

Australian Economic Comment

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Economics

A 'V-shaped' recovery may be less likely this time

Australia

- ♦ Australia's economic recovery following the initial COVID-19 shock was a highly impressive 'V'-shaped bounce back. However, the arrival of the Delta variant in Sydney in late June has markedly changed the Australian story, pushing the economy into another downturn. Many forecasters, including the RBA, are expecting that the subsequent rebound will be similarly 'V-shaped'. But it is worth considering that the next recovery could be different, partly because, this time, the case numbers are unlikely to fall back to zero. Adjusting to 'living with the virus' may mean the recovery is more drawn out and gradual than the snapback from the initial shock.

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As is by now well understood, the main approach used in Australia (and New Zealand) to manage the COVID-19 pandemic has, so far, been to enforce a hard border to keep the virus out and then respond to any outbreaks using testing, tracing, quarantining and region-specific lockdowns. This approach had worked well, such that, after the initial shock and nationwide lockdowns in early 2020, COVID-19 cases fell to near-zero levels, the economies were re-opened domestically, and a 'V'-shaped economic bounce back ensued. In Australia's case, GDP and employment had both regained their pre-pandemic levels by Q1 2021.

However, as we have noted for some time now, the benefits of this strategy for managing the COVID-19 pandemic were likely to come up-front, while the costs were likely to come later.

First, this is because we expected that the significant costs of having a closed border were set to mount over time, particularly due to stalled migration and thus population growth. How and when the international border will re-open is still highly uncertain.

Second, there was the risk that if and when the virus finally arrived in the community, the adjustment 'living with the virus' would be a bumpy ride, particularly given a sluggish vaccine rollout.

The Delta outbreak in Sydney, which began in late June 2021, has marked a turning point in this strategy, and for the economic outlook. This partly reflects the significantly greater transmissibility of the Delta variant, which has challenged testing, tracing and quarantining systems. For New Zealand, it is still too early to know if the recent Delta outbreak in Auckland, which began last week, will be a turning point for that country too.

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For Australia, just over two weeks ago, the RBA's official statement had forecasts suggesting that, after an expected contraction in GDP in Q3, there would be a strong 'V-shaped' bounce back in Q4, surpassing the Q2 level and kicking off a monotonic recovery.

But what if this time is different? What if the recovery is not 'V-shaped'?

There are good reasons to believe it might not be.

First, unlike Australia's own previous experiences in the earlier stages of the pandemic, case numbers are now not likely to fall back to zero in New South Wales (NSW). Instead, the state will need to 'live with' the virus. The primary focus is on rapid deployment of the vaccines. But even when 70 or 80% of the population is vaccinated, the virus will need to be managed, which is a sharp contrast to earlier in the pandemic when the case numbers had fallen back to zero. This may blunt the re-opening of the NSW economy, even after much of the population is vaccinated.

Second, most of the other state and territories are still running elimination, zero-tolerance strategies. While this remains the case, the borders with NSW will need to remain largely closed to people movement. Maintaining this strategy is also likely to mean periodic lockdowns when cases get through, which will clearly disrupt economic activity.

If and when these jurisdictions eventually shift, or are forced to shift, to 'living with' the virus, the adjustment from no cases, to some cases and the protocols it entails is likely to be economically disruptive. Again, it seems unlikely that the transition from zero cases and low vaccine rates, to high vaccine rates and some cases will see a sharp bounce back the same as was seen earlier in the pandemic in Australia when cases fell back to zero.

Third, some observers might argue that other countries, for example the UK and US, have had strong bounce backs once the vaccination rates rose to higher levels and these economies could be re-opened. Australia may be a bit different though. In those countries the worst of conditions was during the earlier stages of the pandemic and the rollout of the vaccine saw much improved conditions. In Australia, rising vaccination rates will protect health outcomes, but overall health conditions (and therefore economic conditions) are likely to still prove to be worse, even after the vaccine has rolled out, than they were when there were zero, or near-zero cases.

In mid-July, after the initial Delta outbreak, we revised our growth forecast down to 2.5% over the year to Q4 2021 (from 3.9% previously). This is markedly weaker than the RBA's own forecast from its more recent official statement of 4.0% over the same period, as the RBA was assuming a 'V-shaped bounce back in Q4.

We see recent developments as a further downside risk to our own forecasts. These include the recent announcement of an extension of the NSW lockdown from 30 August, to 30 September, Victoria's extended lockdown and the clear statement from policymakers in NSW that cases are not expected to fall back to zero. This last factor means that a snap, broad-based re-opening of the NSW economy at some vaccination rate threshold seems less likely and that the borders of the remaining states and territories with NSW are set to remain heavily constrained for an extended period.

We think all of this means that there is a risk that the RBA will choose to defer its plans to taper its QE programme (currently set for September), given that it had left the door open to this possible policy shift at its last meeting.

We expect an economic recovery to get going more fervently in 2022, when we expect the national vaccination rate to be above 70%. However, even for 2022, we remain sceptical that there will be a strong 'V-shaped' bounce back, as the dynamics of the pandemic effect, as discussed above, and other headwinds, weigh on growth.

Disclosure appendix

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