HSBC Global Research

19 January 2022

Australia in 2022

Learning to 'live with' it

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Economics - Australia

- Australia has shifted from an 'elimination' to 'living with the virus' plan for COVID-19, helped by high vaccination rates
- This adjustment is set to weigh on the pace of growth in activity in the near term but allows for fuller re-opening
- Inflation and wages growth are edging higher but are low and how quickly they pick up is a key question for the RBA

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Pandemic strategy moves to its next stage

After early success in maintaining an 'elimination' strategy for managing the COVID-19 pandemic (helped significantly by Australia's distant island geography), the strategy has shifted to adjusting to 'living with' the virus.

The arrival of the Omicron variant has been met with policymakers taking only limited action to contain it and relying on high vaccination rates (93% for 16+ year olds as of 17 January) and a strong hospital system to protect the population. State and international borders have re-opened (with the exception of Western Australia), albeit with stringent entry requirements. The resulting surge in cases – Australia had 109k new cases a day, on average, in the week to 14 January, up from a previous peak of 2.3k a day in October 2021 – is set to weigh on growth in Q1 2022.

For 2022, our central case sees an economic upswing supported by the consumer, as services consumption picks up and households draw down savings. However, at the same time, we see the housing market cooling, after a boom, and expect that some of the adjustments to the post-pandemic 'new normal' are yet to play out, given significant forbearance in recent years. We have a below-consensus view on GDP growth in 2022, at 3.5%, versus consensus at 3.9% and the RBA at 5.0%.

Inflation and wages growth are comparatively low and expected to pick up but gradually enough that the RBA will not feel the need to slam on the brakes with rate hikes in 2022 – although the end of QE in H1 2022 seems likely. A re-opening border is expected to see a labour supply boost, tempering nascent wage pressures.

This is an abridged version of a report by the same title published on 19-Jan-22. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

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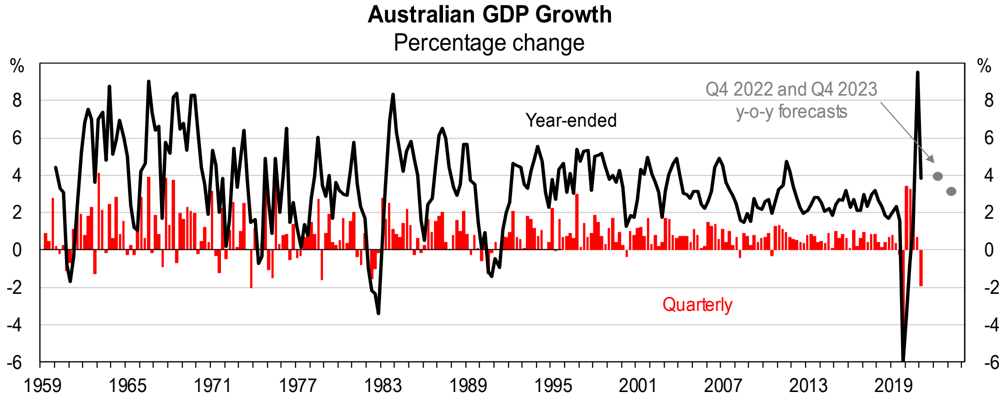
1. A sharp contraction in growth in 2020 was preceded by a long boom



Source: ABS, HSBC estimates

'Longest boom' to the 'sharpest shock'

Australia's 'elimination' approach saw early economic benefits …

Years of growth stability in Australia were abruptly ended with the COVID-19 pandemic (Chart 1). However, Australia has fared better than most countries. The initial 'elimination strategy', mostly achieved by rapidly closing the borders, was particularly effective in delivering strong health outcomes and, combined with significant fiscal and monetary stimulus, delivered better economic outcomes than in most economies.

However, the speed of the transmission of the Delta variant, which arrived onshore in June 2021 (and the subsequent Omicron variant from December 2021) drove a shift in strategy from 'elimination' to rapid vaccine rollout and 'living with' the virus.

… but the arrival of the Delta variant in June 2021 saw a sharp shift in strategy

After a slow start, vaccinations ramped up rapidly to high levels by late 2021 and the economy has been re-opening since Q4 2021. The recent surge in case numbers, driven by the Omicron variant, has been met with more muted activity restrictions by the authorities, not strict lockdowns, although households and businesses have become more cautious and supply chains are being disrupted, particularly by labour shortages.

A rebound is underway …

Economic activity should rebound after the Delta variant shock …

As a result of the re-opening and high vaccine protection, economic activity has been rebounding from the Q3 2021 Delta variant-related lockdowns. We forecast a strong bounce back in Q4 2021 GDP, although growth is then likely to lose some momentum as the economy adjusts to 'living with' the virus (Chart 2). In the short run, the Omicron variant outbreak is weighing on activity, as high case numbers see cautious household behaviour, despite the high vaccination rates.

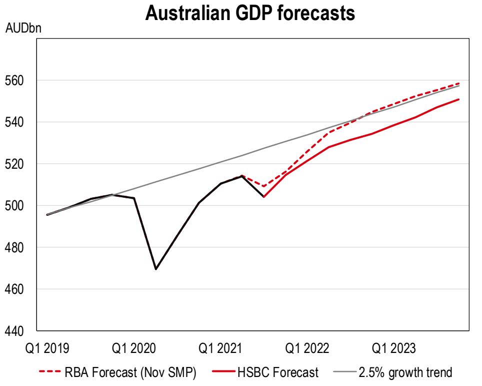
Through 2022 and 2023, we expect growth in each quarter, but we see the economy tracking below its pre-pandemic trend GDP level, in large part because of a lower expected pathway for Australia's population.

… but the Omicron variant is a clear risk through H1 2022

The recovery from the Q3 lockdowns has been clearest in the jobs market, with firms ramping up recruitment in anticipation of the post-Delta variant recovery, re-opening and labour shortages that have been a result of the closed border. Employment had its single strongest monthly rise in November 2021 and hours worked bounced back as well (Chart 3). Job vacancies were at record highs of almost 400k jobs nationwide in Q4 2021, compared with pre-pandemic numbers in late 2019 of around 225k job vacancies.

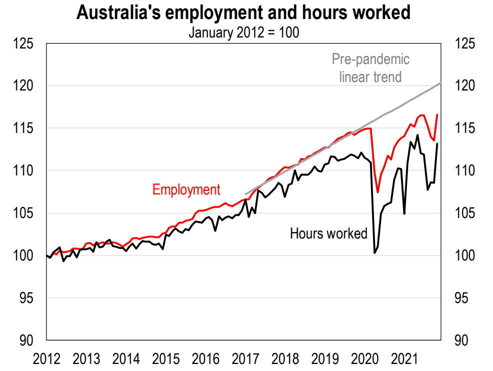
Much of the labour demand has been met from workers re-entering the labour force, which saw the participation rate rise back to around its record high in November (Chart 4). This is in stark contrast to the US, where participation rates are still well below the pre-pandemic levels.

2. We see a continuous upswing through 2022 and 2023 as the bumps get smaller …



Source: ABS, RBA, HSBC estimates

3. Employment is once again rising, as are hours worked



Source: ABS

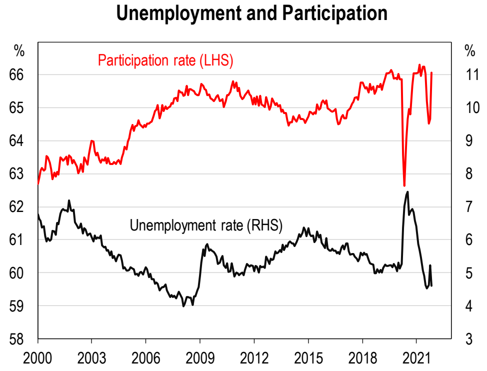
The labour market has recovered quickly …

However, even with the boost to local jobs market participation back to high levels, the strength in demand pushed the unemployment rate back to multi-decade lows, largely reflecting the closed border, which has constrained labour supply (Chart 5).

… but wages growth has remained subdued

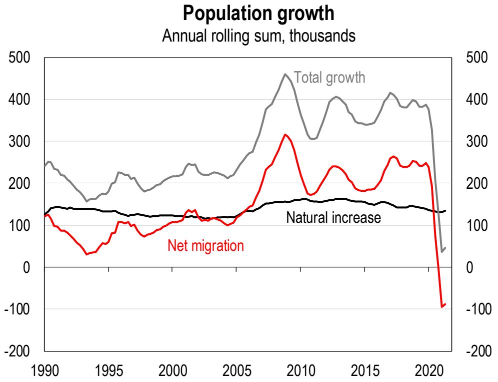
As we discuss further below, it is this availability of local labour that has helped to keep overall wage pressures subdued, although the international closed border (and constrained state borders) have clearly delivered pockets of labour shortages, for example, wait-staff, fruit pickers and some IT workers. The wage price index ran at only 2.2% y-o-y in Q3 2021, which is still well below the rate needed to lift CPI inflation sustainably back to the RBA's 2-3% target range.

4. Labour market participation has bounced back and unemployment is down



Source: ABS

5. Population growth has stalled, as net migration has been a drag



Source: ABS

… border re-opening should boost population and labour supply

Opening the border is unlikely to support stronger wages growth …

The borders are also re-opening. This is set to boost labour supply, as international students and skilled migrants return. Although the arrival of migrants may take some time and other factors are currently constraining labour supply, such as quarantining requirements for COVID-19 positive workers, for the jobs market, the squeeze on labour supply from the closed borders is likely to be near its peak. As we discuss below, although wages growth is set to rise, we expect this process to be gradual.

… but we expect a gradual increase in wages growth, as the jobs market tightens

The boost to population growth from the re-opening border will help Australia's economy to head back towards its pre-pandemic GDP pathway. However, we do not expect the re-opening migration programme to be large enough to make up for the migrants that did not come, or chose to leave, during the pandemic. In our view, this leaves our forecast for the economy on a lower GDP pathway than the pre-pandemic trend, as we show in Chart 2. In contrast, the RBA expects the economy to be back on its pre-pandemic pathway for the level of GDP from late 2022 and in 2023.

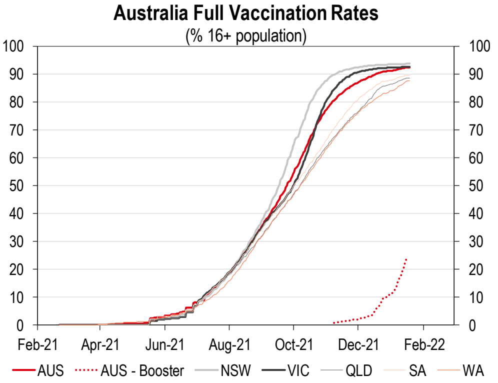
Adjusting to 'living with' the virus will create growth bumps

There is expected to be more economic volatility through the year …

Although we expect q-o-q growth in each quarter of 2022 – that is, we are not forecasting outright contractions – we do expect a slowdown in q-o-q growth in Q1 2022, as households and businesses adjust to 'living with' the virus and as the Omicron variant outbreak weighs on activity. The various states of Australia are at different stages of the adjustment process and Western Australia has yet to begin this process, with its border still closed until 5 February.

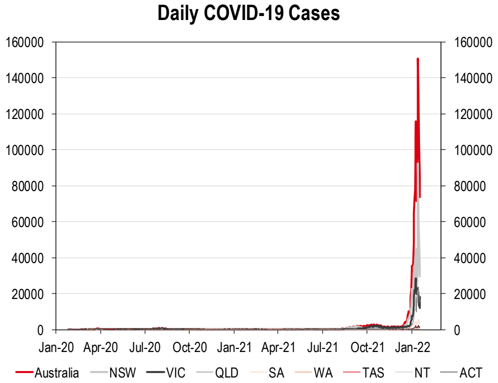
Although the Australian population is now highly vaccinated, the soaring new case numbers are still disrupting activity. The national vaccination rate is 93%, up from just 3% in June 2021 (Chart 6). Nonetheless, case numbers have risen sharply and have reached as high as 150k a day in January, with a 7-day average of 105k per day in the week to 17 January (Chart 7).

6. After a slow start, vaccination rates rose sharply in H2 2021 …



Source: Covid19data.com.au, HSBC

7. Re-opening and Omicron variant's rapid transmission-driven 'skyrocketing' cases



Source: COVID19data.com.au, HSBC

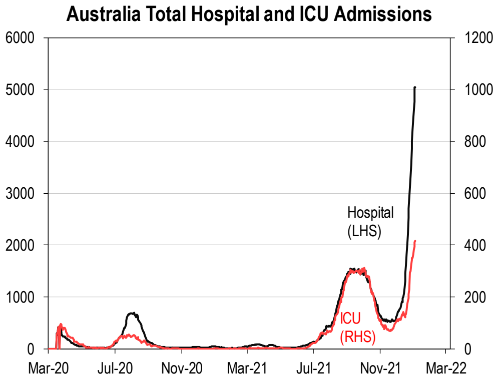
For policymakers, the focus has shifted to keeping hospitalisation and intensive care unit rates manageable, although, given the sharp rise in new cases, even these are now at new highs (Chart 8).

… as the COVID-19 virus continues to play large role in economic dynamics

However, soaring case numbers and rising hospitalisation rates are seeing households become more cautious. Large numbers of workers are needing to self-isolate, which is also disrupting some supply chains. There has been a sharp reduction in mobility of retail, recreation and transit to CBD workplaces (Chart 9). As Omicron variant cases peak – which state governments' expect to occur in coming weeks – some of the disruptive effects should start to abate.

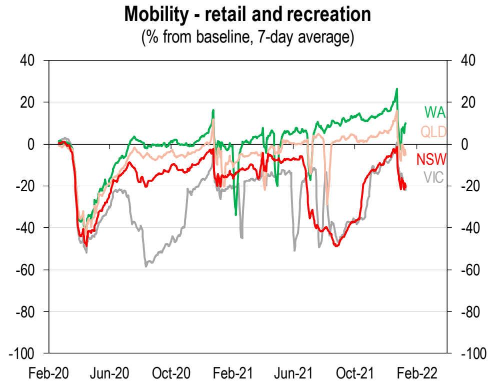
More broadly, there remains considerable uncertainty about the likely development of the COVID-19 virus itself. The Omicron variant, despite being highly transmissible, appears to have less severe symptoms for most of the population than previous variants, with death rates much lower for any given number of Omicron variant sufferers in a population. However, future variants could be more or less severe in their health effects than the Omicron variant and vaccine effectiveness could also differ with future variants.

8. Focus has shifted hospitalisation rates



Source: Covid19data.com.au, HSBC

9. Households have become more cautious, as case numbers have risen



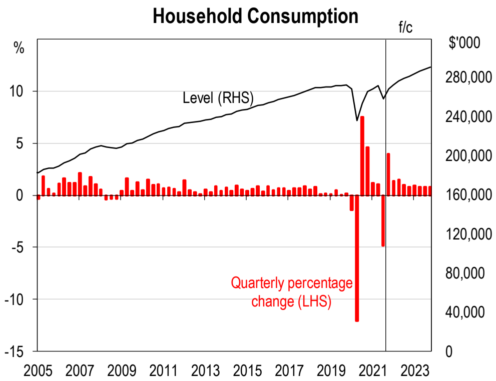
Source: Google, HSBC

The recovery is set to be consumer-led …

Increased consumption of services is set to support the recovery …

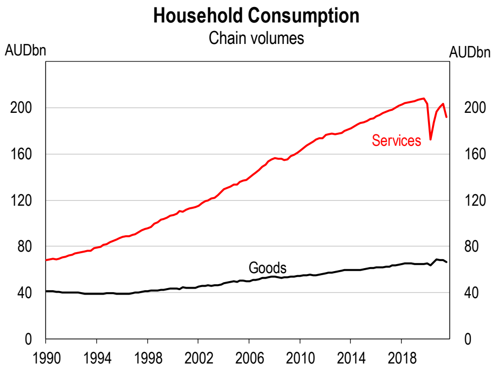
Our central case is that the recovery will be driven by consumption growth, as households start to spend more on services that have been unavailable or constrained through the pandemic, such as restaurants, sporting and theatre tickets, and travel and accommodation. We see household consumption growth of 4.0% in 2022, which would follow growth of 4.2% in 2021 and the substantial 5.8% fall in 2020 (Chart 10).

10. Cashed up households are expected to drive a consumption-led upswing …



Source: ABS, HSBC estimates

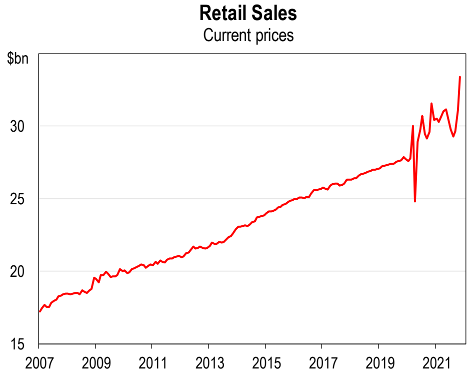
11. … as consumers go back to spending more on services



Source: ABS

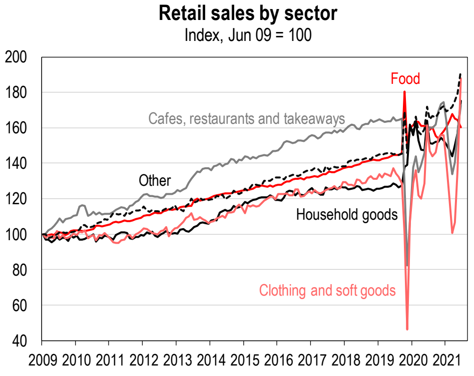
We expect much of the ramp-up in consumer spending to be on services, which were 7.7% below the pre-pandemic level as of Q3 2021 (Chart 11). Much as has occurred in other economies, the pandemic has driven a surge in spending on household durable goods, such as furniture, computers and gym equipment, as well as at-home food consumption, which has lifted retail sales to new record highs (Charts 12-13). We expect a return to more normal spending patterns over 2022 and 2023, weakening retail sales but boosting spending on services.

12. The pandemic has lifted goods sales, boosting retail spending …



Source: ABS

13. … particularly of food and household durable goods



Source: ABS

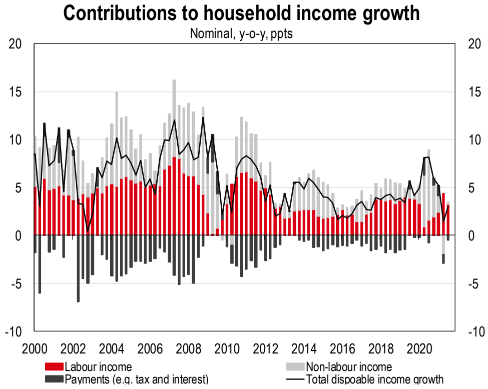
Consumer spending is set to be supported by rising labour income, as employment growth continues and households drawn down on excess savings that have been accumulated through the pandemic.

… underpinned by a wealth effect and excess household savings …

Rather unusually for a recession, household income growth accelerated through 2020, as a sharp rise in government benefits more than offset a slowdown in labour income growth (Chart 14). Although the pandemic-related benefit programmes have largely ended, strong employment growth and a gradual pick-up in wages growth is now supporting household income.

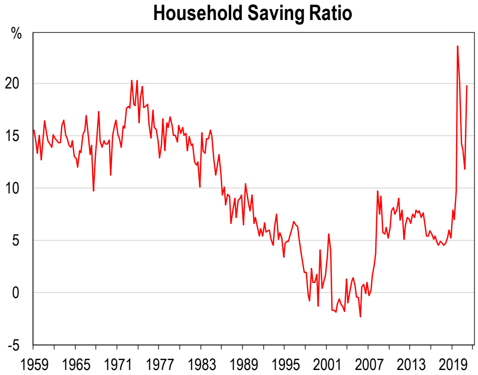
Given strict limits on many forms of consumption and increased household caution through the pandemic, the household saving rate rose to new record highs and is still well above its pre-pandemic levels (Chart 15). Our estimates suggest excess savings sum to around AUD200bn (10% of GDP), which adds to the rise in household wealth that has been largely driven by increasing housing prices. We expect some of this excess saving to be deployed on additional 'excess' spending.

14. Household income growth was strong but has slowed …



Source: ABS

15. … although much of the boost was saved

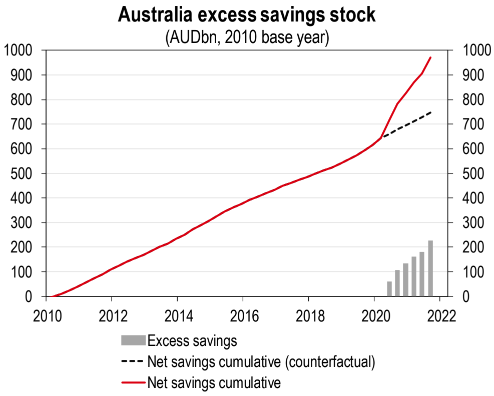


Source: ABS

However, we do not expect the 'excess savings' to be fully run down, or to all end up boosting local consumption.

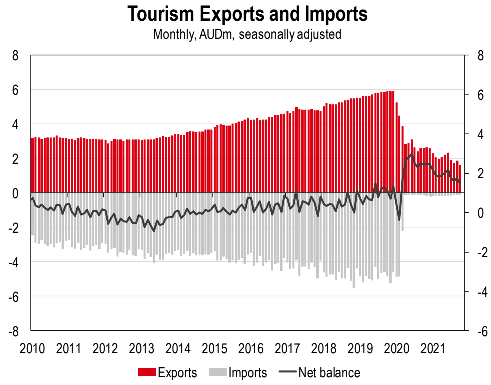
First, some of this cash has been used to make excess repayments on mortgages (building up buffers) and, given high household debt levels and the shock of the pandemic, households may choose to pay down mortgages faster than in the past (similar to what happened after the 2008-09 Global Financial Crisis).

16. Households have a stack of 'excess savings' to deploy if they choose to …



Source: ABS, HSBC estimates

17. … but a lot of it could be the holiday budget, and could eventually leak offshore



Source: ABS

… although not all savings will be funnelled back into domestic spending

Second, a large chunk of the excess savings is the amount that Australians typically spend on international travel over a two-year period (around AUD120bn). Some households are likely to put aside these funds for future holidays and, as the border re-opens, we expect some of this spending to leak offshore (Chart 17).

Third, the pandemic has driven some pull-forward of household durable goods purchases, such as furniture and new motor vehicles, which are unlikely to be repeated in the near term.

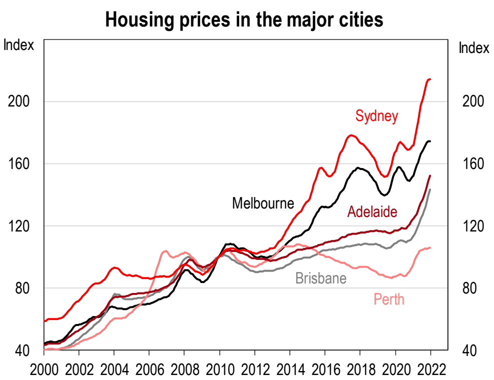
Finally, a booming housing market, supported by falling interest rates, readily available credit and fiscal measures directed at supporting housing construction are all likely to have supported a boost to household spending, particularly of household goods. However, we expect the housing boom to cool in 2022 (Charts 18-19).

The housing market is set to cool

After a strong rise in 2021, housing price inflation is set to cool

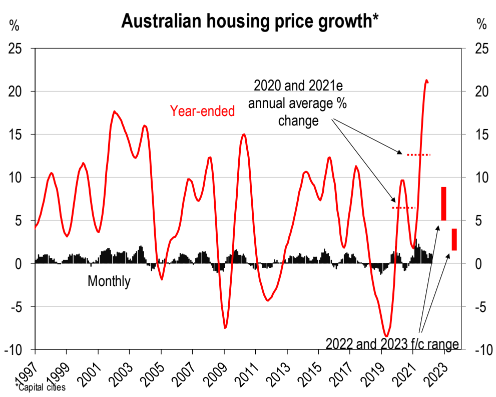
We see national housing price growth slowing to single-digit rates in 2022 from the double-digit pace of 2021 (Table 20).

18. Housing prices have risen strongly across the country …



Source: Core Logic

19. … but we expect the housing boom to cool in 2022 and 2023



Source: Core Logic

The key factors that are set to weaken housing price growth are:

- interest rates are not likely to fall further, and some fixed mortgage rates are rising;
- macro-prudential settings have been tightened, and we may see further moves in this direction; and
- the boost to housing supply, in part driven by fiscal support measures, combined with stalled population growth, as a result of the closed border, have resulted in our housing market balance indicators suggesting some oversupply.

We expect housing price inflation of 5-9% nationally in 2022, down from 13% in 2021

A cooling housing is another factor that is set to keep consumers from fully running down their excess savings.

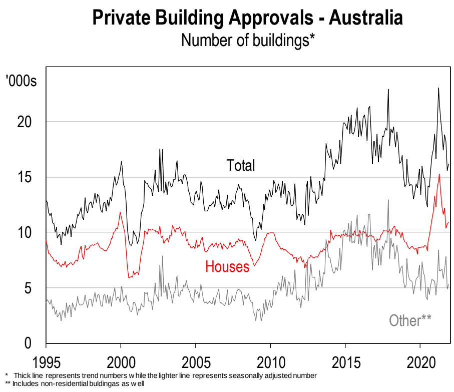
20. Housing price forecasts for Australia's major cities

	2021		2022f		2023f	
Sydney	**15**		**4 to 8**		**0 to 4**	
- Detached houses		19		6 to 10		0 to 4
- Apartments		7		2 to 6		2 to 6
Melbourne	**8**		**5 to 9**		**1 to 3**	
- Detached houses		9		6 to 11		0 to 3
- Apartments		5		2 to 6		1 to 4
Brisbane	**15**		**7 to 11**		**3 to 5**	
- Detached houses		17		10 to 14		0 to 5
- Apartments		6		4 to 8		2 to 6
Perth	**16**		**3 to 7**		**1 to 3**	
Adelaide	**15**		**7 to 11**		**1 to 3**	
Canberra	**18**		**9 to 13**		**6 to 8**	
Hobart	**20**		**12 to 16**		**5 to 7**	
National	**13**		**5 to 9**		**1 to 4**	

Note: *Assumes cash rate assumptions in Table 41.
Source: Core Logic RP Data, HSBC estimates

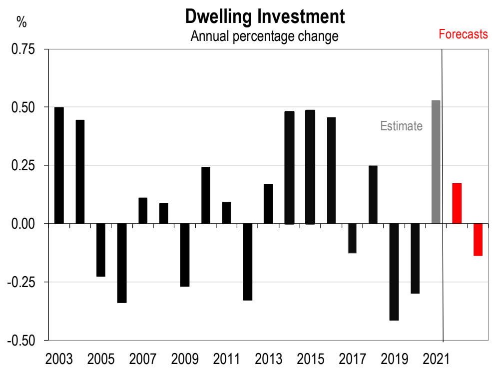
Housing construction is also set to be a drag on growth from the second half of 2022 and in 2023, as the effects of the pandemic-related government subsidy schemes subside. Building approvals have already peaked, after a sharp policy stimulus-related spike in approvals for detached houses (Charts 21-22).

21. Building approvals have peaked for the cycle …



Source: ABS

22. … and foretell a likely fall in housing construction from H2 2022 and into 2023



Source: ABS, HSBC estimates

A sustained business investment upswing is still uncertain

The pandemic has been a testing time for businesses, with significant volatility brought about by the various outbreaks of the COVID-19 virus, as well as policy responses from governments and responses of households to the circumstances they have faced.

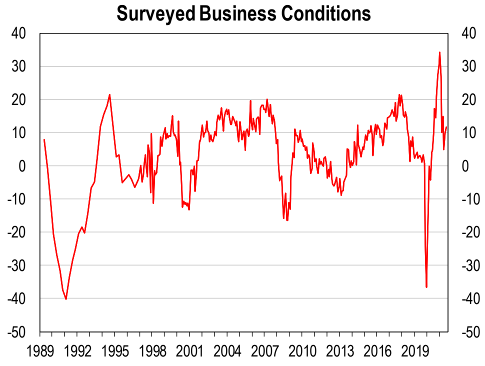
Business investment looks set to recover despite continued uncertainty …

The sharp ups and downs in the surveyed business conditions give a sense of the roller coaster ride business have been on (Chart 23). After a sharp initial fall in H1 2020, business conditions rebounded to high levels before the Delta variant-related lockdowns saw them fall back, albeit to still positive levels, before the recent re-opening has driven some recovery.

Many firms have also had to rapidly adjust their business models, some to facilitate staff working from home, others to the shift in demand from in-person to online service provision and still others to deal with supply chain disruptions and increased volatility in the availability of labour.

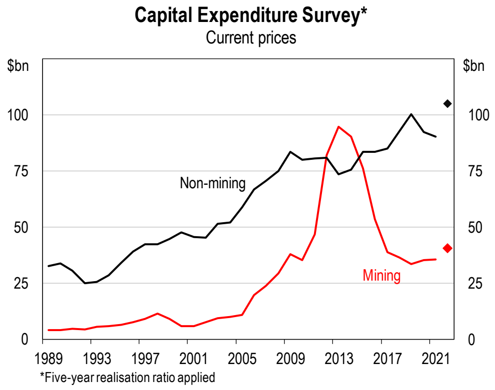
It makes sense that for some businesses many of these changes would motivate increased capital spending, as different capital is needed for adjusted business models. In addition, part of the fiscal response to the pandemic has been accelerated depreciation schemes and other incentives that encourage a pull-forward of capital spending. The ABS capex survey shows that non-mining businesses expect to lift their investment by 16.5% in 2021-22 (applying the five-year realisation rate), which would be the strongest increase in 26 years (Chart 24). Surveys of business investment intentions are also consistent with a likely upswing in business investment (Chart 25).

23. Business conditions have been very volatile



Source: Refinitiv Datastream

24. Non-mining businesses expect to lift investment strongly



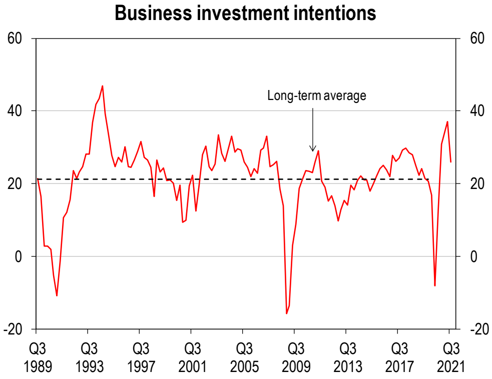
Source: ABS, HSBC estimates

… but there are a number of medium-term headwinds

However, we also see a number of headwinds. First, the fiscal support is unlikely to be repeated at the same scale as it was during the pandemic and its effect is set to fade. Second, the expected downturn in housing construction in the second half of 2022 may weigh on investment plans for some businesses. Third, to the extent that increased investment reflected an adjustment to increased online sales and work from home, after two years for pandemic much of this adjustment may very well have happened.

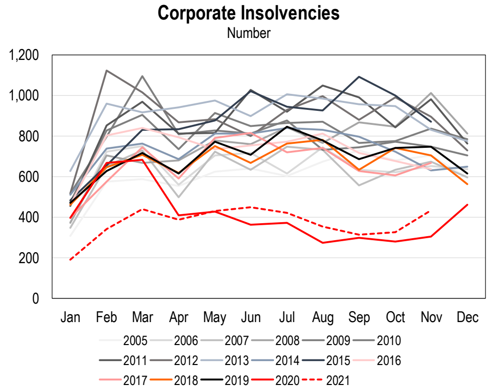
Finally, the extraordinary extent of forbearance delivered to businesses – for example, safe harbour arrangements for insolvencies and loan repayment and tax payment holidays – has seen a halving in the rate of corporate insolvencies through the pandemic. This is a highly unusual performance during a recession. We expect that, as the economy adjusts to ‘living with’ the COVID-19 virus and forbearance measures are removed, which may occur more fervently after the forthcoming Federal election, corporate insolvencies are likely to rise.

25. Surveyed investment intentions are positive



Source: Refinitiv Datastream

26. Corporate solvencies have remained well below pre-pandemic levels



Source: ASIC

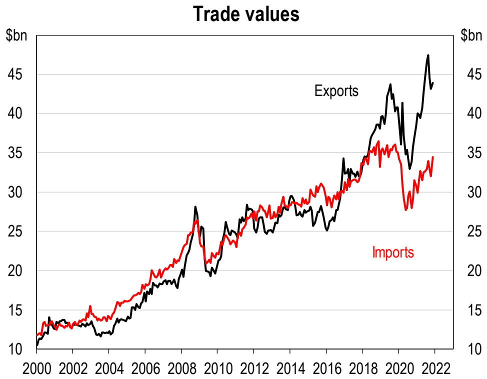
Trade has boomed, but there are challenges ahead

Australia's trade has been strong through the pandemic, with record monthly trade and current account surpluses. A strong rise in export values has been supported by Australia's commodity export basket prices rising to their highest level on record in AUD terms, in turn, supporting a record high terms of trade (Chart 27).

Trade has been a key support for Australia through the pandemic …

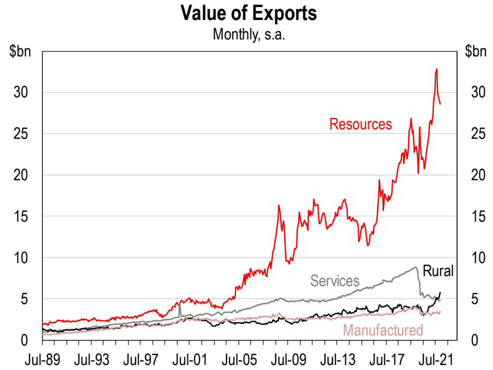
The strong rise in exports has been largely driven by resource exports, including iron ore, coal and liquefied natural gas (Chart 28). Imports have been held back, as there has been a sharp fall in imports of tourism and education services (Australia is typically a net importer of tourism services).

27. Exports have boomed, while imports have fallen back …



Source: ABS

28. … with high commodity prices driving much of the rise in export values

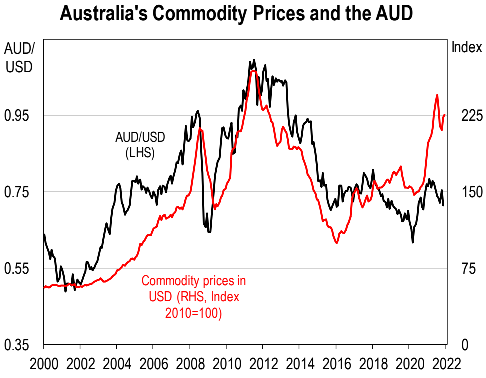


Source: ABS

A key factor helping to support the ramp-up in the AUD value of exports has been that the currency has not followed the rise in commodity prices in the same way that it has in many previous cycles (Chart 29).

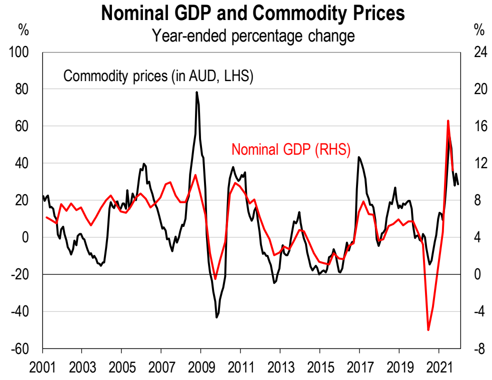
In part this reflects that the upswing in commodity prices has not been matched by a strong upswing mining investment intentions (which would then draw in foreign capital). This could reflect that mining companies do not see the current higher commodity prices as a sustained 'super-cycle' upswing, as was the case in the early 2000s China-driven commodities boom. Resource companies may also be unable, or unwilling, to ramp up investment, given rapidly shifting global climate change policies and investor trends (for example, for coal mines). The AUD is also likely to have been somewhat held down by the RBA's asset purchase programme (its quantitative easing).

29. Commodity prices have risen, but the AUD has not followed



Source: Bloomberg, RBA

30. Strength in commodity prices has supported nominal GDP



Source: ABS, RBA

… supported by the rise in commodity prices, which masked deeper challenges

The rise in AUD commodity prices has delivered a significant boost to national incomes, with very strong nominal GDP growth through 2021 (Chart 30). This has been driven by mining sector profits and has delivered a significant boost to tax revenues.

However, we see the headline strength in Australia's trade as masking some deeper underlying challenges. In particular, Australia's relationship with China, its major trading partner, has become increasing strained. Although China's strong need for Australian commodities has more than offset this impact on trade so far, a longer perspective may mean less positive growth opportunities, given this geopolitical challenge.

Another area of concern is services exports, which have been heavily constrained by the closed borders. We set out more detail on the services export opportunities below.

Inflation and wages growth are set to pick up, but how quickly?

CPI inflation has remained comparably low in Australia …

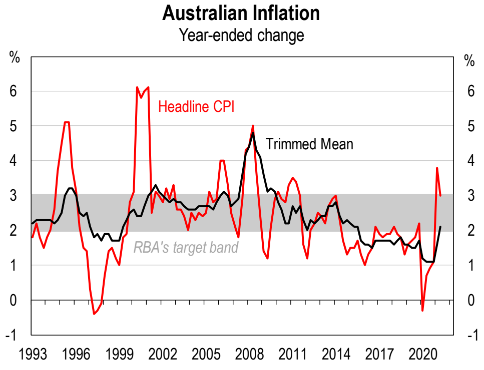
Unlike the US, the UK and Europe, at this stage, Australia's inflation remains comparably low. The Q3 2021 print showed headline CPI at 3.0% y-o-y and the key underlying measure, the trimmed mean, at 2.1% y-o-y (Chart 31). By comparison, headline and core measures of inflation are well above target in much of the Western world.

However, Australia's inflation dynamics appear to be quite different. Unlike the US, motor vehicle prices have not risen strongly and rental growth is also pretty modest (Chart 32). Local electricity prices are falling, given recent rapid adoption of rooftop solar panels by households, which is a strong contrast to trends in the US, the UK and Europe, where electricity prices are up sharply, in part reflecting a steep recent rise in gas prices.

… in part due to different inflation component and wages dynamics

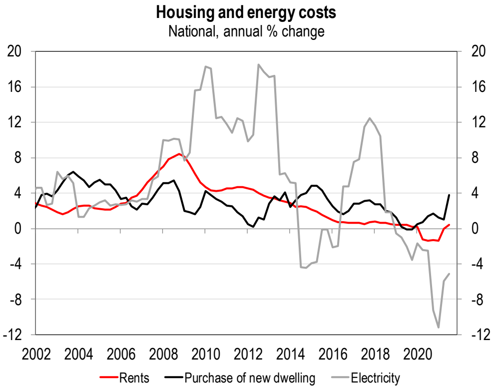
Although the Omicron variant outbreak is causing some local supply chain disruptions, it is not clear that these are showing up in higher measured prices, with more of the effect, so far, seemingly coming through in quantity rationing.

31. Australian inflation is still comparably low, despite edging higher



Source: ABS, RBA

32. Key components of the local CPI are much lower than in much of the West



Source: ABS

We expect inflation to pick up, as the economic recovery from the pandemic continues through 2022, but we expect that the acceleration is likely to be gradual, rather than sharp.

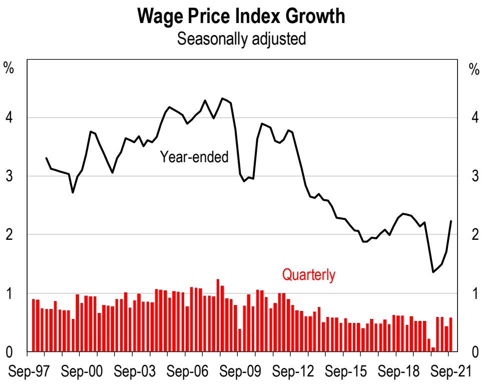
Core inflation remains comparatively low, as does wages growth …

A key factor is that inflation started off persistently low, well below the RBA's 2-3% target band prior to the pandemic and these low inflation expectations have become somewhat embedded in the wage setting process. Now that wage freezes that were imposed early in the pandemic have been removed, the wage price index has picked up (Chart 33). However, wages growth has only returned to its pre-pandemic rates of around 2.0-2.5%, not the higher, earlier rates of 3-4% that are needed to sustainably lift underlying inflation back to the RBA's 2-3% target range.

… with both expected to lift, but it is likely to take some time

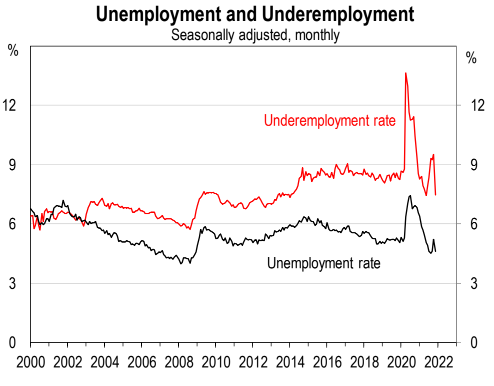
A tightening labour market is set to put upward pressure on wages growth, but it is likely to take some time to become a broad-based wages growth upswing, given that almost two-fifths of wages are determined through enterprise bargaining agreements (which are typically three years long).

33. Wages growth is lifting but remains low and has significant inertia



Source: ABS

34. A tightening jobs market will put upward pressure on wages growth



Source: ABS

The RBA is set to remain comparably dovish

We see the RBA cash rate on hold through 2022 …

After a long period of below-target inflation, the RBA has shifted its approach to monetary policy. Previously, the RBA has sought to pre-empt a pick-up in inflation, but the RBA is now planning that it will need to see inflation sustainably on target before it starts to raise its cash rate.

For the RBA, a key element of this is needing to see that wages growth is set to lift from its current and recent lows of around 2.0-2.5% and instead track at 3-4%. As we discussed above, Australia's enterprise bargaining agreement system puts significant inertia into the wage setting process, which is likely to mean a gradual, rather than sharp, upswing in wages growth.

… though a tighter-than-expected labour market is an upside risk to the cash rate

With this in mind, and given the low inflation and wages growth starting point, we expect that the RBA cash rate rises are more likely to be in 2023 than in 2022.

A key risk to this is that the unemployment rate falls more quickly than we (or the RBA) expect and drives a more rapid pick-up in wages growth. Another risk is that the supply disruptions from the Omicron variant outbreak persist for longer than expected and feed through to broader inflationary pressures.

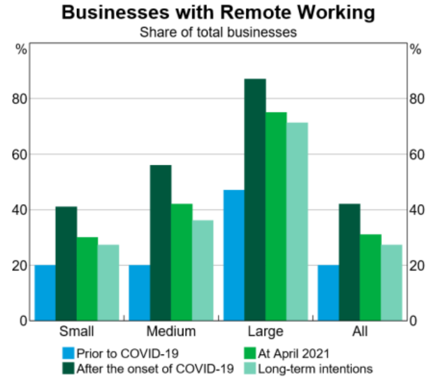
Thoughts on the pandemic 'new normal'

As discussed above, adjusting to 'living with' the COVID-19 virus is expected to deliver a somewhat bumpy recovery. In addition, some households, businesses and policymakers are still needing to adjust to the pandemic 'new normal'.

Australia's economy is on a pathway to a 'new normal'

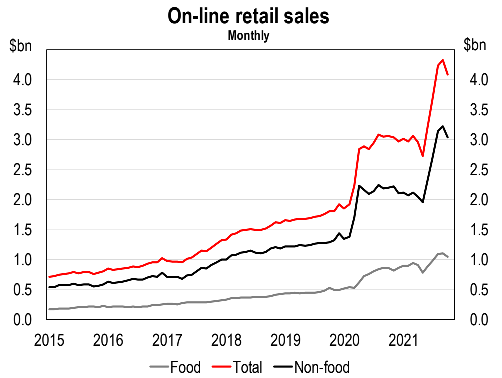
One aspect of the 'new normal' is expected to be increased work from home. This is likely to mean less demand for offices, less transit to central business districts, less spending in these locations and a redistribution of this spending to other locations, for example, to retailers in suburbs near the beach or in regional areas. Surveys of firms show that businesses expect more remote working in the long term when compared with pre-pandemic expectations (Chart 35). Of particular note, of the large businesses, which are more likely to occupy CBD office buildings, around 20ppt more of them expect remote working than pre-pandemic.

35. More work from home is likely to be a feature of the 'new normal' …



Source: ABS, RBA

36. … as is a persistently higher rate of online retail spending



Source: ABS

The pandemic has also seen a large increase on online retail sales. Part of this continues a trend that was apparent pre-pandemic, but the pandemic has accelerated the adjustment (Chart 36). Increased online retail sales are likely to continue to be a challenge for shopping centres and in-person retailers. On the other hand, opportunities are created for merchants with a strong online presence, and set to be increased demand for industrial warehouse assets.

The pandemic has also sharply reduced business travel, with much of the activity being replaced by virtual forums (such as video conferencing). Although business travel is likely to bounce back, and initially quite strongly, we expect the medium-term trend will be for less business travel than during the pre-pandemic years. Firms are likely to see the business travel as a cost they can control and may also seek to reduce business travel as a means to meet climate policy goals.

The challenges and opportunities

Although Australia had a long stretch without a recession prior to the pandemic, growth was not particularly strong and productivity growth was low.

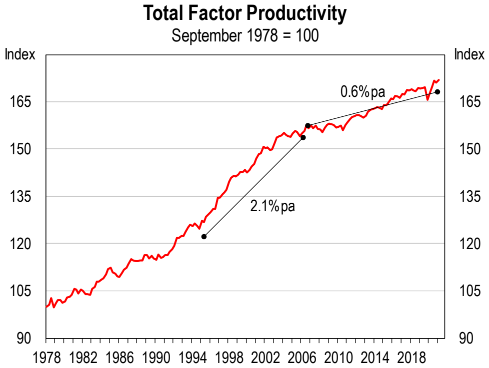
The pandemic could have provided a catalyst for Australia to address long-term issues …

Australia faced a range of challenges, including an increasingly inefficient tax system, a lack competition in many markets, and disjointed climate change and energy policy, amongst others. There was also limited appetite for reform, with the last big macroeconomic reform in Australia the introduction of the Goods and Services Tax in 2000.

Although the pandemic and the economic crisis it entailed could have been used as a catalyst for a large shift in the direction of economic reform, this has not occurred.

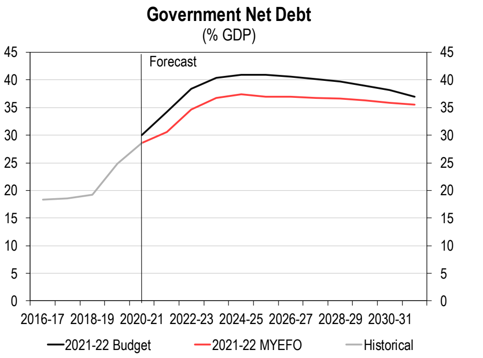
Many of the pre-pandemic challenges remain. Critical amongst these, and likely to be partly a result of the lack of reform, has been a significant slowdown in productivity growth, which has persisted through the pandemic (Chart 37).

37. Australia's low productivity growth is a long-term structural challenge …



Source: ABS, HSBC estimates

38. … and the rapid rise in debt is going to be a challenge following the pandemic



Source: Treasury

Aside from the challenges discussed above, the pandemic has also left Australia with two other critical macroeconomic challenges.

… but does not appear to have spurred a broad reform agenda

First, to support the economy in the face of the pandemic, government debt has soared, such that Australia shifts from being a low debt to a middling debt country (Chart 38). There has also been a political shift, with both major parties now avid supporters of large spending on social programmes, such as aged and disability care. Pre-pandemic it was the Coalition government that had a significant focus and commitment to delivering a balanced budget and seeking to reduce public debt levels. Although much of the government's budget spending in 2020-21 was directed at pandemic-support measures, the 2021-22 budget broadened this out to higher general social spending on areas, such as aged and disability care.

Second, through the pandemic-period the geopolitical backdrop has shifted markedly and, in Australia's case, the bilateral economic relationship with China has become much more challenged.

Given still weak productivity growth, higher government debt levels and a more challenging geopolitical environment, a focus on growth engines and reform to support these is critical.

Renewables, education and migration

We see three key opportunities for long-term growth

We have long advocated that Australian policymakers ought to focus on four areas of reform. These are: tax reform, competition policy, infrastructure, and climate and energy policy.

However, as we recognise that broad reforms are unlikely in the near term, it may be that policymakers ought to focus more on making economic adjustments that help to support specific areas where we see that Australia has strong growth opportunities. We see key opportunities for Australia in a range of areas but particularly in renewables, education and migration.

Renewables could be a big growth engine

Renewables are a natural advantage for Australia

The economics of renewables have dramatically shifted in recent years due to the sharp fall in the cost of renewables, particularly due to the plummeting prices of solar panels, wind technologies and batteries for energy storage.

From a global perspective, Australia is hardly a leader in carbon emission abatement or policy. Australia is a large exporter of fossil fuels and also a larger emitter than most economies in per-capita terms. However, this challenging starting point, from an emissions perspective, means that Australia also has vast opportunities.

First, Australia ought to continue to invest in the transition of Australia's energy and transport network by shifting it further towards renewables.

Second, given Australia's natural advantages, such as a large land mass, lots of empty space, sunlight and wind, the country could develop a comparative advantage in low-carbon energy production for export, either directly, via cable or through conversion to hydrogen, of in the form of processed minerals.

Education exports and local human capital improvements are key

Education – both exports and local – provide relatively large value-add

The pandemic and closure of the international border to manage it has been a significant challenge for the education exports industry, which typically relies on students being able to come to Australia to study in-person. Online learning enrolments by students residing offshore has provided some offset and many students that were already onshore prior to the pandemic have also continued to contribute to growth. However, the industry has taken a significant hit.

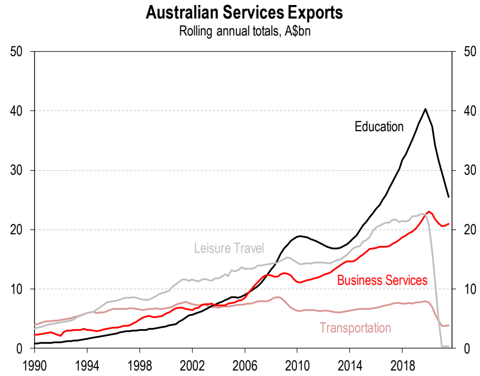
With the border re-opening to students, there is now scope to, once again, ramp up. However, Australia's more challenged relationship with China may be a headwind.

In general, education exports offer a large opportunity for Australia, given their relatively large value-added contribution. The education sector contributes to economic activity, both directly and indirectly. While students are here to study, directly consuming education, they also consume local housing, food, goods and services, further supporting the economy. Services industries also tend to be more labour intensive, and education can provide some relief for a tight labour market through students' part-time employment.

There are at least four opportunities for Australia's education exports: (1) to provide revenue for institutions and the economy; (2) to enhance the learning experience of Australian students; (3) to ensure that Australia has the supply of workforce skills that are needed to continue to power economic growth; and, (4) to strengthen people-to-people connections with other nations and support their development (Department of Education, Skills, and Employment).

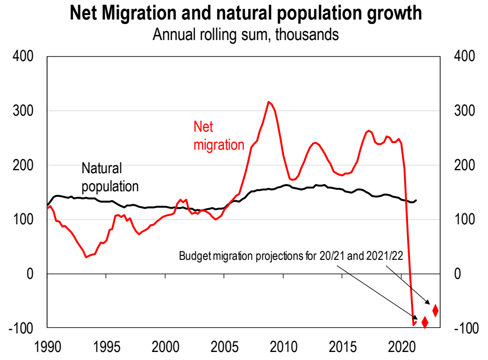
Domestically, education is also key for Australia's human capital development, which, in turn, is key for long-term macroeconomic outcomes. The productivity commission has noted the need for education improvements, such as raising teacher quality and reducing teacher shortages. Australia's relatively poor performance when compared to international counterparts, including declining literacy and numeracy, with students in 2019 an average of one-year worth of education behind those 15 years ago.

39. Reviving services exports is an opportunity for growth …



Source: ABS

40. … and migration is a clear driver, which could support the economy



Source: ABS, Treasury

Migration is a big lever and could be re-targeted

Migration has been a key driver of Australia's economic outcomes, and the closed international border through much of the past two years has provided a timely reminder of this. Immigration has played a significant role in supporting population growth, and has been an increasingly important contributor to Australia's workforce. For example, building Australia's skills through immigration is sometimes quicker and more cost-effective than "making" the skills in Australia, particularly if the feedback mechanisms between domestic education and employers are weak.

Migration has, and will likely continue to be, a big growth driver

Although the quantity of migration is important for an aggregate demand impulse, the composition is equally important for the supply side and Australia's long-term potential. Both these factors could be re-targeted as the international border fully re-opens to better address Australia's long-term growth needs. The number of people, age distribution, specific skills, and type of visa could all be leveraged, with a focus on younger migrants and high-skilled migrants.

Another opportunity is for policymakers to give businesses the tools to hire from the global pool of labour specifically. An example of this would be sponsorship, where – if businesses cannot address their labour needs from Australian sources, and are paying a sufficiently high wage – they can sponsor a migrant for a visa linked to their employment.

One consideration, abstracting from the near term, is the long-term factors, which may affect migration. Global ageing populations, and climate change, are chief among these and factoring them into policymaking would help to mitigate the risk of large migration swings in the future.

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