The 2019/20 year in review

With key economic data for the last financial year now released, this issue of Plain English Economics provides a summary of the state of the Australian economy in 2019/20.

Economic Growth

Key Statistic: Real GDP down 6.3% between June 2019 and June 2020.

Australia’s economic growth dropped markedly in the second half of the 2019/20 financial year, with real Gross Domestic Product (GDP) at the end of June being 6.3% below the level recorded one year earlier. With the latest annual population growth estimate of 1.4%, the rate of GDP growth per capita (person) was negative 7.7% in the year to June 2020. As shown in the chart below, economic growth has been below the longer-term average of 3% over the majority of the past 5-years.

The COVID-19 crisis and association business shutdowns have been the main driver of the sharp downturn in economic growth experienced over the 6 months to June 2020. With June being the second consecutive quarter of negative economic growth, Australia, like most of the world, entered a technical recession. For Australia, the run of largely uninterrupted economic growth since 1991 has ended.

The shutdowns associated with the COVID-19 crisis resulted in falling production as well as a contraction in domestic demand. The largest component of domestic demand, household consumption, was 12.7% lower in the June 2020 quarter than it was one year earlier in real terms. This contrasts to the average annual real growth rate of 3.2% in household consumption over the two decades prior to 2020. Consumption expenditure is normally relatively stable, and the magnitude of the decline experienced over the past two quarters has been unprecedented.

Despite record low interest rates, business investment also declined 5.5% over the year to June and was also a key contributor to the weaker rate of growth. Low interest rates have also failed to maintain previous high levels of capital expenditure on dwelling construction. In the year to June 2020, dwelling investment expenditure declined by 11.2%. In the case of both business investment and dwelling investment, a negative trend was already in place prior to the COVID-19 crisis, but this trend appears to have accelerated. This decline in dwelling investment has been sharp since the residential housing boom passed its peak in June 2018.

Following a period of uninterrupted growth since 2011, the volume of exports also declined over the second half of 2019/20. Export volumes in the June quarter were 10.6% lower than one year earlier. Lower overseas demand resulted in declines across most categories of exports, with service exports (e.g. education & tourism) being particularly impacted by border closures, with a 27.3% decline. Exports of metal ores, however, were an exception and rose in volume by 4.3% in the year to June. This reflected ongoing strong demand from China for iron ore as well as the fact that mining was less impacted by operational closure than most other industries.
However, more than offsetting the decline in export volumes was a 19.1% drop in imports in the year to June 2020. This fall can be partially attributed to lower business investment, with the import of capital items falling by 16.7%. Changes in capital expenditure levels will typically have a direct impact on imports, as the majority of capital goods are produced overseas. Imports of consumer items also declined, by 8.8%. However, the largest fall was recorded by service imports, with the lack of overseas travel by Australians being the main contributor to a 58.4% decline in the volume of service imports.

Public sector demand made a positive contribution to economic growth in 2019/20, with an increase of 6.1%. It should be noted that the large transfer payments made to businesses and households as part of the COVID-19 assistance packages are not measured as government consumption (but would be measured as household consumption if spent by households). However, COVID expenditures did have some impact on public sector demand, with higher defence spending used to assist the COVID response one area of increase.

In contrast to the sharp decline in consumption expenditure, household incomes rose significantly over the second half of 2019/2020. This reflected the impact of government assistance payments, which more than offset the decline in normal wages and earnings. In total, household disposable income rose by 5.9% in the year to June. With consumption spending declining despite this rise in household income, the Household Savings Ratio increased sharply. As at June 2020, the percentage of household disposable income that was saved and not spent on consumption was 19.8%, which is the highest level since 1974. In the same period last year, the household savings ratio was just 2.5%. The sharp jump in household savings is likely to reflect a cautious attitude to spending by households due to uncertainty over future earnings; as well as a reduction in opportunity to conduct normal expenditure due to lockdowns.

Australia’s unemployment rate was 6.8% in August 2020, which is below a cyclical high of 7.5% recorded in July 2020, but well above the 5.2% recorded one year earlier. Clearly the business shutdowns associated with the COVID-19 crisis have impacted employment conditions. However, unemployment is likely to have been substantially higher if it were not for a fall in the workforce participation rate and the Job Keeper program. After being at a historically high level of 66.0% at the end of calendar 2019, Australia’s workforce participation rate (i.e. the percentage of the adult population either employed or seeking employment) dropped sharply to a low of 62.7% in May this year, before partially recovering to 64.8% in August. The net drop in the participation rate in response to the COVID-19 crisis is likely to reflect a tendency for some displaced workers to take “time off” and not seek re-employment immediately.
The number of workers employed has contracted by 2.6% over the year to August. However, the number of hours worked has fallen by significantly more, being down 5.1%. This is likely to at least partially reflect the role of the Job Keeper program in enabling employers to retain workers, even though activity levels have dropped materially. Related to the decline in hours worked has been an increase in the underemployment rate from 8.5% to 11.2% over the year to August. Underemployed workers are those employed people who want, and are available for, more hours of work than they currently have.

Q2: Explain why the rise in unemployment in Australia over the past year has been less than would normally have been anticipated to result from a 5.1% fall in hours worked.

**Inflation**

**Key Statistic:** CPI decreased 0.3% in the year to June 2020.

Inflation moved into negative territory in the June quarter of 2020, with Australia’s Consumer Price Index (CPI) falling by 1.9% in the quarter to bring the overall annual rate of inflation down to negative 0.3%. This is below the 1.6% increase recorded one year earlier, continuing the pattern of inflation being maintained below the Reserve Bank’s 2% to 3% target range. “Underlying Inflation” (calculated by removing the more volatile or large one-off category movements) is also below this target range at 1.3%.

The negative movement in the CPI in the June quarter was the largest quarterly fall in prices since 1931 in the era of the Great Depression. The result was heavily impacted by a 19.3% fall in the cost of petrol, reflecting decreased world oil prices as Russia and the OPEC nations failed to reach agreement on supply constraints. The temporary removal of Childcare fees by the Commonwealth Government also had a significant one-off impact on the CPI measure. Outside of these specific influences, the substantial drop in consumption expenditure is likely to have contributed to weaker price growth more broadly. Generally, weak demand has been a factor associated with low inflation in recent years, both locally and abroad.

Also contributing to low inflation over recent years has been the lack of “cost push” pressure from wages. Despite periodic strong employment growth, there has been very little upward pressure on wages growth. The chart above traces the annual rate of increase in underlying inflation and the Wage Price Index. In the 12 months to June 2020, the Wage Price Index was 1.8% above the level of one year earlier, which is the lowest rate of growth since the Wage Price Index commenced in 1998. With employment growth weak as a result of the COVID-19 crisis, there may continue to be a lack of cost push pressure on inflation in the period ahead.

Q3: Describe how Australia’s inflation rate is likely to be impacted by the changes to the economic environment caused by the COVID-19 crisis.

**External Accounts**

**Key Statistic:** Current Account surplus was $36.5 billion in the 2019/20 financial year, which was 1.8% of GDP.

Australia’s Current Account position improved significantly over the past year. The $36.5 billion surplus represented a turnaround from the $14.2 billion deficit recorded in the previous financial year. The shift to a surplus, which commenced in the June quarter of last year, represents the first surplus position since 1975.

A comparison of the June quarter of 2020 with the June quarter of 2019 shows that seasonally adjusted receipts from the exports of goods declined from $99.8 billion to $90.6 billion. This was partially offset by a reduction in payments for imports from $80.1 billion to $73.6 billion. However, with exports declining by more than imports, the surplus on the Balance on Merchandise trade fell from $19.7 billion to $17.0 billion.
The majority of the movement in receipts and payments for exports and imports was due to volume changes, rather than price changes. The Terms of Trade Index was relatively stable, moving from 109.1 points in June 2019 to 107.1 points in June 2020. The Terms of Trade is well below its peak of 130.3 points recorded in the mining boom of September 2011.

Whereas the Balance on Merchandise Trade deteriorated, there was a substantial improvement in the Net Services Account. Net Services moved from a deficit of $0.6 billion in the June 2019 quarter to a surplus of $6.9 billion in June 2020. Border closures, restricting the travel of Australians to overseas venues has sharply reduced service imports. This has more than offset the decline in service exports from inbound tourism and education.

The Net Incomes Account continues to be in deficit, although the size of the deficit narrowed from $14.5 billion to $6.1 billion between the June quarters of 2019 and 2020. Lower interest rates, which reduces the amount of interest payable on Australia’s foreign debt, could have contributed to this narrowing. Reduced dividends payable on foreign investments in Australian equities may have also been a factor.

Monetary Policy

Key Statistic: Cash interest rate at 0.25%

Monetary policy has been eased over the past year, with the cash rate falling from 1.25% at the start of July 2019 to 0.25% currently. Reductions of 0.25% were announced by the Reserve Bank in July 2019 and October 2019, with 2 reductions of 0.25% announced in March 2020. In addition to the interest rate reductions, the Reserve Bank also announced in March special funding support for banks to facilitate lending, as well as broader financial market liquidity support. The central bank also commenced the targeting of a 0.25% yield for 3-year Australian government bonds via purchases of bonds in the secondary market.

Prior to the COVID-19 crisis, interest rates were already at record low levels as the central bank attempted to support demand and return inflation to the target range. With the COVID-19 crisis having a sharp contractionary impact on demand, the case for further monetary stimulus was strong. In addition, with most overseas interest rates also falling, lower interest rates domestically were required to avoid upward pressure being placed on the $A.

Fiscal Policy

Key Statistic: in 2019/20 an underlying cash deficit of $85.8 billion (4.3% of GDP) is expected. In 2020/21 the expected deficit is $184.5 billion (9.7% of GDP).

The Commonwealth Government had forecast a budget surplus position for the 2019/20 financial year. However, the COVID-19 crisis triggered a sharp reduction in taxation and need for immediate expansion in government expenditure. Key expenditure measures included the Job Keeper program ($85.7 billion), the JobSeeker supplement ($16.8 billion), household support payments ($9.4 billion) and business cashflow support payments ($31.9 billion). These expenditure programs have been aimed at neutralising some of the impact of the economic downturn caused by the COVID-19 related shutdowns on businesses and individuals, as well as facilitating a faster recovery once the COVID-19 crisis ends.

Q4: Identify the factors that have led to an improvement in Australia’s Current Account position over the past year.

Q5: Describe the rationale for the current expansionary monetary and fiscal policies in place.