ECONOMIC UPDATE

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WEEK ENDING 23RD JULY 2021

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Summary

- The lockdowns will almost certainly see Q3 record negative GDP growth;
- Assuming lockdowns end in the next few weeks there should be a strong bounce in growth in Q4;
- In Q1 National saving hit its highest level in over 30 years;
- The decline in Government saving was more than offset by higher private sector saving;
- Caution and inability to spend was part of the answer;
- A bigger part is the very high level of the terms of trade;
- The current lockdown may see a temporary bounce in saving;
- Household and business saving will likely decline over the next next year.

The latest lockdown will have a significant hit on economic growth. It is increasingly hard to see how Q3 will not be a negative quarter (current thinking is -0.5%). How negative will depend upon how long the lockdowns last. A very strong GDP number (1.7%) is the most likely outcome for Q4. This assumes that we don't get another COVID wave later in the year.

Last year the national saving ratio hit its highest level in over 30 years. Over the past fifteen-plus years movements in that ratio largely reflected changes in the terms of trade (the price of exports relative to the price of imports). If the relationship holds it suggests that national saving is likely to decline as the commodity price cycle turns.

Different sectors save at different rates. The massive increase in private-sector saving in 2020 was matched by a massive fall in government saving. Over the next year government saving will continue to be negative as budgets are set to provide ongoing strong fiscal support. But once economic growth reaches target governments are likely to focus on re-building their saving.

Last year household saving exploded. More of the increase in saving was due to the weakness of spending than the rise of income. The extent of the current lockdown in Sydney (and other cities) means there is a chance that saving may rise in the current quarter. But once the lockdown ends household saving is likely to decline.

There will also likely be changes to the composition of household saving. Surveys indicate a decline in the proportion of households wishing to put their money into deposits or pay down debt. Both proportions though remain above their pre-GFC level. The sharemarket is looking more attractive to households, as does the attraction to Super for a number of households.

Last year there was also a significant rise in corporate saving. Over the next couple of years there will almost certainly be a decline in business saving. Businesses are very confident about the profit outlook (at least until the recent lockdowns). But competition for labour and materials will mean that cost growth will be higher. Dividends will rise. Cash levels in the corporate sector overall is at a high level (although cash flow is an issue for some SME's).

All About COVID

The appearance of another COVID wave over recent weeks has been disappointing, but not surprising. At some stage much of the rest of the world has had difficulty with the latest COVID mutation. It was only a matter of time before we were confronted with that problem.

It is widely agreed that widespread vaccination is the way to return life back to 'normal'. But even here there is disagreement. The appropriate vaccination target has not yet been agreed. A target of 80% of the adult population (62% of the total population) has been widely discussed. But we don't know for sure what proportion is necessary to stop the virus spreading.

Even if 80% is the right number the challenge might be to get that proportion of the population vaccinated. Right now supply of Pfizer is probably the biggest constraint on getting a larger proportion of the population vaccinated (although demand is a bigger constraint for the over 60's). But even when supply of vaccine increases surveys suggest it might be hard to get a large enough proportion of under 60's vaccinated. The international experience is that the vaccination rate slows sharply once it hits about 60% of the population.

The other question is that even when (if) we reach the appropriate target, will Australia feel comfortable to open up the economy given that COVID will still be prevalent globally. The UK recently proclaimed 'Freedom Day' in recognition of the widespread vaccination of its population. But it has been hit by another COVID wave. The number of new cases has risen substantially although the hospitalisation and death rates are well down on previous waves. But people are still going to hospital and are still (unfortunately) dying.

The economy will take a big short-term hit

The latest lockdown will have a significant impact upon economic growth. The economy was absolutely booming entering the third quarter. Order books were full (although Victoria businesses took a bit of a hit from their lockdown in June). The unemployment rate was falling quicker than expected. All the signs were that the economy was on for a 1%-plus number in Q3 (which is very strong).

But the extent and degree of the Sydney lockdown (and that of some of the other states) means GDP growth will slow sharply. Mostly the economy has surprised on the high side during this pandemic and so I had been reluctant to downgrade my GDP forecasts too aggressively. But it is increasingly hard to see how Q3 will not be a negative quarter (current thinking is -0.5%). How negative will depend upon how long the lockdowns last.

The experience of the past year has shown that the economy bounces back quickly once the lockdowns finish and people regain confidence to resume their 'normal' lives. The degree of Government income support is more difficult to assess this time compared to what was provided by JobKeeper. But the momentum of the economy is stronger than it was going into COVID. So a very strong GDP number (1.7%) is the most likely outcome for Q4. This assumes that we don't get another COVID wave later in the year. Hopefully the increasing vaccination rates should reduce the chance of that happening.

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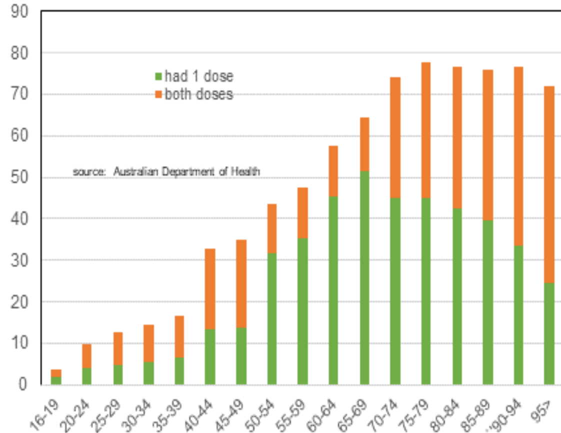
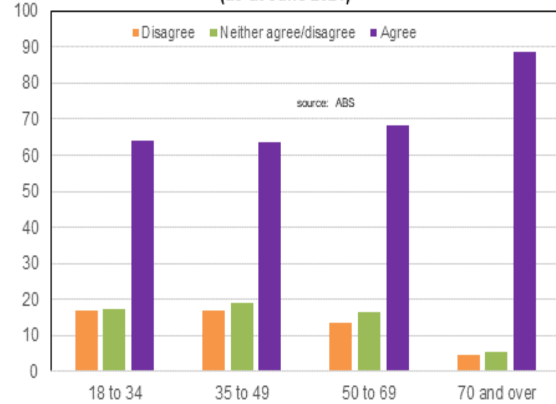
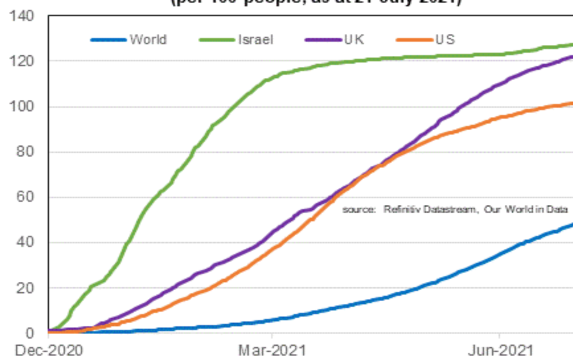
Vaccination rates are highest amongst the over 70. There remains no agreement on the target.



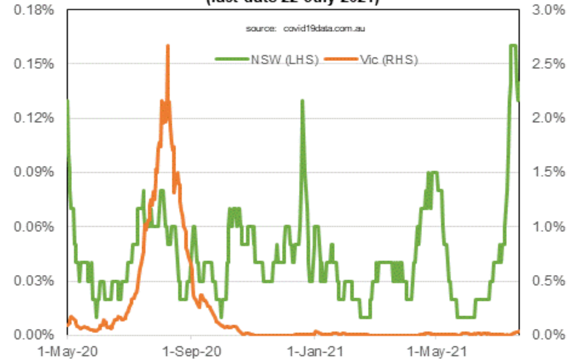
Surveys suggest that we may struggle to get to an 80% target without incentives.



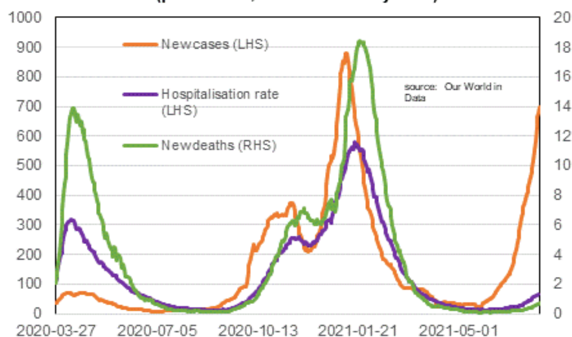
The global experience has been that it has been tough to get more than 60% of the population vaccinated.



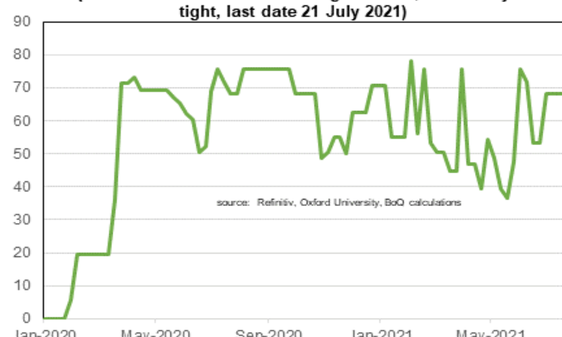
Positive COVID tests in Sydney has hit a high. But are less than 10% of the peak in Melbourne last year.



A third COVID wave is hitting the UK. Hospitalisation and deaths are substantially lower. But they are rising.



The stringency of Government regulations has returned back near last year's highs.



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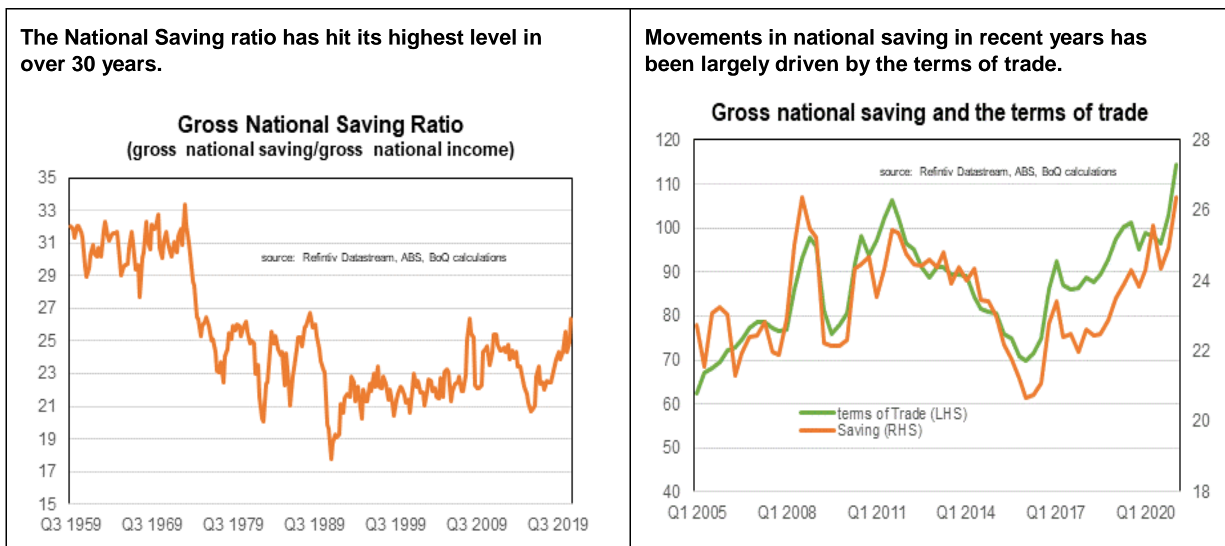
Long-term issue: National saving

Until the recent outbreak the consensus view was that the domestic economy was very strong. The main downside risk was the re-appearance of COVID. But the upside economic risk often cited (including by me) was the potential for the 'mountain of saving' that was built up last year to be spent once the economy fully re-opened.

Last year the national saving ratio (the combined saving of households, firms and governments relative to national income) hit its highest level in over 30 years. Up until the early noughties that ratio was on a declining trend. This was principally because a more efficient financial system meant that households and firms did not have to save as much to access finance.

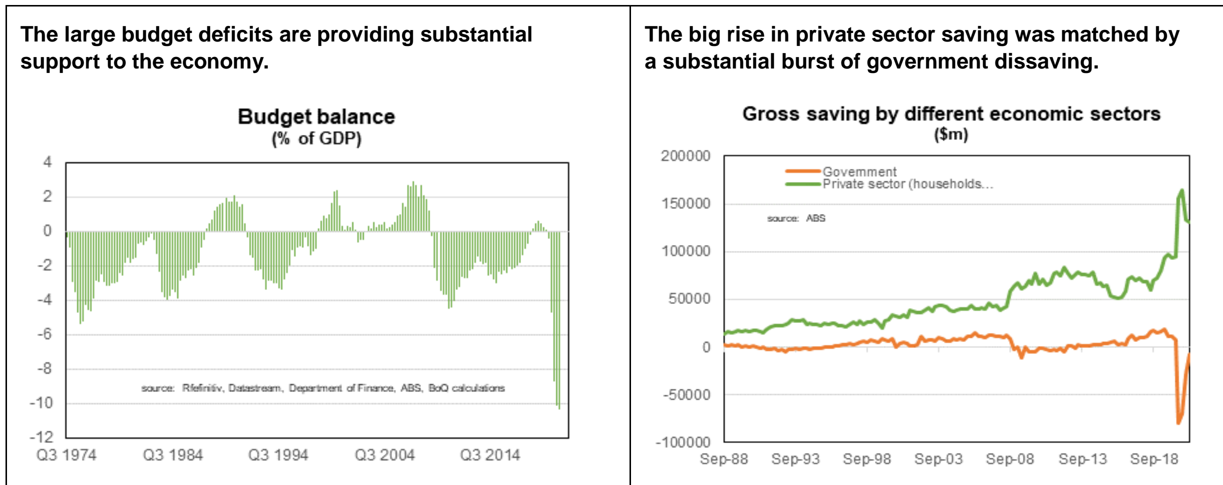
But over the past fifteen-plus years movements in the national saving rate have largely reflected changes in the terms of trade (the price of exports relative to the price of imports). If the relationship holds it does suggest that national saving is likely to decline when the commodity prices cycle turns.



Government saving – the buffer

Different sectors save at different rates. The Government saving performance over recent years has mainly been the mirror image of what has happened in the private sector. Last year the massive increase in private-sector saving was matched by a massive fall in government saving as policies were put in place to absorb the blow to household disposable incomes from COVID. This is how Government budgets' should operate. Fiscal policy acts as an offset to developments in the private sector to reduce the fallout in the economy.

Over the next year government saving will continue to be negative as budgets are set to provide ongoing strong support to the economy. This fiscal support may yet need to increase depending upon the extent and duration of the lockdowns. But once economic growth reaches the target (unemployment rate 4-4.5%) governments are likely to focus on re-building their saving by allowing their operating budgets to return back towards a surplus. The saving will be used to pay down debt as well as help fund large infrastructure programs.



Household saving – the only way is down

Gross household saving is often measured as a ratio (relative to disposable income). But it is interesting to look at it in actual amounts. The total amount of saving was relatively steady over the course of the 1990s at around $10b per quarter (which meant that the ratio to disposable income fell over time). The total amount of household saving rose in the early noughties, helped by the extra income pumped into the economy by a rising terms of trade (as well a rise in household caution reflecting worries about higher debt). Household saving has been broadly flat for much of the past decade, impacted by the slower growth of household disposable incomes.

Last year household saving exploded. Despite Australia experiencing the most serious peacetime recession since the Great Depression, household disposable incomes rose underpinned by a range of government programs (notably JobKeeper). Lockdowns meant that households had less ability to spend (no travel). A comparison relative to the trends prior to COVID suggests that more of the increase in saving was due to the weakness of spending than the rise of income. A big rise in household saving also took place in other developed economies.

The extent of the current lockdown in Sydney (and other cities) means there is a chance that saving may rise in the current quarter (although income support may not provide the same support to household deposable incomes last year). But once the lockdown ends household saving is likely to decline. How much lower remains the key question.

I would expect the level of saving to be higher than it was in March last year for at least the next 6-12 months given restrictions that remain on spending (particularly travel). The strong economy should mean higher incomes (providing the greater ability to save). And the events of the past year may lead households to want to be more cautious (so have a higher of level of saving). Once the international border is opened further declines in the saving rate is likely.

In addition to changes in the level of saving there will also likely be changes to the composition of saving. A lot of the extra saving of last year went into deposits. Partly that was households wanting a ready source of liquid funds. But also consumers put money into offset accounts to repay debt. The high level of uncertainty meant money was taken out of the equity market. And the desire for liquidity saw a substantial slowing of inflows into Super (as well as the Government allowing people to take money out of Super to provide cashflow support).

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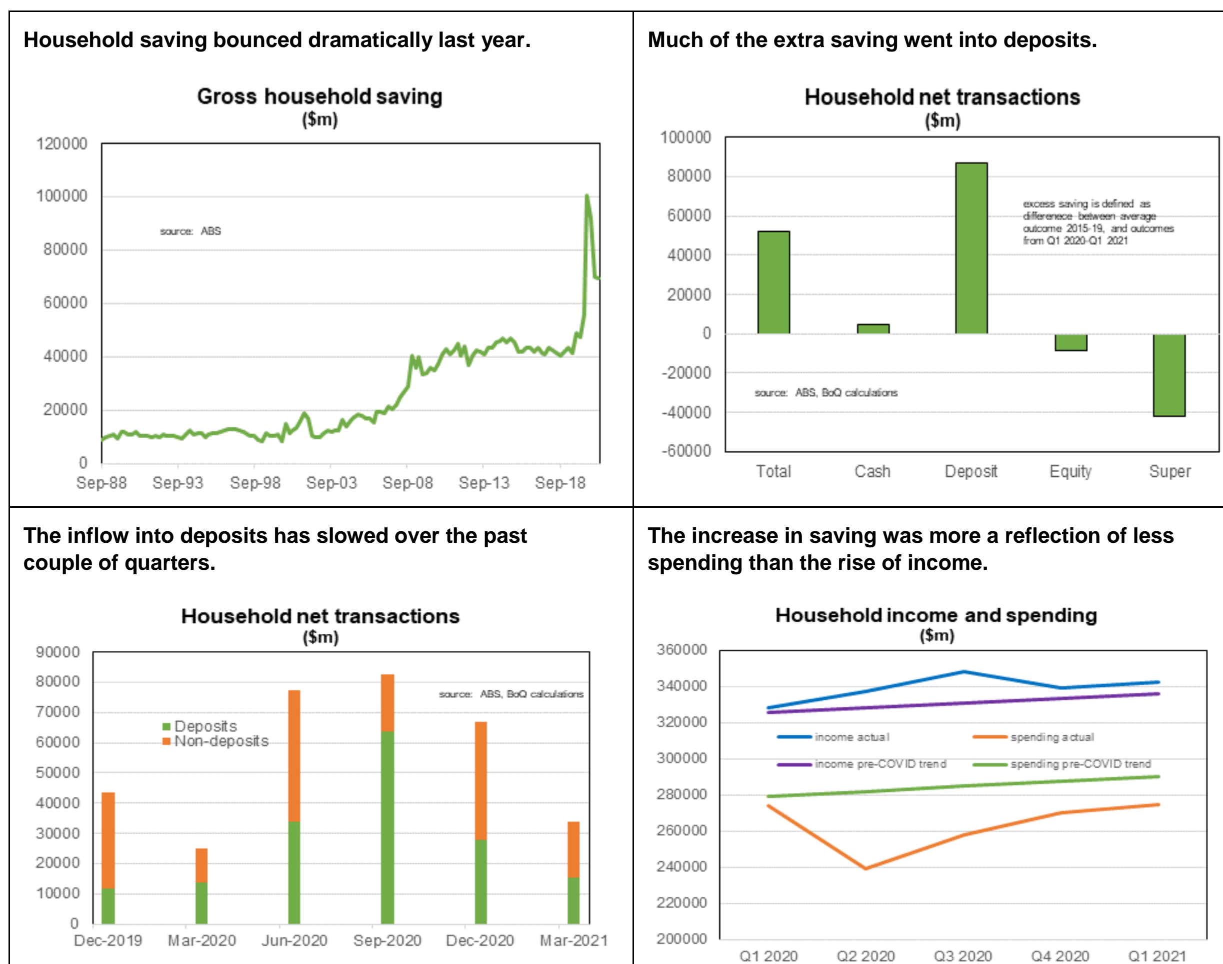
The flow into deposits peaked in the second quarter of last year, a time when the lockdown impact on spending was most stringent and concern about the economic outlook most pessimistic. In subsequent quarters not only has the rate of household saving fallen but the proportion of that saving flowing into deposits has decreased.

Surveys indicate a decline in the proportion of households wishing to put their money into deposits or pay down debt (a reflection of rock-bottom interest rates). Both proportions though remain well above their pre-GFC level. The sharemarket is looking more attractive to households, as does the attraction to Super for a number of households.

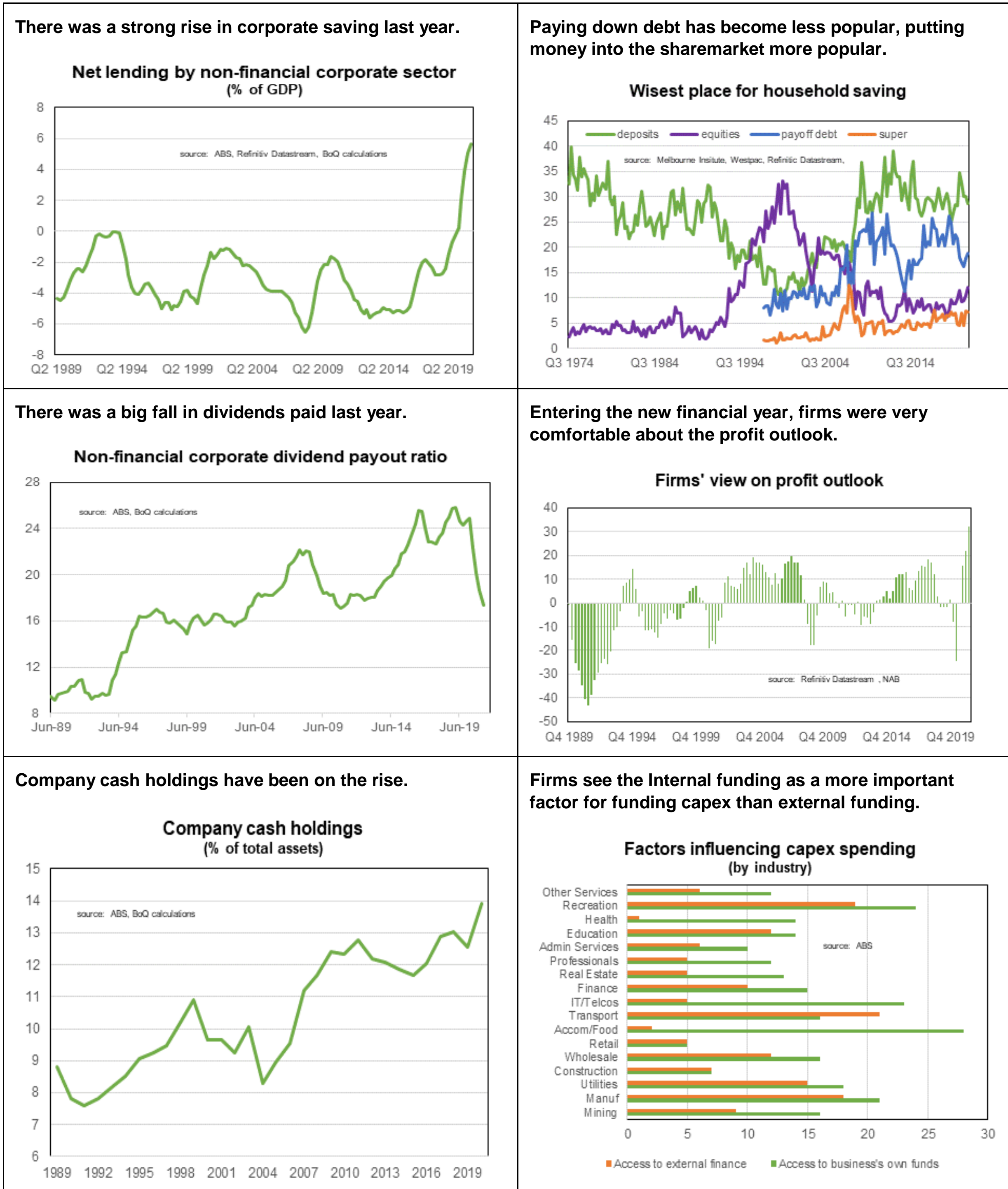


Corporate saving – less to build more

Last year there was also a significant rise in corporate saving. Partly that reflected strong revenue growth, notably by miners. Caution about the economic outlook meant that firms kept a lid on costs. Low interest rates led to low debt servicing costs. And last year governments assisted firms by proving tax deferrals (for some the rent deferrals were a positive, for others a negative). The uncertain environment meant that capex spending was kept to a minimum with the saving put into the bank.

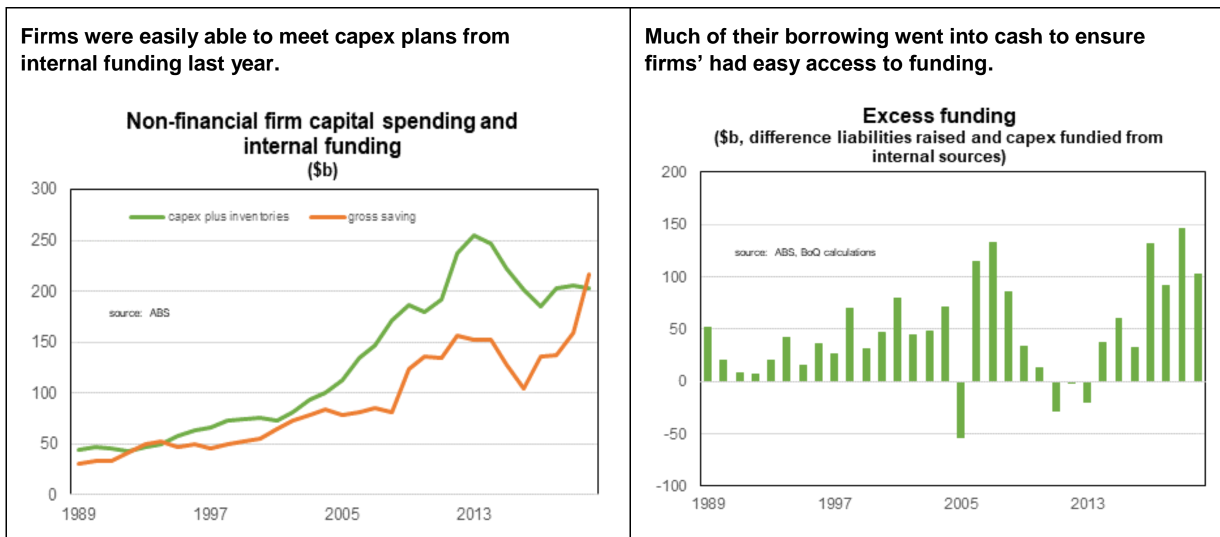
Over the next couple of years a decline in business saving is likely. Businesses are very confident about the profit outlook (at least until the recent lockdowns). But competition for labour and materials will mean that cost growth will be higher. They will (and) are able to pass some (but not all) of those costs

onto their customers. And Governments' are unlikely to provide the same income support through tax and rent deferrals. Dividends will rise.



Lower saving is likely to result in slower growth in business deposit growth. Firms' will use their saving to fund big capex plans, to boost dividends or to repay the debt raised last year when concerns about the economic outlook were higher. A recent ABS survey indicated that access to own internal funding sources was twice as important as access to external finance although its importance differs across

sectors. Cash levels in the corporate sector overall is at a high level (although cash flow is an issue for some SME's).



In the short term, renewed lockdowns may see household and business saving rise. But once the economy re-opens, consumer and business spending will rise and saving decline. From a national standpoint this will be partially offset by a rise in government saving. The overall aggregate number will determined by movements in the terms of trade.

We live in interesting times.

Regards,

Peter Munckton
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Bank of Queensland