ECONOMIC UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

WEEK ENDING 4TH MARCH 2022

BOQ GROUP

Key points

- **The biggest impact of the Russia-Ukraine crisis might be the uncertainty of what will happen;**
- **There is a high probability the conflict will lead to higher global inflation. The impact on economic growth is less clear;**
- **The Australian economy ended 2021 on a good note, and there are reasons to think 2022 might be better;**
- **Confidence about the economic outlook and higher inflation means the cash rate might rise even before wages growth touches 3%.**

Summary

Removing Russia from the global economy will have an impact. The impact would have been bigger one or two decades ago. But Russia has been under sanctions since its invasion of Crimea in 2014 and its interactions with the global economy subsequently declined. Russia is a big player in a number of mining and agricultural products. Prior to the conflict it was its importance as an exporter of energy to European countries (notably Germany and Italy) that was a major concern.

The main impact of the sanctions will be to make it very difficult for the Russians to make payments in the global trading and financial systems. The effectiveness of the sanctions reflects the predominance of the $US in the global payments system. There is a good chance in the short term (1-2 years) the sanctions could be very effective. But the use of the sanctions will encourage countries to examine alternative methods to make international payments (such as the development of digital currencies).

The sanctions will also impact capital flows into and out of Russia. The biggest financial linkages are direct investments. It is likely to be hard for many Russians to access a fair chunk of their international wealth for some time. But it is also likely to be tough for international companies (and fund managers) to sell their Russian assets. There is uncertainty as to how big the impact will be in removing Russia from the global economy. The longer the uncertainty lasts the more likely financing costs rise, a negative for the global economy.

The biggest global impact of the sanctions is likely to be the reduction of Russian supply to global energy and agricultural markets resulting in higher inflation (that in turn could reduce economic growth). Global central banks (most notably the Federal Reserve) might have to provide additional liquidity to financial markets. But the current level of inflation is likely to mean that central banks will continue increase interest rates in coming months.

The broad theme of the Q4 Australian GDP numbers was that domestic economic growth was a lot stronger than analysts (including myself) had anticipated ending 2021. The size of the economy at the end of last year was not only above its pre-2019 level but also back to its pre-pandemic trend growth rate. Growth was strongest in Air Transport in 2021. While a relief this really was just a bounce back from the horrendous 2020. The agricultural sector is benefiting from high commodity prices and favourable weather. The IT sector from the digitisation trend. Rail transport is still doing it tough.

The bottom line is that the Australian economy ended 2021 on a good note. And there are many reasons to expect the music to keep playing this year. As always, there are risks.

As expected the RBA did not change interest rates. And the accompanying commentary was largely as expected. The pace of wages growth is broadly going in line with RBA expectations. The RBA has acknowledged there is a growing chance that inflation might be higher for longer than their current projections. This means that that the cash rate might rise before wages growth hits 3% if inflation is higher than the RBA expects. This makes the Q1 CPI number (released 27th April) a potential dance-floor clearer.

What have we done wrong

What an extraordinary past few years. Just over two years ago we were staggered by the enormity of the bushfires that hit the East Coast of Australia. Since then we have had a once in a century pandemic and now a once in a century rain storm. When are those 'normal' times going to return?

And then the Russia-Ukraine crisis reminds us that major wars happen in the 21st century and have a serious impact upon the global economy and financial markets. There is still plenty we don't know. Most important is how long the war will last. Even assuming that the war is relatively short (1-3 months) it is likely that the sanctions will last longer. It is unlikely that the 'West' would want the sanctions to end until Ukraine has regained its sovereignty. But a Ukraine with tighter links with Western Europe is something that Russia does not want.

Economic impact of the crisis

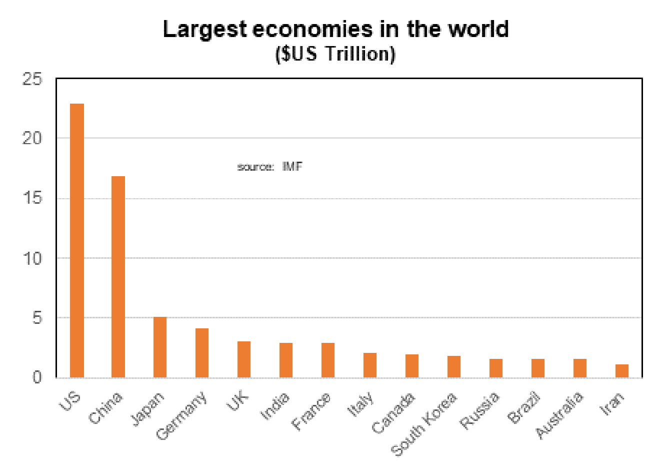
At around $US1.6 trillion the Russian economy is a little bigger than Australia. At about 2% of the global economy its removal from the global trading and financial system will have an impact. The impact would have been greater one or two decades ago. But Russia has been under sanctions since its invasion of Crimea in 2014 and its interactions with the global economy subsequently declined.

Russia and Ukraine combined are a relatively small part of the global trading system but both are major players in a number of mining and agricultural markets. Prior to the conflict it was there importance of Russia as an exporter of energy to some European countries (notably Germany and Italy) that was one of the key economic considerations.

Russia's importance in energy markets is the main reason why they was excluded from the impact of sanctions. But inevitably there has been uncertainty about the scope of the sanctions (eg, which bank accounts can be used to pay for oil and gas). That uncertainty is playing a role in the rise of oil and gas prices. More generally the exclusion of major commodity suppliers at a time of strong demand and supply constraints is likely to mean an extended run of higher commodity prices.

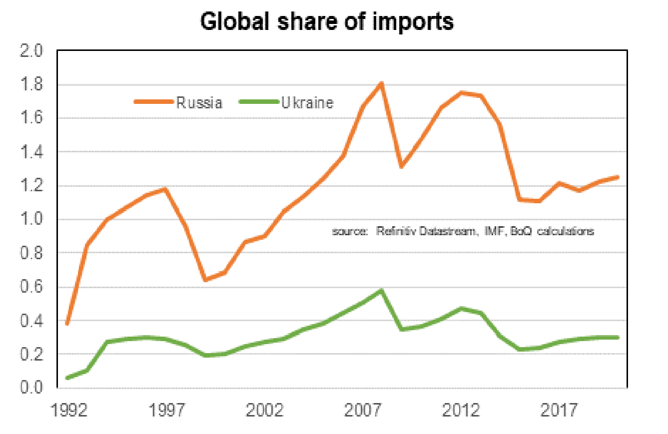
Over time the direction of Russian trade has shifted from the West (Europe) to South (towards China and much of the rest of Asia). Partly that reflects the growing importance of Asia in the global economy, and particularly in the global trading system. But it also is a reflection that previous sanctions were implemented most stringently in the US (particularly) and Europe. The ongoing rise of the Asian economy and the impact of the new sanctions will likely see a further shift of Russian trade towards Asia (notably China). Russia is a big importer from some neighbouring countries exports (such as the Baltic states).

Russia is a little bigger than the Australian economy.

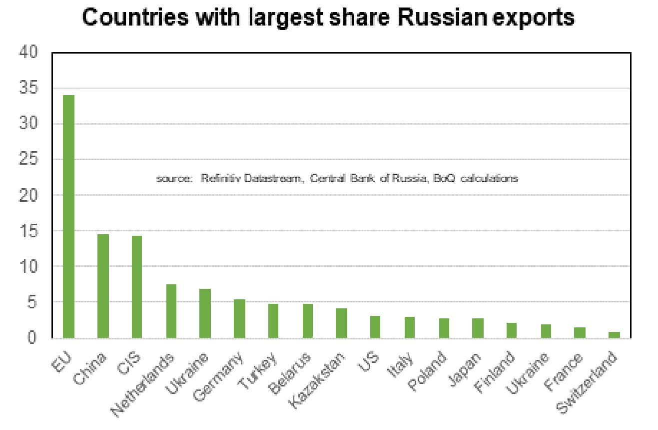


Russia has lost global export market share over the past decade.

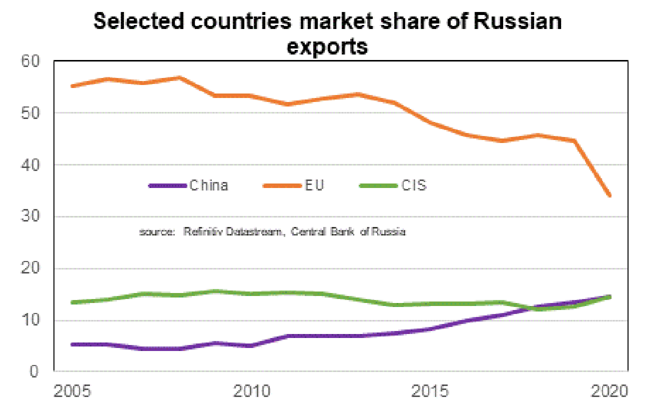
The relatively modest size of its economy means Russia takes a smaller share of the global imports.



Europe, China and neighbouring countries receive the biggest buyers of Russian exports.



Europe is becoming a less important buyer to Russia with more exports directed towards China (and the rest of Asia).



Russia is an important global player for some mining and agricultural products.

The main impact of the sanctions will be to make it very difficult for the Russians to make payments to access the global trading and financial systems. This includes access to over half of Russia's (large) foreign exchange reserves that it would have been hoping to use to support its currency and domestic financial system. The effectiveness of the sanctions reflects the predominance of the $US (and therefore the US banking system) in the global payments system. There is a good chance in the short term (1-2 years) the sanctions could be very effective (they have been against Iran). But the use of the sanctions will encourage countries to examine alternative methods to make international payments (such as the development of digital currencies).

The sanctions will also impact capital flows into and out of Russia. The Russian Government has a low debt burden, with only around $US29b owned by foreign investors. The banking systems with the largest exposures to Russia are France and Italy (about $US25b combined). Fund managers may wish to reduce their exposure to Russia but this might be hard to do for some time with the closure of the Russian financial system.

The biggest financial linkages are direct investments (ie, foreign companies such as BP owning a part of an oil project, Russians owning London real estate). It is likely to be hard for many Russians to access a fair chunk of their international wealth for some time. But it is also likely to be tough for international companies to sell their Russian assets.

This leads to the more substantial issue and that is the uncertainty of how big the impact will be about the removal of Russia from the global economy. It is hard to know all the linkages, particularly the financial ones. It is this uncertainty that has led to the selloff in global equity markets. The longer the uncertainty lasts the more likely financing costs rise, a negative for the global economy.

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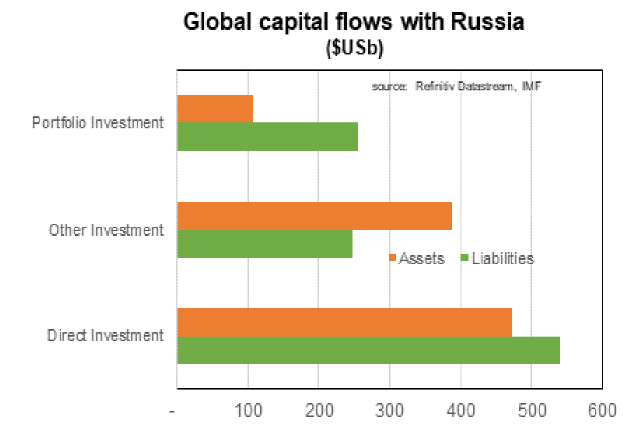
The removal of Russia (and Ukraine) from the global economy could be expected to reduce global demand although that might be more than offset by the rise in defence spending in many countries. The bigger global impact is likely to that the reduction of Russian supply to global energy and agricultural markets will lead to higher prices (that in turn could reduce economic growth).

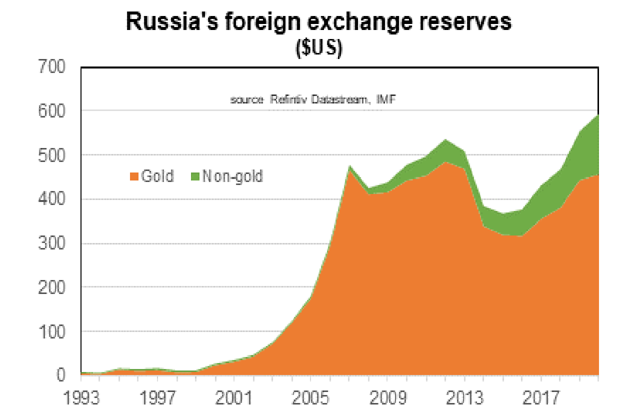
Financial markets are currently thinking that the impact of the war on commodity prices (and therefore inflation) will be short-lived. Maybe that is right although the risk is that the sanctions (and therefore the impact on commodity prices) will be longer lasting. And the longer inflation stays higher the more likely that inflation expectations will increase. In turn that increases the chances that inflation will remain too high.

Global central banks (most notably the Federal Reserve) might have to provide additional liquidity to financial markets (for example to help meet increased demand for $US). But the current level of inflation is likely to mean that central banks will continue increasing interest rates in coming months (as Bank of Canada has just done). The longer the uncertainty about the war lasts the greater the chance that the pace of the global rate hikes for the second half of this year won't be as aggressive as current financial market pricing. This could mean that inflation stays higher for longer. And may result in interest rates having to head to a higher level than currently suggested by financial markets.

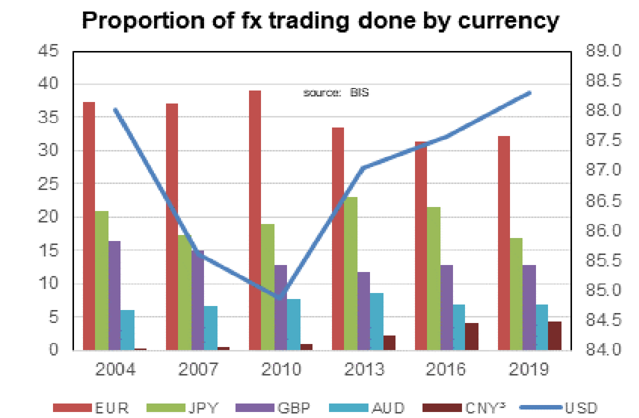
Direct investment comprises the largest proportion of global capital flows with Russia.



A bit under 40% of Russia's foreign exchange reserves are either in gold (held in Russia) or are in Chinese assets.

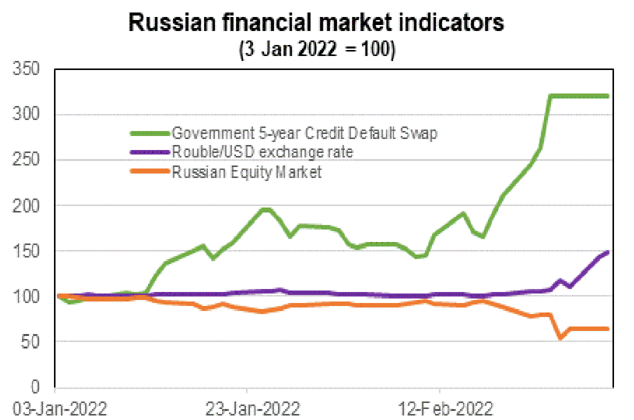


The $US predominates international foreign exchange trading.



Note: USD RHS axis

The War and the impact of sanctions has had a massive impact on Russian financial markets.



The Australian economy entered 2022 in fine fettle

I will write more on the performance of the Australian economy in coming weeks. But the broad theme of the Q4 GDP numbers was that economic growth was a lot stronger than analysts (including myself) had anticipated ending 2021. It is this strength of the economy that is leading to the very high demand for workers (together with the lack of supply of workers due to low immigration is leading to the very low unemployment rate).

The size of the economy at the end of last year was not only above its pre-2019 level but also back to its pre-pandemic trend growth rate. Consumer spending on services picked up in the December quarter as Sydney and Melbourne lockdowns ended. But the level of spending on services remains (just) below its end 2021 level while consumer demand for goods remains elevated (a factor behind the global supply-chain problems). Supply constraints and strong demand means that inventory levels (relative to sales) remains low. The desire for firms to build stock should be a positive for economic growth this year.

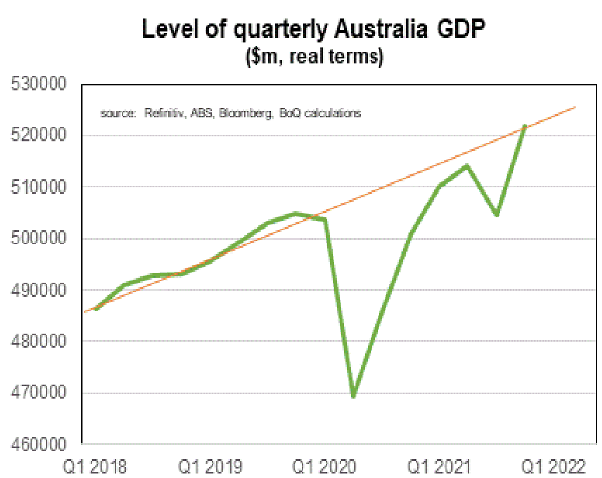
Growth was strongest in Air Transport in 2021. While a relief this really was just a bounce back from the horrendous 2020. Things are still tough for the airlines with the size of the sector still less than 20% of its pre-COVID level. The agricultural sector is benefiting from high commodity prices and favourable weather. The IT sector from the digitisation trend. And the food and beverage manufacturing sector has done well with more people eating at home and international supply-chain problems increasing demand for local goods. Growth was also modest in the year for coal and iron ore miners. Weather-related and other shutdowns played a role. High commodity prices will be making iron ore and coal miners smile wider this year.

The GDP numbers include another measure of labour costs (average earnings). They grew by 3.1% over the year, about the same as the wage price index (once bonuses are included). No real need for the RBA to be uncomfortable.

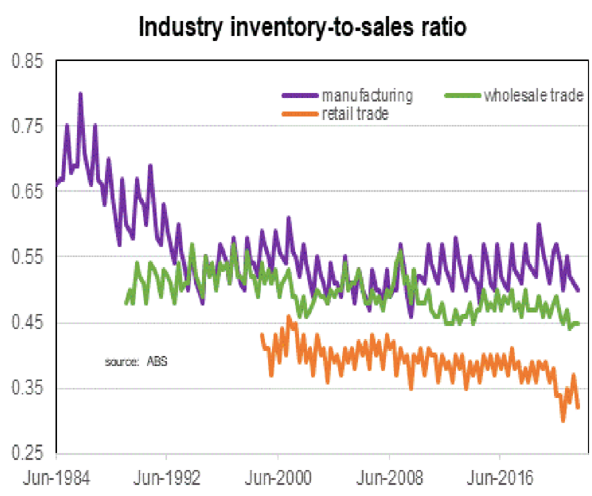
The bottom line is that the Australian economy ended 2021 on a good note. And there are many reasons to expect the music to keep playing this year. High commodity prices means exports should be strong. Builders have plenty of houses to complete. There is a mountain of infrastructure work to be done. Firms look to be boosting their capex budgets. A low unemployment rate and rising wages growth should mean consumers will continue to spend. And in an election year, fiscal policy should remain supportive.

What are the risks that the music might stop? The appearance of a deadly variant of COVID would be one although the recent pandemic news has been benign. Rapid global interest rate rises and the impact this would have on asset prices and borrowers is something to be watched. What happens to workers real wages (wages growth after taking account inflation) will be important. And of course we still need to see how the Russia-Ukraine crisis plays out.

The Australian economy has returned to its pre-pandemic trend growth path.

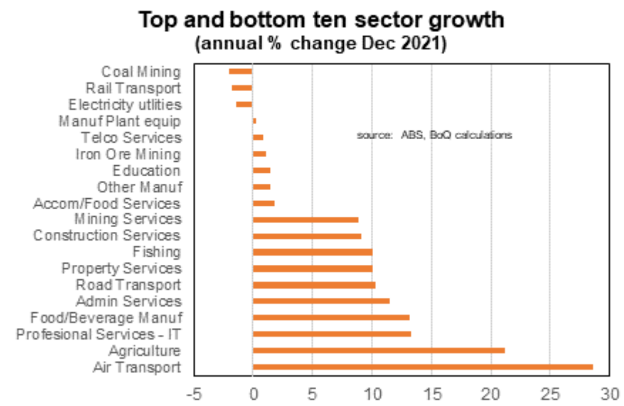


Inventories are low across many sectors.

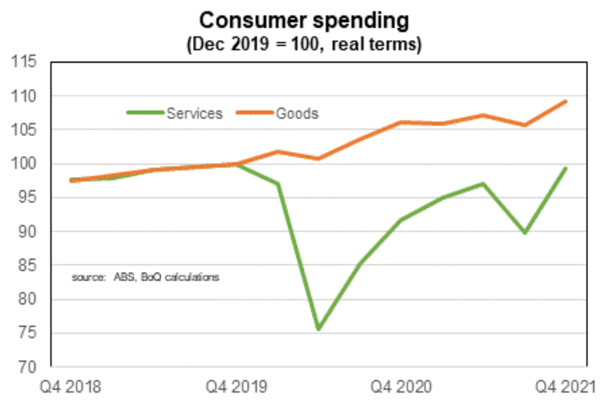


 Bank of Queensland Limited ABN 32 009 656 740 (BOQ).

Air Transport had a better 2021. It needs an even better 2022.



Consumer spending on services is picking up.

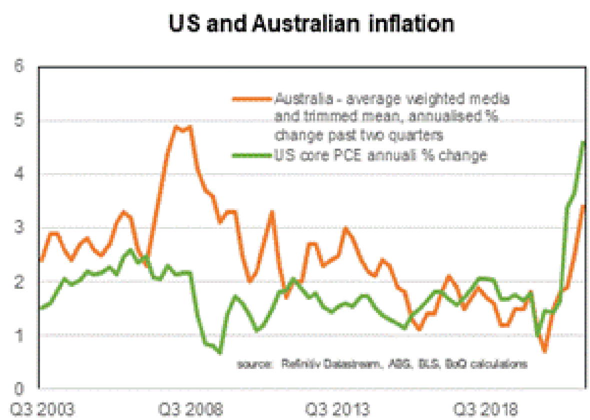


RBA playing the patience game

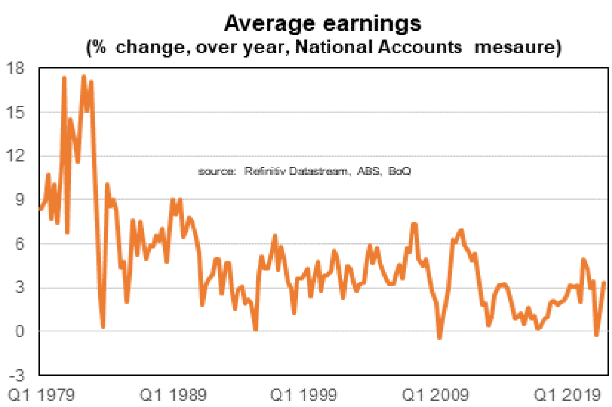
In a big week, the RBA also had its March Board meeting. As expected there was no change in interest rates (or discussion about what to do about its balance sheet). The accompanying commentary was largely as expected. The RBA noted that the Russia-Ukraine War adds an element of uncertainty. Wages growth has picked up, but only back to pre-pandemic levels. The RBA have become more open about the possibility that inflation might stay higher for longer. They noted the uncertainty about what higher global inflation might mean for Australia as well as how long supply-chain problems (and the very strong demand for goods) might last.

The pace of wages growth is broadly going in line with RBA expectations. If that is the key trigger for an interest rate hike then an increase wouldn't happen until towards the end of the year, and possibly not until 2023. But as the RBA has acknowledged there is a growing chance that inflation might be higher for longer than their current projections. The strength of the labour market means that the unemployment rate is at decade lows and will very likely lead to stronger wages growth. This means that that the RBA might end up raising the cash rate before wages growth hits 3% if inflation is higher than they expect. This makes the Q1 CPI number released on 27th April a potential dance-floor clearer.

Australian inflation is moving on the same path as the US.



The GDP numbers provided another indication that wages growth is picking up.



It was Motley Crue who sang all bad things must end. Already the economy is producing more than one jaunty note. With some luck with the weather and on the heath front (as well as less dire geo-political news) things (as D:Ream put it) can only get better.

We live in interesting times.

Regards

Peter Munckton
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Bank of Queensland