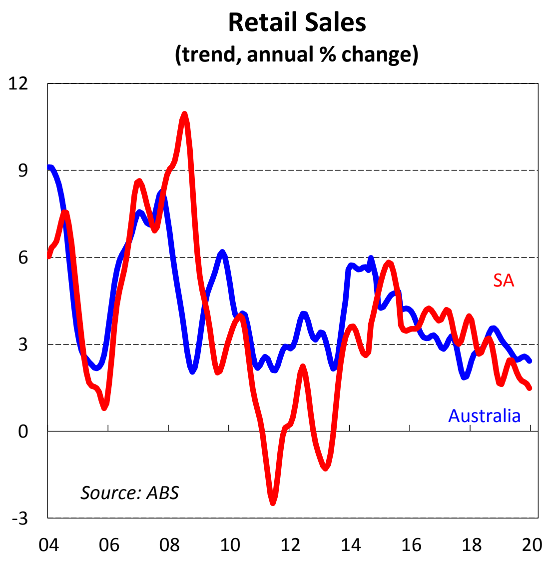
Similar to the national trend, the South Australian economy was vulnerable heading into the type of shock caused by the coronavirus. Household spending was a weak link before the outbreak and is poised to be impacted materially. The South Australian Government has announced a stimulus package worth $350 million to combat the impact of the virus. Like the Federal stimulus package, it should provide some relief but the State is still likely to experience a downturn in the first half.

Economic activity by State and territory is principally provided by Gross State Product (GSP). GSP is the closest measure to GDP. GSP showed South Australia grew by 1.4% in the year to the June quarter, down from 2.3% in the year to June 2018 and below the long-run average of 2.1%.

State final demand is published more frequently (i.e. quarterly), but it excludes the trade sector. **State final demand** eked out a 0.1% gain in the December quarter of 2019, ending two consecutive quarterly declines in the June and September quarters. Economic growth has been hurt by weak consumer spending, subdued business investment and adverse weather conditions on crop production. Offsetting some of these drags to growth has been high levels of infrastructure spending.

On March 11 the South Australian government announced a stimulus package aimed at supporting economic growth in the face of stricter measures implemented to stop the spread of the coronavirus, as well as the impacts of the bushfires and drought. The measures are relatively broad-based, reflecting the multiple headwinds they address. They included support for the tourism, housing and health industries and the bringing forward of infrastructure projects. The longer lead times with infrastructure spending and investment incentives mean that many of the benefits may not materialise until later in the year.





We expect economic growth to decline in the coming quarters. Activity was likely disrupted in Q1 due to the bushfires and international tourist arrivals. Growth will be boosted over the medium term by continued infrastructure spending and fiscal stimulus.

Household spending has been the weakest link in the growth picture over recent quarters. Consumer spending has been lacklustre, as consumers grapple with soft wages growth and a recent upturn in unemployment. **Retail spending** registered a tepid 0.1% increase in January following a 1.4% plunge in December. In volume terms, retail sales declined 0.3% in the December quarter. Indeed, in volume terms, retail spending has dropped for four of the past five quarters and the annual rate is contracting.

There have been anecdotes that many small businesses are already suffering from the containment measures necessary to slow the spread of the coronavirus. The cancellation of large public gatherings has hurt speciality suppliers and auxiliary services companies. Stockpiling appears to have offset a decline in discretionary spending in February, according to preliminary data from the ABS, however, a more broad-based impact on spending is likely to be seen from the month of March onwards.

This acute weakness in retailing has been hurting broader economic activity in South Australia and likely reflects the patchy outcomes in house prices through this year. A softer labour market and high household debt will continue to constrain spending in South Australia. Interest rates at record lows (currently 0.50% with the prospect of more to come) will support incomes and flow through to increased spending, once confidence returns.

South Australia has also been grappling with a decline in house prices. Dwelling prices in South Australia fell from January through to August in 2019 and have since staged a mixed recovery. Dwelling prices stabilised in September and then recovered in October and November, led by unit prices. Monthly dwelling price gains in Adelaide slowed from 0.5% in December to 0.1% in February. Adelaide dwelling prices were 0.4% higher over the year in February. Increased uncertainty in the wake of the coronavirus is likely to depress sales volumes in the coming months.

Building approvals in South Australia have been volatile in recent months. There were sharp falls registered in December and January, driven by a decline in high-rise approvals. Detached house approvals have risen modestly. In January, total building approvals were down 33.9% from their 2017 peak. The patchy profile of approvals and the uncertain outlook delays the prospect of a pick up in residential construction until 2021.

New private business investment was weak in 2019. In the December quarter, capex dropped 1.4% in South Australia and was 5.7% lower than a year ago. Businesses now face even more uncertainty about the economic outlook, which is likely to restrain investment further. Hurdle rates also remain high and sticky, despite the fall in interest rates and recently announced fiscal stimulus packages.

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