

Key points

- The economy has been buffered by long-lasting significant events;
- Some of those events have largely ended, some are current, some will be with us for some time;
- These events are having an offsetting impact in how the economy will evolve;
- A key to the economy and interest rate outlook is how far income growth will be above the rate of inflation.

Summary

Australia was less impacted by the GFC than most other developed economies. But a backdrop of a weak global economy and declining structure of world interest rates meant that interest rates in Australia also declined sharply. The negative impact from the GFC has largely passed. This means that one factor that has been holding back the domestic economy and interest rates over recent years is no longer in play.

The end of the mining boom played an important role in an extended period of Australian economic underperformance in the years prior to the pandemic. By 2018 the fallout from the end of the mining boom began to diminish. The terms of trade started to improve and mining capex spending started to increase. State Governments' have ramped up their infrastructure spending.

Pandemics have historically resulted in lower economic growth, inflation and interest rates. The economics have been different in this pandemic. Demand has still been weak. But Governments' and central banks have been able to substantially offset any income declines. Online shopping has enabled the demand for goods to continue. Lockdowns and rising consumer caution have hit the supply of goods and services. The result has been higher inflation and therefore higher interest rates.

Wars almost always lead to higher demand and lower supply. They result in higher inflation (and therefore higher interest rates). Russia and Ukraine's importance as commodity exporters has led to significant rise in commodity prices. By itself this will lead to higher inflation and hurt importing commodity countries (notable Europe, China, Japan and Korea). Commodity exporters (such as Australia) benefit. To me the short-term economic growth impact of the disruption caused by the war is unclear. In the medium term (longer than 1-2 years) demand is likely to be higher due to higher defence spending.

In recent years there has been growing recognition that climate change will have a significant impact on the economy and society. The result has been increasing investment in alternative energy and more spending to mitigate the cost of the climate change that has already happened. From an economic standpoint that means higher demand (greater investment).

Global population growth is both slowing and aging. This means that growth in the global labour force will be slower and will likely lead to slowing growth in demand. An older population also requires more government spending on income support (pensions) and health. An aging and declining population was first called out as a possible issue for Australia about twenty years ago. But the subsequent strong immigration growth meant that Australia experienced a period of strong population growth. And because immigrants were younger than resident Australians it reduced the immediate concern about an aging population. This underlines the importance of a return of strong immigration growth.

High debt levels typically reduce demand. A large amount of debt can be a problem in very low inflation times (particularly if there is deflation). It is less of a problem during periods of rising inflation (and wages growth) as borrowers have greater capacity to repay debts. Crucial is what happens to interest rates relative to wages and profit growth (or more precisely, disposable income growth). The strength of disposable income growth will play an important role in how high interest rates will go in coming years.

Economic impact of the crisis

Since the pandemic started a constant refrain has been that it will be great when things can return to 'normal'. But that begs the question as to what is 'normal'. The economy has been buffered by a number of significant events since the GFC. And will continue to do so over the next decade. These trends have had implications for the strength of the Australian economy as well as the level of domestic interest rates.

The GFC

The causes of the global financial crisis (GFC) are still being debated (and will continue to be so for some time to come). I believe it started as too much lending to the housing market in the US. The entire US financial system was vulnerable as it had too much leverage. Given the importance of the US to the world financial system the shock quickly went global. This created additional problems in Europe given that continent's higher level of government debt and leverage in their banking system.

The result was that banks were less likely to lend (particularly in Europe). Government spending was constrained (again particularly in Europe) reflecting concerns about debt levels. Households and firms became cautious about borrowing and spending. All of this meant that global demand was weaker. The economy was also hit by a decline in supply (due to a lack of financing). The result was that economic growth was substantially weaker and inflation lower. Central banks had to cut rates aggressively to support their economy, as well as providing substantial liquidity to support their financial systems.

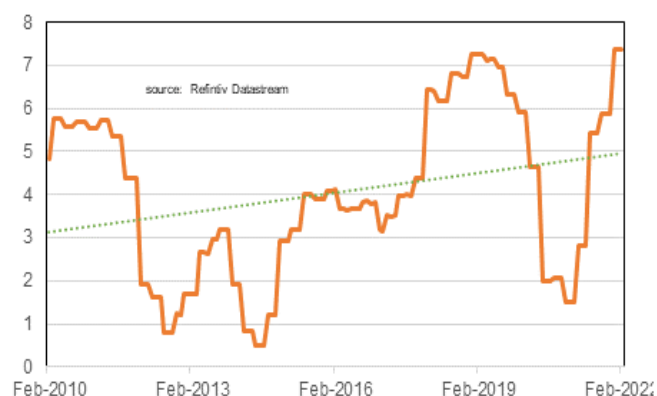
Australia was less impacted by the GFC than most other developed economies. A weaker exchange rate was one reason, another the stronger state of the banking system. Low debt levels meant the Australian Government could spend to support the economy. High commodity prices due to the strength of the Chinese economy was important. And a higher level of interest rates meant that the RBA could use monetary policy aggressively to support the economy.

A backdrop of a weak global economy and declining structure of world interest rates meant that interest rates in Australia also declined sharply. Research has shown that recessions caused by financial crisis last longer than 'garden-variety' recessions. That is because it takes longer for the economy to recover from having overvalued asset prices, too much debt and a troubled financial system. This meant that for much of the previous decade the fallout from the GFC weighed upon economic growth as well as the global level of interest rates.

But the negative impact from the GFC has largely passed. A sure sign is the improving shape of European banks. All Governments (including those in Europe) are now actively using fiscal policy to support their economy. Business and consumer confidence has improved (although they have taken a hit more recently from higher inflation). All this means that one factor that has been holding back the domestic economy and interest rates over recent years is no longer in play.

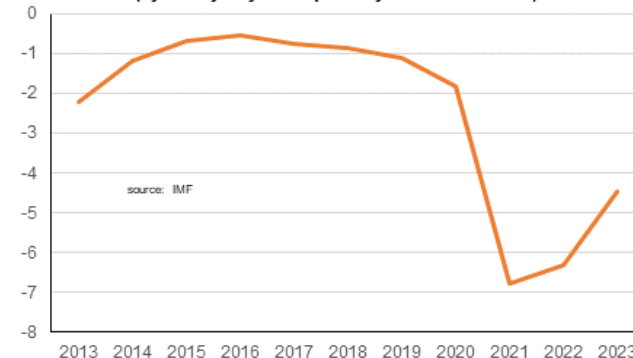
European banks have begun to recover from the fall out of the GFC.

European banks' return on equity



European Governments are aggressively using fiscal policy to support their economy.

Euro Area Fiscal Policy (cyclically-adjusted primary balance % GDP)

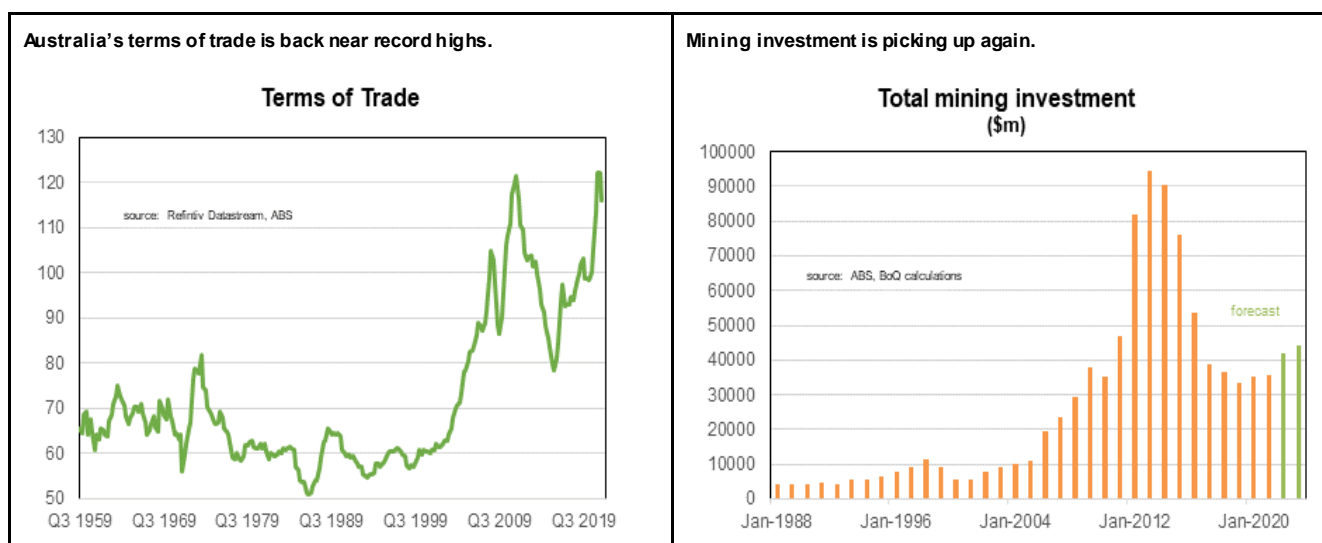


End of the mining boom

One trend that did impact Australia significantly (and other commodity-producing countries such as New Zealand and Canada) was the end of the mining boom (it was the largest in Australia's history). This had two big macroeconomic impacts. The big increase in supply as a result of all the mining investment resulted in a significant fall in the prices of our major mining exports. The result was a substantial slowing in national income growth (slower profit and wages growth). This was compounded by the significant decline of business investment. Finally, the jump in prices and wages that took place over the period of the mining boom left the Australian economy relatively uncompetitive when the mining boom came to an end.

The end of the mining boom played an important role in an extended period of Australian economic underperformance in the years prior to the pandemic. But the period of economic weakness could have been even worse given the size of the mining boom. Partly the Australian economy was cushioned by the big rise in the volume of exports once the mining projects were completed. The Australian economy was also supported by ongoing strong population growth (leading to strong residential and in time infrastructure investment). The backdrop of a global economy still heavily impacted by the GFC meant that interest rates were low as the mining boom ended. A flexible exchange rate meant the \$A could decline significantly to offset the impact of a falling terms of trade (falling commodity prices).

By 2018 the fallout from the end of the mining boom began to diminish. The terms of trade started to improve (partly the result of bad weather impacting iron ore exports in Brazil). This increased miners' profitability and led them to increase their capex spending (particularly on plant and equipment) after an extended period of cost cutting. State Governments' started to ramp up their infrastructure spending. Entering the pandemic another of the trends that had weighed upon the economy and domestic interest rates had largely come to an end.



The COVID Pandemic

Pandemics have historically resulted in lower economic growth, inflation and interest rates. This reflects weaker demand (less people, a rise of consumer caution) partly offset by lower supply (less workers, lower trade between regions). The economics have been different in this pandemic. Demand has still been very weak (evidenced by the big falls in GDP growth). But Governments' and central banks have been able to substantially offset any income declines for most households and businesses. Online shopping has enabled the demand for goods to continue to increase (partly at the expense of lower demand for most services).

Lockdowns have caused a sharp drop in hours worked in the economy and therefore impacted the supply of goods and services (historically all workers would have still have had to have gone to work). The tough quarantining regulations and border closures have occurred in previous pandemics. The difference this time is that the greater prevalence of global supply chains and international people movement meant that the border closures and

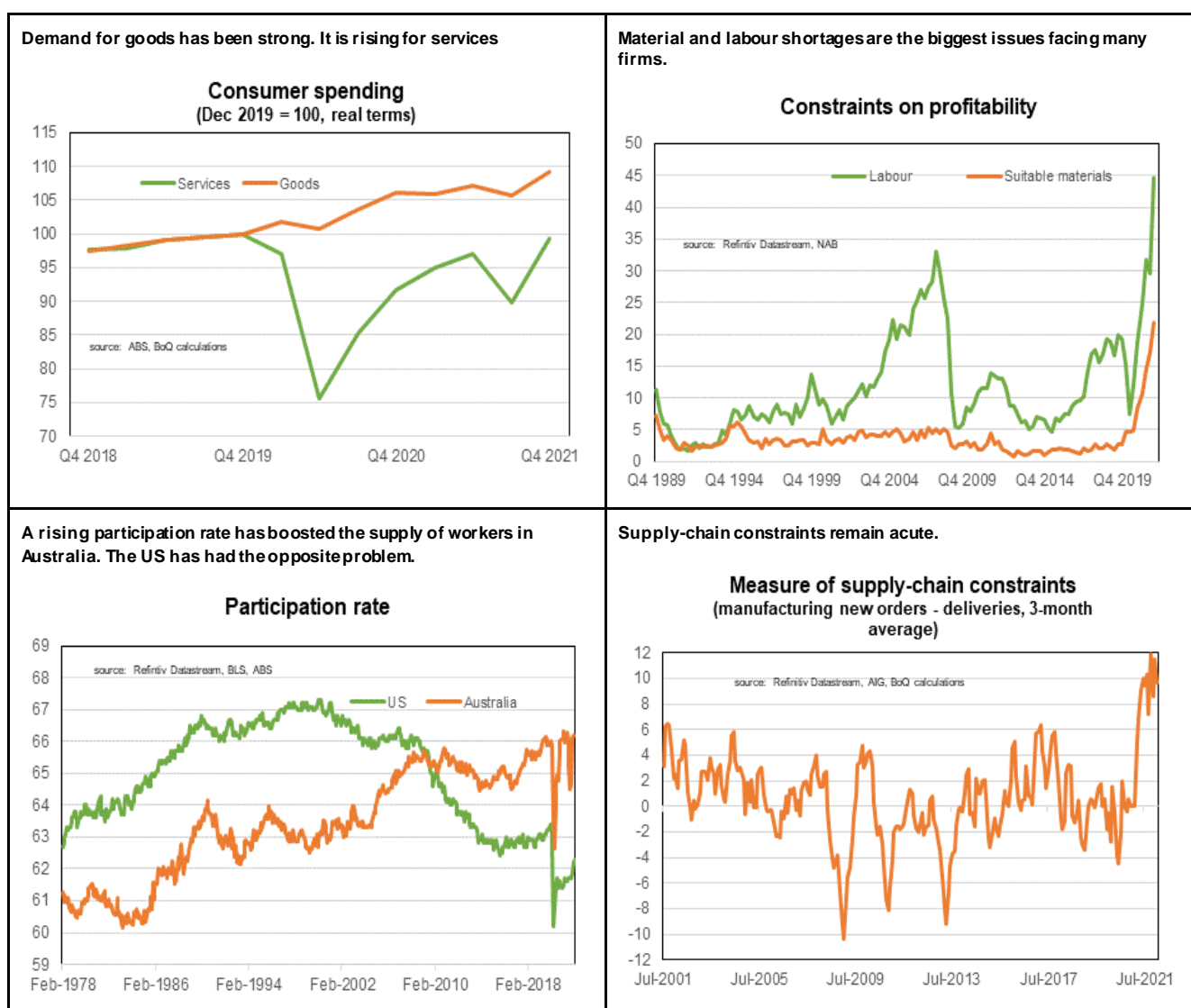
ECONOMIC UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

WEEK ENDING 18TH MARCH 2022

quarantining had a bigger impact. This pandemic has therefore been characterised by strong demand as economies re-open (and for goods during lockdowns) and supply shortages. The result has been higher inflation and therefore higher interest rates.

Typically following pandemics there are less workers and so there is stronger real wages growth (wages growth after inflation). A slowing in growth of labour supply is also happening this time but for different reasons. In some countries (notably the US and the UK) the participation rate has not yet recovered (partly reflecting fear of COVID) to its pre-pandemic level. Immigration growth (the key driver of population growth in most developed economies) has been lower and could remain lower for an extended period (notably for skilled immigration) reflecting ongoing restrictions and tight labour markets in many economies. With the demand for workers high there are good reasons to expect higher wages growth over the next 1-2 years.



War and rising geo-political concerns

Wars almost always lead to higher demand and lower supply. They result in higher inflation (and therefore higher interest rates). Demand rises before and during wars as countries look to strengthen their armed forces. Afterwards there is a massive reconstruction. Supply declines due to the destruction caused by the war as well as the disruption to trade.

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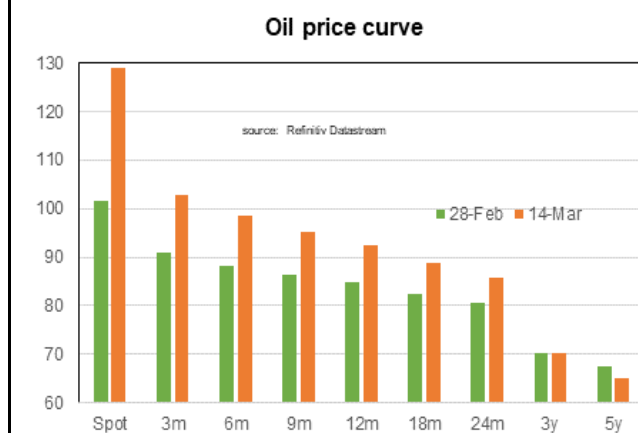
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WEEK ENDING 18TH MARCH 2022

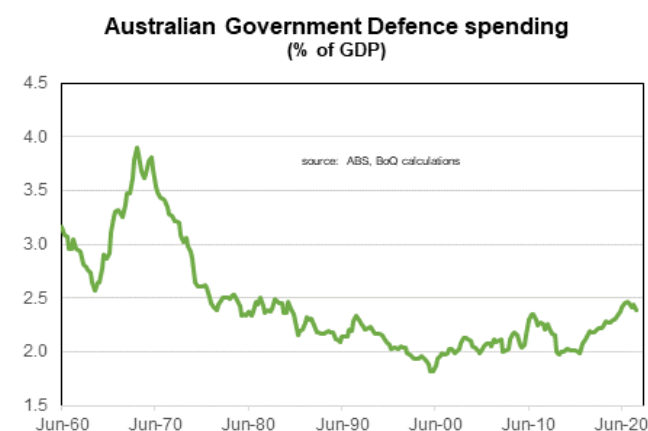
We will not understand the full impact of the Russia-Ukraine crisis for some time. Even if there is a relatively quick resolution to the conflict we don't know how long the sanctions will last. Unless there is an escalation outside of Ukraine the crisis is likely to have less of an impact than some of the other wars in the previous century (such as Vietnam or Korea) reflecting the relatively smaller weight of Russia and Ukraine in the global economy. But Russia and Ukraine's importance as commodity exporters has led to significant rise in commodity prices. By itself this will lead to higher inflation and hurt importing commodity countries (notable Europe, China, Japan and Korea). Countries that export those commodities (such as Australia) benefit.

The initial net impact on global growth is likely to be lower (commodity exporting countries such as Australia are likely to save some of their extra income). But governments from importing countries have the option to use fiscal policy to at least partially offset these price rises (they are look to do this in Europe). There will be more Government spending on defence as well as securing supply chains for goods deemed 'essential'. In the medium term (longer than 1-2 years) demand is likely to be higher due to higher defence spending. At the same time the likelihood of a less globalized world means supply could be lower or at least more expensive. The end result is higher inflation and higher interest rates.

Oil prices are very high in the short term but are expected to decline significantly over the next 2-3 years.



Global defence spending is on the rise.



Climate Change

In recent years there has been growing recognition that climate change will have a significant impact on the economy and society. The result has been increasing investment in alternative energy (solar, wind), as well as towards products that don't use fossil fuels (electric cars). There is also more spending to mitigate the cost of the climate change that has already happened. That increased spending is either preventative (making office buildings more energy efficient) or reactive (reconstruction after floods and bushfires).

From an economic standpoint that means higher demand (greater investment). Supply in the economy from the spending may be unchanged as the new 'clean' energy replaces what is currently driven by fossil fuels. The hope in time is that the new energy will allow the economy to be cleaner and more efficient (including improved reliability). As the transition takes place there will be a strong demand for labour to undertake the new investment although this will be offset by lower demand for sectors associated with fossil fuels (eg, coal mining). The current strength of the labour market makes it easier for workers from impacted sectors to find alternative employment.

The impact of the rise in demand is during the transition phase (rather like an extended period of mining investment). During that period the supply is unchanged. The result could be higher prices although technology is reducing the transition cost (lower prices for electric cars and solar roof panels). To the extent there is a tax on carbon it would initially result in higher prices although it would also incentivise the movement towards cleaner energy. The current high oil, gas and coal prices if sustained will have a similar impact.

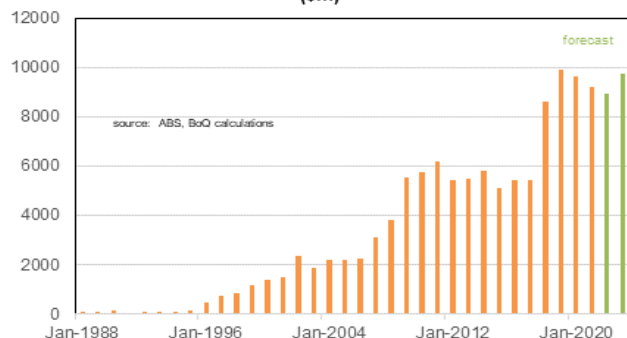
ECONOMIC UPDATE

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WEEK ENDING 18TH MARCH 2022

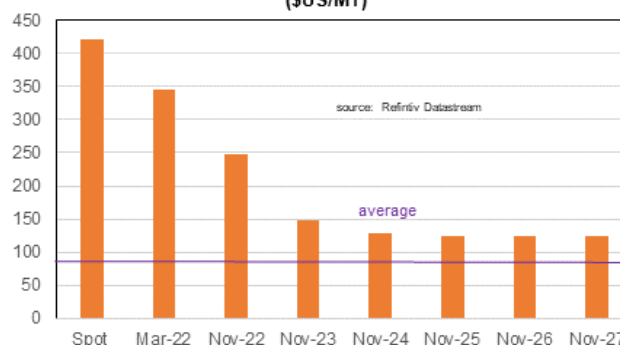
Investment in the utility sector has been rising over recent years.

Total investment by Utilities Sector (\$m)



Coal prices are high now, and are expected to remain above its historical average for some time to come.

Newcastle Coal (\$US/MT)



Aging and declining population

Global population growth is both slowing and it is aging. This means that growth in the global labour force will be slower and will likely to lead to slowing growth in demand. An older population also requires more government spending on income support (pensions) and health.

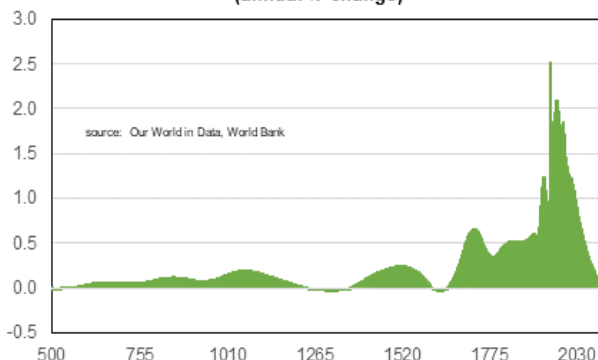
An aging and declining population is a significant issue for a number of Northern Asian (China, Japan and Korea) and European countries (much of continental Europe). It was first called out as a possible issue for Australia about twenty years ago when Treasury first started publishing the Intergenerational Reports. But the subsequent strong immigration growth meant that Australia experienced a period of strong population growth. And because immigrants were younger than resident Australians it also reduced the immediate concern about an aging population.

This underlines the importance of a return of strong immigration growth. The Centre for Population is currently forecasting that immigration growth will pick up substantially next financial year and almost be back to pre-COVID levels by the following financial year. But there are risks that forecast may not be met. Most countries still have some COVID regulations and they differ between countries. The experience of the pandemic could for a period reduce the desire for some to move to different countries. Very low unemployment rates in most developed countries means there is less economic incentive to move to Australia.

Slower population growth is likely to mean weaker demand growth and therefore lower inflation. Both factors point to lower interest rates (although an older population could also result in lower rates of saving).

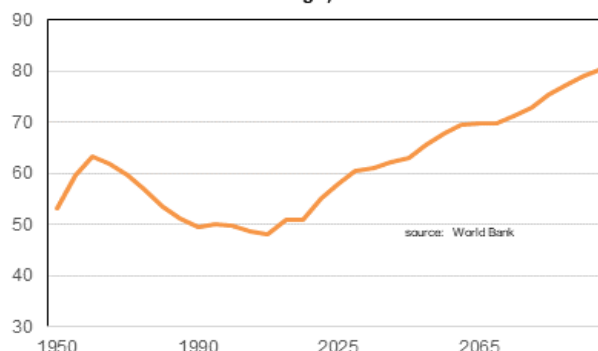
Global population growth is slowing dramatically.

World population growth (annual % change)



And the domestic population is aging.

Australian dependency ratio (% less than 15 and greater 65/population working age)



Rising debt

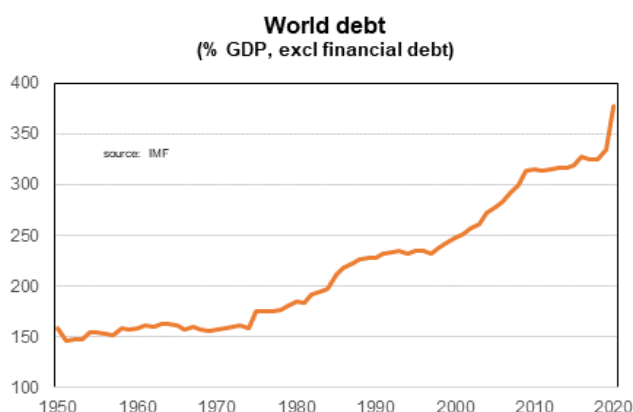
High debt levels typically reduce demand. High debt can be thought of past borrowing that bought demand forward from the future. High debt levels can also make consumers and firms cautious about borrowing in the future. It can also make banks cautious about lending.

High debt may not always be bad. It depends upon what the borrowing has been used for. Higher debt that is used for investment to boost productivity creates a greater capacity to repay debt. That has been less the case in Australia over recent years where a fair portion of the rise in debt has been for households to buy houses. There has also been a rise in government debt, a large chunk of which has gone to fund a big rise in recurrent spending (although there has also been a big jump in infrastructure investment in more recent years).

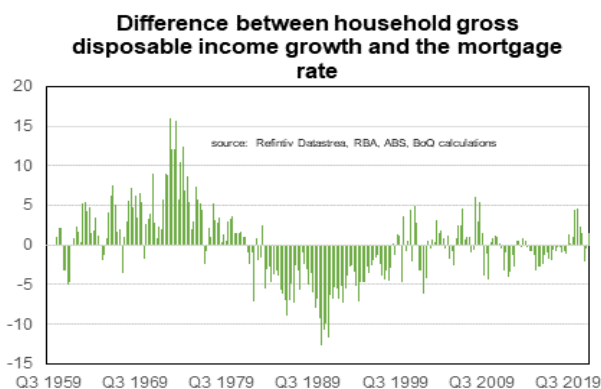
High debt in nominal terms (ie, the actual value of the debt) can be a problem in very low inflation times (particularly if there is deflation). It is less of a problem during periods of rising inflation (and wages growth) as borrowers have greater capacity to repay debts. Crucial is what happens to interest rates relative to wages and profit growth (or more precisely, disposable income growth).

Currently rising interest rates could start to hit low-income earners relatively quickly with real wages growth negative. But real disposable income growth will improve over the next couple of years. While the CPI will likely rise over the next 6-9 months it should decline thereafter (how quick and to what level are the crucial questions). Wages growth will rise. The Government will provide some additional income support (particularly for low-income earners) to help with the rise in the cost of living. The strength of disposable income growth will play an important role in how high interest rates will go in coming years.

The pandemic has seen another jump in global debt.



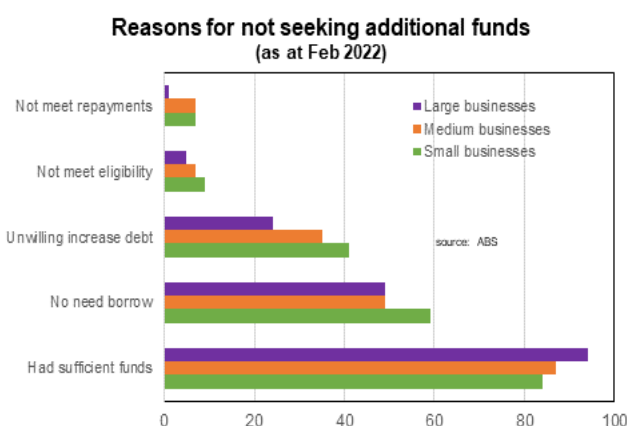
Disposable income growth in Australia has slowed over recent months.



Households remain keen to pay off debt.



A sizeable proportion of firms (notably SME's) are reluctant to increase their debt.



ECONOMIC UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

WEEK ENDING 18TH MARCH 2022



The economy evolves over time for many reasons. Some are short term factors (such as bushfires and floods). Some are due to government or central bank decisions (higher government spending, lower interest rates). But there are also factors that impact the economy for years (or in some cases decades). Some of those factors (an aging population, high debt) suggest the economic growth will be slower in the future, with inflation being high for only a short period of time and only modest rises of interest rates. Other factors (the impact of the pandemic, heightened geo-political tensions, climate spending) are more suggestive of sustained stronger demand and the possibility of a longer period of higher inflation and a higher level of interest rates.

I think the risks are biased towards the higher cash rate. The key will be whether income growth is able to sustainably be above the inflation rate.

We live in interesting times.

Regards

Peter Munckton
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Bank of Queensland