ECONOMIC UPDATE

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WEEK ENDING 19TH MARCH 2021

BOQ GROUP

Summary

- **The economy is improving. But there are bumps;**
- **Supply-chain problems are one of them. They are likely to be only short term.**
- **Proposed longer-term solutions are more problematic;**
- **Households are likely to reduce their saving. The main game is to increase wages growth;**
- **Business investment is currently too low. In time it will rise.**

Last year there began a discussion as to what firms might do in response to supply-chain problems. One view was that firms could hold a higher level of inventories. Firms have not built up bigger stock piles partly because it is currently hard to lay your hands on big pile of extra goods. But the other issue is that holding additional stock is a big cost.

An alternative thought to mitigate supply-chain problems is to increase the amount of goods manufactured domestically. The Government has set aside some money to do that. But the import-to-sales ratio remains near its historical highs. The reason why we import so many manufacturing goods is that other countries can do it more cost efficiently than we can.

A related suggestion was that we need to diversify our imports away from China. But China has actually increased its share of the global export market over the past year. Partly that reflects that China has handled COVID better than most countries so has less domestic restrictions on its economy. It also reflects that China happens to be a very efficient producer.

The domestic household saving ratio is likely to decline further. How far will depend upon a variety of factors including consumer confidence about the jobs market and the pace of wages growth.

Running down saving means that household consumption growth for a period can grow faster than income growth. But that process can only go on for so long. For consumer spending to stay strong for any sustained period requires stronger wages growth. The February unemployment rate reading of 5.8% highlighted that the jobs market is in a lot better shape than even the most optimistic forecasters thought possible six months ago. In time this should mean better news on the wages front.

As often happens during recessions business investment is currently weak. Firms uncertain about the economic outlook are unlikely to make big capex commitments. Relative to the size of the economy, the most significant decline in investment over recent years has been non-residential (reflecting the end of the mining boom). There has also been a fall in plant and equipment investment. Disappointingly, there has also been a trend decline in R&D investment. The big positive though has been the significant uplift of investment in digitization.

The stronger economy and government incentives means that capex spending is starting to rise again, notably on plant and equipment. If economic growth is strong over the next 1-2 years continued strong business investment is likely.

It is hard dealing with supply-chain problems

Over many years the global economy became more integrated and efficient. China and Eastern Europe entered the global trading system. Technology improved, transportation costs fell. These trends enabled companies, regions and countries to become increasingly specialised and productive. Multi-national companies helped create international supply chains.

But recent events have called into question the way the global economy has become structured. The US-China trade spat that started in 2017 was the first worry. Australia is now having its own trade dispute with China. The ‘America First’ approach under President Trump raised what role the US would play in the global trading system.

The relationship between the US and China will be one of the big geopolitical issues for the next couple of decades. But of more immediate practical importance is that the pandemic has highlighted the fragility of supply chains. Delivery times have blown out in many countries due to supply-chain problems. A recent survey of Australian firms by the ABS indicated that it is a growing headache for domestic companies.

The supply-chain problems are likely to last until the major countries can get their economies back up and running into top gear. Last year there began a discussion as to what firms might do in response to supply-chain problems. One view was that firms could hold a higher level of inventories. And maybe this will happen in time. But it has not happened to date with the national inventory-to-sales ratio hardly rising. And in the retail sector the stock-to-sales ratio has actually fallen (a result of the surprising strength of retail sales last year).

One reason that firms have not built up bigger stock piles is that supply-chain problems has meant it is hard to lay your hands on big pile of extra goods. But the other issue is that holding additional stock is a big cost. And extra cost is a problem for firms during a time of economic uncertainty. It is also a problem for industries such as wholesale and retail trade that have operating profit margins typically in the single digits.

An alternative thought to mitigate supply-chain problems is to increase the amount of goods manufactured domestically. The Government agrees and has set aside $1.5b to create a strong manufacturing capability in areas of health (such as vaccines and medical products) and defence.

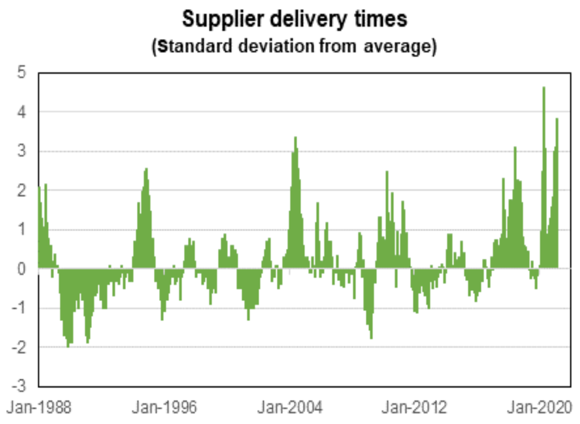
In time this might reduce our reliance upon imports in some critical areas. Other countries are doing the same. But currently the import-to-sales ratio remains near its historical highs. And while that figure may fall a little in the future, I would not expect a substantial decline. The reason why we import so many manufacturing goods is that other countries can do it more cost efficiently than we can.

A related suggestion was that we need to diversify our imports away from China. Intuitively this makes sense. Having a heavy reliance upon one supplier or customer is a big risk. And that is what has happened with our trade relationship with China.

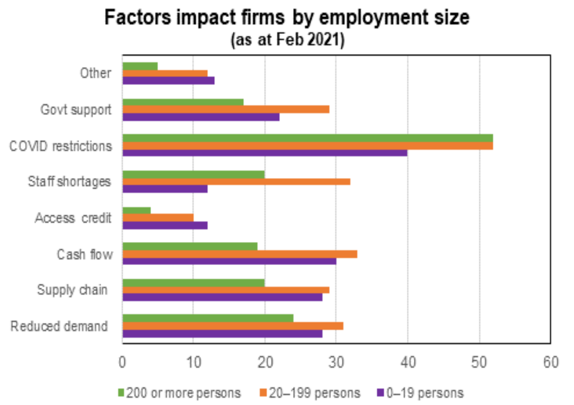
But China has actually increased its share of the global export market over the past year. Partly that reflects that China has handled COVID better than most countries so has less domestic restrictions on its economy. It also reflects there has been very strong demand for medical protective equipment and computer monitors, two areas that that China dominates in supplying.

The bigger picture though is that China is a very efficient manufacturing country, helped by having a large workforce, an increasingly efficient transport system and a growing (very large) domestic market. In time importers might be able to find alternative sources for goods. But the current trading system has been set up for maximum efficiency. It is going to be hard to find alternative countries that offer the same cost and efficiency benefits as China.

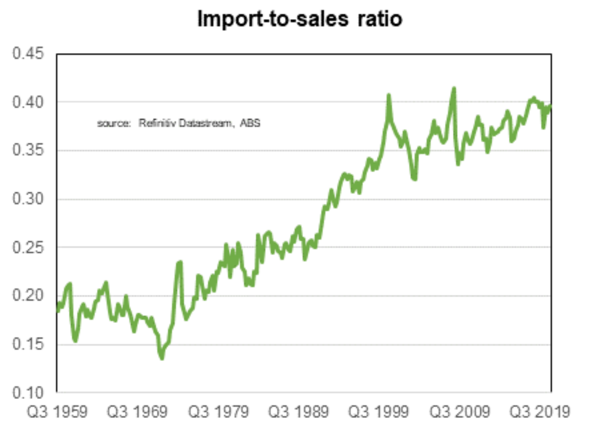
It is taking longer to deliver goods globally.



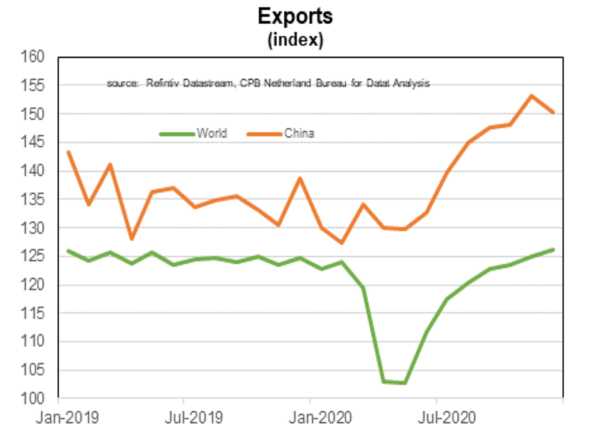
Supply chain problems is a rising problem for domestic firms.



The import-to-sales ratio remains near record highs.

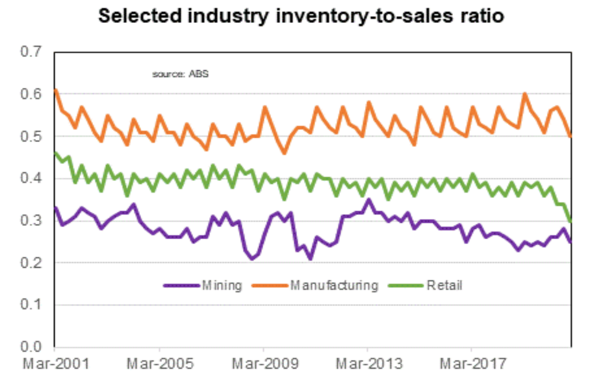


China has gained export market share over the past year.



Inventory levels remain relatively lean.

And have even been run down in the retail sector.



There will be further falls in household saving

The biggest unknown for the domestic economy this year is how much of the ‘saving mountain’ that consumers have built up will be spent.

The household saving ratio peaked at over 25% in the June quarter last year and has since declined to (a still high) 12% by the December quarter. The decline partly reflected the opening up of the economy over the second half of last year. Consumers could leave the house and buy shoes or eat at their local restaurant. An improving economy also meant that more consumers became more confident to go on a bit of a splurge.

Such a pattern in the household saving ratio is not unique to Australia. Very similar patterns were evident in the UK and Canada. There has been a notable rise in the US household saving ratio in recent months reflecting the impact of the Trump fiscal stimulus from last year. And the ratio could head a little higher in coming months as the most recent fiscal boost from the Biden Administration hits household bank accounts. Household saving has also increased recently in Germany reflecting the impact of renewed lockdowns. In both countries though the household saving ratio will almost certainly decline as the year progresses as consumer confidence improves on the back of the vaccine rollouts and improving economies.

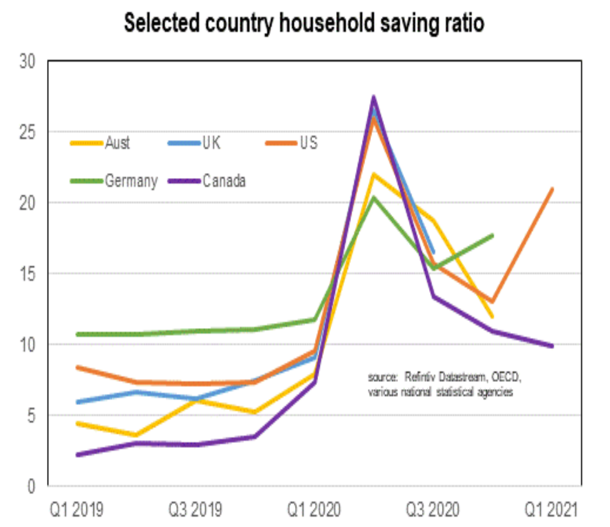
How low can the domestic household saving ratio go? That will depend upon a variety of factors including consumer confidence about the jobs market and the pace of wages growth. From 2009-16 the ratio averaged around 7.5%. It subsequently declined as very weak disposable income growth meant consumers dipped into their saving to maintain their standard of living. I think it is likely that the ratio will decline to at least the levels seen 2009-16, and possibly lower.

Running down saving means that household consumption growth for a period can grow faster than income growth. But that process can only go on for so long. For consumer spending to stay strong for any sustained period requires sustained stronger income growth.

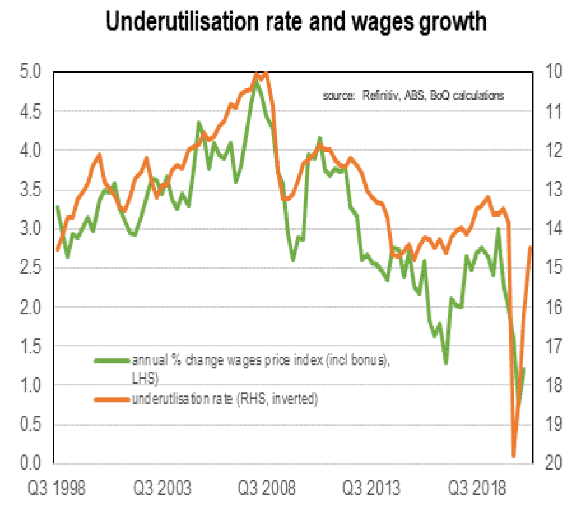
The good news is that growth in real disposable income (income after taking into price rises, taxes and interest payments) at the end of 2020 increased at its fastest pace since 2012. This reflects the big government income support programs, very low interest rates reducing interest payments, low inflation, tax cuts and rent (and interest rate) payment holidays. The income support and payment holidays are coming to an end. And interest rates look increasingly unlikely to fall any further.

But there is hope. The February unemployment rate reading of 5.8% highlighted that the jobs market is in a lot better shape than even the most optimistic forecasters thought possible six months ago. The end of JobKeeper at the end of March could cause a blip higher in the unemployment rate. But there is increasing confidence that there will be further reductions in the unemployment rate over the next 1-2 years. And in time this should mean higher wages growth (the RBA is aiming for a number north of 3%). And therefore more consumers hitting the shops.

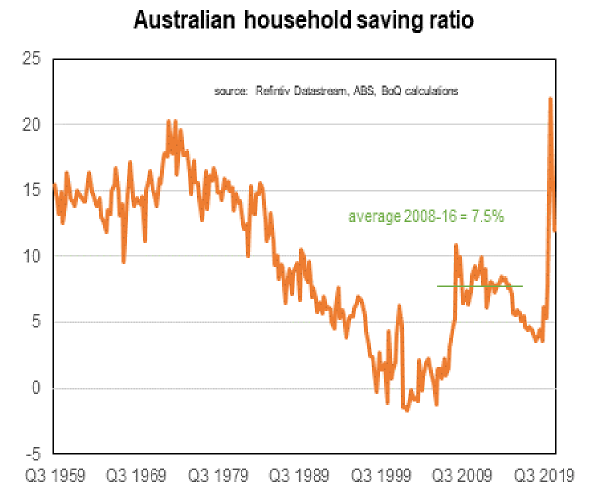
Households in many countries went on a saving binge.



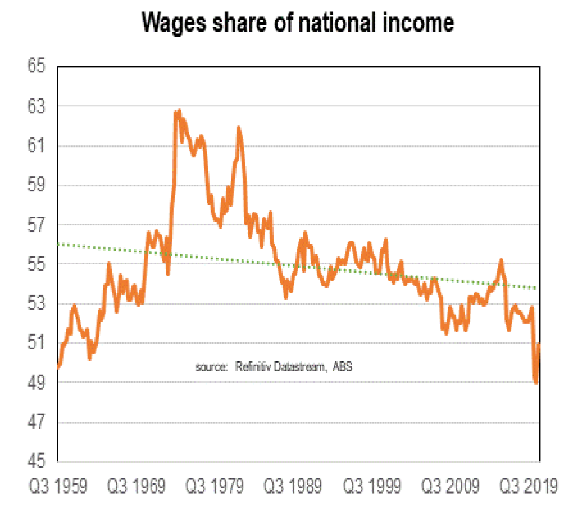
As the underutilization rate declines, wages growth should improve.



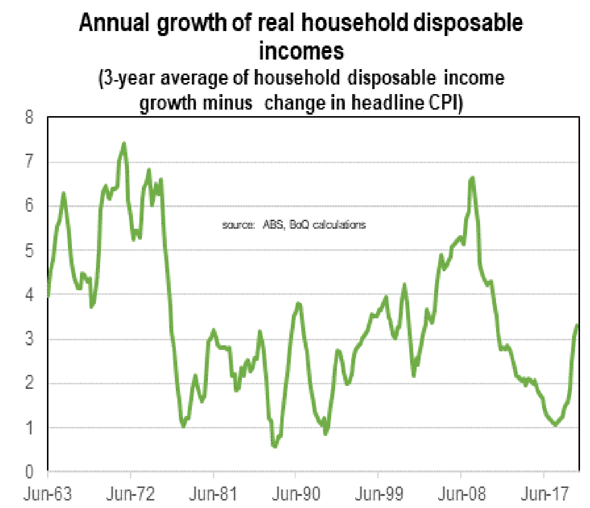
The saving rate has started to decline. And it will decline further this year.



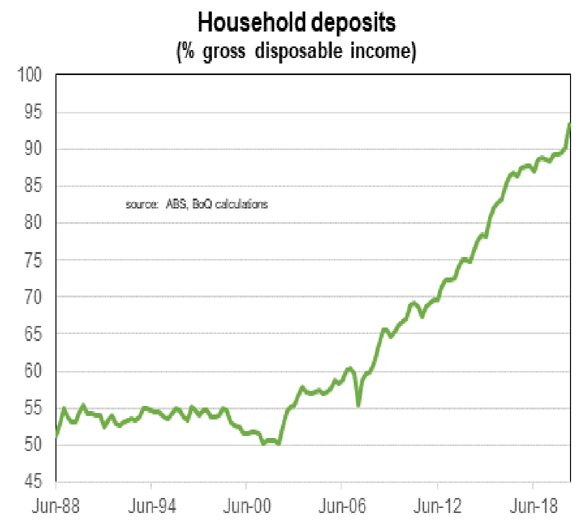
Wages have been getting a smaller cut of national income.



Disposable income growth is again on the rise. But can it be sustained.



Households have built up a mountain of saving.



In time investment will increase

Business investment matters. It matters because it boost GDP growth today. And it matters because it lays the foundation of boosting GDP growth of tomorrow.

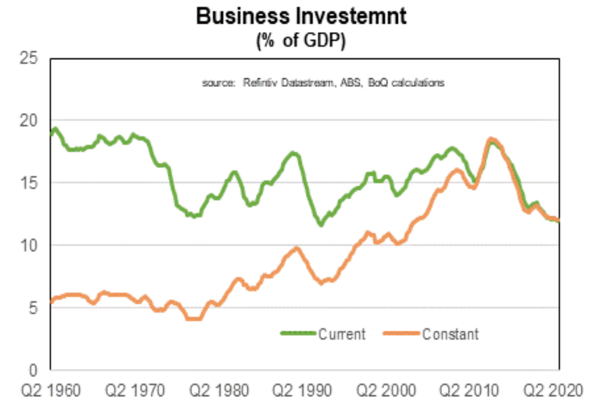
As often happens during recessions business investment is weak. Firms uncertain about the economic outlook are unlikely to make big capex commitments. In current dollar terms business investment in the economy is at its lowest level since the 1990s recession.

But the decline of business investment does not look as stark after adjusting for price changes (ie, measured in constant terms). This is because the price investment in the economy has declined relative to other goods and services (notably for plant and equipment). Certainly there has been some decline of investment but that is only to be expected following the largest mining boom in Australia's history. Australia's capex performance still looks pretty good when compared to the US.

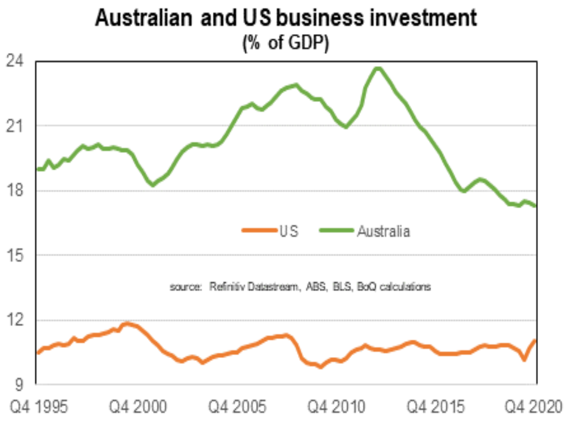
Relative to the size of the economy the most significant decline in investment over recent years has been non-residential (reflecting the end of the mining boom). There has also been a fall in plant and equipment investment (partly reflecting falling prices). Disappointingly, there has also been a trend decline in R&D investment. The big positive though has been the significant uplift of investment in digitization. That is a trend that still has some way to run.

There has been some better signs. The stronger economy and government incentives means that capex spending is starting to rise again, notably on plant and equipment. Businesses indicate that a further rise in capex spending is on the way in coming months. A recent survey by the ABS though suggested that capex spending might decline a little next financial year. But if economic growth is strong over the next 1-2 years, stronger business investment is likely.

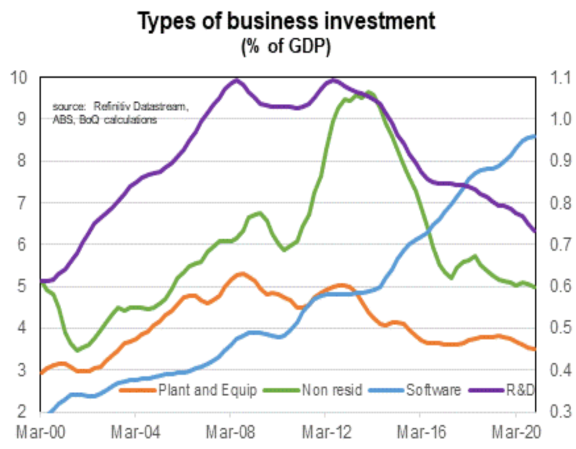
Business investment has declined from its mining boom peak. How much of a concern depends upon what measure used.



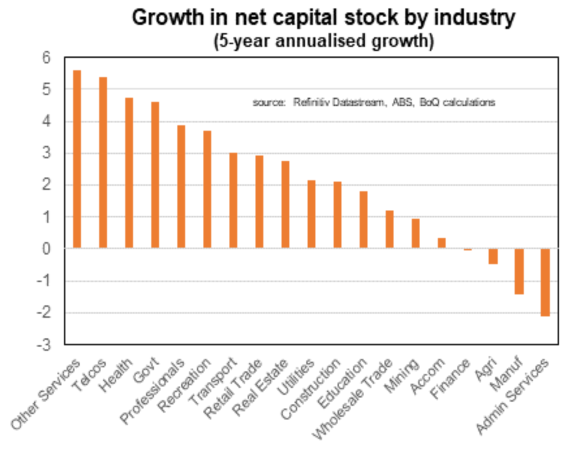
Australian business investment is stronger than in the US.



There has been less spending on most types of investment. But there is bigger budgets for digitization.



Investment spending has been mixed by sector.



We live in interesting times.

Regards,

Peter Munckton
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