ECONOMIC UPDATE

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WEEK ENDING 3RD SEPTEMBER 2021

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Key points

- **Q2 GDP growth was stronger than expected;**
- **All agree that things have taken a sharp turn for the worse in Q3;**
- **But next year is still likely to be a good one for the economy;**
- **The economy will be supported by very low interest rates;**
- **It may yet require further fiscal support.**

Summary

The June quarter national accounts data was the threatening storm that never arrived. GDP growth in Q2 was 0.7%, a pretty decent number. In the quarter there was plenty of consumption, infrastructure spending and the frenzied activity in the housing market. Exports and inventory investment were the soft spots.

The Q2 GDP number could have been even higher. Lockdowns did not help. There were also shutdowns in the mining sector impacting exports. But a more substantive reason was that the economy was constrained by supply-chain problems and labour shortages.

Farmers have done very well, as have the retail, wholesale trade and road transport sectors. It is the service sectors that have been doing it very tough (particularly Air and Rail Transport) impacted by the lack of people movement and gatherings.

The big potential upside for the service sectors is the high level of household saving. Although down from its 2020 peak, it is above the average rate recorded in the decade prior to COVID. The domestic and international experience is that saving rates decline as restrictions are eased, with service sectors a beneficiary.

The economic outlook for Q3 has evolved dramatically even just over the past month. The weaker growth comes down to two causes. Tighter government restrictions in NSW, Victoria and the ACT has substantially reduced the amount of economic activity that is able to be done. And the decline in business and consumer confidence (particularly in those regions) means there has been a decline in the desire to do things.

The international evidence is that rising cases has moderated economic activity, even in those countries with relatively high vaccination rates. But the experience of the US and Europe is that while rising case numbers has some impact upon economic activity even with higher vaccination rates, the impact is weaker than over the past year.

The virtual certainty that GDP growth will be heavily negative in Q3 has led to a discussion about the possibility of a 'technical' recession. It is widely agreed in this slowdown that the (likely) short (but very sharp) duration of the slowdown and the size and shape of government income support programs will result in only a modest rise in the unemployment rate. The labour market impact of the economic slowdown will be more evident in other indicators, such as less hours worked and a declining participation rate.

Another sign of a recession is a dramatic fall in national income growth. But Government support programs have largely offset much of the fall from the decline of household and business incomes (albeit at the cost of larger budget deficits and higher government debt). In any event, the technical definition of a recession is unlikely to hit this year.

June quarter GDP: Good but could have been better

The June quarter national accounts data was the threatening storm that never arrived. Heading into the release of the number financial market expectations about the economic performance in the June quarter had been downgraded aggressively. Some even expected a negative number (although to be fair those analysts' revised up their forecast to a positive figure before GDP was released).

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As it turned out GDP growth in Q2 was 0.7%, a pretty decent number. In the quarter there was plenty of consumption (by both households and governments). Infrastructure spending was a plus, as was the frenzied activity in the housing market. Business investment was neutral (spending on plant and equipment and digitization continued to grow). Exports and inventory investment were the soft spots.

The June quarter was characterised by businesses reporting the best trading conditions in over two decades, high capacity utilisation, rising job vacancies, a declining unemployment rate, strong rises in the number of hours worked and positive consumer sentiment. Economists spent that quarter bringing forward their expectations about the timing of the first cash rate hike.

Indeed, if the wind had of being blowing in the right direction the Q2 GDP number would have been even higher. Lockdowns did not help. There were also shutdowns in the mining sector impacting exports.

But I think a more substantive reason why growth was not stronger was that the economy was constrained by supply-chain problems and labour shortages. Certainly that was the feedback from many firms. Skilled labour shortages were a big reason why construction work in the June quarter was not stronger. It is also a factor why a number of infrastructure projects have not progressed more rapidly.

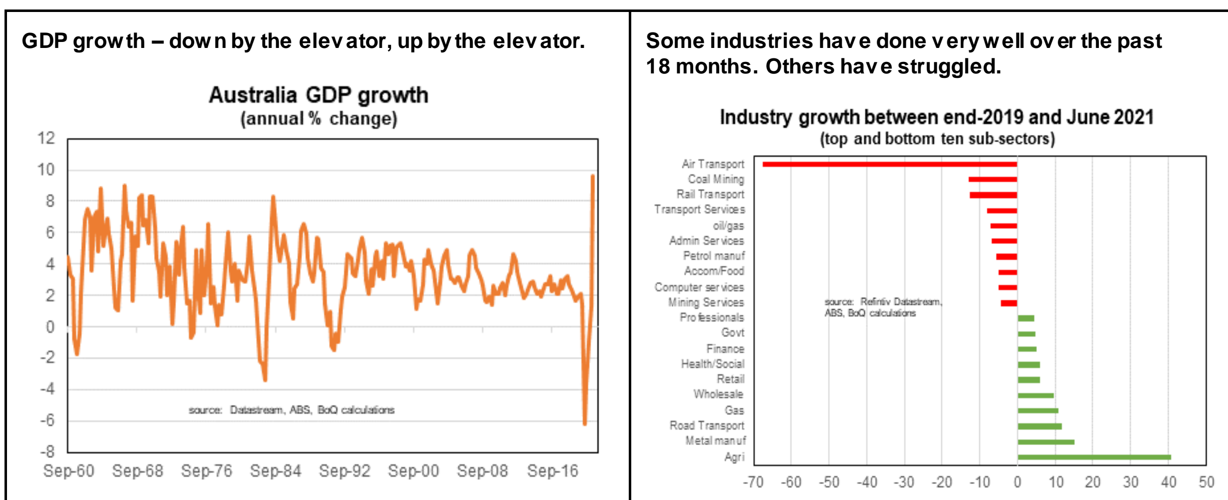
Strong demand at a time of supply-side constraints played a role in inventories detracting from growth (there was a big rise in government inventories but the total increase in Q2 was less than in Q1). The inventory-to-sale ratio is well below average levels in a number of sectors. This suggests that inventory investment will help provide an economic boost in coming quarters.

Economic outcomes very mixed between sectors

All the time different sectors of the economy grow at different rates. That could be because of variable factors (weather), shifts in consumer and business trends (digitization) or the state of the economic cycle (housing, manufacturing and tourism do better when the economy is strong).

But the difference in growth rates between sectors over the past year has been the widest since the mid-1970s (when the ABS first started providing detailed industry data). Farmers have done very well, boosted not only by the bounce back from the drought but also being less constrained by COVID restrictions. The retail and wholesale trade sectors, as well as road transport, have been boosted by consumers' being stuck at home doing online shopping. It is the service sectors that have been doing it very tough (particularly Air and Rail Transport) impacted by the lack of people movement and gatherings.

The big potential upside for the service sectors is the high level of household saving. In the June quarter that ratio dropped to a bit under 10%. Although down from its 2020 peak, it is above the average rate recorded in the decade prior to COVID. Lockdowns will mean a rise in forced saving in Q3 (evidenced by the increase in bank deposit growth in June and July). The domestic and international experience is that saving rates decline as restrictions are eased, with service sectors a beneficiary. An ABS survey of households indicated that travel was the most popular choice to spend more saving if they could (other choices included buying or renovating their house, or paying down debt).



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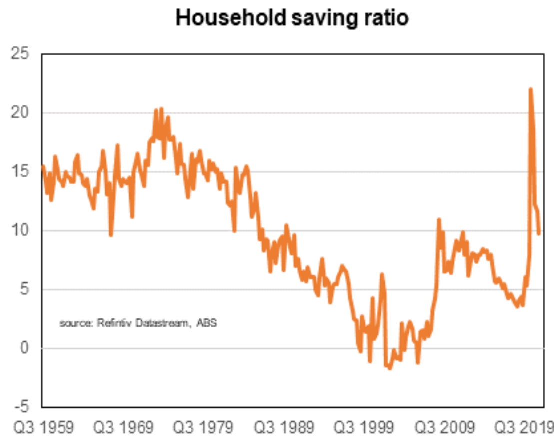
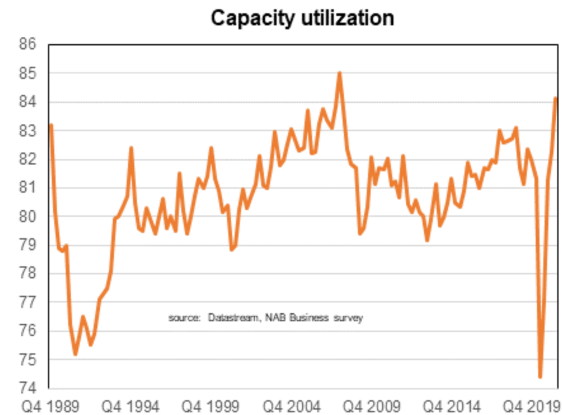
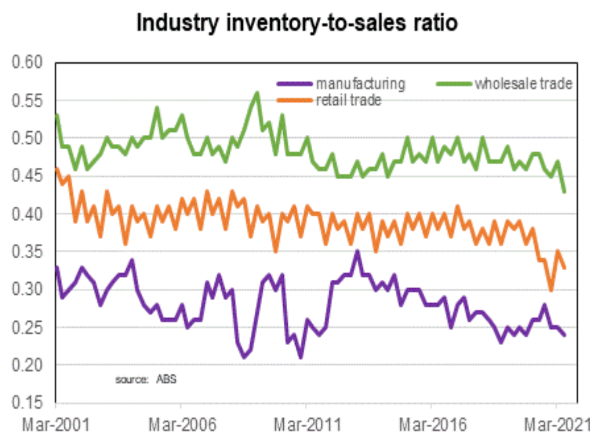
The household saving ratio remains at a high level (and may go higher in Q3).



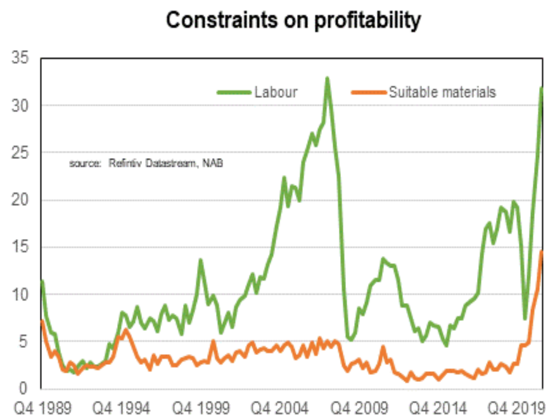
In the June quarter firms reported highest level of capacity utilisation post GFC.



The inventory-to-sales ratio is low in a number of sectors.



Supply-chain problems and labour shortages were big issues in Q2.



But there are tougher times ahead

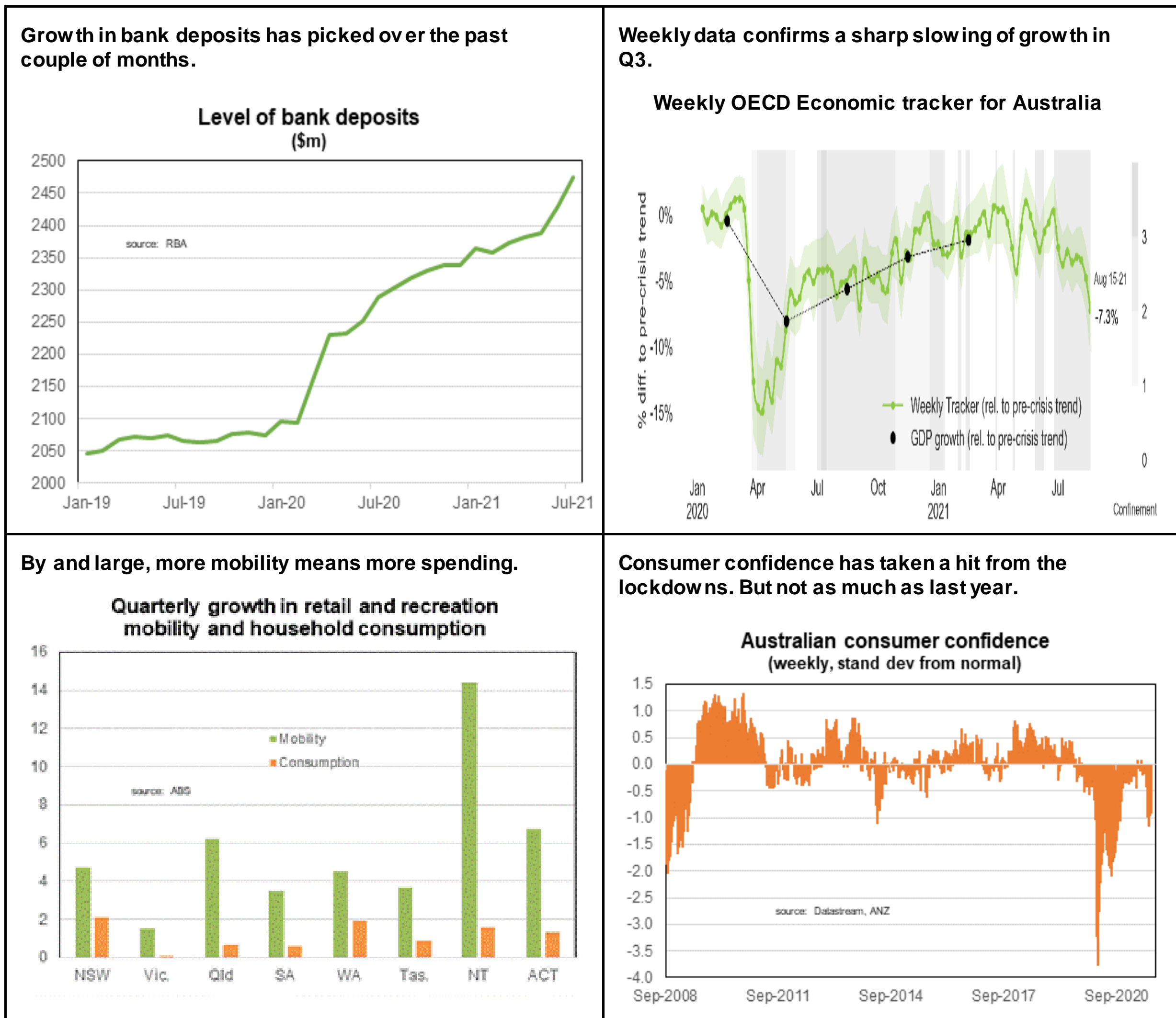
The Q2 GDP number did not leave a lasting mark on financial markets. The Sydney lockdown has resulted in economic conditions changing too much. To the extent the June Quarter GDP numbers said anything it was that the economy was entering H2 2021 with good momentum.

But the economic outlook has evolved dramatically even just over the past month. At the start of August the RBA thought that the economy might decline by around 1% in the September quarter. By mid-August the Federal Treasury thought that the decline might be closer to 2% (also the consensus expected in the financial markets according to a Bloomberg survey conducted towards the end of August). By the start of this month some economists were plumping for a GDP outcome of -4% (or worse).

The weaker growth comes down to two causes. Tighter government restrictions in NSW, Victoria and the ACT has substantially reduced the amount of economic activity that is able to be done. And the decline in business and consumer confidence (particularly in those regions) means there has been a decline in the desire to do things.

The international evidence is that rising cases has moderated economic activity, even in those countries with relatively high vaccination rates. For example, while the US economy is largely open the impact of rising COVID cases has impacted activity in the service sectors (plane trips remain below pre-COVID levels, music concerts are being cancelled). But the experience of the US and Europe is that while rising case numbers has some impact upon economic activity even when vaccination rates are higher the impact is weaker than over the past year. Even

now in Australia the drop in business and consumer confidence has not been as stark as Q2 last year reflecting government assistance, the availability of vaccines and greater understanding of the disease.



Is the economy in recession?

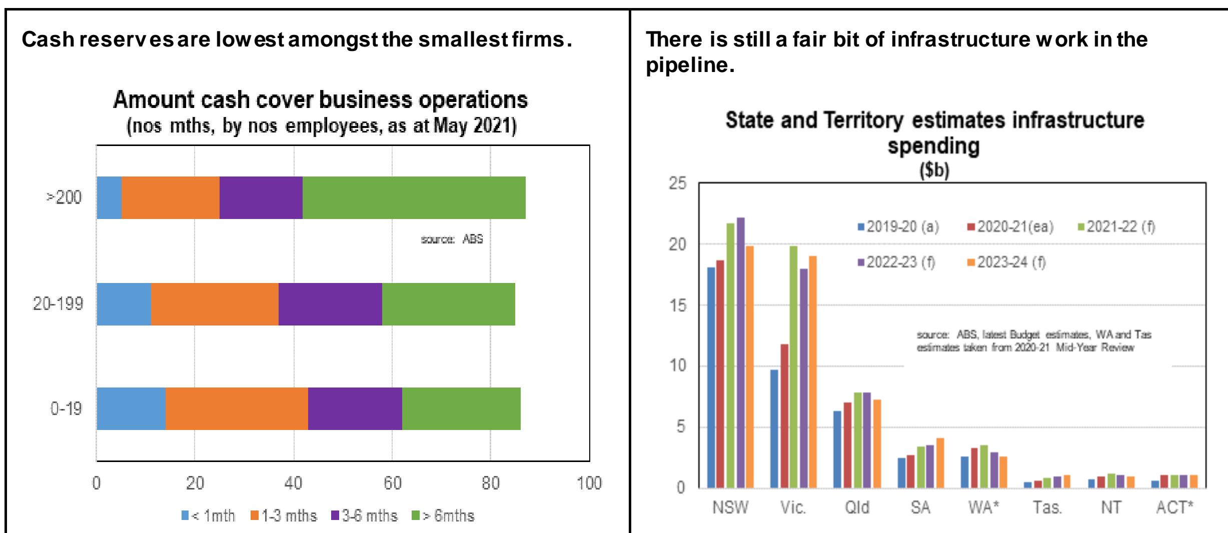
The virtual certainty that GDP growth will be heavily negative in Q3 has led to a discussion about the possibility of a 'technical' recession. In Australia that has been defined as two quarters of negative GDP growth. This benchmark implies that a recession can only occur if economic growth is negative for at least six months. Maybe a better definition might be based upon a set percentage decline in economic activity.

An argument for using the length of time is that short (even very sharp) economic slowdowns may not impact on the variables that matter to most people in the community. It is widely agreed in this slowdown that the (likely) short (but very sharp) duration of the slowdown and the size and shape of government income support programs will result in only a modest rise in the unemployment rate. The labour market impact of the economic slowdown will be more evident in other indicators, such as less hours worked and a declining participation rate.

Another sign of a recession is a dramatic fall in national income growth. But Government support programs have largely offset much of the fall from the decline of household and business incomes (albeit at the cost of larger budget deficits and higher government debt). Sky-high commodity prices has led to a high terms of trade that is providing plenty of support to national income growth.

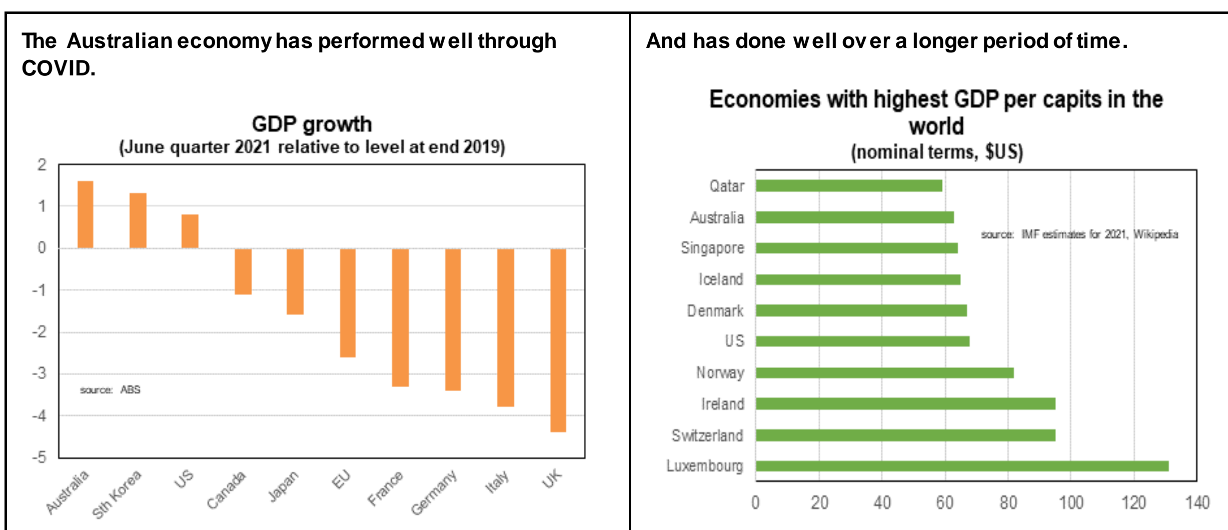
In any event the technical definition of a recession is unlikely to hit this year. The NSW Government appears determined to start re-opening the economy once an 80% vaccination rate is achieved in that state. And on current pace they might hit that level by early November. The bounce-back in economic activity we usually see from re-opening should means that Q4 GDP growth will be positive.

Nonetheless, the shutting down of almost 60% of the national economy for a few months will cause a sharp economic contraction. A fair bit of the economic pain usually associated by such a dire economic event will be largely (but not completely) dulled. But the longer the lockdowns last the greater the economic pain. An ABS survey in May indicated that a fair proportion of smaller firms have relatively low cash balances making them vulnerable to ongoing tough economic times.



From a longer-term perspective the Australian economy has done pretty well

Leaving aside what may happen this quarter it remains the case that the Australian economy has handled COVID pretty well. Australia is one of the few countries in the OECD that had a larger economy at the end of June 2021 than it did at the end of 2019. And over an even longer time frame Australia's economy has done so well that it is now the twelfth largest in the world. All of the larger economies have bigger populations. After adjusting for population size, Australia's GDP per capita is the 9th highest in the world (about the same level as the US).



So GDP growth in the June quarter was better than expected. There is no doubt Q3 will be a tough one for the economy. But there remains reasons for optimism for 2022.

One question I am often asked is when we will return to pre-COVID times. The short answer is I hope we don't. By global standards we have done pretty well. But the level of our unemployment rate and pace of wages growth pre-COVID were signs that we could have done better. The good news is that we have a decent chance to achieve a better outcome in coming years. COVID looks to be with us for some time yet, meaning the road travelled for at least the next year might be bumpier than we would prefer. But it least the road maybe heading in the right direction. To achieve the better outcomes the RBA will need to keep interest rates unchanged for at least the next two years. And the potential for ongoing restrictions to fight COVID means that more fiscal support may yet be required.

We live in interesting times.

Regards

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