BOQ GROUP

Key points

- **GDP growth fell 1.9%in Q3 2021;**
- **While a sharp fall it was a lot better than expected;**
- **The economic impact of COVID has been mixed between industries, types of spending and states;**
- **A big rebound in GDP is virtually in Q4.**

Summary

In the couple of weeks before Omicron parts of Europe and the US were fighting rising virus numbers of the Delta strain. Australia should be in a better state than Europe and the US is currently by winter-time (when the spread of the virus is more likely). We have a higher vaccination rate, and most of the population are likely to recently have had a booster shot by then. The arrival of a new variant has added caution. But there is a good chance that an updated vaccine could be in play by mid next year. The ongoing issue is how Governments', consumers' and firms react to the news of the emergence of a new virus strains or rising case numbers. In time society will get more comfortable that the health system will be able to minimise (but not eliminate) the risk of COVID.

The Q3 GDP growth of -1.9% was worse than any single quarterly decline during the 1990s recession. But it was half as bad as the -4% that some forecasters were expecting a few weeks back. The main driver of the big drop was the Sydney, Melbourne and Canberra lockdowns. With those lockdowns now at an end a substantial bounce in economic growth is likely in the December quarter.

Typically declines in GDP would be a cause of major angst. It has not been on this occasion as the Government has been very successful in buffering household and incomes from the fallout of the pandemic. The impact of COVID can be more clearly seen on quarterly household spending that was over 3% below December 2019 levels at the end of September 2021.

COVID has impacted not only how much consumers spend but also where they have been spending it. Spending on goods is comfortably above its pre-COVID trend. COVID though has severely impacted spending on services. Extremely low interest rates, the rapid rebound in the economy and government support programs has seen investment of all types rise following the nationwide lockdown in 2020.

COVID has had a differential impact between industries and between states. Demand in the regions that have endured lockdowns (Victoria, NSW and the ACT) was particularly weak in the September quarter. There has continued be growth of economic activity in the other states.

The Government was able to provide massive fiscal support because for some time Australia ran a very conservative fiscal policy (modest deficits, low debt). An argument could (and was) made that pre-COVID fiscal policy should have been more supportive of the economy. The low level of debt meant that the Government was able to comfortably provide substantial support to the economy very quickly. That should be taken into account when setting fiscal policy in the future.

The maintenance of strong income growth has allowed for strong spending on the stuff that households and firms could buy (such as cars, equipment) and rising saving (because they couldn't buy services). This created a demand-supply mismatch as lockdowns and other restrictions meant that production of goods was unable to keep up with demand. This will change as factories everywhere again get back to full capacity (that already is happening) and more spending switches back to services and away from goods. A lot of attention on the demand-supply mismatch has been on the supply problems. But with a high level of saving and very tight labour markets it is likely that demand will remain strong. Both the Federal Government and the RBA have begun dialling back fiscal and monetary support to the economy.

The COVID story is not finished

At the time of writing it is not clear what the implications of the Omicron virus will be. The worst-case scenario is that the virus turn out to be both more deadly than previous versions and immune to current vaccines. This would result in sustained border closures and potentially the re-imposition of more stringent restrictions. It is a risk and is the reason why many developed countries have (at least temporarily) moved to restrict international migration.

The early evidence is that the new strain is more contagious than the Delta variant. More tentatively it is thought that the consequences of the new virus might be less severe. The data on cases, hospitalisations and deaths in coming weeks will tell us whether this is correct. There appears to be a high degree of confidence from those in the know that a new effective vaccine could be developed within months if necessary.

What Omicron highlights is that COVID retains its ability to impact society and the wider economy. It is human nature to hope that the worst is over once the latest virus wave diminishes. COVID though will remain a concern while a significant proportion of the global population have either not caught the disease or remain unvaccinated.

In the couple of weeks before Omicron parts of Europe and the US were fighting rising virus numbers of the Delta strain. Mainly the increasing cases have been amongst the unvaccinated. But it may also be impacting those that have been vaccinated for over 3-4 months (the evidence is that vaccine effectiveness against symptomatic infection declines after a couple of months although its effectiveness against hospitalisation and death remains high after that time).

The result has been a tightening of restrictions in a number of European countries (mandating vaccination, re-imposing mask-wearing regulations, limiting opening hours of bars and nightclubs). Some countries have started to roll out booster shots. There has been less movement on the regulation front to date in the US. Consumer confidence has declined in the regions experiencing rising case numbers, particularly amongst the older members of society.

Australia should be in a better state than Europe and the US is currently by winter-time (when the spread of the virus is more likely). We have a higher vaccination rate, and most of the population are likely to recently have had a booster shot by then. The development of a pill (if taken early enough) that can reduce seriousness of the disease is also likely to be widely available. The arrival of a new variant though has added caution. But there is a good chance that an updated vaccine could be in play by mid next year.

The ongoing issue is how Governments', consumers' and firms react to the news of the emergence of a new virus strains or rising case numbers. Given what we have been through over the past couple of years it is understandable that Governments and consumers' are currently reacting with caution. In time society will get more comfortable that the health system will be able to minimise (but not eliminate) the risk of COVID. The economy has already gone some way to adapting to COVID waves (each successive wave has had a diminishing effect on the economy). But the virus is still leaving economic scars.

The economy has got smaller

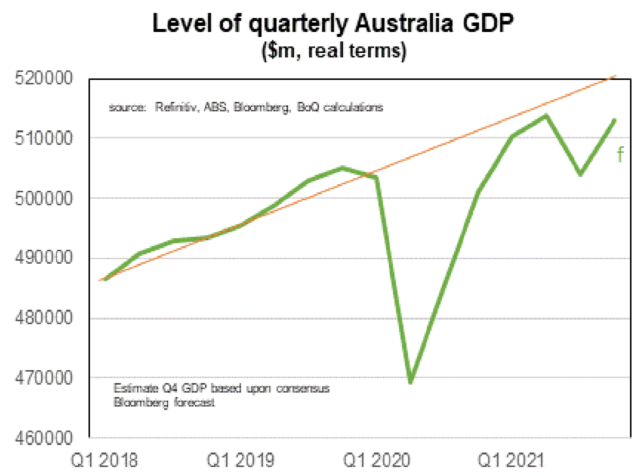
The Q3 2021 GDP numbers is one of the vivid scars. The Q3 GDP growth of -1.9% was worse than any single quarterly decline during the 1990s recession. But it was half as bad as the -4% that some forecasters were expecting a few weeks back. The main driver of the big drop was the Sydney, Melbourne and Canberra lockdowns. With those lockdowns now at an end a substantial bounce in economic growth is likely in the December quarter (according to Bloomberg the consensus expects 1.8% growth in Q4).

Because of the overwhelming impact of the lockdowns (and the sharp subsequent snap back of economic growth) there is less point than usual of doing an in-depth analysis of the GDP numbers. But it is worthwhile stepping back and looking at where COVID has left the Australian economy after the past 18 months.

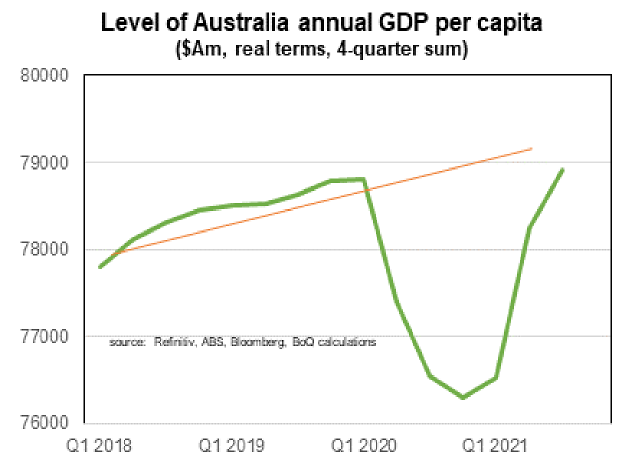
Following the Q3 decline the Australian economy was again smaller at the end of September than it was at the end of 2019. That will be short-lived following the expected big rise in the December quarter. But the economy will still be smaller than it was in June 2020. And it will still be over 1% below where the economy would have been if it had of been growing at the same rate it was pre-COVID.

The size of the economy matters. It measures how much spending, production and income growth happens in society. But a better (but far from perfect) measure of economic well-being is GDP per capita. Pre-COVID that measure had been growing very slowly reflecting modest GDP growth at a time of strong population growth. Although there was a decline in the quarter, the annual growth rate is above where it was at the end of 2019 partly reflecting the weakest population growth in over a century.

The size of the economy remains below its pre-COVID peak.



GDP per capita has just snuck back above its end-2019 level.



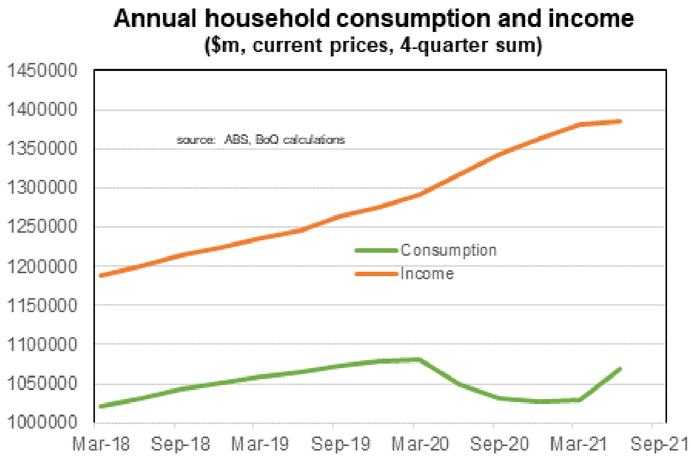
Private-sector incomes have got bigger

Typically declines in GDP would be a cause of major angst. It has not been on this occasion as the Government has been very successful in buffering household and incomes from the fallout of the pandemic. So successful was the Government programs that the trend in household disposable incomes actually rose after COVID.

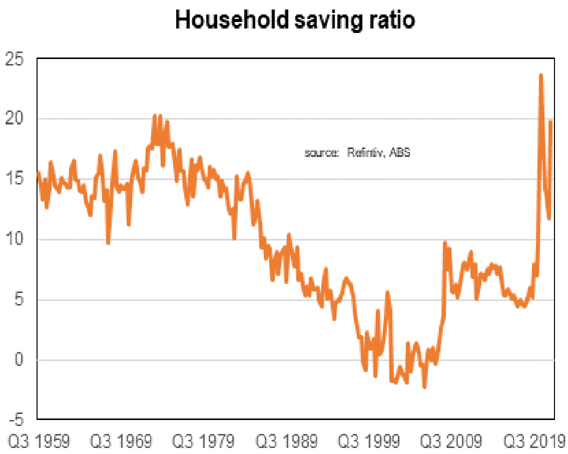
The impact of COVID can be more clearly seen on quarterly household spending that was over 3% below December 2019 levels at the end of September 2021. Some of that weak spending would be down to consumer caution. But government income support and the underlying strength of the jobs market would have moderated any reduction in household willingness to spend. The bigger issue has been the ability to spend, with consumers in some cities stuck at home, borders closed and some businesses shut.

Firms' have also benefitted from government income programs as well as very low interest rates. Many shareholders have benefitted from very low interest rates boosting the value of their investment. But it has not been all goods news for shareholders. Dividends are increasing, but are still well down from pre-COVID times as firms have kept more cash-on-hand as a precaution to meet expenses.

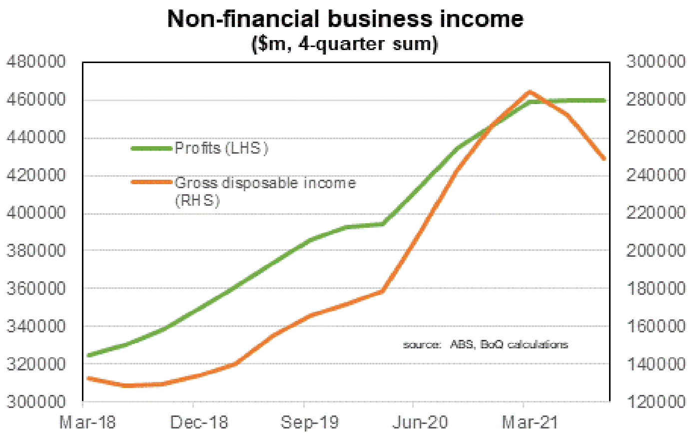
Income is up but spending has not yet reached its pre-COVID level.



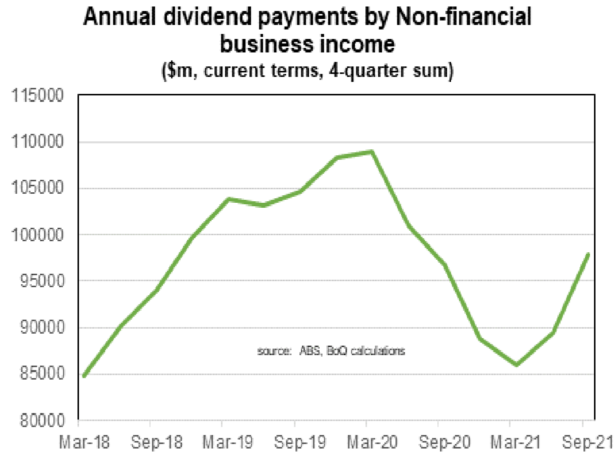
And that is why the saving ratio is so high.



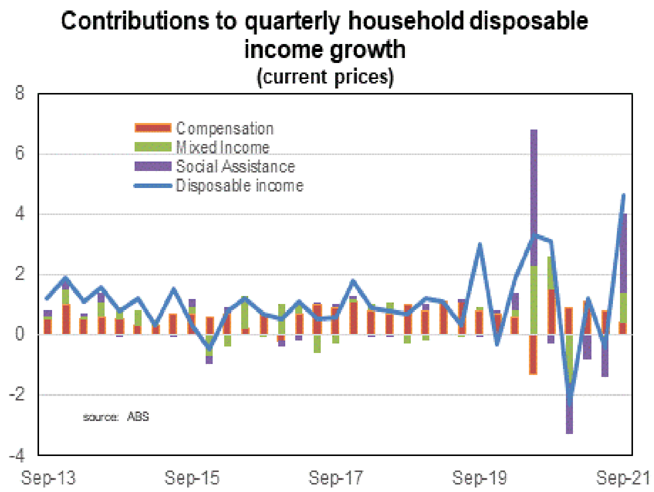
Firms also benefited last year from government income support programs.



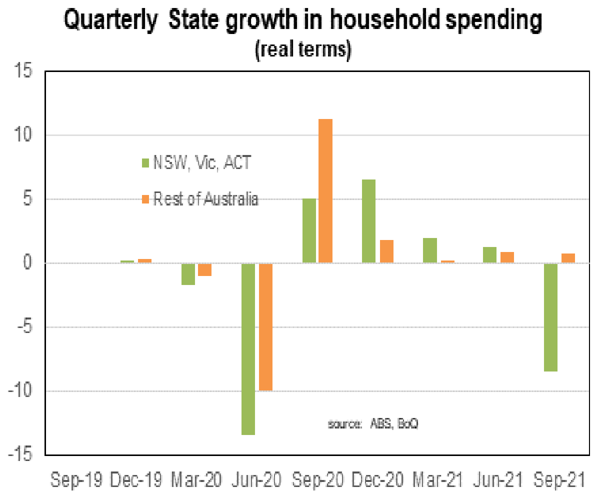
COVID has taken a bite of dividends.



Government income payments have buffered household incomes against COVID.



The states not in lockdown have performed well through COVID.

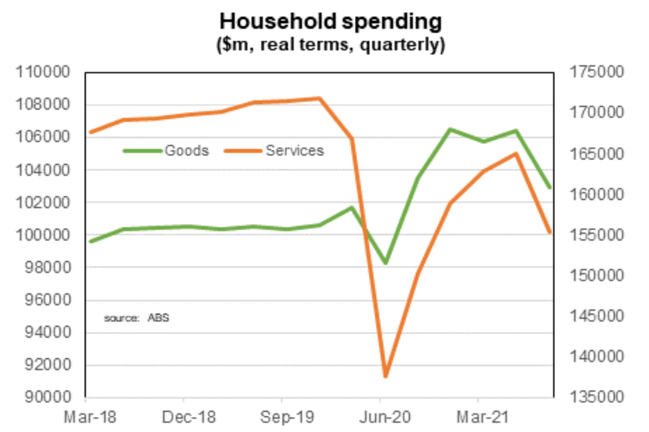


The impact of COVID on spending in the economy has been mixed

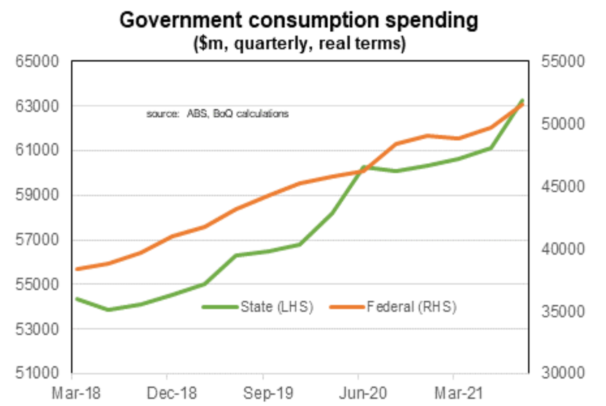
COVID has impacted not only how much consumers spend but also where they have been spending. Spending on goods is comfortably above its pre-COVID trend. COVID though has severely impacted spending on services. After all, goods can be delivered to your front door but a service must typically be provided by someone in-person (although that is starting to change with developments such as Telehealth). Both federal and state government consumption spending has played an important role in stabilising the economy.

As would be expected during a period of economic uncertainty investment spending as a proportion of the economy has declined since the end of 2019. But extremely low interest rates, the rapid rebound in the economy and government support programs has seen investment of all types rise following the nationwide lockdown in 2020. Lockdowns did have an impact on construction in the September quarter. And supply-chain problems weighed on equipment investment. But ABS surveys suggests that private sector capex budgets will be up strongly this financial year. And there is plenty of work in the pipeline for residential construction for at least the next couple of quarters.

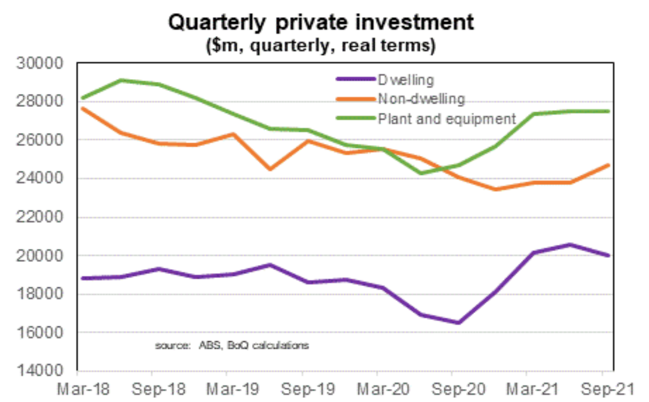
Spending on goods has been strong, but weak on services.



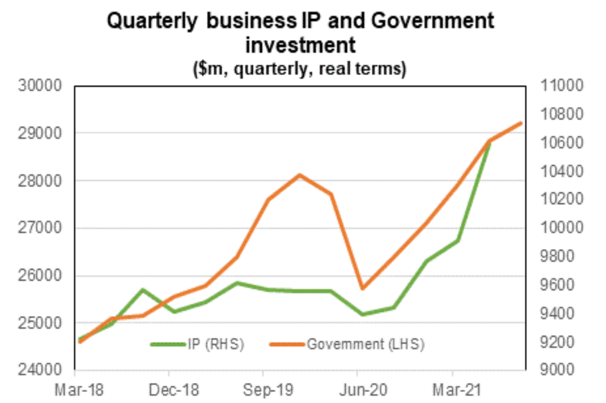
Government consumption spending has provided important support to the economy over COVID.



Low interest rates, an improving economy and government incentive has led to a pickup of all types of investment.



Spending on infrastructure and digitisation is at a record high

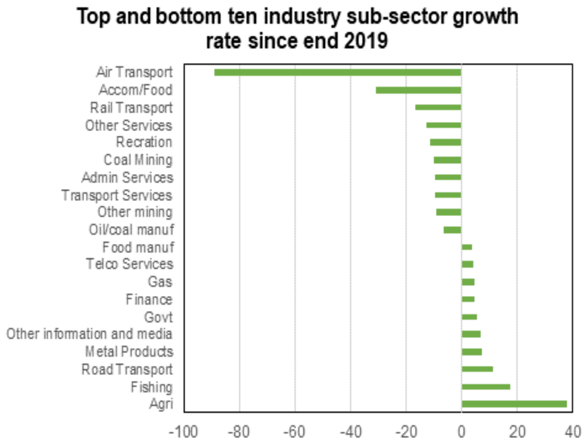


COVID has had a differential impact between industries since the end of 2019. Many farmers have had a good time reflecting high commodity prices and favourable weather. The increase in demand for goods has helped the trucking, retail and wholesale sectors. Increased demand for testing has boosted the health industry (although lockdowns can impact elective surgery and dentists). Ongoing growth in NDIS has underpinned the social-services sector. Very low interest rates has boosted activity in finance, while increased spending on digitisation has increased demand for IT workers (there has also been strong demand for accountant and lawyers). The pandemic has meant a bigger role for the government.

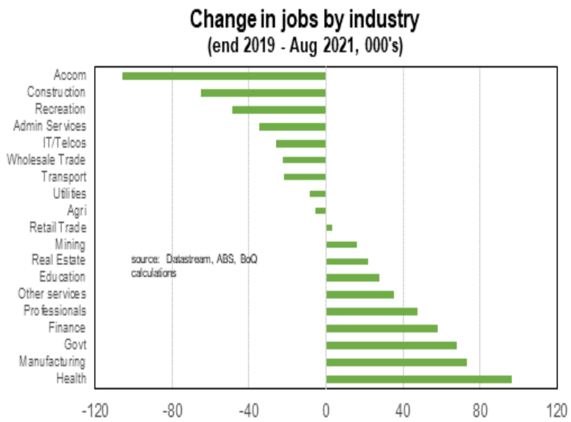
But the airline industry has done it very tough. Less people are catching a train or bus to work (although freight trains have been busy). Mining has been mixed (partly reflecting weather). The Recreation and Accommodation and Food Service sectors have been hard hit by the lockdowns.

The pandemic has also had a mixed impact between states. Demand in the regions that have endured lockdowns (Victoria, NSW and the ACT) was particularly weak in the September quarter. There has continued be growth of economic activity in the other states.

The impact of COVID has been mixed between industries.



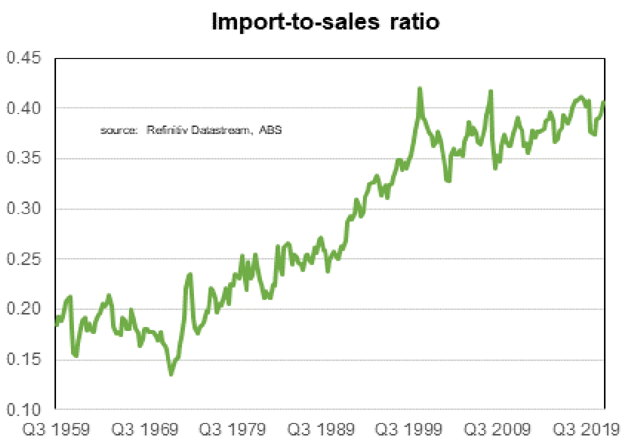
And this has reflected on which sector have been growing jobs.



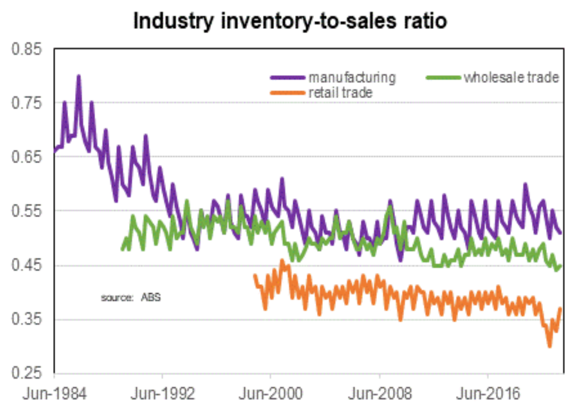
Some questions

Finally, some thoughts on a couple of economic issues that have surfaced over the past year. There has been discussion that firms' having become aware of problems caused by the current structure of supply-chains will look to hold more inventories and onshore more production. Certainly that has been the response to some business surveys. But the evidence that is happening so far is mixed (at least on a large scale). The import-to-sales ratio is still near a record high. Inventories in the wholesale sector remain near their record lows, and are below their long-term average in the manufacturing and retail sectors.

The import-to-sales ratio remains high.



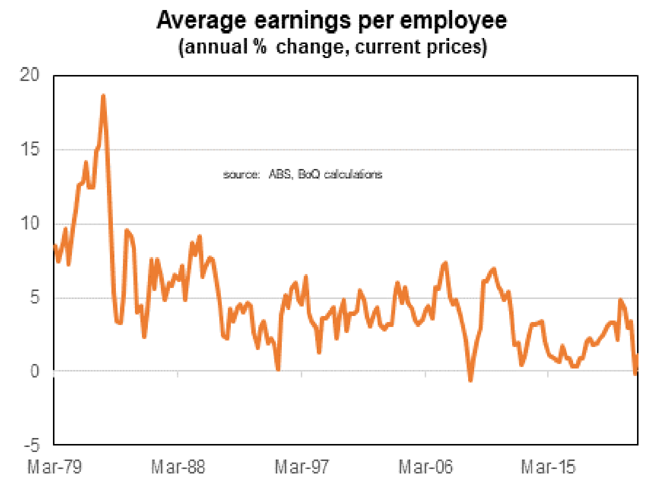
Inventories remain low relative to sales across the key goods industries.



Another discussion point is that the very strong state of the labour market will lead to a pickup of wages growth. We already know from the best measure (Wages Cost Index) that did not happen in the September quarter, and this was confirmed in the measure included with the GDP numbers. It will be interesting to watch developments in the share of national income that goes towards wages in coming quarters. That ratio has artificially dropped near to its historic low as a result of the pandemic. A tight labour market may well see the wages share return to the level it was for around for much of the post-GFC period.

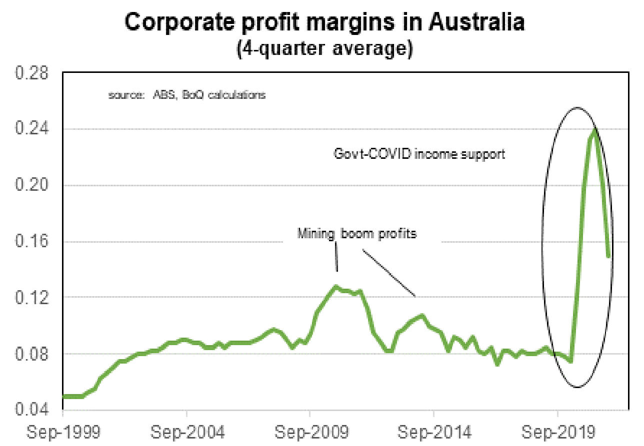
A smaller wages share at a time of decent household and corporate income growth has led to rising corporate profitability. But profit margins have been declining this year (although they remain at a high level). Profit margins are wider than historical average levels across most, but not all, sectors of the economy. The finance sector has benefitted from rising credit growth, falling loan losses, rising superannuation inflows and increasing asset prices. But very low interest rates and tough competition has meant tightening margins. The increasing installation of solar energy by households (and some warmer weather) has reduced electricity prices. Good for the householder, not so much the electricity supplier. Reduced use by households of public transport (including taxis and Ubers) meant narrower profit margins.

Wages growth remains modest.

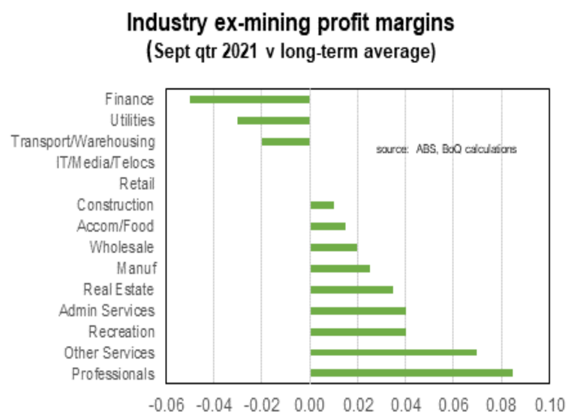


The proportion of the national income going to wages is rebounding from near a historical low.

Profit margins are declining, but remain high by historical standards.



Most, but not all, sectors have benefitted from wider profit margins.



Where does that leave us

The initial view was that the economy would face a 'V-shaped' recovery from the pandemic. In terms of spending and production that has largely been the case. The RBA and the Government have successfully enabled private-sector incomes to keep growing. Potentially the template that the authorities followed this time in supporting incomes could be used again in future recessions. That would be harder to do though if a recession was also characterised by higher inflation.

The Government was able to provide massive fiscal support because for some time Australia ran a very conservative fiscal policy (modest deficits, low debt). An argument could (and was) made that pre-COVID fiscal policy should have been more supportive of the economy. The low level of debt meant that the Government was able to comfortably provide substantial support to the economy very quickly. That should be taken into account when setting fiscal policy in the future (although other countries with substantially higher government debt levels were able to also provided plenty of fiscal firepower).

The maintenance of strong income growth has allowed for strong spending on the stuff that households and firms could buy (cars, equipment) and rising saving because there was a lot of stuff they couldn't buy (services). This created a demand-supply mismatch as lockdowns and other restrictions meant that production of goods was unable to keep up with demand. This will change as factories everywhere again get back to full capacity (that already is happening) and more spending switches back to services and away from goods.

A lot of attention on the demand-supply mismatch has been on the supply problems. But with a high level of saving and very tight labour markets it is likely that demand will remain strong. Stronger investment will boost capacity in the economy to meet some of this higher demand. Both the Federal Government and the RBA have begun dialling back fiscal and monetary support to the economy. We can expect the debate on how much generosity is necessary to continue through next year.

We live in interesting times.

Regards

Peter Munckton
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