ECONOMIC UPDATE

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WEEK ENDING 21ST MAY 2021

BOQ GROUP

Summary

- Many firms are saying that conditions are very buoyant;
- But while demand is strong, there are a number of supply side constraints;
- The risk is that the supply-side constraints last longer than what financial markets and central banks think;
- Wages growth although low is rising, and may increase further as the jobs market stays strong.

The economy is powering ahead. Firms indicated that conditions in April were at their strongest level in at least 25 years. The Budget was designed to give the economy another big shove. The health efforts to fight the virus have played an important role in boosting the economy. But they also act to restrict supply.

The key question for central banks (such as the RBA) and financial markets is how much of this mismatch between supply and demand is short term and how much is long term. There is a clear risk that some supply shortages could last for an extended period. Most notably labour shortages may remain part of the landscape, at least until the international border re-opens.

One of the key indicators that the RBA will be watching to understand whether the rise of inflation is short- or a long-term phenomenon is wages growth. In both the December and March quarters' wages growth was surprisingly strong. The big picture is that there has been a dramatic fall in the underutilization rate (unemployment rate plus those working part-time that want a full-time job). And this usually coincides with stronger wages growth.

Conceptually it would be expected that the heightened labour shortages would lead to firms offering higher wages (there are anecdotes this is happening). Rising labour shortages did not lead to higher wages growth pre-COVID. But they could this time. The participation rate is already near record highs (of course it could always go higher). And the Centre for Population does not expect immigration growth to return back to its pre-COVID levels until at least mid-2024.

The other key factor to watch as to whether any price rise is sustainable is inflation expectations. Certainly there has been a rise in companies' views about prices. To date the rise of consumer inflation expectations has been more muted. Medium-term financial market inflation expectations have risen back towards the RBA's 2-3% inflation target. The RBA expects 'underlying' inflation to only be 2% by mid-2023.

Sustained low inflation may well be the right call. But the data is likely to show higher prices for at least the next couple of quarters. The longer that there are labour and supply shortages the more likely there will be higher prices and workers will demand higher wages.

Higher but for how much longer

One of the great things about my job is that I get the opportunity to leave my desk to visit clients. A few weeks back I was at Beef Week in Rockhampton, and then drove on to Gladstone. My post-Budget schedule took me to the Gold and Sunshine Coasts. I can report that the airports in Queensland are getting busier!

Some of the feedback that I received from clients was that prices are on the rise. Others spoke about the increasing difficulty of getting workers. Trouble getting materials was also noted.

The data matches the anecdotes. Across the economy capacity use is above average. It is particularly high in the manufacturing and retail industries, making it hard for firms in those sectors to meet heightened demand. The proportion of companies indicating labour shortages are at their highest level since the peak of the mining boom. Material shortages were seen to be at their most dire in at least thirty years.

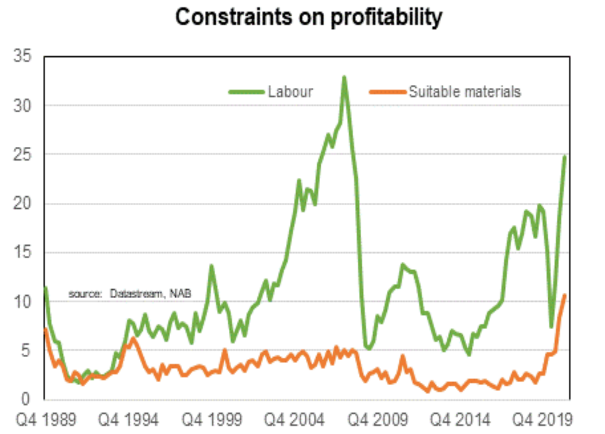
All of these problems are an indication of the basic economic law of when demand is running ahead of supply. On the demand side the economy is powering ahead. Firms indicated that conditions in April were at their strongest level in at least twenty five years. Consumer confidence is rising. The Budget was designed to give the economy another big shove. Monetary policy is doing its bit.

The health efforts to fight the virus have played an important role in boosting the economy. But they also act to restrict supply. The closure of the international border is limiting immigration. In turn that is impacting the availability of workers (particularly in sectors such as Accommodation and Food Services). In other countries restrictions and worries about the virus has crimped production. An oft-quoted example is that a lack of workers has restricted chip production that has reduced the production of cars. One outcome has been the rise of used car prices (it has also played a role in the lack of cars available for rental).

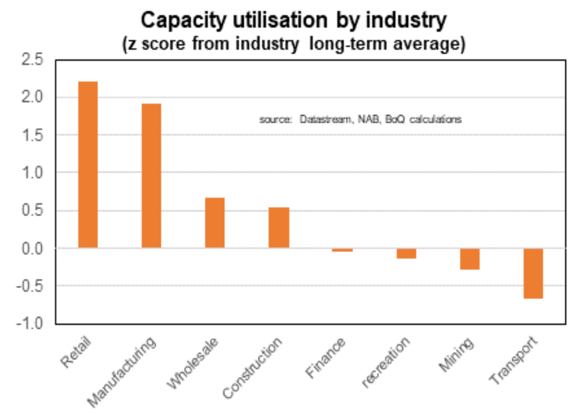
The key question for central banks (such as the RBA) and financial markets is how much of this mismatch between supply and demand is short term and how much is long term. If it is short term then the RBA and financial markets will look through the outcome (as they are doing now). But there must be some risk that the supply-demand mismatch will last for longer.

Governments and central banks are doing their utmost to ensure demand remains strong. Some supply shortages will be short term. In time manufacturer's and retailors will expand capacity. But there is a clear risk that other supply shortages could last for an extended period. Most notably labour shortages may remain part of the landscape, at least until the international border re-opens.

There are growing supply-side constraints on the economy.



Demand is also creating shortages, particularly in the retail and manufacturing sectors.



Sustained inflation needs higher wages growth

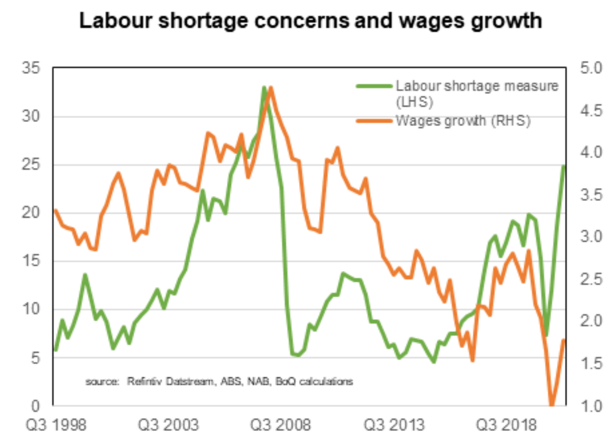
One of the key indicators that the RBA will be watching to see whether the rise of inflation is short- or long-term phenomena is wages growth. Labour costs are the largest cost for most firms. If there is a sustained rise in wages growth then over time prices are more likely to rise (higher price growth also makes it easier for firms to afford higher wages growth).

In both the December and March quarters' wages growth was surprisingly strong. In December the surprise was put down to a stronger-than-expected economy leading to more firms 'unfreezing' wages growth. In March the surprise was the impact of an increase in the minimum wage. But every quarter has its 'one-offs' (last year it was the temporary freeze in wages). The big picture is that there has been a dramatic fall in the underutilization rate (unemployment rate plus those working part-time that want a full-time job). And this usually coincides with stronger wages growth.

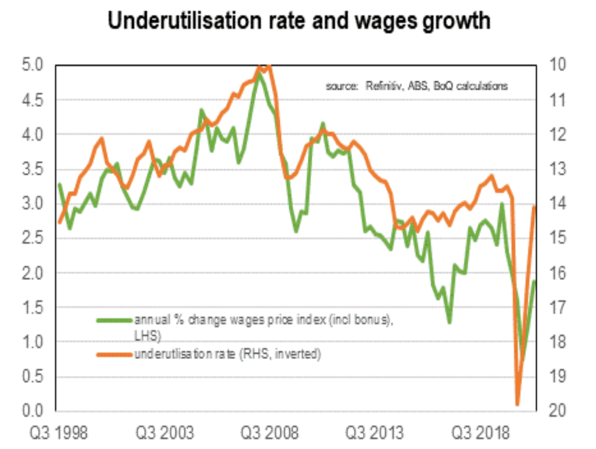
Conceptually it would be expected that the heightened labour shortages would lead to firms offering higher wages (there are anecdotes this is happening). Rising labour shortages did not lead to higher wages growth pre-COVID. Partly this may have reflected concerns about tough competition making it hard for firms to raise prices to 'pay' for an increase in wages. Low productivity growth also meant firms would have had problems affording a big pay rise. Strong immigration growth and a rising participation rate meant that firms were able to get workers from outside the existing labour force.

But some of those conditions are changing. The participation rate is already near record highs (of course it could always go higher). And the Centre for Population does not expect immigration growth to return back to its pre-CVOID levels until at least mid-2024. There must be some chance that with demand strong and firms in a buoyant mood that companies may now feel they are in a stronger position to afford a bigger pay packet.

There are growing labour and material shortages.



The cost of labour is not putting upward pressure on prices.



As well as expectations that inflation will stay higher

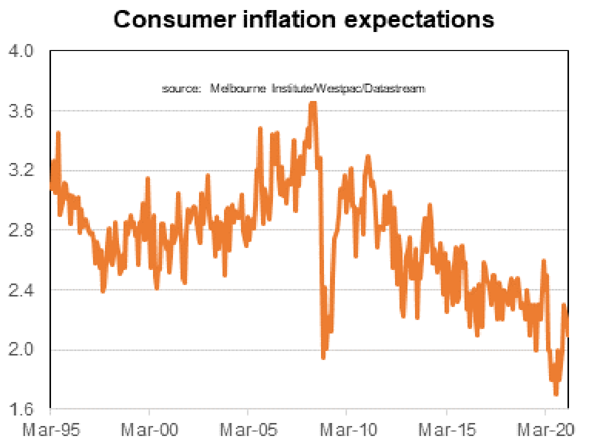
The other key factor to watch as to whether any price rise is sustainable is inflation expectations. If firms and consumers expect higher inflation they are more likely to demand higher wages and/or feel more relaxed about putting up prices.

Certainly there has been a rise in companies' views about prices. Firms view about higher prices is at its highest level in over 12 years. To date the rise of consumer inflation expectations has been more muted. Medium-term financial market inflation expectations have risen back towards the RBA's 2-3% inflation target.

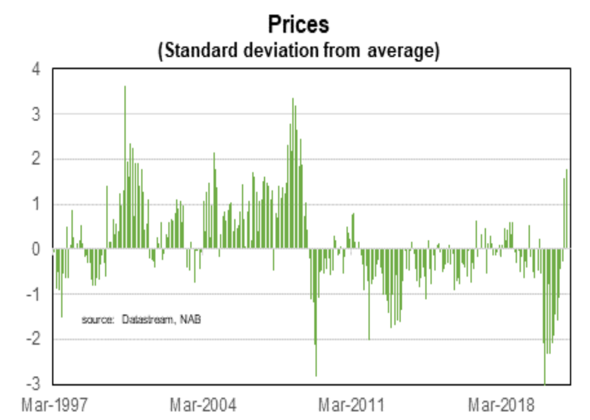
Right now central banks believe that any near-term rise in prices will prove temporary. The RBA expects 'underlying' inflation to only be 2% by mid-2023. The Federal Treasury expects it to be only marginally higher.

Sustained low inflation may well be the right call. But the data is likely to show higher prices for at least the next couple of quarters. The longer that there are labour and supply shortages the more likely there will be higher prices and workers will demand higher wages.

Consumers' inflation expectations have risen only modestly.



But for the first time in a decade firms are looking at higher prices.



We live in interesting times.

Regards

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