ECONOMIC UPDATE

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WEEK ENDING 18TH JUNE 2021

Summary

- The rate of vaccination in Australia is starting to pick-up;
- Stronger rates will be necessary to allow for the economy to re-open;
- COVID has changed the supply-demand dynamics in the economy;
- The key question is whether these changes are short- or long-term;
- Global central banks have been bringing forward the timing of the rate rises.

The pace of vaccination in Australia has lagged many peer countries. But it has picked up. There is no doubt the recent news out of Melbourne has played a role. Greater availability of vaccines has also been helpful. As has the expansion in the number of people eligible to be vaccinated. The news that Astra Zeneca is not recommended for 50-60 year olds though may slow down things.

The aim is to vaccinate a large enough proportion of the population to achieve 'herd immunity', although there is no certainty on how large that is. Surveys indicate that around 65-70% of the population are happy to be vaccinated, with about 10-15% not. The key policy issue is to maximize immunization rates amongst the remainder of the population. On this question the international evidence has been mixed. A variety of strategies may be necessary to boost vaccination rates.

Getting a large proportion of the population vaccinated is an important step in opening international borders. The recent Federal Budget assumed that international borders will not be fully open until mid-2022. And a return to pre-COVID immigration rates are assumed not to take place until mid-2024. Around three-quarters of respondents to a recent survey thought that timing was about right or was too optimistic. But even then it is not clear how long it will take for the Australian population to feel comfortable about having widespread international people movement even when (if) most people are vaccinated.

One outcome of COVID is that it has changed patterns of demand and supply in the economy. The result has been higher prices. Firms' believe now has been the easiest time to raise prices in over a decade. Consumers have also started to notice higher prices.

The key questions though is how long will the increase in demand and limitation to supply occur? Already in Australia (as well as the US, Europe and China) there are signs that as economies re-open a higher proportion of spending is going on services (such as going to a restaurant).

Unsurprisingly, all central banks agree that the rise of inflation will prove temporary. After all if they did not they would need to begin to increase interest rates shortly. Financial markets are also of that view. And there are sound economic reasons to believe that the supply-demand dynamics will be short term. But there must be some risk that the increase of inflation will prove to be longer.

Central banks have started to recognize that the stronger demand conditions may require interest rates to rise earlier than they had previously expected. The central banks of New Zealand and Canada are talking about increasing interest rates next year. Some on the Federal Reserve Board are thinking the same. The RBA has so far kept to its view that it is unlikely to be raising interest rates until 2024. Financial Markets are not so sure and have hikes pencilled in for 2023.

COVID remains the key near-term economic risk

The news from the most recent Melbourne COVID outbreak has generally been good. There has been only a small number of new cases over the past week. The cases that have been discovered have been linked. This has allowed Melbourne to (slowly) open up again. Time will tell how concerning the most recent case in Sydney has been. But the evidence to date has been that NSW has dealt with any COVID outbreaks well.

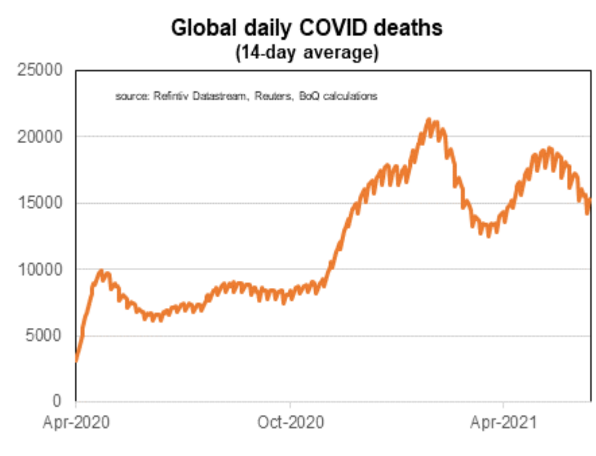
From a broader perspective Australia has become increasingly efficient in how it is dealing with COVID. Last year the easing of restrictions by state governments following outbreaks would have been slower. But we now know more about the disease. Governments' have become more comfortable with their tracking, tracing and testing capabilities. Much of the population continues to 'do the right thing'.

The discussion as to when international borders may open continues. The Federal (and state) Government(s) understandably remain cautious. While there has been a decline in the trend over the past month, the global death rate is higher than it was for much of last year. Some countries that had dealt with the crisis well (such as Malaysia) have had a tougher time over recent weeks.

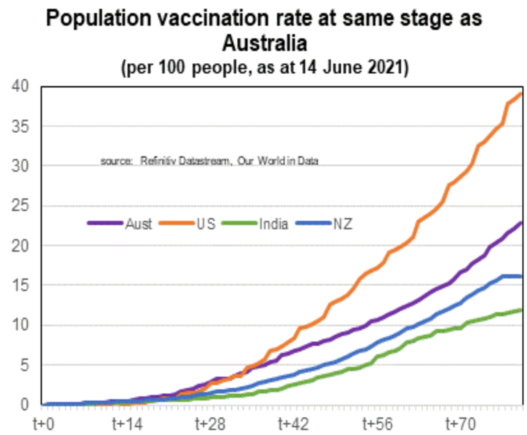
As is recognized the key to ending the COVID crisis is widespread vaccination. The pace of vaccination in Australia has lagged many peer countries. But of course many of those countries have suffered more from the crisis and so have a greater incentive to take the vaccine. Vaccination rates in other countries that have handled the crisis well (such as New Zealand) have also been low. For much of this year the global rollout of the vaccine was at a pace that widespread immunisation would not occur until mid-2024. But the news over recent weeks is that the supply of vaccine globally will be increased. So there is the potential for full immunisation to occur earlier.

The pace of vaccination has also picked up in Australia. There is no doubt the recent news out of Melbourne has played a role. Greater availability of vaccines has also been helpful. As has the expansion in the number of people eligible to be vaccinated. The news that Astra Zeneca is not recommended for 50-60 year olds may slow down things.

Global death rates are declining but they remain high.



Vaccination rates in Australia are rising, although the pace remains below in the US.



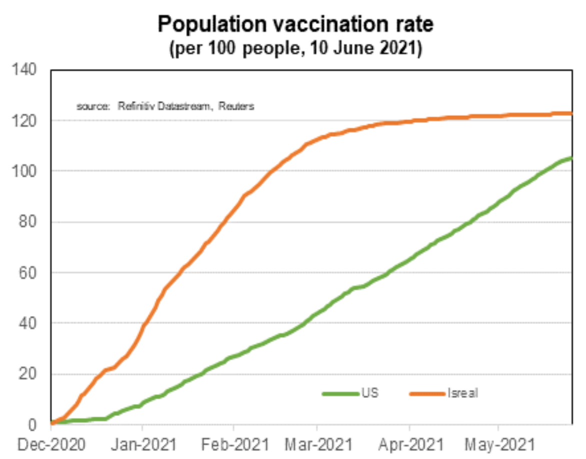
The aim is to vaccinate a large enough proportion of the population to achieve 'herd immunity', although there is no certainty on how large that is. For polio 80% of the population needed to be immunised. For measles it is 95%. Given it is a new virus, it is not clear what the rate should be for COVID. It is also not clear whether ongoing 'booster' shots will be necessary to maintain immunity.

Surveys indicate that around 65-70% of the population are happy to be vaccinated, with about 10-15% not. The key policy issue is to maximize immunization rates amongst the remainder of the population. On this question the international evidence has been mixed. By mid-April 120 out of 100 people in Israel had at least one shot of a vaccine (remembering you need two shots to be immunized). That proportion has hardly changed since then. There are signs that the rollout of the vaccine is slowing in the US (although that may a natural slowing as a higher proportion of the population had their 'shot').

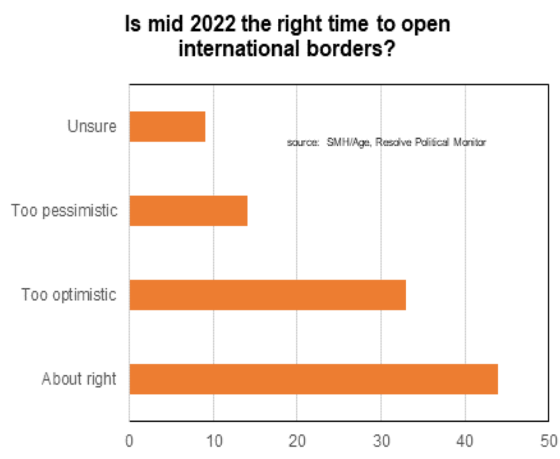
A variety of strategies may be necessary to boost vaccination rates. Making sure we get adequate supply of non-Astra Zeneca vaccines will be critical. Improved education about the vaccines is important. Governments' have been increasing the number of sites where vaccine shots are available. The number of venues may need to be increased further to make it even easier for people to become vaccinated. More use of email or SMS (or social media) could be done. Incentive structures have been used overseas (such as freedom of travel for those with a vaccine 'passport').

Getting a large proportion of the population vaccinated is an important step in opening international borders. The recent Federal Budget assumed that international borders will not be fully open until mid-2022. And a return to pre-COVID immigration rates are assumed not to take place until mid-2024. Around three-quarters of respondents to a recent survey thought that timing was about right or was too optimistic. But even then it is not clear how long it will take for the Australian population to feel comfortable about having widespread international people movement even when (if) most people are vaccinated.

Vaccination rates have slowed sharply in Israel in recent months.



Only a small proportion of people would like international borders opened up within the next year.



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It's all about supply and demand

One outcome of COVID is that it has changed patterns of demand and supply in the economy. Strong government income support (particularly in Australia) has meant that demand has been a lot stronger than anyone had forecast. Restrictions on people movement has meant that more of this spending has been on goods (tv sets, cars) than on services (travel, going to the footy). The stronger than expected demand also meant that many firms ran down their inventories to very low levels (notably manufacturer's and retailors).

COVID also impacted supply-chains. In other countries workers have been sick, or have left the labour force to look after their family. Closure of borders has limited the ability of firms' to find new workers. High demand and logistical problems has led to rocketing transport costs. The Baltic Dry Index (a measure of shipping freight costs) has increased sharply over recent months (albeit is well below the levels seen during the peak of the mining boom).

The result of substantially stronger demand and limited supply has been higher prices. Firms' believe now has been the easiest time to raise prices in over a decade. Consumers have also started to notice higher prices.

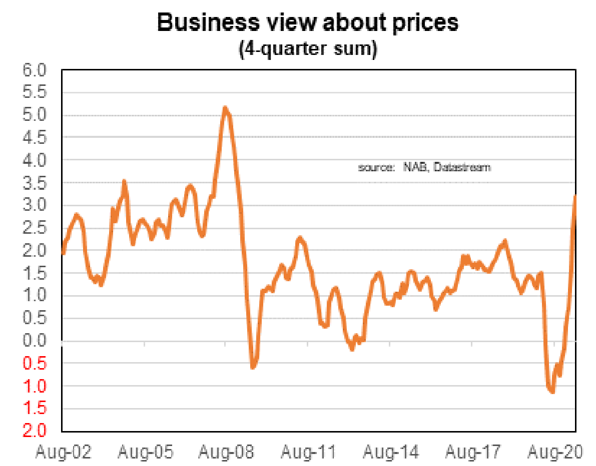
The key questions though is how long will the increase in demand and limitation to supply occur? Already in Australia (as well as the US, Europe and China) there are signs that as economies re-open a higher proportion of spending is going on services (such as going to a restaurant).

Unsurprisingly, all central banks agree that the rise of inflation will prove temporary. After all if they did not they would need to begin to increase interest rates shortly. And there are sound economic reasons to believe that the supply-demand dynamics will be short term. As the economy re-opens it will be easier for firms to find workers to meet the increase in demand. At some point firms will be happy with a higher level of inventories. Financial Markets expect a significant rise of inflation in the US over the next year but a notably lower inflation rate the year after.

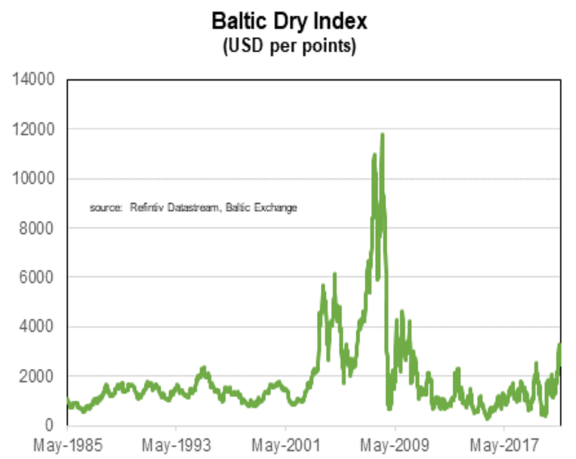
But there must be some risk that the increase of inflation will prove to be longer. The supply chain shortages may take longer to solve. For example, the estimate to eliminate chip shortages that have reduced car production have been estimated to take anywhere from 1-2 years. Australian Governments are still providing strong fiscal policy support. The longer the international border is closed the harder it will be for firms to find employees.

Central banks have started to recognize that the stronger demand conditions may require interest rates to rise earlier than they had previously expected. The central banks of New Zealand and Canada are talking about increasing interest rates next year. Some on the Federal Reserve Board are thinking the same. The RBA has so far kept to its view that it is unlikely to be raising interest rates until 2024. Financial Markets are not so sure and have hikes pencilled in for 2023.

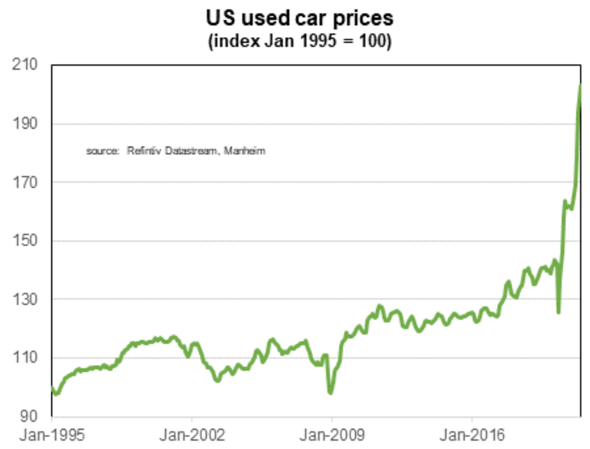
Firms say that they have been able to raise prices.



Shipping costs have increased.



And so have used car prices overseas.



Financial markets are expecting the rise of inflation will prove temporary.

Implications

More generally, the longer that prices stay high the longer that firms and consumer expect they will remain high. To date the so-called 'inflation expectations' has risen back to levels consistent with the RBA's 2-3% inflation target. But the longer the supply-demand imbalances remain the more likely that prices could head higher and stay higher. Which would lead to higher interest rates.

We live in interesting times.

Regards,

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