Bank of Melbourne

Wednesday, 22 July 2020

NSW Economic Outlook

Summary

- **The NSW economy has suffered a major blow from the double whammy of the bushfires and COVID-19. A sharper contraction is due for the second quarter of this year as tight restrictions to prevent the spread of COVID-19 came into effect.**
- **Tourism has been severely impacted as visitors were prevented from travelling to bushfire-affected areas and as COVID-19 hampered international travel from late January, particularly from China. The contraction in State final demand of 1.5% in the March quarter was the largest of all States and territories, and the largest decline since the December quarter 2000.**
- **The loss of international visitors will also have a large negative impact. NSW receives more international visitors than any other State. Nearly 40% of short-term arrivals over 2019 spent most of their time in NSW.**
- **The outlook greatly depends on containment of the virus. A nascent recovery from the middle of this year is now at risk, given a growing cluster of cases related to Sydney's South West. Some restrictions have already been imposed for hospitality services and there is a risk of further lockdown measures being imposed in NSW. It follows the rising number of cases in Victoria and subsequent lockdown measures in parts of the State. The closure of the border between the two States has also limited interstate travel on top of the international travel restrictions.**
- **Post-pandemic, the outlook is fraught with challenges. The NSW unemployment rate has risen to 6.9%, the highest since 1998, although lower than the national rate of 7.4%. Unemployment is likely to stay elevated for some time, and the unemployment rate is likely to rise further, especially if tighter movement restrictions are re-introduced.**
- **The weakness in the housing market is coming off the back of an upswing over the second half of 2019 and in early 2020 where prices rose for 11 months straight. Loan repayment deferrals and extensive government support may have prevented forced selling in the early stages of the pandemic and when job losses were greatest. Dwelling price growth in Sydney began moderating in April and did not begin falling until May. Soft incomes and concerns regarding the outlook amid COVID-19 is weighing on demand. The stalling in overseas migration is also denting underlying housing demand.**

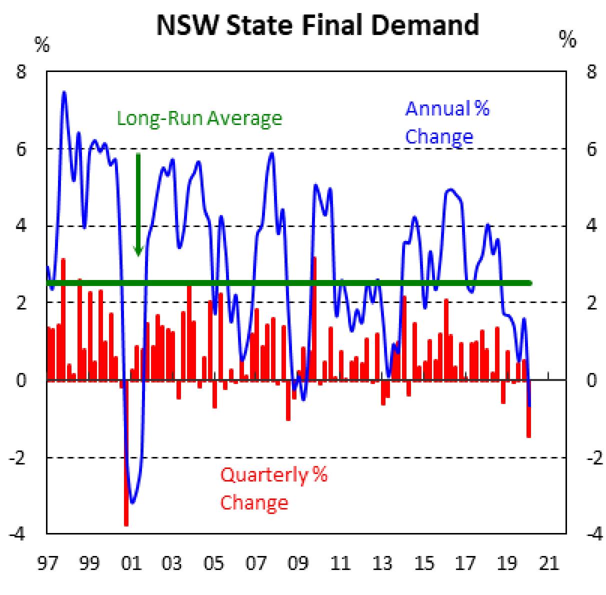
National Economic Outlook

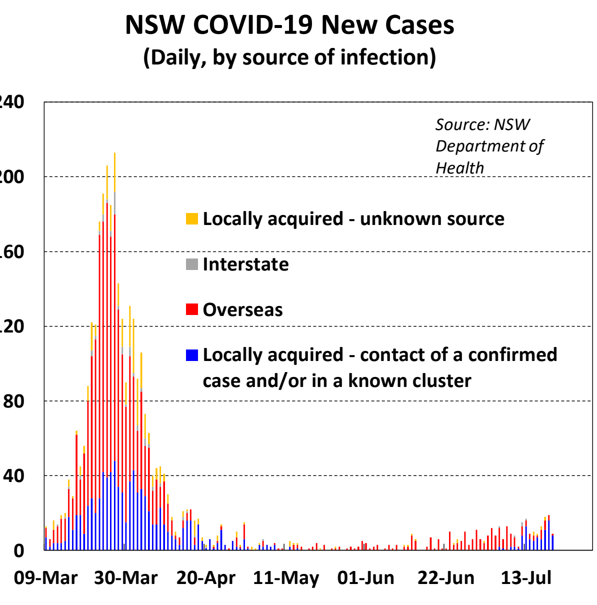
The COVID-19 pandemic has cast a large shadow on the domestic and global economy. A sharp contraction in economic activity is expected this year. It reflects restrictions, including distancing, to prevent the spread of the virus and the impact of caution and uncertainty among consumers and businesses. The loss of tourism and migration flows due to international border restrictions are also key factors hurting economic activity. We expect the Australian economy to contract 4.2% this year with the deepest contraction expected for the June quarter of this year. A recession over the first half of this year is a virtual certainty. Household services have been hit particularly hard, but all industries have been impacted.

Restrictions have been lifted in most of the country, which suggests some recovery in economic activity over the second half of this year. That said, re-imposed restrictions in Melbourne and some regional Victorian towns will put a lid on this recovery. Moreover, rising COVID-19 cases in other parts of Australia, particularly in NSW, suggests that there is an elevated risk that further restrictions could be imposed, and recovery could be delayed.

The lingering threat of COVID-19 will lead to more long-lasting changes in behaviour among consumers and businesses. Even once the virus becomes well contained, social distancing measures will remain in place, limiting the ability for many businesses to return to normal operating conditions. Economic activity is unlikely to recover fully to pre-pandemic levels for some time.

Significant stimulus measures from the Federal government, NSW government and the Reserve Bank (RBA) have helped cushion the impact from the virus and associated restrictions. There is a major concern around some key support measures expiring at the end of September, including JobKeeper, although the Government has announced that the wage subsidy will be extended to 28 March 2021 at a reduced level and with tighter eligibility. Further details on possible further income support measures, including potentially a bringing forward of tax cuts, are scheduled to be announced tomorrow. The Federal Treasurer delivers his economic and fiscal update tomorrow. A key risk to the outlook is if support measures are withdrawn too early when economic activity has not fully recovered and when unemployment is still rising.





NSW State Economic Outlook

The NSW economy has suffered a major blow this year from the double whammy of the bushfires and COVID-19.

Tourism has been severely impacted as visitors were prevented from travelling to bushfire-affected areas and as COVID-19 hampered international travel from late January, particularly from China. The contraction in State final demand of 1.5% in the March quarter was the largest of all States and territories, and the largest decline since the December quarter 2000. A further and larger contraction is expected for the June quarter.

The weakness in demand was driven by the private sector across household spending and business investment, as the restrictions preventing COVID-19 from spreading placed physical limitations on economic activity as well as hitting confidence.

Government spending related to the response to the bushfires and the COVID-19 pandemic provided some support. However, it was not enough to offset the pullback in the private sector.

The outlook greatly depends on containment of the virus. A nascent recovery is now at risk, given a growing cluster of cases linked to Sydney's South West. It highlights the risk of lockdown measures being imposed in NSW, which would depend on whether cases continue to rise. The daily increase in cases is still lower than the peak reached of 206 new cases on 25 March (local transmission accounted for 59 cases), but there remains a risk that new cases will accelerate and there is considerable uncertainty about how the virus will evolve.

A stay-at-home order would result in recovery being delayed further. New restrictions are gradually being implemented and have been placed on limits for bookings at pubs and restaurants. Indoor hospitality venues will be limited to no more than 10 people per group as of Friday July 24, and these restrictions are already in place for pubs and hotels. Pubs are allowed no more than 300 customers. Weddings are limited to 150 people while funerals are limited to 100.

It follows the rising number of cases in Victoria and subsequent lockdown measures in parts of the State. The closure of the border between the two States has also limited interstate travel on top of the international travel restrictions.

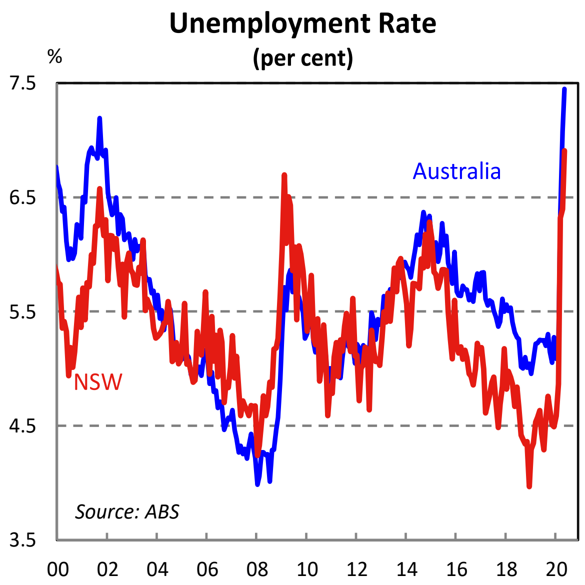
The outlook is fraught with challenges. A significant number of job losses throughout the lockdown period will take time to recover. While a large proportion of the jobs lost between March to May have been regained, the level of employment is still 191k or 4.6% lower than its level in February. The **unemployment rate** lifted from 4.9% in March to 6.9% in June, the highest since September 1998, although lower than the national rate of 7.1%. Unemployment is likely to stay elevated for some time and the unemployment rate is likely to rise further, especially if tighter movement restrictions are re-introduced. There is also a proportion of those employed relying on government assistance and raises the question of the impact from these measures expiring.

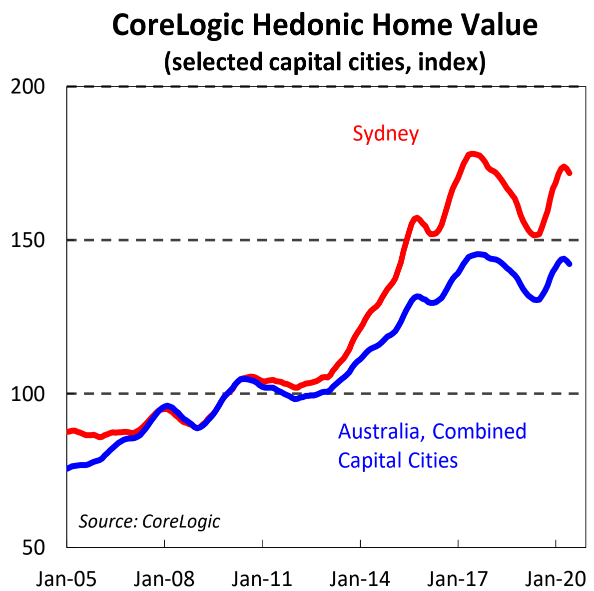
The loss of incomes points to ongoing weakness in **household spending**, which was facing headwinds even before the pandemic began. High household debt burdens combined with weak wages growth meant that household consumption in NSW at the end of 2019 grew near its weakest annual pace in ten years. The pandemic has added another massive headwind to household spending, particularly for services. It led to a sharp fall in household consumption of 1.6% in the March quarter, the largest quarterly fall since 1986, and an even larger fall is expected for the June quarter. While the lifting of lockdown measures suggests some recovery is likely over the second half of this year, social distancing and lost tourism suggests activity is still likely to be much lower than pre-pandemic levels.

NSW will also have a relatively large negative impact from the loss of international visitors, which receives more international visitors than any other State. Nearly 40% of short-term arrivals over 2019 spent most of their time in NSW.

The loss of international tourism has already had flow-on consequences for the housing market. The flood of short-term accommodation to the long-term rental market has likely been a big contributor to the spike in rental vacancies in Sydney, which are currently sitting at close to 4% according to SQM research. Sydney's vacancy rate is higher than any other capital city. Any vacancy rate above 3% suggests that rental market is oversupplied and suggests further downward pressure on rents.

Falling prices suggest that the less favourable rental conditions are translating into weaker demand. Investor demand has been negatively impacted to a greater extent than owner occupiers, as reflected in the relative weakness in lending to this segment. Demand for apartments is also more impacted than demand for stand-alone housing with fears around infections spreading more elevated for apartment living.





The weakness in the housing market is coming off the back of an upswing over the second half of 2019 and in early 2020 where prices rose for 11 months straight. Loan repayment deferrals and extensive government support may have prevented forced selling in the early stages of the pandemic and when job losses were greatest during April. **Dwelling price** growth in Sydney began moderating in April and did not begin falling until May, when they fell 0.4%. However, price declines accelerated further in June, falling another 0.8%, and further price weakness is expected. Soft incomes and concerns regarding the outlook amid COVID-19 is weighing on demand. The stalling in overseas migration has also dented underlying housing demand.

This weakness is expected to extend to **residential construction,** which was only beginning to gain traction prior to the pandemic escalating. Concerns over cladding and building quality weighed on the sector from around the middle of last year. There is the home builders bonus offered by the Federal government which provides a $25,000 grant to build a new home or for substantial renovations which could provide some support. However, there is strict criteria to be eligible for the support. New builds must not exceed $750,000 and for renovations, the existing property must not be worth more than $1.5 million. These requirements suggest that a large proportion of Sydney's property market would be ineligible to receive the grant.

Business investment was also on weak footing earlier in the year. **Capital expenditure** was down 4.6% in the year to the March quarter and was in decline for three consecutive quarters. The uncertainty with regards to the outlook and the reassessment of new business models in a COVID-19 world indicate that investment spending will likely contract further and remain weak for some time.

However, the government sector will be an important pillar of support in this period. There have been extensive measures announced during the pandemic, from both Federal and State governments. The NSW Government has announced waivers for payroll tax, brought forward payroll tax cuts and various industry support. A $3 billion Infrastructure and Job Acceleration Fund has been announced for "smaller shovel-ready projects". A range of infrastructure projects have also been fast-tracked. In April, the State Government announced 24 projects to be fast-tracked including the $4.6 billion Snowy Hydro 2.0, $1.5 billion redevelopment of the Mt. Druitt CBD and a range of smaller projects.

Outlook and Risks

We expect a mild recovery in economic activity to take place after a contracting over the first half of this year, but there is a growing risk that this recovery will be delayed. The outlook depends highly on containing COVID-19 in NSW – the next few weeks will be critical in determining whether testing and contact tracing capabilities are sufficient to stem the spread. Statistics on new cases in NSW will be closely watched, especially cases where the source of the infection is unknown. New cases could determine whether greater movement restrictions would need to be enforced in NSW. If so, the downturn would likely be extended, and the recovery would stall.

Contact Listing

Chief Economist
Besa Deda
dedab@bankofmelbourne.com.au
(02) 8254 3251

Senior Economist
Janu Chan
chanj@bankofmelbourne.com.au
(02) 8253 0898

Economist
Nelson Aston
nelson.aston@bankofmelbourne.com.au
(02) 8254 1316