# International economics: light at the end of the tunnel?

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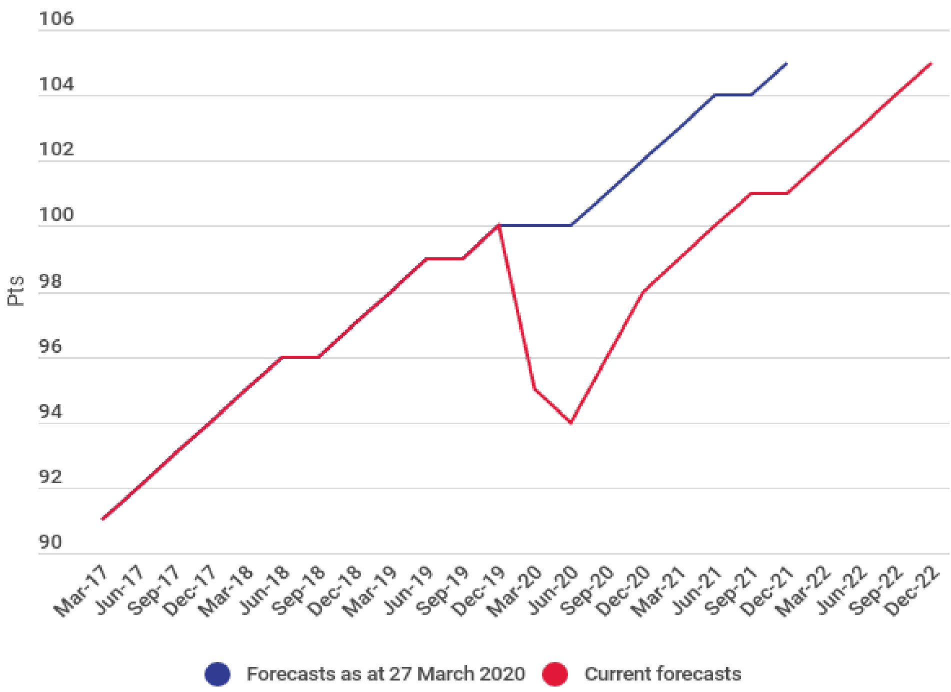
In this CEDA information paper, Commonwealth Bank of Australia Head of International Economics, Global Economic & Markets Research, Joseph Capurso, assesses the global economic outlook and the lasting influence that COVID-19 is likely to leave on industries and economies around the world.

- The global economy is bouncing back as lockdowns ease but, after an initial surge, the recovery may run out of puff.
- Some industries will need to be restructured, particularly if a vaccine is not found soon.
- High unemployment, low inflation and low interest rates will remain for years.

## The evolving global economic recovery

A peculiar recession makes for a peculiar recovery – the contraction in output was very deep but very quick at only a few months. The high frequency indicators suggest a rebound has already started but we expect the pace of the recovery to run out of puff after an initial surge caters to pent-up demand. A quick return to the pre-corona-virus path of economic activity is unlikely (Figure 1).

**Figure 1: CBA world GDP forecasts**



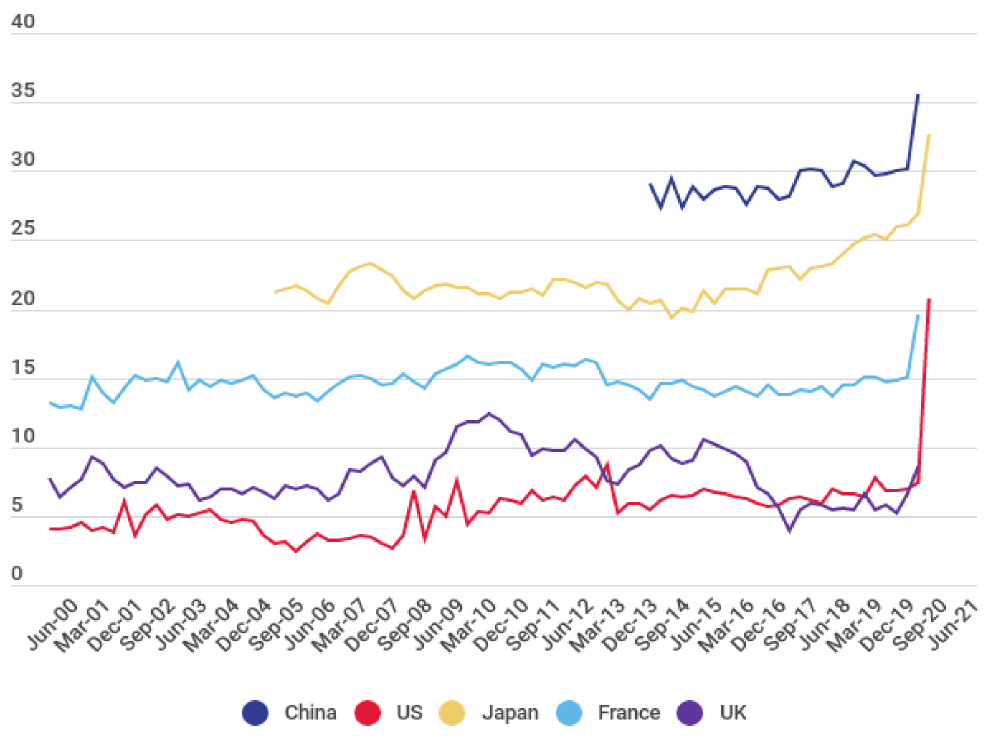

Source: CBA

Some businesses will not re-open. International tourism will remain closed while borders are largely shut except in parts of Europe. Consumer services will be slower to rebound than consumer goods because of social distancing.

Unemployment rates and underemployment rates will take many years to return back to pre-virus rates. Large slack in the labour market will bear down on growth in wages and prices. As a result, interest rates will remain low for years.

In advanced economies, governments supported households with grants and wage subsidies. The lockdowns 'forced' high income earners to significantly lift saving (Figure 2).

**Figure 2: Household saving rate (% of household income)**




Source: CBA, Bloomberg, CEIC

Those savings are being drawn down as fear of catching the virus eases. By contrast, Chinese policy support is focused on infrastructure spending. Investment is commodity-intensive and benefits commodity exporters such as Australia.



The evolution of the virus remains an important source of uncertainty for the economic outlook. A quick development and distribution of a vaccine would brighten the economic outlook but this remains unlikely in the near-term. In the meantime, successfully isolating virus outbreaks is critical to avoid the re-imposition of widespread lockdowns. A double dip recession is possible if economy-wide lockdowns are re-imposed. So far lockdowns have been limited to particular geographic areas and industries. Governments are loath to re-introduce lockdowns because they now know the economic costs are very high.

The months long lockdown in the first half of 2020 means most economies will contract in 2020. But economic growth will likely be strong in the second half of 2020 in the absence of widespread lockdowns. The strong growth in the second half of 2020 will flatter economic growth rates in 2021.

We forecast economic activity will contract the most in Europe at 7.5 per cent, because the spread of the virus was widespread before policy responded. We estimate Japan’s economy will contract by around 6.75 per cent because of its low growth potential and ill-fated tax increase in late 2019. The rebounds in Europe and Japan will be slow in our view. New Zealand will also be hard hit (-7 per cent in 2020) because its lockdown was most stringent, but it can rebound strongly by 3.5 per cent in 2021.

We expect the US to contract by around six per cent in 2020 and rebound solidly in 2021 by three per cent. China will grow at its slowest rate in decades at only 1.5 per cent in 2020, but strong action to contain the virus and support the economy paves the way for eight per cent growth in 2021.

## A two-month global financial crisis?

The early stages of the coronavirus shock morphed into a financial crisis. Financial conditions tightened materially as market participants priced-in a sudden worsening of the economic outlook. Higher equity risk premiums and widening credit spreads, among other factors, tightened financial conditions. Tight financial conditions risked making a bad situation worse.

Central banks responded to the tightening of financial conditions by cutting their policy interest rates, restarting or increasing their asset purchases, and starting or restarting liquidity and lending programs.

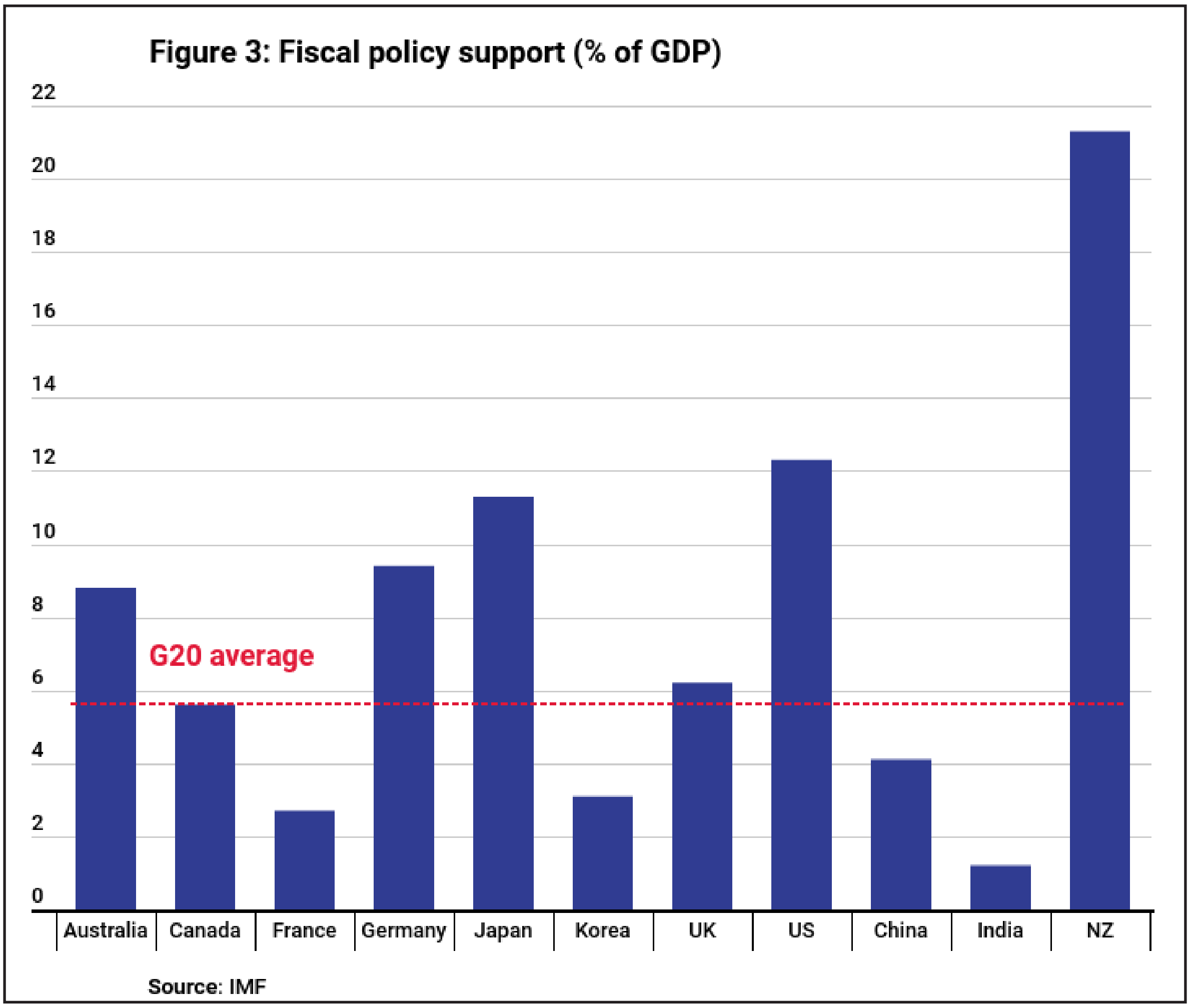
The policy activism was led by the US Federal Reserve. The Fed reopened and enhanced its standing USD swap lines with other central banks including the Reserve Bank of Australia (RBA). The swap lines reduced the USD cost of borrowing for non-US banks and corporates.

The Federal Reserve and the RBA went hard early as they expanded their balance sheet by half within a few months but since May, the RBA's and the Fed's balance sheet has not changed much. By contrast, the Bank of England, the European Central Bank (ECB) and the Bank of Japan (BoJ) have steadily increased their balance sheets. The slow steady increase in the BoJ's balance sheet reflects that its balance sheet is already very large at over 100 per cent of GDP. By contrast, the next largest balance sheets relative to the economy are the ECB at 46 per cent and the Fed at 32 per cent of GDP.

Looser US financial conditions spread through the world via financial markets. Lower US interest rates along the curve bore down on interest rates in many economies. One outcome of lower interest rates is higher prices for bonds and equities. Higher asset prices are particularly important for those economies dependent on capital markets (bonds and equities) to finance businesses, such as the US.

Central bank cuts to interest rates also freed up income to those consumers and businesses with variable interest rate debt or those who could refinance loans. Variable rate mortgages are particularly important in Australia. Lowering debt repayments helped ease cash flow problems while incomes are, hopefully, only temporarily depressed. Improved cash-flow can speed up the recovery once the fear of the virus passes, or people adjust to the new reality of potentially catching the virus.

Governments supported households and businesses with direct grants and subsidies (Figure 3). Some governments also provided equity capital to central bank lending programs. For example, the US government provided the Federal Reserve with equity to fund the Main Street Lending Program ($US75bn), the Money Market Mutual Fund Liquidity Facility ($US10bn), and the Term Asset Backed Securities Loan Facility ($US10bn).




The quick efforts of central banks shortened the financial crisis to only a few months but the scars of this deep, albeit brief, recession will last years. One outcome of the recession is low inflation. Inflation and inflation expectations were already weak in many economies before the coronavirus struck. A mild bout of deflation is a risk in Japan and the Eurozone. The weak inflation outlook means central bank's policy interest rates are likely to stay very low for an extended period.

## Some implications for Australia

It is easy to think the global recession will weaken foreign demand for Australian exports but the reality is not so simple.



Policy makers in Australia and elsewhere did not sit on their hands as their economies plunged into recession. The Chinese government's policy response has, and will, benefit Australia. The marked increase in infrastructure spending is especially beneficial. The mere mention of higher infrastructure investment supported the iron ore price. An increase in commodity prices is like a pay raise for the Australian economy.

Australia recorded large trade and current account surpluses in Q1 2020. We estimate these surpluses increased even further in Q2 2020.  High commodity prices and large current account surpluses support the valuation of the Australian dollar. We forecast AUD/USD will lift to 0.72 by the end of 2020 and 0.77 by the middle of 2021.

Easy global financial conditions spilled over to Australia. As the Governor of the Reserve Bank of Australia (RBA) has said, low interest rates in the major economies are one influence that bear down on Australian interest rates. Lest the Australian dollar appreciate too much.

The RBA's low official cash rate is important in Australia's economic recovery. The interest rates Australians pay for home mortgages, business loans and overdrafts are extremely low. The spreads that large highly rated Australian corporates pay in capital markets are also very low.

We do not wear rose-coloured glasses. The border closures in Australia and elsewhere are a major impediment to tourism and education exports, although it is worth pointing out that Australia's reliance on these exports is often over-stated.

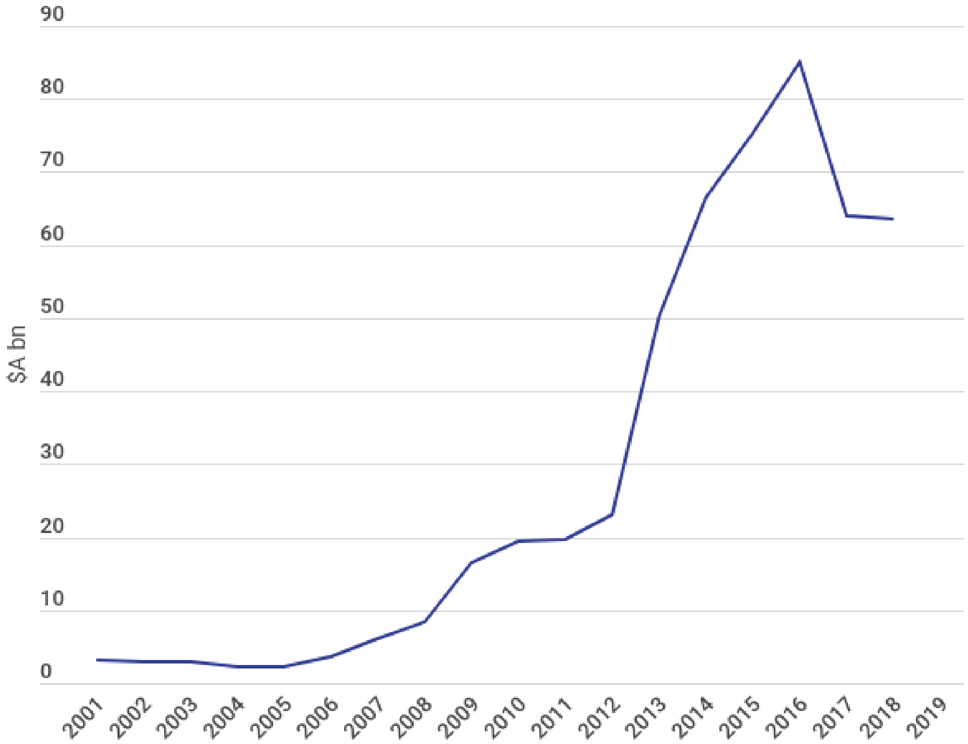
So too is Australia's reliance on exports to China. We estimate about 20 per cent of Australia's exports to China are re-exported to third economies. Border closures also mean Australian tourism imports – the money spent by Australian residents overseas – have dropped sharply.

The border closures also have a domestic dimension. It is no exaggeration to say Australia is a country built on immigration.  Immigrants increase the size of an economy. Their demand for homes, and everything inside, creates incomes and jobs. They also supply some of the labour and capital that businesses need.



Government-to-government relations – geopolitics – can also be relevant for economies. Frictions between the Chinese government and some of its neighbours and trade partners have increased in recent years. These tensions have many dimensions. One of those dimensions is an increase in trade barriers on some agricultural commodity trade between Australia and China but so far Australia's exports to China have not been curtailed significantly. Another dimension is the decrease in investment inflows from China in recent years (Figure 4). But Australia's string of current account surpluses means Australian savings are adequate to finance investment.

**Figure 4: Chinese investment in Australia**




Source: ABS, CBA



## Some views on long term trends

A view on the long run economic outlook cannot ignore the pandemic and potential policy responses. In the best case scenario, quick development and distribution of a vaccine would brighten the economic outlook, allowing life to slowly get back to normal.

At the other extreme, without a vaccine, economies would be periodically disrupted as local or widespread shutdowns are implemented to isolate and contain virus outbreaks. Such an unstable environment would constrain long term business investment and possibly consumer durables spending.

Each country will make their own choices about the stringency of lockdowns. Some countries are less concerned about public health and have a greater need to restart their economies. Some populations will have a higher compliance with social distancing requirements. Therefore, quality and access to health care may become a comparative advantage for economies in the foreseeable future.

## Changes in behaviour

Economics is nothing if not the study of behaviour. Until and if a vaccine is developed, people and businesses will need to adapt to new ways of moving, working and living. Changes to the way people interact and businesses operate will be needed to minimise the risk of infection.

Economists call these changes ‘structural change’. Structural change often increases costs upfront while delivering (uncertain) benefits later. The structural changes that are possible are as long as a piece of string. Change may become more urgent in some industries such as food services, retail and people transport to have a viable and safe future. It is possible the virus encourages a new wave of investment to implement change.

For example, the need for physical distancing could lead to increased demand for office space per employee, but working from home may reduce the number of employees in the office. It is unclear which of those two influences will dominate. If working from home is more than a transitory trend, retail and food services businesses may move from CBDs to the suburbs. For those that do venture into the office, public transport systems may need to be restructured to keep people a safe distance from each other.

The coronavirus may have modestly accelerated the switch to online sales because people are confined to their homes. The switch to online can continue to alter the balance between bricks and mortar retail and the warehouse and delivery model. But delivery delays and fewer flights can sap consumers' enthusiasm to shop online because part of the appeal of online shopping is speedy service.

## The role of government

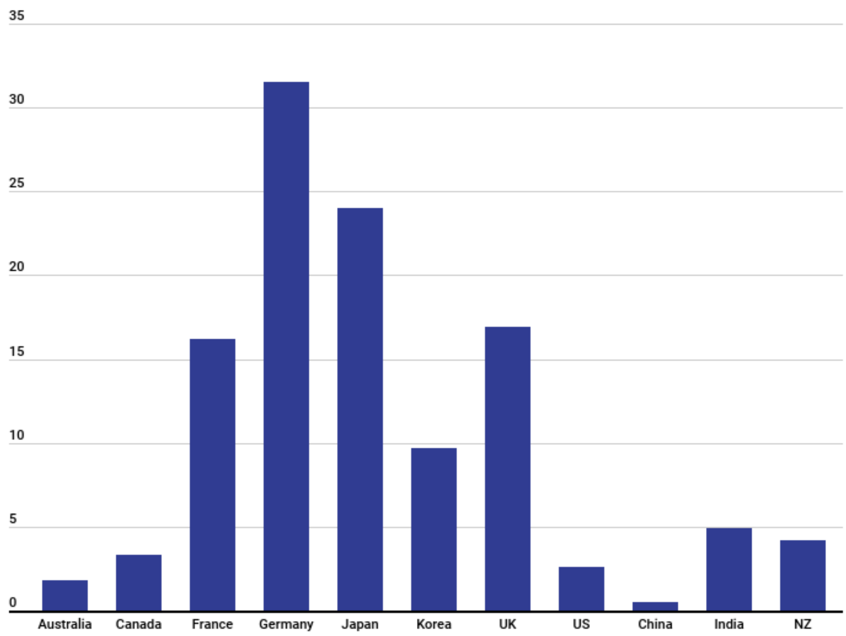
Governments can facilitate structural change. Some of the jobs lost during the recession will not return. The role of government could change from saving existing jobs to facilitating the transfer of workers and capital from industries that will permanently shrink, such as air travel, to industries that have better prospects. Government can support people to retrain or relocate.

Governments have provided ample loans, guarantees and equity. Once the recovery is on a sustainable path, governments and banks will need to distinguish illiquid but solvent businesses from insolvent businesses, which will need to close. If they are not closed, so-called 'zombie companies' will use resources and hold back structural change and economic growth.

## The 3Ps

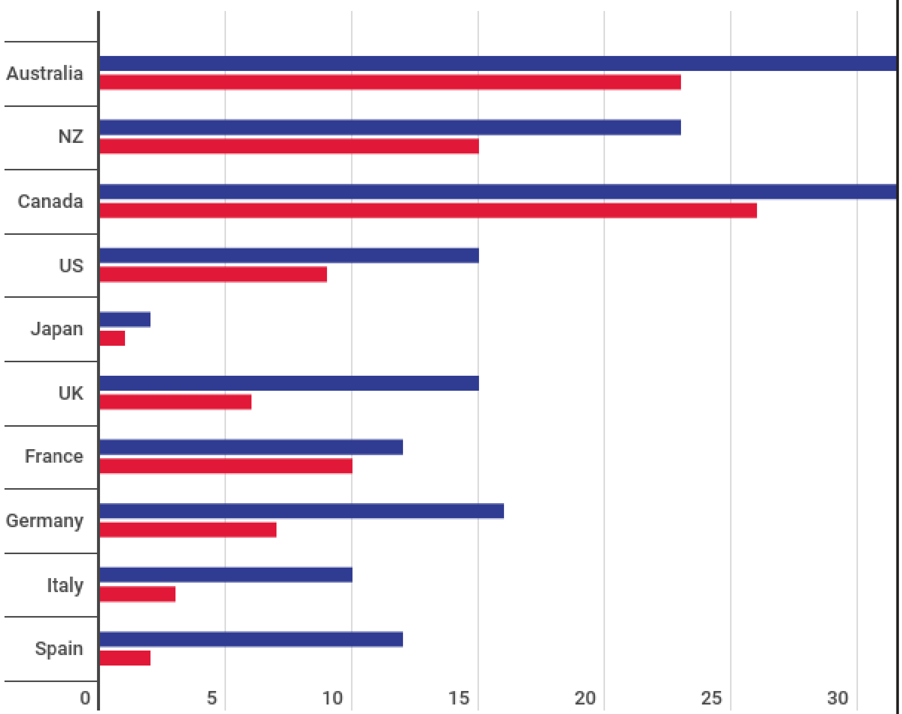
Economists like to think of economic growth as comprising "three p's": population, productivity and participation in the labour force. Some economies under our coverage (including Australia) traditionally have strong population growth reflecting migration. Therefore, closing the borders severely reduced immigration and population growth.
Changes to immigration makes a difference both to the recipient and source countries.

**Figure 5: Government liquidity support**




**Source:** IMF

**Figure 6: Migrants (% of population)**




**Source:** Bloomberg, CBA

There is an additional perspective. One lesson from East Asia is economic growth can be accelerated by moving people from low productivity agriculture to higher productivity factories.  Similarly, moving an accountant or engineer from a poor economy to an advanced economy with access to the latest tools and management know-how can lift productivity and economic growth in advanced economies, as well as globally. The upshot is less migration is a headwind to global growth, particularly in advanced economies with historically high migration rates.

## Supply chains and reshoring

The pandemic highlighted many economies have insufficient inventories of medicines and medical equipment. The pandemic also highlighted that the production of some medicines and medical equipment is concentrated in several developing economies, particularly China.

Much higher inventories of medicines and medical equipment would have left economies less exposed to the disruption of global medical supply chains but higher inventories are costly. That is why businesses operate a 'just-in-time' inventory system.

Global supply chains are long and complex; they cannot be changed easily or quickly. China is an important part of global manufacturing supply chains. Nevertheless, there may be a push in some economies to replace imports with local production. There are two ways to re-shore production: one will hinder global growth, the other will not.

Tariffs can discourage the purchase of imports and stimulate local production. However, real incomes would decrease because prices would increase. Higher prices may be a cost worth bearing but they are a cost. Lower real incomes will reduce global growth.

Re-shoring can occur without the cost of tariffs. Automation and robotics have reduced the comparative advantage of low cost labour in developing economies. Robot use is highest in economies with advanced manufacturing capabilities. Reshoring of some manufacturing capability is unlikely to be an important driver of employment. Manufacturing close to the consumer reduces the cost of holding inventory. Just-in-time inventory may survive. The upshot is the pandemic may accelerate structural changes to global trade that were going to occur anyway.



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