BIS OXFORD ECONOMICS

COVID-19 MACROECONOMIC CENTRAL SCENARIO AND DOWNSIDE FORECAST

PREPARED FOR THE AUSTRALIAN ENERGY MARKET OPERATOR

29 April 2020

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UPDATED CENTRAL AND NEW DOWNSIDE SENSITIVTY

- Given the rapid change in social and economic conditions in March and April, AEMO engaged BIS Oxford Economics to update its ‘baseline’ Central scenario, and provide a ‘downside’ sensitivity, that specifically focused on the worst case outcome (for the economy) from the pandemic.
- The scenarios were designed to capture the range of possible outcomes for the economy over the near term, as well as the transition into the long run. This analysis included an assessment of the broad impact on the economy’s supply side potential.

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KEY ASSUMPTIONS

Central case

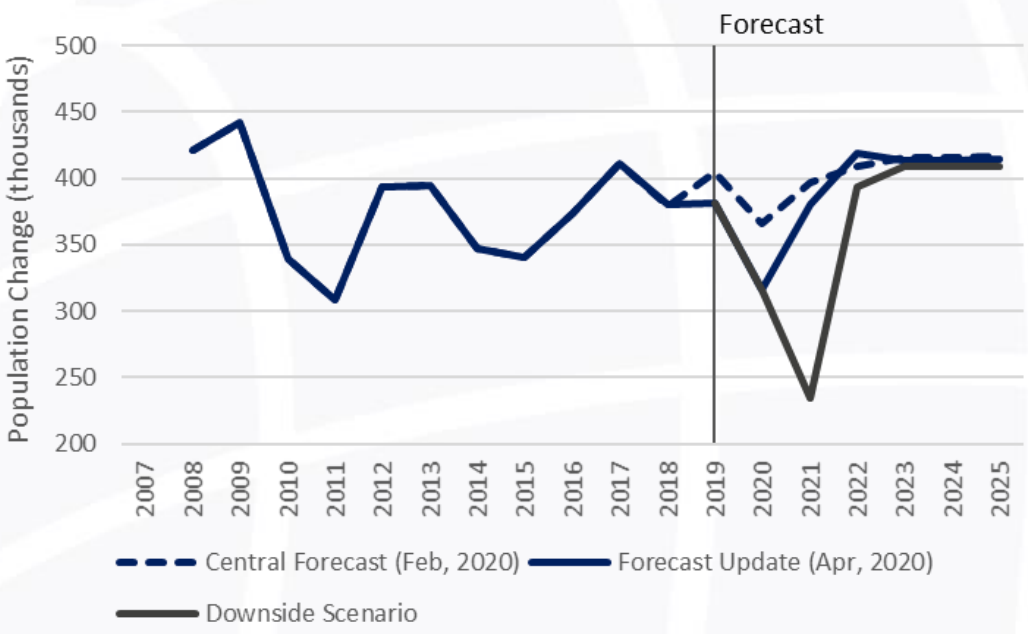
- After a period of rapid growth, the number of new cases is expected to decline, signaling that the travel restrictions and social distancing are limiting transmission
- Severe restrictions on activity are maintained until the end of Q2 2020, and then relaxed gradually in Q3 and Q4 (international travel restrictions are the last to be removed). Underpinning this is the success of the government's testing, tracing, quarantine strategy. Long term solution is the rollout of treatment and/or a vaccine, that removes the threat of a future deadly pandemic.
- Monetary policy remains very supportive for quite some time, further fiscal support (to stimulate the recovery) is announced, possibly in the budget in October.
- Some permanent loss of activity, particularly in the travel, tourism and higher education sectors
- Risks remain to the downside. Key way markers include i) progression of outbreak and no second wave in Q3 (or beyond), ii) impact on labour market and the number of jobs saved by JobKeeper, iii) indirect impact on business investment and construction and iv) degree of disruption/drag created by global supply chain dislocation

Downside case

- Based on modelling done by academics in the UK, look at an alternative where only way to control COVID-19 is through strict social distancing which must be maintained for 15-18 months until a vaccine is widely available.
- Experience globally is intermittent lockdowns, with new case clusters erupting repeatedly.
- Fiscal and monetary support packages are extended. But this is not enough to prevent widespread bankruptcies, particularly in the sectors that are most exposed.
- Long run supply side potential is severely impaired. Persistently unemployment and firm bankruptcies created hysteresis effects; workers skills and motivation atrophy as they become long run unemployment, and economic connections are severed as firms go to the wall.
- Key data that will determine whether this outcome is likely is rate of spread, and the impact on transmission of relaxing the restrictions.

POPULATION

Fig 5. Population change outlook

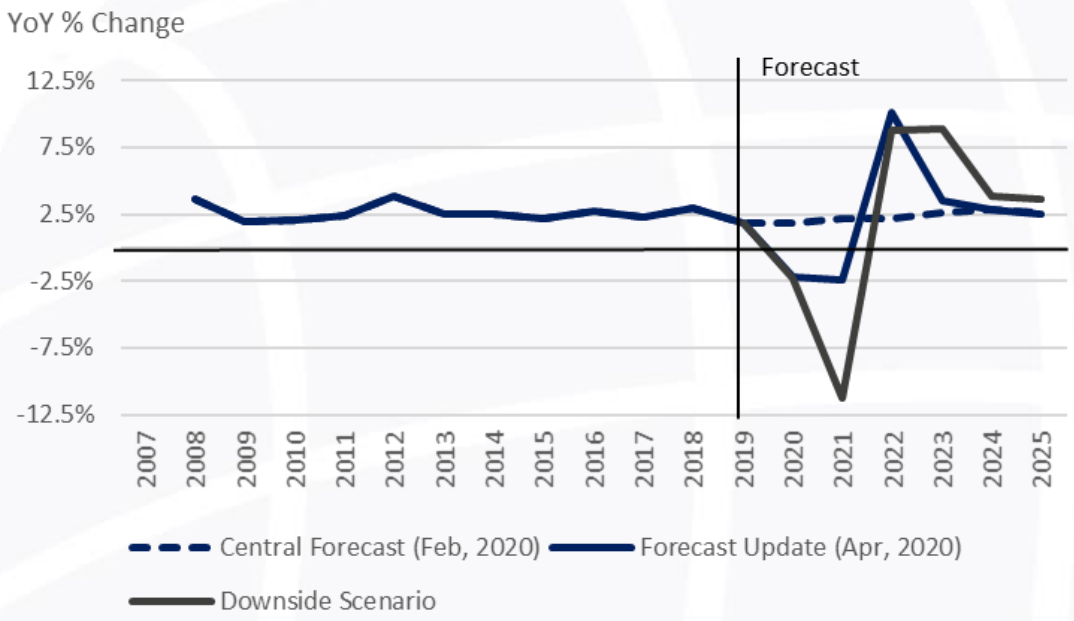


Source: Haver Analytics/ BIS Oxford Economics

- Baseline assumes sharp fall in NOM in FY21, with a recovery after this in line with borders re-opening in Q4 2020.
- In the downside scenario, international borders remain closed for longer. This in turn leads to a sharp fall in overseas migration flows in the near term.
- The drag on net overseas migration will be deeper and longer lasting than in the central scenario.
- As border controls are lifted, we expect a gradual recovery in NOM. However, significant permanent job losses in some sectors within the downside scenario will mean that less overseas job seekers will be attracted and cumulative NOM does not return to pre-COVID-19 levels.
- In relative terms, the impact is greatest on NSW and VIC, which accrue the greatest share of net overseas migration, while the smaller states are relatively less exposed.

GROSS DOMESTIC PRODUCT

Fig 6. Gross Domestic Product YoY growth

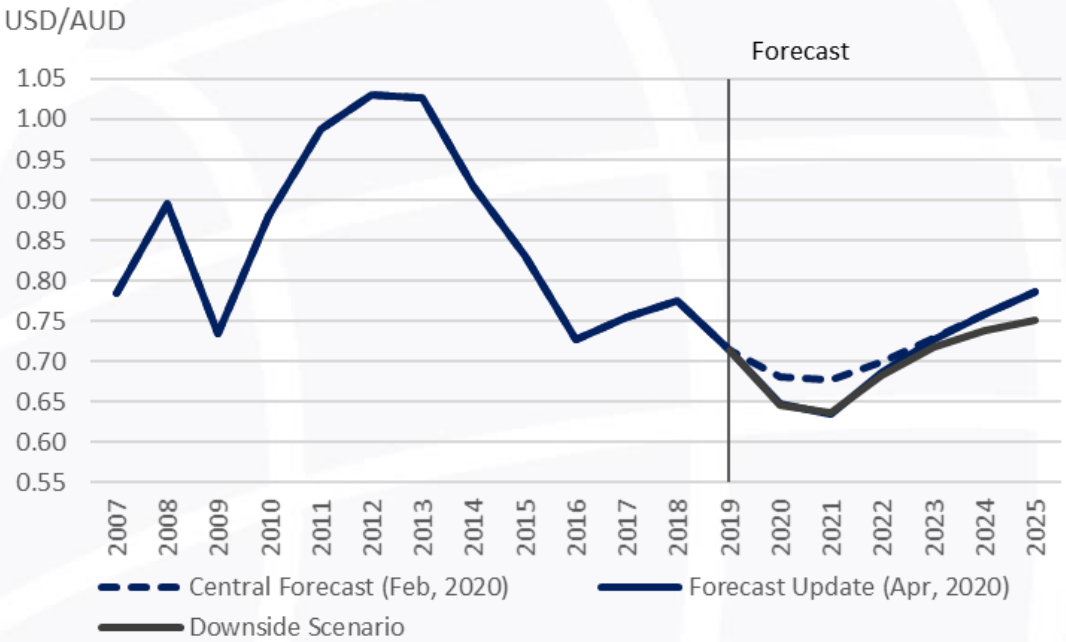


Source: Haver Analytics/ BIS Oxford Economics

- With the base scenario assuming that the severe restrictions on activity are maintained until June 2020, the projected growth rate for FY20 is broadly the same in the two cases. But the need to maintain the restrictions until mid-2021 results in the economy taking a second leg down in the downside scenario, with an 11.2% pts contraction in FY21.
- Unlike previous economic cycles, consumer spending will account for the majority of the fall in GDP. But in percentage terms, business investment could decline by more, with uncertainty around the outlook set to weigh heavily on capital expenditure.
- Overseas trade, particularly for services, will take a longer time to regain momentum after the lock-down is lifted, as globally we expect people will remain cautious and it will take some time before they are travelling overseas for business or leisure. But with commodities demand expected to hold up relatively well (supported by stimulus policy in China), net exports will provide a significant positive boost to GDP.

FOREIGN EXCHANGE RATE

Fig 7. Foreign exchange rate outlook (USD/AUD)

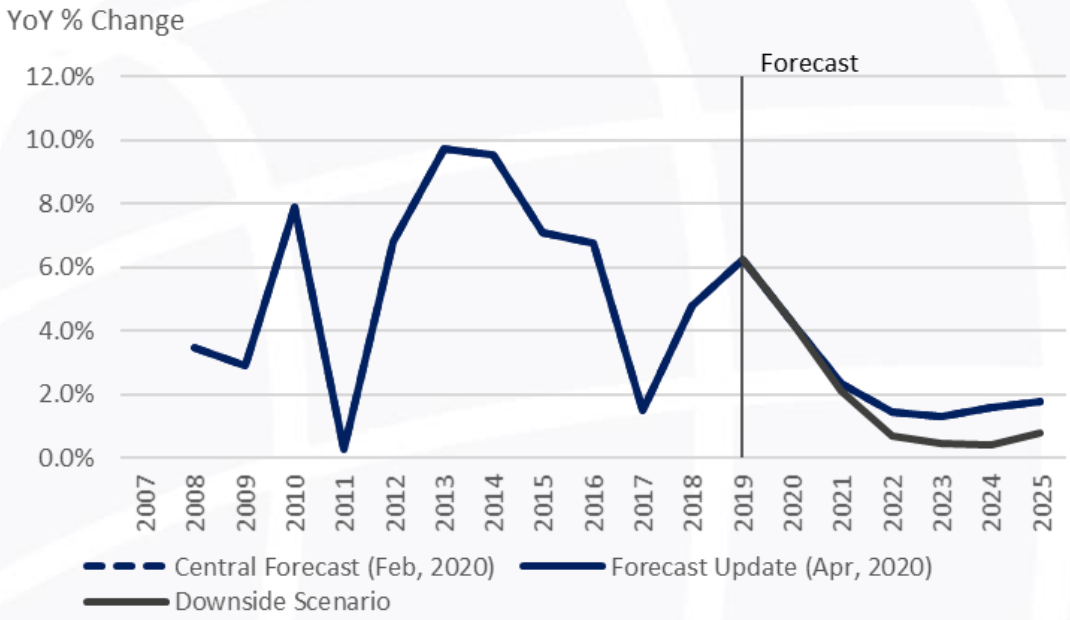


Source: Haver Analytics/ BIS Oxford Economics

- In the near term, the need for all countries to extend lockdown periods and severely curtail activity results in limited further downward pressure on the AUD. This largely reflects the deterioration in all countries' fundamentals.
- In the near term the trajectory for the AUD across the two scenarios is similar. This is due to our assumption that the recovery profile from the pandemic will be broadly similar across the globe; if Australia is required to maintain strict social distancing then this will be the case elsewhere.
- Over the medium term, as economic activity recovers, central banks around the world resume rate normalisation, but at a very slow, gradual pace; it is likely that it would take until the end of the 2020s before the cash rate reached its new terminal rate.
- While rate normalisation will be further delayed in the downside scenario, as in the case of the central scenario, Federal Reserve and the RBA are expected to normalise interest rates at a similar pace, limiting upward pressure from a narrowing of the interest rate gap. Over the long run, the deterioration of the growth environment leads to a small depreciation (relative to the baseline projection).

MINING GVA

Fig 8. Mining GVA YoY growth

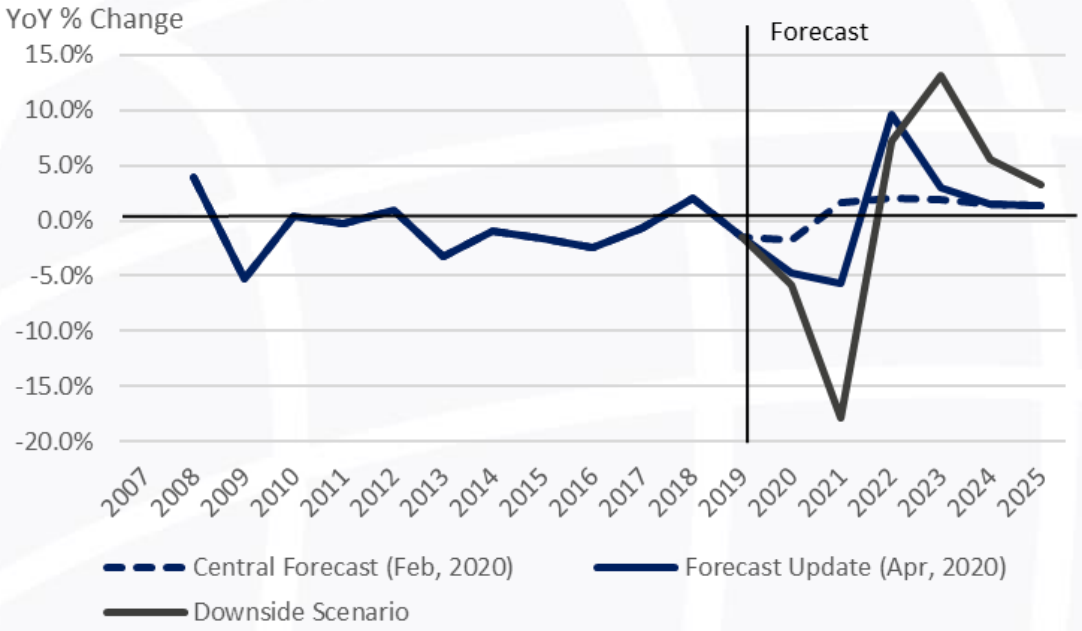


Source: Haver Analytics/ BIS Oxford Economics

- In the central scenario, with the exception of oil, mining related commodity prices are expected to be through the worst of their downturn in H1 2020.
- Iron ore prices have held up, due to supply disruptions in Brazil and Australia while base metals and coal have relatively limited exposure to the new epicentres of the COVID-19 outbreak (US and Europe). Their main source of demand (China) is on the path to recovery, helped by a series of supportive fiscal and monetary policy measures.
- As a result, we expect mining GVA to be relatively resilient to the headwinds from the COVID-19 outbreak going forward, though a wind-down from historical levels will continue as production reaches capacity.
- In the near term, the outlook is similar to the baseline, with China expected to ramp up its stimulus packages in order to maintain some growth through 2020 and into 2021. But over the long run, weaker global demand for commodities (as a result of the negative shock to potential output in a number of economies) begins to weigh on the sector.

DOWNSIDE SCENARIO RESULTS: MANUFACTURING GVA

Fig 9. Manufacturing GVA YoY growth

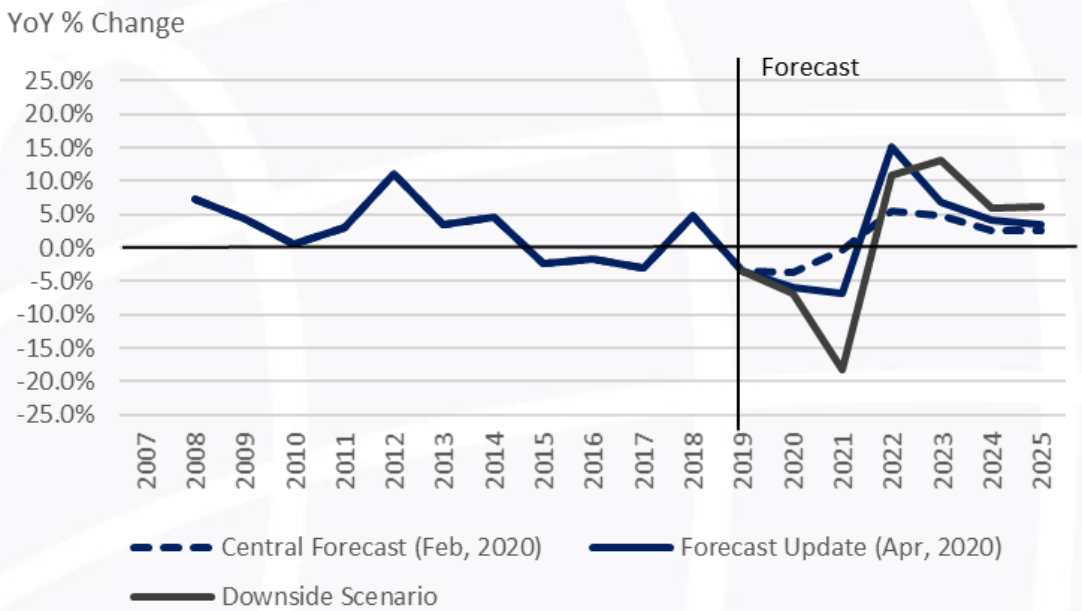


Source: Haver Analytics/ BIS Oxford Economics

- Although supported by food processing and oil refined products, both of which use limited inputs from overseas, manufacturing output still falls sharply in the baseline, contracting by 4.8% in FY20 and 5.7% in FY21. This reflects both supply chain disruption and the weak international environment, with exports of manufactured products set to fall sharply in the near term.
- In the downside scenario, the trade environment becomes even more challenging and supply chains grind to a complete halt, which results in a deeper and much more prolonged downturn. Manufacturing GVA falls by 17.9% in FY21, before the recovery gets underway in FY22. But the extent of the damage to supply chains means that the recovery period lasts for over two years, and there is considerable long run damage to the level of potential output.

CONSTRUCTION GVA

Fig 10. Construction YoY growth

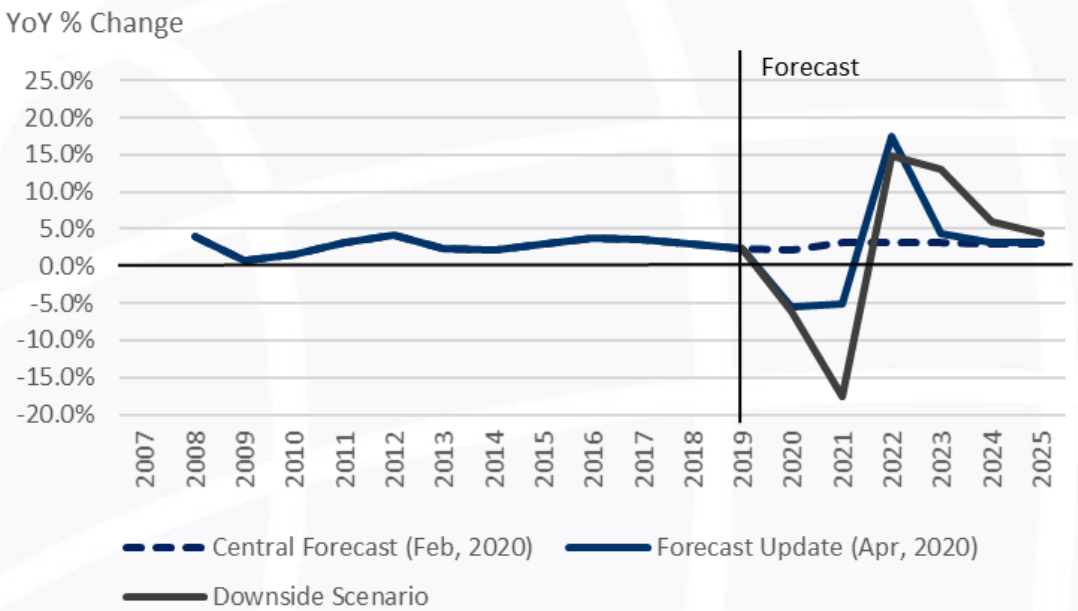


Source: Haver Analytics/ BIS Oxford Economics

- With the restrictions on activity not extending to the construction sector and supply chain disruption not likely to bite until Q3 2020, construction GVA is likely to be close to the central forecast projection from February 2020 (note that this projection assumed a fall in GVA, as a result of the downturn in residential construction activity).
- Moving into FY21 and beyond, the downside scenario sees a marked acceleration in the pace of decline in activity. For residential construction, a combination of weaker overseas migration and restrictions in the housing market significantly reduces demand for new construction.
- Non-residential construction will also lose momentum, with all sectors reining in their capital expenditure plans. Hotels and restaurants, retail facilities and arts facilities are the most exposed, along with higher education.
- In the downside scenario, these headwinds will intensify, resulting in a contraction in Construction GVA by 6.9% in FY20 and 18.2% in FY21.

PRIVATE SERVICES GVA

Fig 11. Private Services GVA YoY growth

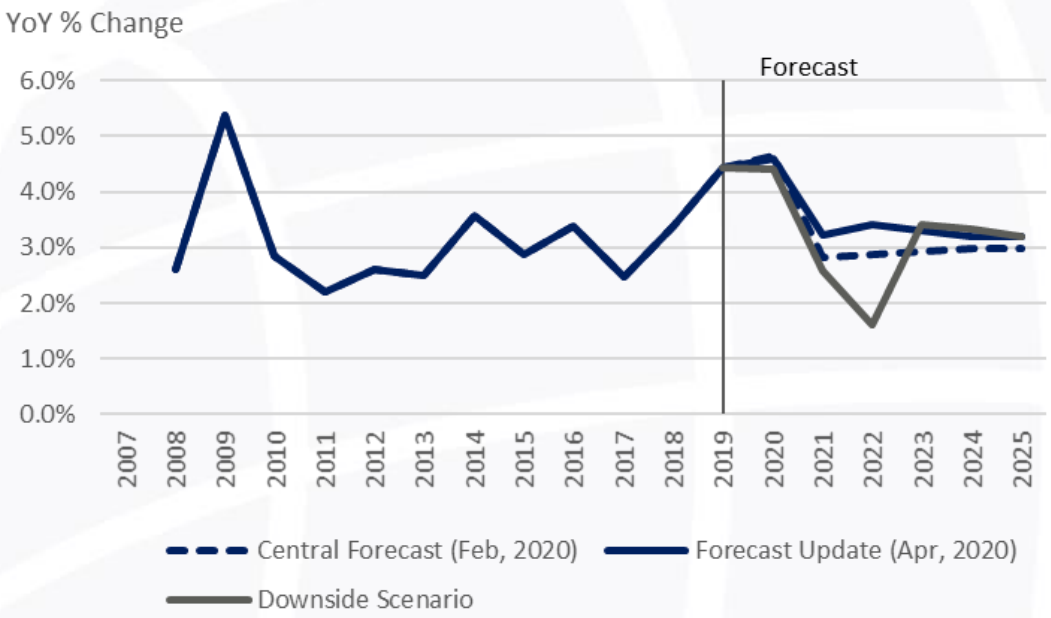


Source: Haver Analytics/ BIS Oxford Economics

- Unlike previous economic cycles, the service sector is extremely exposed to the impacts of the pandemic and public health response. Large parts of the service economy, such as wholesale and retail trade, food and accommodation services, travel, and real estate services have been brought to a near-halt as a result of social distancing.
- In the central scenario, this will result in a 5.4% contraction in FY20 while in the downside scenario the impact will be more profound and longer-lived, resulting in substantial falls in output in FY20 and FY21.
- There will be a strong immediate rebound in growth for private services GVA following the unwinding of the lock-down, as services start back up after being cut back severely during lock-down. But it takes time for activity levels to normalise in the central scenario, partly as a result of the restrictions being lifted gradually and partly as a result of a lingering drag from the downturn. In the downside scenario, the size of the permanent drag is much more pronounced, with all sectors seeing a reduction in activity relative to baseline.

PUBLIC SERVICES GVA

Fig 12. Public Services GVA YoY growth



Source: Haver Analytics/ BIS Oxford Economics

- Health, Education and Public Administration are collectively captured as public services.
- COVID-19 has placed heightened demand on our healthcare systems and related sectors as well as public administration (such as Centrelink and other My Gov services).
- Consequently, public services GVA, in contrast to other sectors of the economy, will be higher than the projections prior to COVID-19 outbreak. Therefore, we have revised up our April forecasts compared to the February baseline (although there is some offset from a weaker outlook for students).
- In the downside scenario, the demands on the health care system and public administration services are stretched for a longer period of time. But this is offset by the drag on higher education as a result of international students being (largely) unable to enrol and attend. This results in a sharp fall in the growth rate of public services in FY22, when the drop off in education services combines with a fallback in demand for healthcare services.

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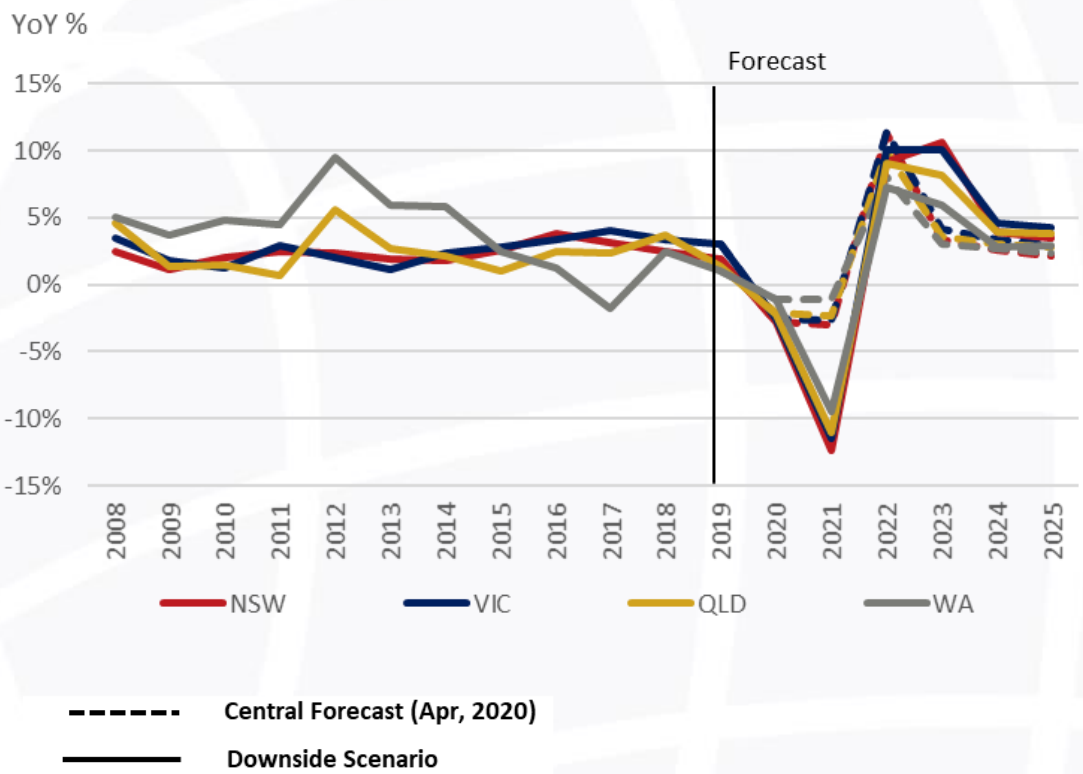
GROSS STATE PRODUCT (MAJOR STATES)

Fig 13. GSP YoY growth: NSW, VIC, QLD & WA



Source: Haver Analytics/ BIS Oxford Economics

- The impact of the lock-down on NOM is more pronounced for NSW & VIC, which accrue the largest number of overseas migrants. This in turn weighs more heavily on GSP in these states than elsewhere (QLD, WA).
- NSW GSP is weighed down further by the downturn in the construction sector, which comprises a significant portion of the states economy.
- For VIC, the downturn in private services places an additional drag on the economy.
- WA faces a more modest downturn in GSP of all the major states. While construction and services weigh on the economy, this is partially offset by the relatively resilient mining sector.
- While QLD performs marginally better than NSW and VIC, supported by its own mining sector, the downturn is deeper than in WA, reflecting the sectors much smaller composition in the state economy.
- Private services and construction face the greatest loss of activity in the downside scenario. Consequently, the worse economic outcomes become more pronounced for the states that make up the largest share of these industries (namely NSW and VIC).

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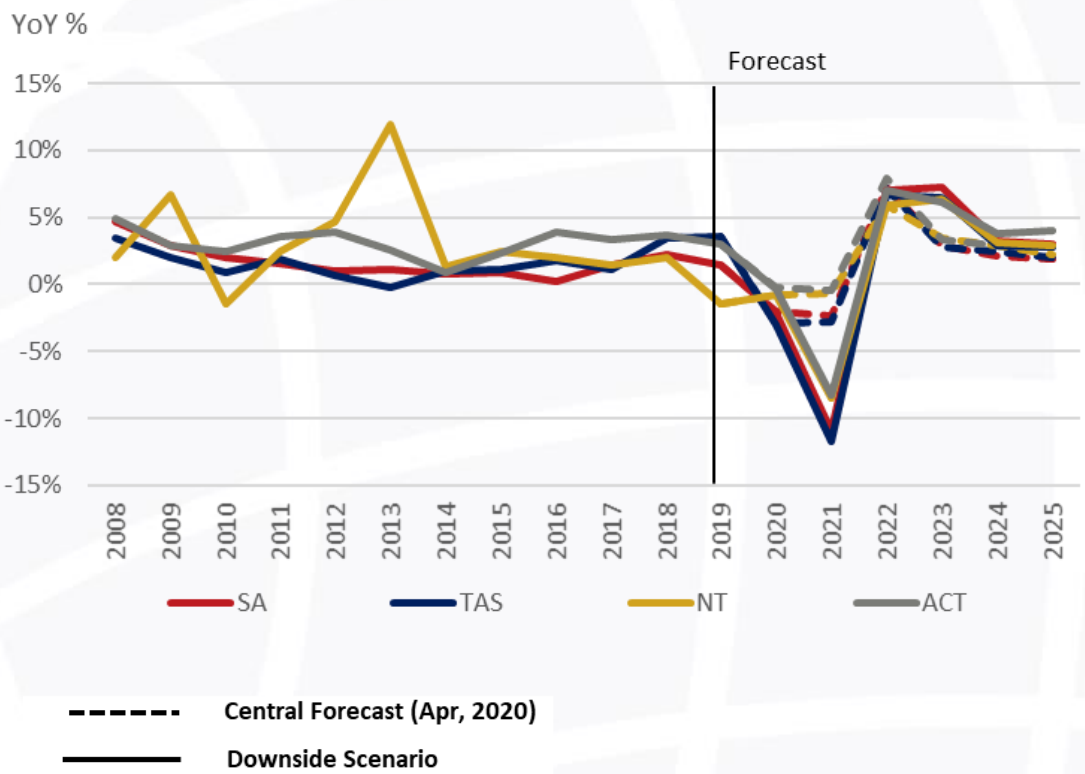
GROSS STATE PRODUCT (MINOR STATES)

Fig 14. GSP YoY growth: SA, TAS, NT & ACT



Source: Haver Analytics/ BIS Oxford Economics

- TAS has the sharpest contraction (3% in FY20) in the central scenario, as a result of the state's reliance on tourism and higher education, both of which have been impacted hard by the restrictions on travel. The recovery in these areas will be gradual; these restrictions are likely to be the last ones to be removed, and we expect people will remain cautious for some time.
- South Australia and the Northern Territory are both relatively protected from the downturn. But supply chain disruption will be a significant factor in the coming months, particularly for Adelaide's manufacturing sector, and the expected recovery in conditions in NT will now take longer, with the pandemic set to delay some mining investment jobs s put out the recent signs of life in the economy.
- ACT is the strongest performing state (in relative terms). Public services dominate the state's economy and demand for this sector will remain elevated and supply will rise to meet it. This becomes even more pronounced in the downside scenario. Meanwhile, ACT also has limited exposure to the other forces (tourism related services and net overseas migration) that present drags on other state economies.

OXFORD ECONOMICS

BIS OXFORD ECONOMICS

Global headquarters
Oxford Economics Ltd
Abbey House
121 St Aldates
Oxford, OX1 1HB
UK
Tel: +44 (0)1865 268900

London
Broadwall House
21 Broadwall
London, SE1 9PL
UK
Tel: +44 (0)203 910 8000

New York
5 Hanover Square, 8th Floor
New York, NY 10004
USA
Tel: +1 (646) 786 1879

Sydney
Level 8, 99 Walker Street
North Sydney NSW 2060
Australia
Tel: +61 2 8458 4200

Belfast
Tel: + 44 (0)2892 635400

Paarl
Tel: +27(0)21 863-6200

Frankfurt
Tel: +49 69 95 925 280

Paris
Tel: +33 (0)1 78 91 50 52

Milan
Tel: +39 02 9406 1054

Dubai
Tel: +971 56 396 7998

Philadelphia
Tel: +1 (610) 995 9600

Mexico City
Tel: +52 (55) 52503252

Boston
Tel: +1 (617) 206 6112

Chicago
Tel: +1 (773) 372-5762

Los Angeles
Tel: +1 (424) 238-4331

Florida
Tel: +1 (954) 916 5373

Toronto
Tel: +1 (905) 361 6573

Hong Kong
Tel: +852 3103 1096

Tokyo
Tel: +81 3 6870 7175

Singapore
Tel: +65 6850 0110

Melbourne
Tel: +61 (0)3 8679 7300

Email:
mailbox@oxfordeconomics.com

Website:
www.oxfordeconomics.com

Email:
info@bisoxfordeconomics.com.au

Website:
www.bisoxfordeconomics.com.au