ECONOMIC UPDATE
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WEEK ENDING 7TH MAY 2021

Summary

- **The recent inflation numbers were low;**
- **But price pressures are building;**
- **And fiscal policy will provide more support to the economy than had been thought;**
- **The risks are that the RBA will need to go earlier than current expectations (H2 2023).**

The most recent quarterly CPI numbers (March 2021) showed inflation rose by only 1.1% over the past year. The March quarter number was constrained by government programs. Business surveys suggest that price pressures are mounting. Financial market medium-term inflation expectations have returned to the middle of the RBA's 2-3% inflation target range.

The bigger picture is that right now the economy is experiencing a period where demand for many goods and services is outstripping supply. It is widely viewed that this will be temporary.

But global central banks and governments are intent on getting the economy firing on all cylinders. This means that it is likely that demand will be very strong for at least the next couple of years. And the slow domestic vaccine rollout means that supply shortages as a result of COVID could be with us for some time yet.

Recently we found out that the RBA kept monetary policy unchanged. How the economy evolves obviously matters for the interest rate outlook. But what really matters is what actually happens to inflation. The RBA will only be convinced that inflation will sustainably move to their target once wages growth moves north of 3%. In February the RBA thought that wages growth in mid-2023 would be only 2%. But the risks are that wages growth will be higher.

The RBA has announced July as the date when they decide whether to change monetary policy. I think the stronger economy means they will make some changes (but not interest rates).

The Budget deficit will be clearly lower than what had been predicted at Budget-time. Some of the better budget outcomes will be banked (reducing the deficit). Some will be spent. There has been less discussion about lower taxes.

Pre-COVID many economists talked about wanting more infrastructure spending. They have got their wish and there is now plenty happening. The talk now is there will be new spending on childcare. The economic justification is that this will encourage more women back into the labour force. If immigration growth continues to remain low a higher participation rate will be necessary to achieve sustained strong economic growth.

Right now the Government is rightly focussed on working with RBA to get the economy running at a faster pace. But over the next couple of years the Federal Government will need to decide how much it wants to reduce debt. A stronger economy will do a fair bit, but not all, of the work.

The green shoots of higher prices

I have just come back from holidays in the Upper Hunter Valley, about 2.5 hours' drive north-west of Sydney. The area is currently a microcosm of the Australian economy. Wineries are being flooded by visitors wanting to spend some of that money that might have been earmarked for an overseas trip. Accommodation was not easy to find (certainly not for a reasonable price). It was tough to get a table at a restaurant. There were plenty of new homes being built (the main problem builders had was sourcing imported materials). And my large Flat Whites were costing me $5!

I read a couple of books (including one on the 10,000 year history of the world economy). But inevitably my mind turned to how the economy has been evolving.

The most recent quarterly CPI numbers (March 2021) showed inflation rose by only 1.1% over the past year. The economy is in the process of recovering from the biggest slowdown since Great Depression so the number was never going to be huge. Indeed, modest inflation rises has been a feature in most developed countries over the early months of 2021.

The quarterly rise was 0.6%, a figure that would be more considered 'average' than low. And the March quarter number was constrained by government programs. Grants for housing (including HomeBuilder) significantly reduced the price of new housing. For example, pre-grants new dwelling inflation was 6.3% in Perth. After the grants it increased by 'only' 2.8%. Federal Government policies also reduced Uni student fees. The housing programs are coming to an end and will lead to higher prices in coming quarters.

Government decisions often impact prices (both up and down). It is a reason why the RBA looks at the so-called 'underlying' inflation data to get a read on what is likely to happen to the 'ongoing' growth in prices. Those 'underlying' numbers were low (0.3-0.4%).

Nonetheless, business surveys suggest that price pressures are mounting. The NAB survey indicated that price rises across a range of industries was at its highest level since 2008. Ditto input costs. Financial market medium-term inflation expectations have returned to the middle of the RBA's 2-3% inflation target range. Consumer views about price rises have also risen, albeit they are at the low end of their historical range.

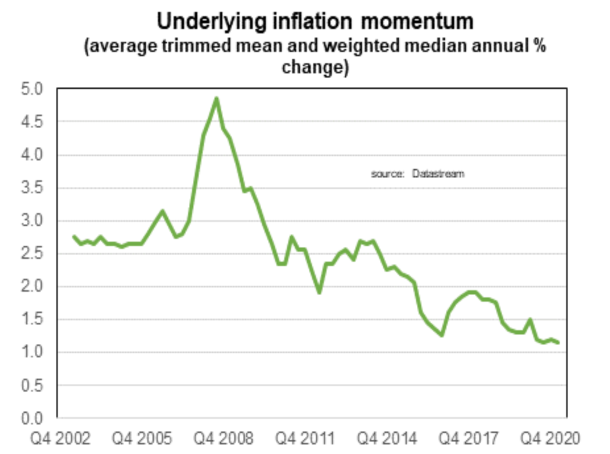
The bigger picture is that right now the economy is experiencing a period where demand for many goods and services is outstripping supply. It is widely viewed that this will be temporary. Demand is high partially because households are making up for lost spending last year. In time this make-up demand could settle back towards a more 'normal' growth of spending.

COVID-related restrictions are impinging on supply globally. Government restrictions on economic activity and closed borders (or the threat of them being closed) is limiting worker mobility. This makes it difficult for firms to operate at maximum capacity. According to a recent ABS survey 30% of firms indicated they faced supply-chain problems (and 37% of those were severely impacted). The sectors reporting the biggest problems were manufacturing, wholesale and retail trade, and other services (such as auto-repair shops). The hope is that the vaccine rollout will in time lead to reduced restrictions and more open borders. This should help boost supply of goods and services.

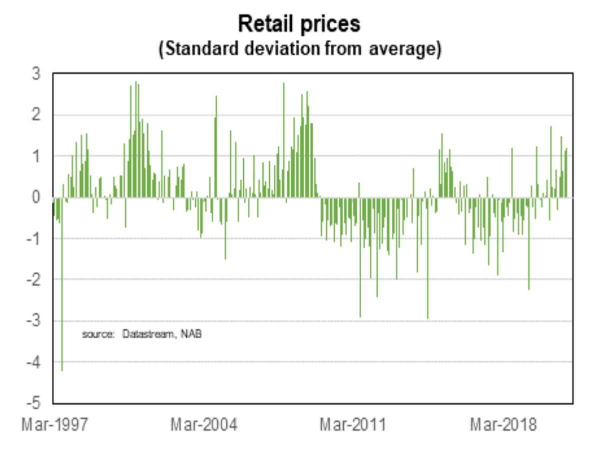
But global central banks and governments are intent on getting the economy firing on all cylinders. This means that it is likely that demand will be very strong for at least the next couple of years. And the slow domestic vaccine rollout means that supply shortages as a result of COVID could be with us for some time yet.

So there is a growing risk that inflation will start surprising on the high side over the next couple of years. How much of this higher inflation ends up being temporary and how much permanent could have a significant influence for the inflation outlook over the rest of this decade.

Underlying inflation is currently very low.



But firms are indicating that prices are on the rise.



The RBA: No change but for how long

Recently we found out that the RBA kept monetary policy unchanged. Once upon a time that meant there was no change in interest rates (the cash rate was kept at 0.1%). But these days it means looking at a wider range of policies. This includes cheap funding to banks (previously announced to finish at the end of June).

The RBA also has two other programs to help the economy. One is Quantitative Easing (QE) where the RBA buys long-term Government bonds to reduce interest rates. The other is Yield Curve Control (YCC) where the RBA pegs the 3-year government yield at 0.1% to help keep short-term rates to the wider economy low. The RBA announced that they will decide at their July meeting whether to extend these two policies.

Whether they do or not will depend upon what is happening to economic activity. And like all forecasters the RBA has underestimated the bounce in the economy. Just three months ago the RBA expected GDP growth to be up 3.5% this year. Now they think it will be up 4.5%. In February they thought that the unemployment rate at the end of 2022 would be 5.5%. Now they expect 4.5%. These revised forecasts are in line with my view.

How the economy evolves obviously matters. But for the interest rate outlook what really matters is what actually happens to inflation. Previously the RBA changed interest rates based on their *forecast* view of inflation. But like virtually everyone else the RBA overestimated inflation over the past decade and arguably kept interest rates too high. Learning that lesson means that they will now only pull the rate trigger once they can see the whites of inflation's eyes (ie, actual inflation of at least 2% and likely to stay there).

The RBA will only be convinced that inflation will move sustainably to their target once wages growth moves north of 3%. In February the RBA thought that wages growth in mid-2023 would be only 2%. This was consistent with their view that rates will not change before 2024. But the stronger economic outlook, lower unemployment rate forecast and mounting claims of labour shortages all suggest that that the risks are that wages growth will be higher by mid-2023. Indeed, the current underutilisation rate (which will almost certainly decline over the next 1-2 years) already suggests that wages growth could be 2.5-3% before mid-2023.

Right now the RBA is like a driver in one of those old manual cars. They are motoring along in top gear. But a turnoff is approaching. The economy is doing well (and is about to get more of a helping hand from the Federal Government). The RBA has announced July as the date when they will decide whether this is their turnoff and require a change to the monetary policy gears. I think they will (at a minimum by not extending their YCC policy but no change to interest rates). We will find out in two months.

The unemployment rate has fallen sharply. And there is further labour market strength on the way.

The stronger labour market is leading to stronger wages growth.

The Budget – Letting the good times roll

Plenty of good things come from a stronger economy. One of them is that it does good things for the Government's budget. Lower unemployment means less spending. More jobs and profit growth means higher taxes. The Budget deficit will be clearly lower than what had been predicted at Budget-time. We will soon find out how much lower.

The Government has copped criticism for not doing enough pre-COVID to get the economy humming. The unemployment rate was 5% but the economy was widely (and justifiably) thought to be just so-so. The RBA means to make sure the economy is travelling better than its pre-COVID speed. And so does the Government. This means that some of the better budget outcomes will be banked (reducing the deficit). But some will be spent. There has been less discussion about lower taxes.

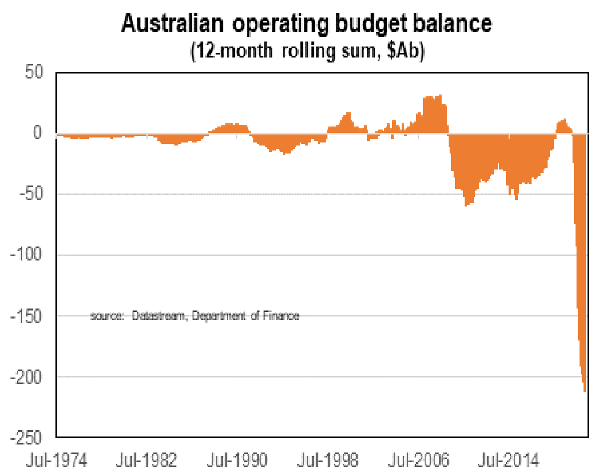
Pre-COVID many economists talked about wanting more infrastructure spending. They have got their wish and there is now plenty happening (by both the federal and state governments). Indeed, most of the new projects are facing delays reflecting problems sourcing skilled labour or resources (as well as the usual problems associated with big projects).

The talk is that there is going to be some new spending on childcare in the forthcoming Budget (and more aged care funding). The economic justification is that this will encourage more women back into the labour force. Female workforce participation rates are below that of males, with the difference most notable for the key child-raising years (25-44). If immigration growth continues to remain low a higher participation rate will be necessary to achieve sustained strong economic growth.

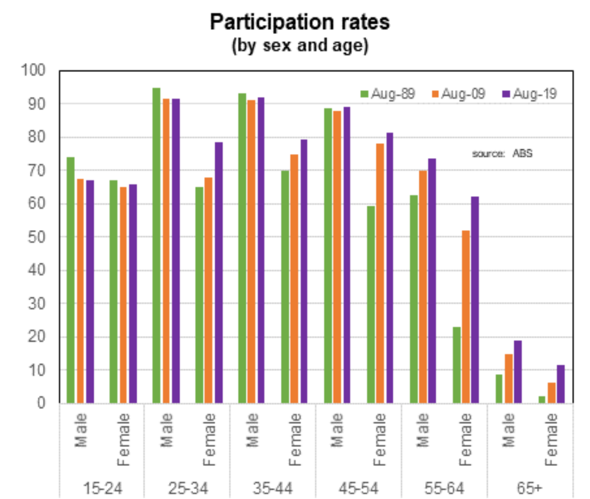
It is a historical fact that the Government has become a bigger part of the economy following a burst of spending. This looks likely to happen again. The longer term question is whether this spending will be financed from higher taxes or a higher deficit. The Government has been quickly able to absorb the fallout from the past two global crisis (GFC and COVID) because it had low government debt. By global standards it still has. And very low interest payments makes the current level of debt affordable.

Right now the Government is rightly focussed on working with the RBA to get the economy running at a faster pace. But over the next couple of years the Federal Government will need to decide how much it wants to reduce debt. A stronger economy will do a fair bit, but not all, of the work.

A stronger economy is helping the Budget.



A higher female participation would help boost economic growth, particularly if immigration remains subdued.



We live in interesting times.

Regards

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