ECONOMIC UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

WEEK ENDING 6TH AUGUST 2021

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Summary

- The extent and length of the Sydney lockdown will result in a negative GDP outcome in the September quarter;
- The outlook for the economy for 2022 and 2023 remains strong;
- Availability of workers and materials will still be major economic issues next year;
- The next move in the cash rate is up, but not until 2023.

The Sydney lockdown has lasted longer than most people had anticipated. In hindsight it should not have been a surprise. The Delta variant is substantially more contagious than previous versions. And it is impacting a population that was largely unvaccinated.

The impact of lockdowns will depend upon the length, spread and severity of Government restrictions, as well as how business and consumer confidence evolves. A measure of the stringency of restrictions is at its tightest level since the Melbourne lockdowns of last year. Consumer and business confidence has declined over the past couple of months, and is similar to what happened following the extended Melbourne lockdown last year. But the level of confidence is higher. The September quarter GDP growth will be around -2%.

The domestic and international evidence is that the shape of the economic recovery post lockdowns is a 'V'. Households are sitting on a 'mountain of saving'. Inventory levels are low. Firms need to invest as capacity utilization levels are high. Federal and state fiscal policy settings remain extremely supportive, as is monetary policy. The state government infrastructure pipeline is huge. Equity markets are near their highs. House prices continue to rise. The 'V' shape is seen in the profile of the recently updated RBA's economic forecasts.

There will almost certainly be further virus 'waves' once high vaccination rates are achieved. Despite the proven effectiveness of the vaccines it is inevitable after the events of the past 18 months there will be initial political and consumer caution at the appearance of any further waves. This means there will likely be further government restrictions on economic activity in the event of a spike of new cases, albeit not as stringent as they currently are in Sydney. Consumer mobility would fall for a period.

The evidence points to a resumption of strong spending once the lockdowns end. The biggest constraint on the economy will then be supply. It will take the rest of this year before the large overseas developed economies are firing on all cylinders. It will take many Asian countries even longer. The shortages of materials that a growing number of firms have been complaining about will likely remain a problem for at least the next 1-2 years.

An even bigger issue is the lack of workers. Mainly that reflects the impact of the closed international borders. Federal Treasury assumes that international borders will only start to open up from mid next year, and then not be fully open until mid-2024. That assumption appears reasonable. This means that problems finding workers might be with us for another 2-3 years.

The RBA is rightly looking through the short-term weakness created by the lockdowns and forecasting a lower unemployment rate and stronger economy into 2022 and 2023. They acknowledge the short-term risks posed by the pandemic. And the potential for short-term pricing pressures. But the experience of COVID is that the easing of restrictions will be slower than anticipated and that the

resultant supply problems will last longer. This suggests that interest rates will need to rise earlier than current RBA expectations of early 2024. I have the first moved inked for mid-2023.

The Sydney lockdown is hurting the economy

The Sydney lockdown has lasted longer than most people had anticipated (including me). In hindsight, while the length of time is surprising it should not have been shocking. The Delta variant is substantially more contagious than previous versions. It is impacting a population that was largely unvaccinated. And in Sydney, a population that had not yet been confronted with a serious outbreak.

The good news is that following a recent sharp rise after re-opening the economy the UK has seen the number of new cases drop sharply. That experience suggests that widespread vaccination does help to reduce new case numbers.

The impact of lockdowns on the economy will depend upon the length, spread and severity of Government restrictions, as well as how business and consumer confidence evolves. A measure of the stringency of restrictions is calculated by Oxford University. That measure is currently at its tightest level since the Melbourne lockdowns of last year.

Consumer and business confidence has declined over the past couple of months, impacted by the Melbourne lockdown in June and then the more substantive Sydney event (and the lockdowns in other states) in July. To date the extent of the decline in confidence is similar to what happened following the extended Melbourne lockdown last year. And given that the length has lasted longer than expected some further decline is likely. But the level of confidence is higher. Consumers' and firms' now understand more about the virus. They are also less worried about their incomes given the extensive support they are receiving from the Government and the RBA and the buffer of saving many of them built up last year.

The aim of the restrictions is to reduce case numbers. That has been a successful strategy to date in Australia although the Sydney outbreak is providing a sterner test. In the long run it is generally acknowledged that the path out of the virus is widespread immunisation. Vaccination rates are picking up. One of the few 'benefits' of the recent surge in COVID cases has been an increase in demand for the vaccine. The daily vaccination rate picked up notably over July. The logistics to access the existing supply of vaccines has improved (more hubs). And the supply of Pfizer will rise in coming weeks.

At current pace the proportion of the population in NSW aged over 16 receiving two vaccine doses should hit 60% by around late-October and 80% by early-December. Given the improvements to supply the vaccination rate should quicken further in coming weeks. It has been speculated that 60% might be the point when the NSW Government starts to look to open up the economy. The big risk at that level of vaccination is that it would result in a big rise in new cases. Some easing of restrictions though is possible.

By October the supply of vaccine will no longer be the crucial constraint. Attention has shifted to the necessary target vaccination rate and whether that target can be achieved. The evidence from surveys and overseas experience suggests it might be tough. It is recognized that a portion of the population are unlikely to be ever convinced to voluntarily take the vaccine. There is a segment of the population that could be convinced but are currently hesitant. The question will be is how far the Government(s) wishes to go in designing the 'carrots and sticks' to boost the take-up rate from the undecided.

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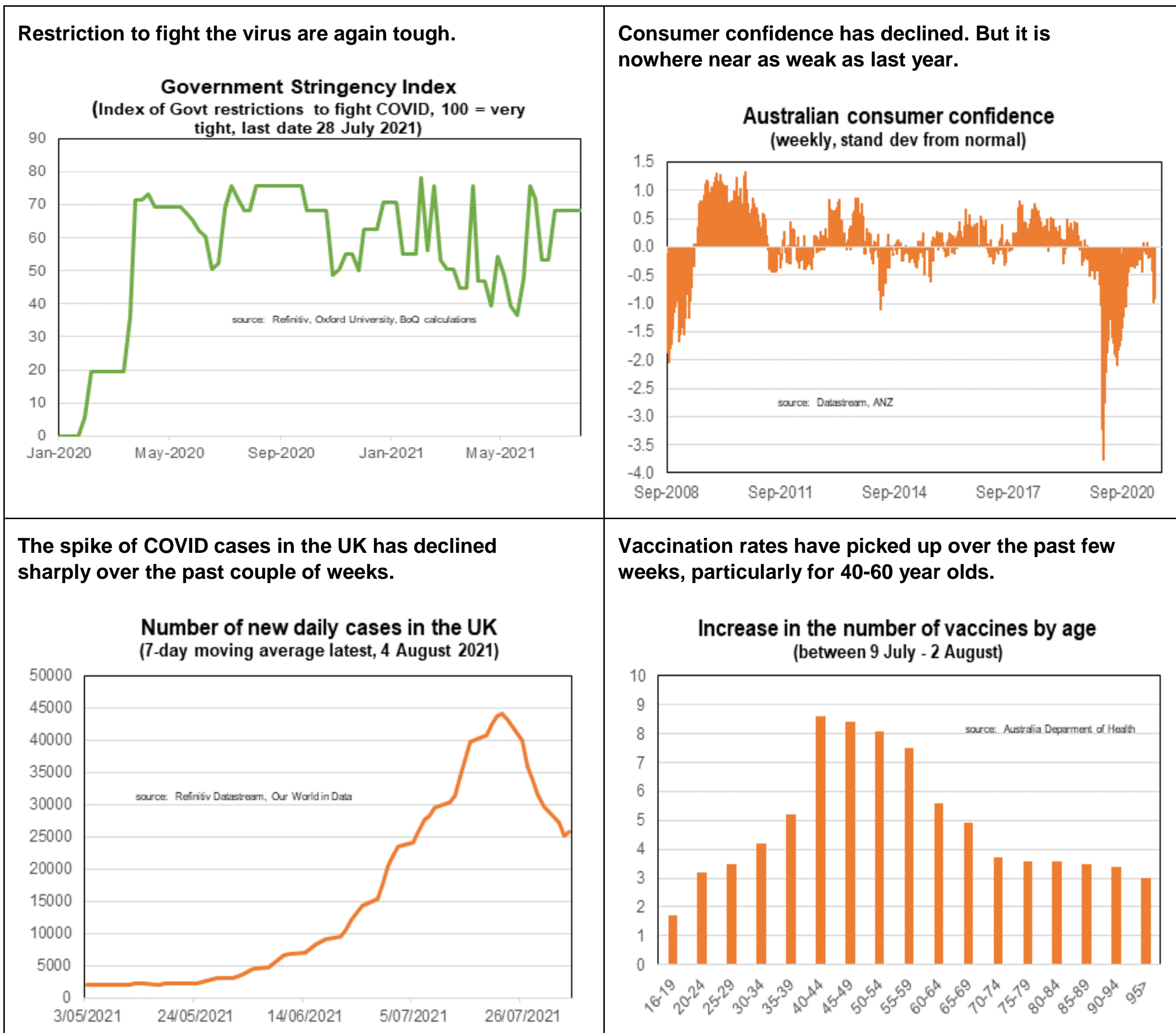


Short-term economic impact is negative

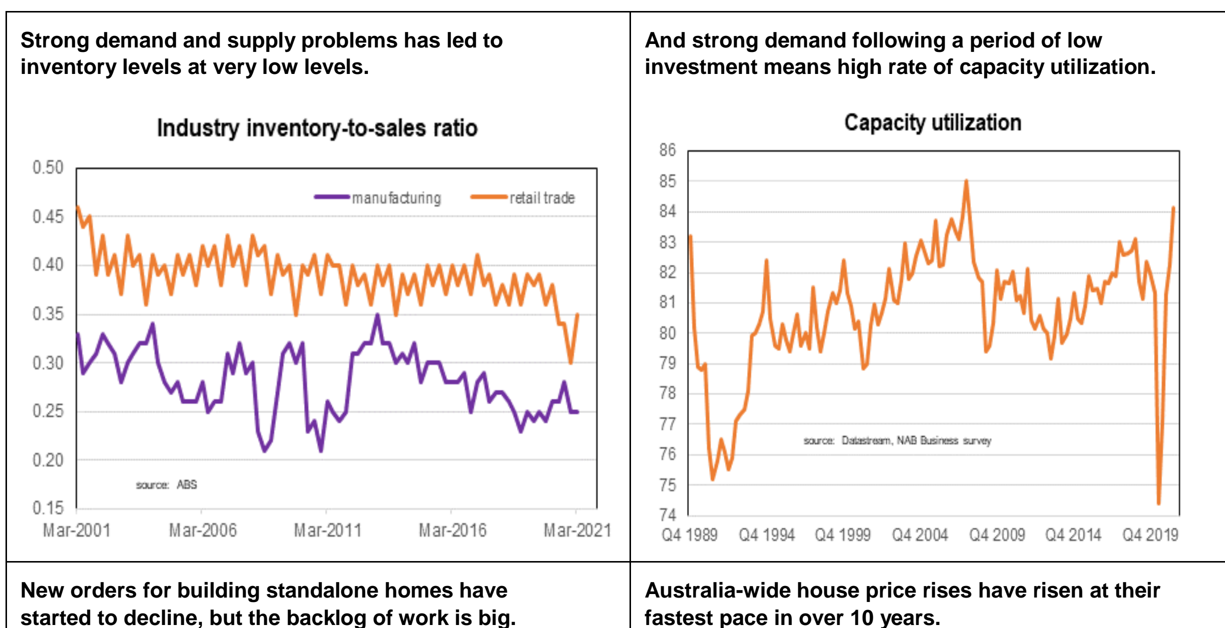
Largely shutting down a bit over 20% of the national economy (the contribution of the Greater Sydney region) for an extended period of time must negatively impact the overall national economy. The estimate of the economic hit ranges from $0.7-1.3b per week. Outside of Greater Sydney (when they are not in lockdown) the remainder of the country is doing well. Assuming that the current level of restrictions largely stay in place on the Greater Sydney region for the entire September quarter (as well as the impact of shorter lockdowns in other states) suggests GDP growth in the September will be around -2%.

The data is consistent with a sharp slowing of growth. Consumer confidence is down. According to ANZ data, the biggest decline has been consumers' views on the economic outlook. Confidence in their own finances has not declined as sharply, a result of generous government income-support programs. Households are indicating they are unlikely to spend as much on household items. That is partly because they spent up big last year on the equipment needed to work or play from home (wait times for bikes remains long and demand for cars high).

Given the extent of government support the hit to consumer and business spending will be bigger than the hit to incomes (similar to last year). This will likely result in a (temporary) rise in household and business saving.

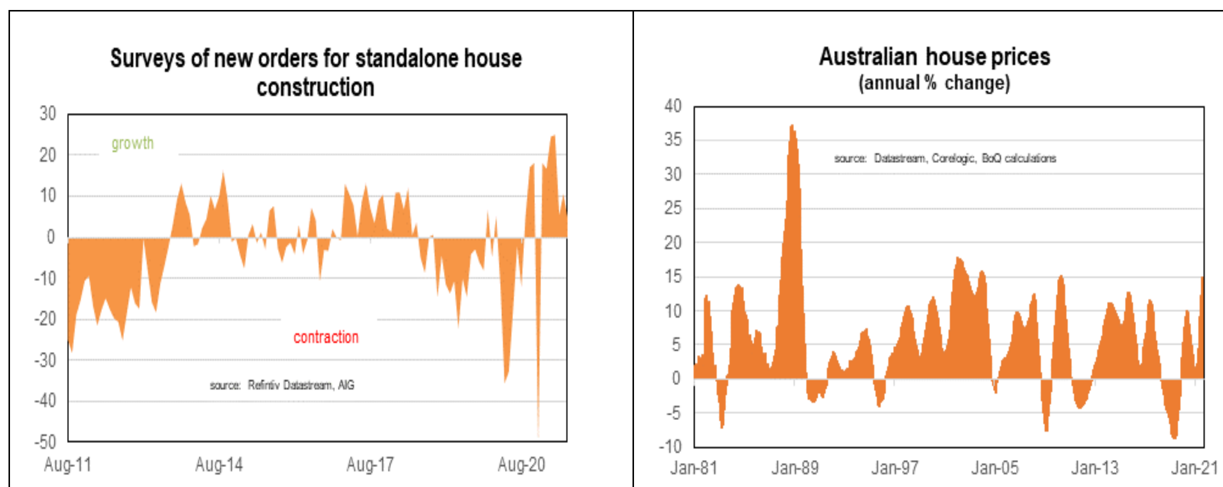
The domestic and international evidence is that the shape of the economic recovery post lockdowns is a 'V'. Households are sitting on a 'mountain of saving'. Inventory levels are low. Firms need to invest as capacity utilization levels are high. Federal and state fiscal policy settings remain extremely supportive, as is monetary policy. The Home Builder program (and the benefit of very low interest rates) has been so successful that strong residential building will run well into next year. The state government infrastructure pipeline is huge. The three largest economic regions (the US, China and Europe) are all experiencing strong economic growth. Equity markets are near their highs. House prices continue to rise.

The 'V' shape is seen in the profile of the recently updated RBA's economic forecasts. The RBA outlook for GDP growth is for around 4% next year, and about 2.5% in 2023. After an initial rise reflecting the impact of the lockdowns, they think the unemployment rate will decline to 4.25% by the end of next year, and 4% by end-2023. Inflation is expected to be 2.25% by end 2023, within their 2-3% target band. I am more optimistic on the economic outlook (5% next year and 2.75% the year after). As a result I think the unemployment rate could be a bit lower and inflation a bit higher (4% and 2.25%, respectively) by the end of next year.



New orders for building standalone homes have started to decline, but the backlog of work is big.

Australia-wide house price rises have risen at their fastest pace in over 10 years.



The key economic issue for the next couple of years will be supply

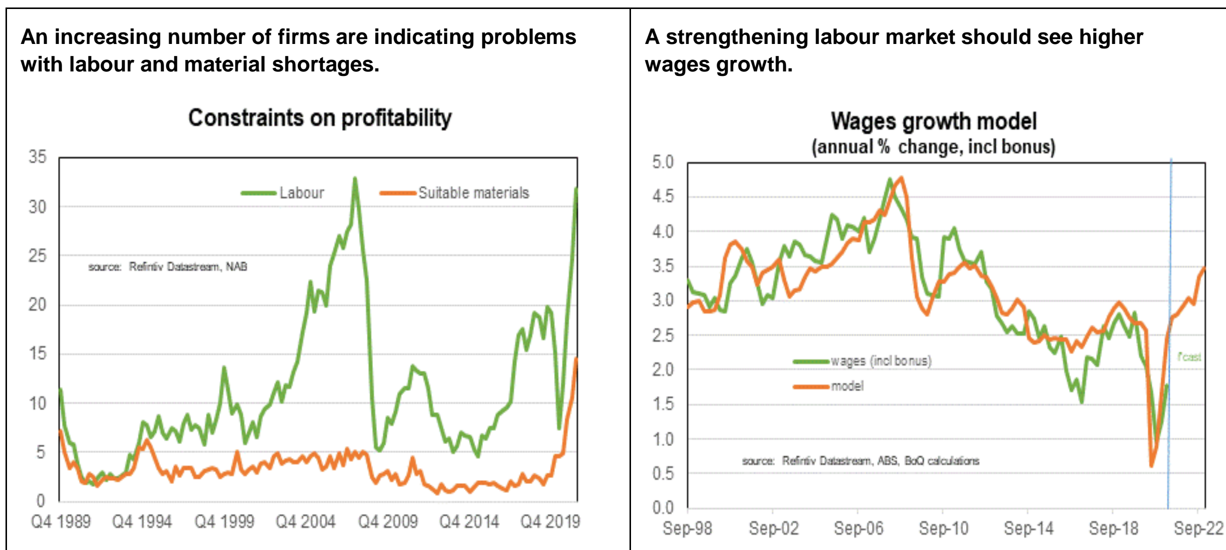
Even with a higher vaccination rate there is likely to be further virus 'waves'. The UK experienced a substantial decline in the number of hospitalizations and deaths from its recent wave because of its high vaccination rate. Despite the proven effectiveness of the vaccines it is inevitable after the events of the past 18 months that there will be initially political and consumer caution at the appearance of any further waves. This means for at least the first half of 2022 there could be government restrictions on economic activity in the event of a spike of new cases, albeit not as stringent as they currently are in Sydney. Consumer mobility (such as going to a restaurant) would fall.

The evidence points to a resumption of strong spending once the lockdowns end. Ongoing restrictions on spending (notably overseas travel) will continue to benefit goods and domestic-focussed service sectors. That benefit will be lower than last year given that a large amount of spending on durable goods has already taken place (computer monitors).

From the start of 2022, the biggest constraint on the economy over the following 1-2 years will likely be supply (assuming no other significant mutation of the virus). It will take the rest of this year before the large overseas developed economies are firing on all cylinders. It will take many Asian countries that are integral to the global supply chain even longer given that they are further behind the US and Europe in their vaccination rate. There are signs from recent global business surveys that the blockages in the global-supply chain have started to move. But given the backlog of orders, low inventory levels and the level of supply problems, the shortages of materials that a growing number of firms have been complaining about will likely remain a problem for at least the next 1-2 years.

An even bigger issue confronting firms is the lack of workers. Mainly that reflects the impact of a strong economy creating a large demand for workers at a time when the closed international borders are limiting potential supply. The uncertainty about the status of state borders also might be playing a role in reducing labour mobility.

Federal Treasury assumes that international borders will only start to open up from mid next year, and then not be fully open until mid-2024. That assumption appears reasonable. This means that the supply of labour from overseas will be low for the next 2-3 years at a time when the demand for workers is likely to remain high. Usually that combination results in higher wages growth, a risk that the RBA has acknowledged.



My outlook is for higher interest rates in 2023

The RBA is rightly looking through the short-term weakness created by the lockdowns, and forecasting a lower unemployment rate and stronger economy into 2022 and 2023. They acknowledge the short-term risks posed by the pandemic. And the potential for short-term pricing pressures. But they believe (as many other central banks and most financial market analysts also do) that any pricing pressure will be temporary.

But the experience of COVID is that the easing of restrictions will be slower than anticipated and that the resultant supply problems will last longer. The longer price pressures last the more likely that households and businesses will expect higher price rises in the future (in the jargon, rising inflation expectations). This suggests that interest rates will need to rise earlier than current RBA expectations of early 2024. I have the first moved inked for mid-2023.

Puzzlingly, financial markets are still pricing the first rate hike towards the end of next year. This is despite their concerns about the impact of the rise in COVID cases on the domestic and global economies. And that they expect any rise of inflation over the next year to be temporary. The RBA have also made it clear that they will need to see a run of inflation and wage figures well above their current level before thinking about the first rate hike. This evidence will take time to appear and is why I think that current financial market pricing looks aggressive.

There was speculation that at its August meeting the RBA may have unwound one of its announcements made at the July meeting due to rising concern about the economic outlook. Namely, the intention to slow its weekly purchases of Federal and State government bonds from $5b to $4b from September. Financial markets were even speculating that weekly purchases might rise to $6b.

The RBA decided to keep its weekly purchases at $4b per week. Why? The bond-buying program has two aims. One is to help reduce the exchange rate and the other is to reduce long-term interest rates. Since the July meeting the $A has fallen and long-term interest rates declined. Further while the short-term economic growth outlook has deteriorated over the past month there has also been a significant increase in fiscal assistance. And despite the certain deterioration in the economy in the September

quarter, the RBA remains confident about the long-term economic outlook. If the economic outlook deteriorates more than what the RBA had been assuming then they (and the government) will do more.

We live in interesting times.

Regards,

Peter Munckton
Chief Economist
Bank of Queensland