

## Key points

- The economic outlook is good for the next 12-18 months;
- The combination of a strong economy and higher inflation will require higher interest rates, starting with a 15bp increase in June;
- There are risks surrounding the outlook;
- The biggest is whether rising interest rates leads to a too drastic slowing of economic growth.

## Summary

The combination of Russia and Ukraine are important exporters of a number of commodity products. Even in an optimistic scenario it will take some time before full Russian and (particularly) Ukrainian supply is restored. The significant jump that has already taken place in commodity prices unless unwound quickly can be expected to make a notable dent in global economic growth this year.

The big concern before the war was that the Russians would stop all energy exports to Europe. That has not yet happened although the threat has again recently made the headlines. Economic modelling by the OECD indicates that when combined with the hit to growth from the rise in commodity prices the stop in energy imports would substantially slow European economic growth this year. The impact on the wider global economy (including Australia) of a stop in gas exports would be less. But given its size a substantial weakening of the European economy would take a notable chunk out of global economic growth.

After dominating the headlines for the past couple of years, COVID has dropped down the rank of domestic news importance. This is a sign that society is getting more comfortable about living with the virus. It is possible that a steep rise in hospitalisation rates could lead to another tightening of government restrictions. But unless a new substantially more dangerous variant appears lockdowns are likely to be a thing of the past.

Most of the world has moved on from the zero COVID strategy. But some countries have not, most importantly China. From a global standpoint, the ongoing COVID struggles in China has a couple of implications. First, as one of the world's largest economies it has the potential to notably slow global economic growth. Commodity exporters (such as Australia) would be particularly hit. Ironically there is a silver lining in that lower Chinese demand might help reduce commodity prices and therefore inflation. Second, as a key participant in many global supply chains ongoing COVID-issues in China will continue to crimp supply. The end result of sustained Chinese struggles with COVID is that the global economy will be weaker, although the impact upon inflation might be more ambiguous.

Combined with strong demand, global supply problems have led to a jump in inflation. To date the economic impact of higher inflation has been minimal. Consumers are still spending and firms are still investing and employing. But higher inflation acts as a tax on incomes. A rising proportion of firms (particularly smaller companies) are starting to find it difficult to meet their financial commitments.

Current financial market pricing indicates that inflation is going to remain above the RBA's 2-3% inflation target for the next year before declining towards the top end of the inflation band. Partly that moderation of inflation would reflect the view that the supply-chain problems will ease over the next year. But a significant factor is the pricing of a substantial increase in the cash rate in Australia (as well as the US, Canada and New Zealand) by financial markets over the next couple of years. The increase in the cash rate expected by financial markets is aggressive. The clear risk is that interest rate increase move too high, too fast.

## **Economic impact of the crisis**

It is increasingly clear that the RBA will be hiking rates in the not too distant future, almost certainly beginning in June. And so they should. With an inflation rate that will be in the '4s' and unemployment rate in the '3s', the cash rate shouldn't be 0.1%.

For some time the RBA's strong preference was to wait for actual evidence that wages growth was north of 3%. They wanted to do this to make sure that the CPI would sustainably be above 2% following a run of years where inflation was below their target band. But the evidence is very clear that the temporary events that were keeping inflation high are proving to be lasting longer than anticipated. This is leading to rising expectations about future inflation from households and businesses. At the same time economic growth has been stronger than analysts had predicted.

This last point is important. While there has been plenty of analysis about the problems caused by supply chains and worker shortages, less remarked upon has been the ongoing strength of the Australian (and global) economy(s). The domestic economy ended last year performing very well. It has started this year on the same high note despite the Omicron wave(s) and rising inflation.

There are good reasons to expect this economic strength to continue for the next 12-18 months. The unemployment rate will be near 50-year lows. Wages growth will rise. Builders' order books are full for the next 1-2 years. State Governments are having to slow down infrastructure projects given the problems about accessing workers and materials. Exporters are doing very well. But there are also clearly identifiable risks that could mean the economic could be playing a different tune.

### **Risk 1: The War stops all Russian energy exports to Europe**

The combination of Russia and Ukraine is only a small part of the global economy. But they are important exporters of a number of commodity products (notably energy and food). They are also important players in particular niche manufacturing categories. For example, Ukraine is an important supplier of wiring harnesses (used in car manufacturing) as well as the world's largest exporter of neon (a gas used in lasers that installs circuits onto computer chips).

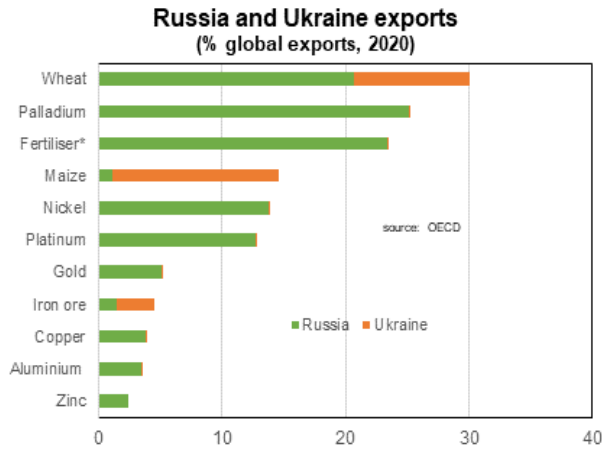
The War has created two problems. Most obviously it has directly reduced supply from Ukraine as factories get damaged, ports are closed and Ukrainian farmers leave to fight the war. But the economic and financial sanctions has severely limited Russian commodity supply hitting world markets. The response has been a sizeable jump in many commodity prices.

We cannot be certain as to when the war or sanctions will end. Even in an optimistic scenario it will take some time before full Russian and (particularly) Ukrainian supply is restored. The decline in the oil price from its peak in early March suggests that for now financial markets are getting more comfortable about the implications of the conflict. Nonetheless, the significant jump that has already taken place in commodity prices unless unwound quickly can be expected to make a notable dent in global economic growth. Importers of commodity prices (notably Europe and Japan) will be harder hit than commodity exporters (such as Australia).

But the big concern before the war was that the Russians would stop all energy exports to Europe. That has not yet happened although the threat of that possibility has made headlines. Economic modelling by the OECD indicates that when combined with the hit to growth already from rise in commodity prices, the stop in energy imports would substantially slow European economic growth this year.

The impact on the wider global economy (including Australia) of a stop in gas exports would be less than the impact upon Europe. But given its size a substantial weakening of the European economy would take a notable chunk out of global economic growth. It is in no-ones interest for Russian energy exports to stop. The Russians need the money, the Europeans need the energy and the rest of the world prefers lower commodity prices. That is why I place a low probability on this scenario occurring. But not every decision taken during a war is based upon logic.

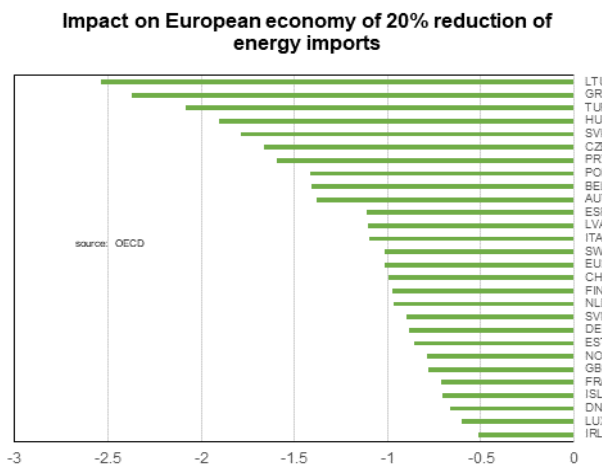
Russia and Ukraine are large exporters in some commodity markets.



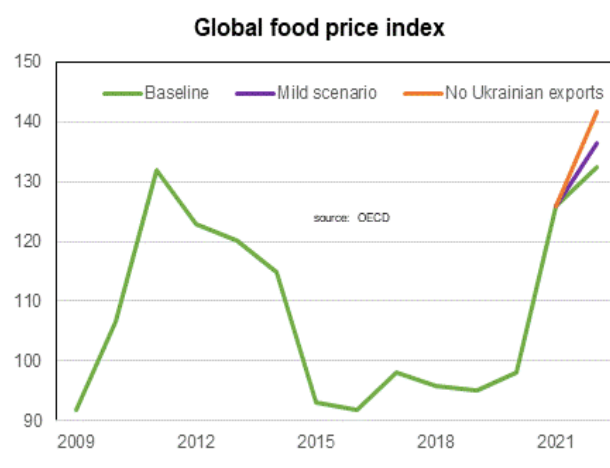
The commodity price rises that have taken place if maintained will slow the global economy.



A sharp reduction in energy Russian exports would have a further marked impact on the European economy.



Food prices are high, with the possibility that they could head higher.



## Risk 2: Rolling Chinese shutdowns because of COVID

After dominating the headlines for the past couple of years, COVID has dropped down the rank of domestic news importance. This is despite another rise in case numbers. This is a sign that society is getting more comfortable about living with the virus. It is possible that a steep rise in hospitalisation rates could lead to another tightening of government restrictions. But unless a new substantially more dangerous variant appears lockdowns are likely to be a thing of the past. And regulations were not notably tightened when Omicron first appeared despite hospitalisations being significantly above current levels.

Most of the world has moved on from the zero COVID strategy that Australia followed for fair chunks of the past two years. But some countries have not. These include Tonga, North Korea, Taiwan and (most importantly) China. China is the world's largest importer of commodities and the largest exporter of manufactured goods. On some measures it is already the largest economy in the world. So Chinese Government decisions to shut down parts of its economy (as it has recently done to Shanghai) to fight COVID can have big implications for the global economy.

It is understandable why the Chinese Government is taking a cautious approach. It has a relatively old population. Its vaccines provide less protection than the ones available in Australia, and a low proportion of its older population have been vaccinated. Its health system is not as developed as in many OECD countries. It has large cities that are densely populated. A significant COVID wave could have significant health implications.

# ECONOMIC UPDATE

PETER MUNCKTON – CHIEF ECONOMIST  
WEEK ENDING 15<sup>TH</sup> APRIL 2022

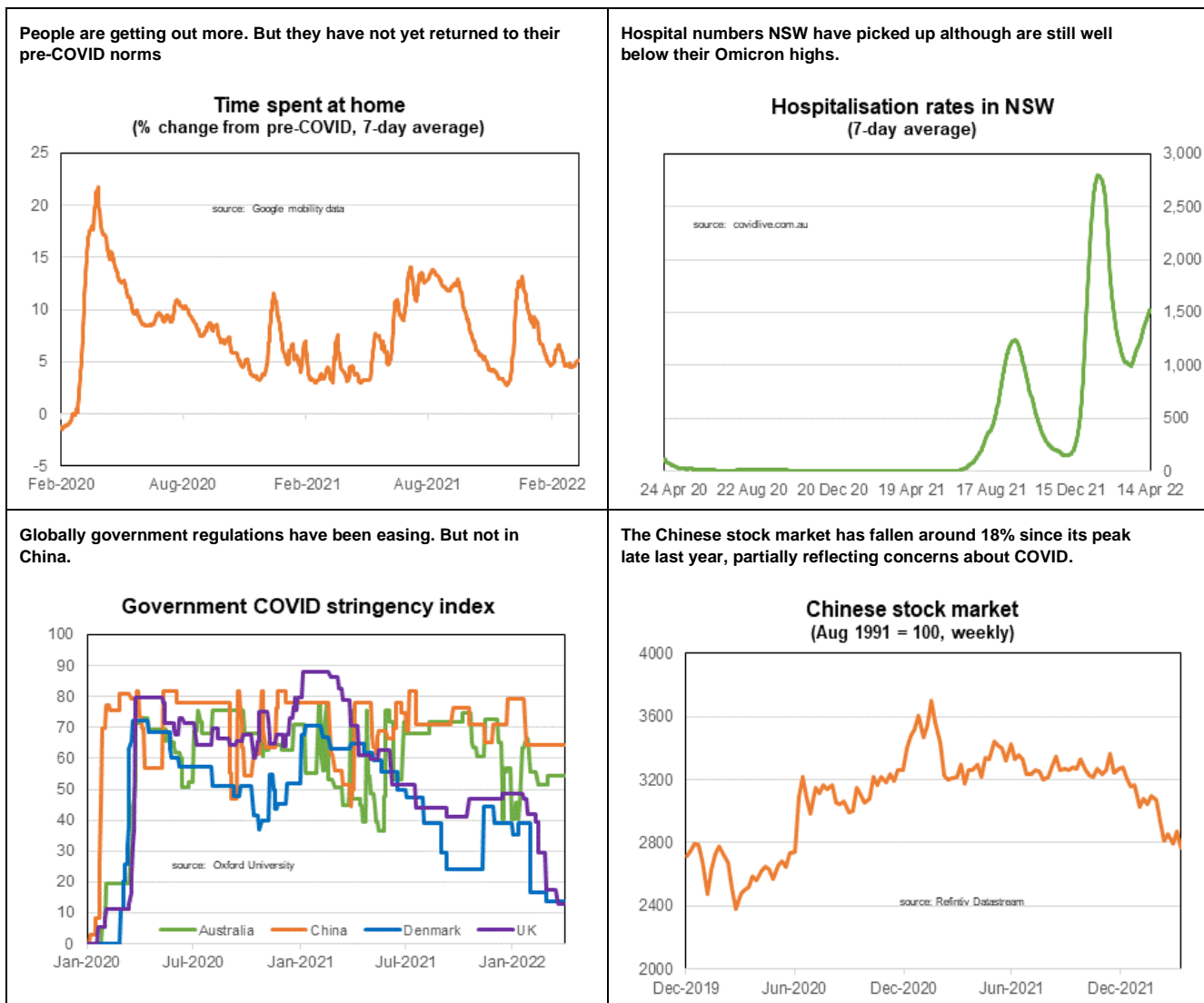


The Chinese Government face a difficult decision. We know that lockdowns substantially hit economic growth. But so does letting the virus run rampant (it drastically reduces consumer and business confidence and their desire to spend).

Presumably the Chinese Government game plan is to try and keep the virus out until they have developed more effective vaccines (they seem reluctant to rely on imported ones). Up to now they have had a good track record in minimising any outbreaks and quickly quashing those that have appeared. But the increasing contagiousness of COVID is making that strategy more difficult to achieve.

Already analysts are marking down their views on Chinese economic growth reflecting the impact of the virus. There is a decent chance of further forecast mark-downs. The Government could support the economy by providing substantial income support in the same way that many OECD countries have done. But the relatively under developed nature of the Chinese welfare system means such programs may not be as effective.

From a global standpoint, the ongoing COVID struggles in China has a couple of implications. First, as one of the world's largest economies it has the potential to notably slow global economic growth. Commodity exporters (such as Australia) would be particularly hard hit. Ironically there is also a silver lining. Lower Chinese demand might help reduce commodity prices and therefore inflation. Second, as a key participant in many global supply chains ongoing COVID-issues in China will continue to crimp supply. The end result of sustained Chinese struggles with COVID is that the global economy will be weaker, with the impact upon inflation more ambiguous.



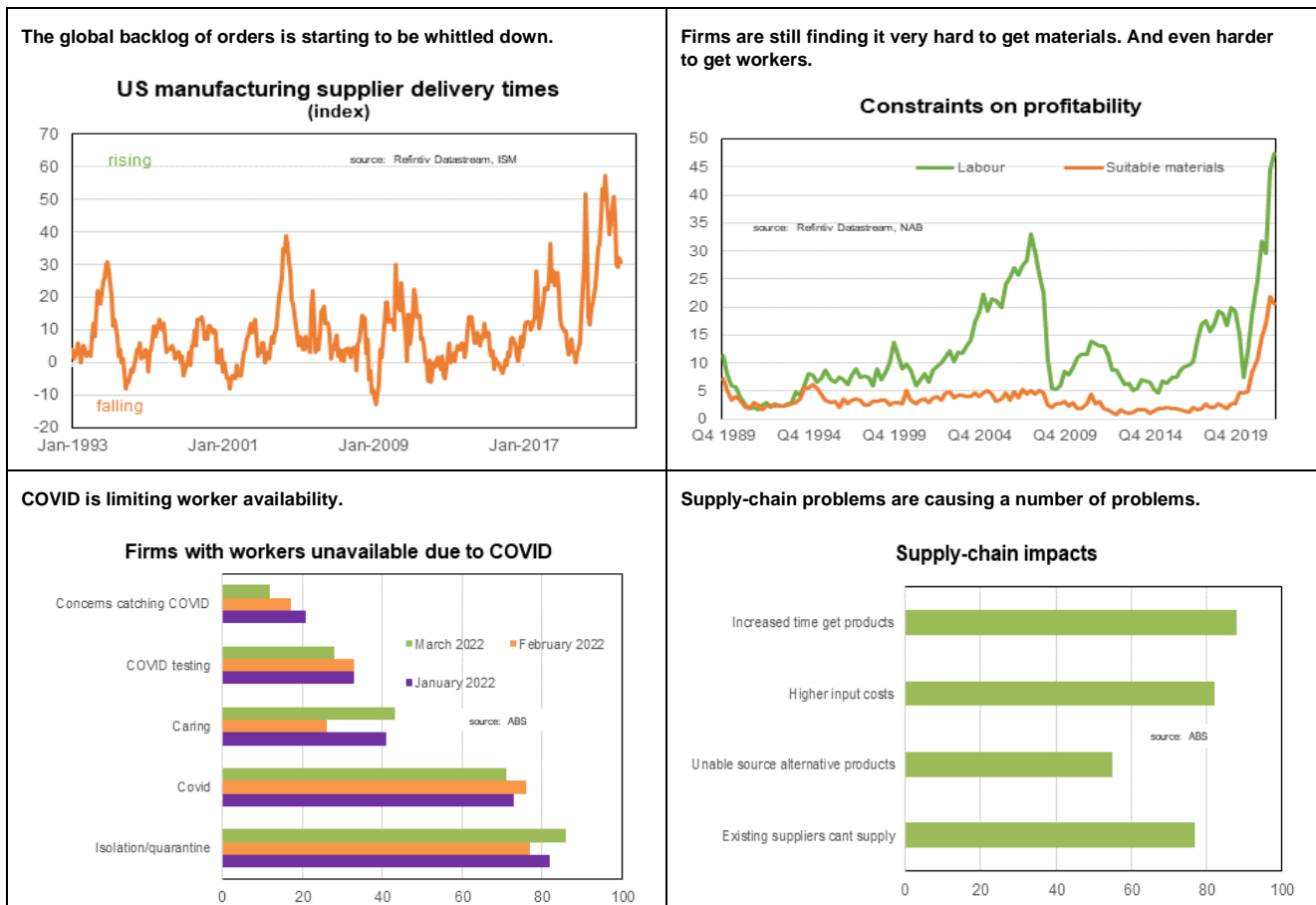
### Risk 3: The supply shock hitting the global economy.

At the start of this year the consensus view was that many of the supply-chain problems would be temporary. The thinking was that as the economy re-opened employees would return to work filling the orders that had built up during the lockdowns. That had started to occur. Car production is up, shipping delays are shorter and the backlog of orders is starting to decline. Nonetheless, the supply-chain problems are lasting longer than anticipated.

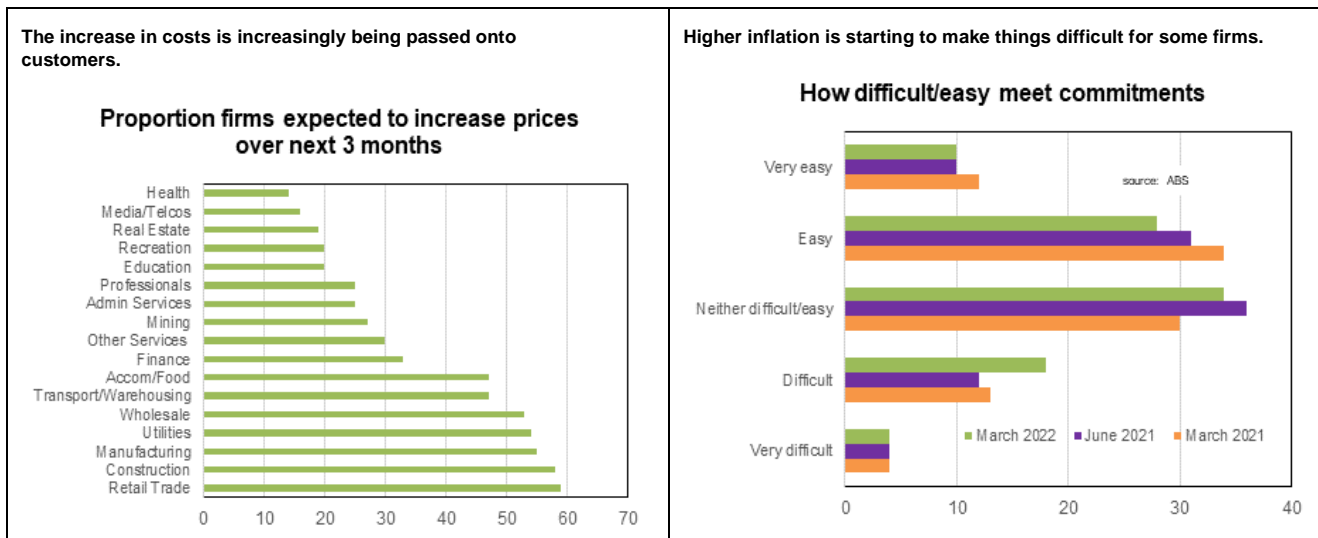
One reason is that COVID is still impacting worker availability. A recent ABS survey indicated that a big majority of firms had workers missing either from catching COVID or related-isolation requirements (as evidenced by the big queues at airports over the April school holidays). More generally firms are facing severe labour shortages (in both Australia and most OECD countries) something that will take time to rectify despite the opening of the borders. And even before the Russia-Ukraine War commodity prices were rising reflecting under investment over recent years. The War only exacerbated that problem.

When combined with strong demand these supply problems has led to the jump in inflation. So far the impact of higher inflation has been minimal. Consumers are still spending, firms are still investing and employing. But the longer that inflation stays high the more likely that will change. A rising proportion of firms (particularly smaller ones) are starting to find it difficult to meet their financial commitments (although the proportion facing significant financial constraints has not yet risen). Household real wage growth is negative. In the recent Budget the Government provided fiscal support to low-income earners (as well as small business) to help them cope with rising prices.

Higher inflation acts as a tax on incomes. Higher inflation will almost certainly be a drag on economic growth this year. Australia as a major commodity exporter is in a better position to cope than many other countries. It is how long inflation remains too high, and what governments and central banks need to do to get lower inflation, will be the key issue determining its economic impact.







### Risk 4: Interest rates head too high to curb inflation

Current financial market pricing indicates that inflation is going to remain above the RBA’s 2-3% inflation target for the next year before declining towards the top end of the inflation band. Partly that moderation of inflation would reflect the view that the supply-chain problems will ease over the next year. But a significant factor is the pricing of a substantial increase in the cash rate in Australia (as well as the US, Canada and New Zealand) by financial markets over the next couple of years.

The increase in the cash rate expected by financial markets is aggressive. In Australia, the cash rate is projected to move from its current level of essentially zero to 2% by end-2022, 3% by end 2023 before reaching a peak of around 3.5% in early 2024. In the US the Federal Reserve is expected to raise their cash rate to 2.5% (from its current rate of 0.25-0.5%) by the end of this year.

The clear risk is that interest rate increase move too high, too fast. The famous US economist Rudi Dornbusch once said that no postwar (US) economic recovery died in bed of old age – the Federal Reserve murdered every one of them. There must be some chance that this will happen again.

Financial markets are providing mixed signals about whether they are concerned about the impact of higher interest rates. Leading economic indicators are not pointing to any significant near-term problems. Research from the New York Federal Reserve based on the shape of the yield curve (the difference between 3-month and 10-year interest rates, and historically a good predictor of the economic outlook) suggests that the probability of a recession over the next year is small. The global equity market has declined, although to date is only around 10% below its peak. Credit spreads though for the riskiest borrowers have started to widen in the US.

Of the four risks, concerns about the impact of higher interest rates on the economy is my biggest worry. It is difficult to be certain as to how high interest rates will need to reach to slow demand, not the least because of the rise of the level of household debt in Australia. It is also not clear as to how much demand needs to slow given the uncertainty as to what will happen with supply. The longer that inflation remains too high the bigger the risk that it will remain too high (because of rising inflation expectations). And therefore the bigger the increase of interest rates that will become necessary.

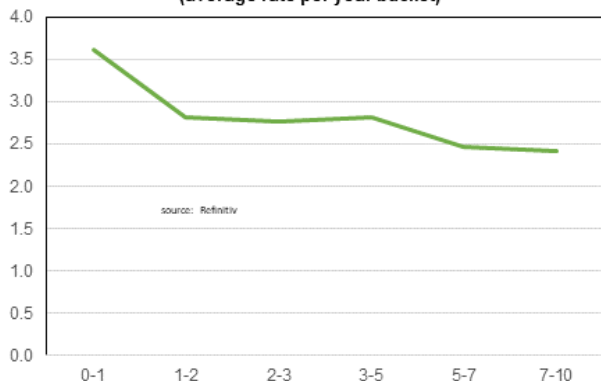
# ECONOMIC UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

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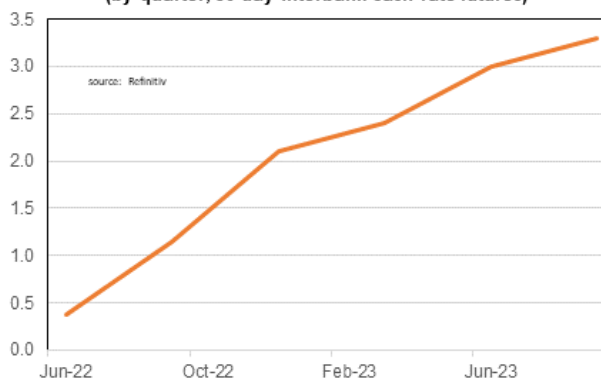
Financial market expect inflation to decline back to the 2-3% target next year.

**Financial Market inflation expectations**  
(average rate per year bucket)



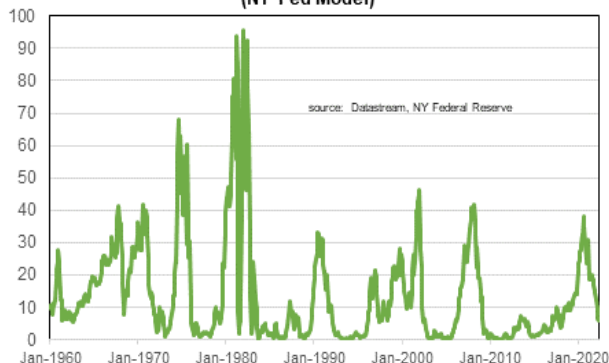
A key factor is the pricing of an aggressive rate hike schedule.

**Expected cash rate in Australia**  
(by quarter, 30-day interbank cash rate futures)



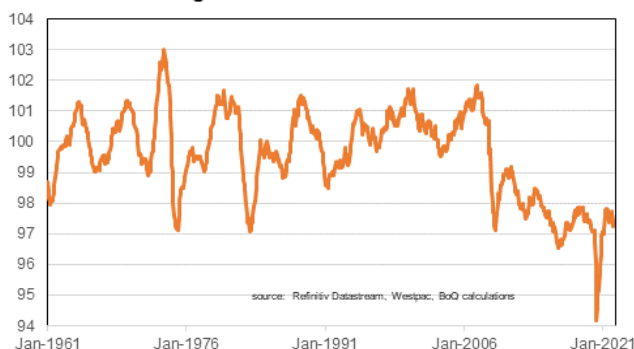
So far concerns about an imminent US recession are muted.

**Probability US recession**  
(NY Fed Model)



And there are few signs of an imminent weakening in the Australian economic data.

**Leading economic indicator for Australia**



There are plenty of reasons for optimism. But there are also clearly identifiable risks. The momentum evident in the economy, the current low level of interest rates and the extent of fiscal support should mean the economy will perform well for the next 12-18 months. Thereafter, the outlook will depend upon how long inflation remains too high, and what the level interest rates will need to get to ensure that inflation becomes less of a problem.

We live in interesting times.

Regards

**Peter Munckton**  
Chief Economist  
Bank of Queensland