ECONOMIC UPDATE

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WEEK ENDING 20TH AUGUST 2021

BOQ GROUP

Summary

- The lockdowns have been more stringent, more widespread and lasted longer than most analysts have envisaged;
- This means that Q3 GDP growth will likely be -3%;
- A 'technical recession' (two quarters of negative growth) is possible, but unlikely;
- The outlook for 2022 and 2023 remains strong, where supply will likely be a bigger issue than demand.

The overseas experience suggested that at some stage we would be confronted with another virus 'wave'. Many countries in the OECD have been hit by at least 3 waves (and some are currently experiencing their fifth one). Developments in NSW (and increasingly Victoria) almost certainly indicate that the lockdowns will last longer than the end of this month. Evidence from across OECD countries is that 'waves' of the virus typically last for 2-5 months. Rising vaccination rates and more stringent restrictions on movement should help to break this wave.

The international experience suggests that at some stage new cases will rise again once restrictions are eased. Governments (and forecasters such as the RBA) have acknowledged that will likely result in periods of tightened restrictions, albeit nowhere near as stringent as they have been over the past 18 months. The recent US experience highlights that government intervention is not required for economic activity to hit a flat spot upon the appearance of another virus wave.

The Australian economy entered this lockdown in good shape. In the second quarter firms indicated that they had not seen business conditions as strong for over 25 years. Consumer confidence was strong, with households indicating that jobs were plentiful. The unemployment rate in July was 4.6%, the lowest level since 2008.

Things have got worse since the July employment report. And even the July jobs report showed some of the impact of the shutdown. There was a decline in the number of hours worked and in the participation rate. This was most notable in NSW, where there was also a fall in the number of employed.

At the start of the month the consensus range for Q3 GDP forecasts were in about a -1 to -3% range. Mobility data suggests that the size of the hit to the economy will be somewhere between what was experienced in the second and third quarters of last year. It looks increasingly likely that the outcome will be at the top end of the consensus range (and possibly higher). With restrictions in NSW likely to last at least into October, Q4 GDP will also take a hit.

I agree with the consensus that once Australia emerges from this wave the rebound of economic growth will be strong. Next year I think the main problem will not be a lack of demand but a lack of supply. Central banks are assuming that these problems are short term and will disappear as economies continue to re-open. That may well turn out to be correct. But producer price data indicates that there is still plenty of pricing pressure in the US economy. The longer that demand for workers remains strong in Australia and is not met by higher supply the greater the chance that wages growth will rise.

Short-term economic impact is negative

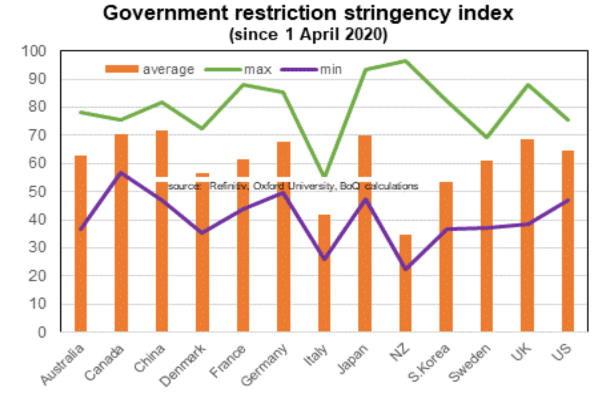
The COVID news in a number of the states (and territories) over the past few weeks hasn't been good. The overseas experience suggests that at some stage we would be confronted with another virus 'wave'. Virtually all countries in the OECD have been hit by at least 3 waves (some are currently experiencing their fifth one). New Zealand has been a notable exception (and some Asian countries such as China) although all countries have had a number of scares. In most countries the number of cases was lower in the first wave. The higher numbers in subsequent waves likely reflects that the virus spread quickly during periods when restrictions were less strict, the impact of 'lockdown fatigue' and the increasingly contagiousness of the virus as it has mutated.

The lockdown(s) are having a significant economic impact. Since the end of the nationwide shutdown in Q2 last year, analysts were consistently surprised by the strength of the economic rebound. Now most forecasters are surprised by the length and severity of the lockdowns. The result is that Q3 GDP forecasts keep getting downgraded. How the economy performs in the September quarter will depend upon the severity, spread and length of the lockdowns.

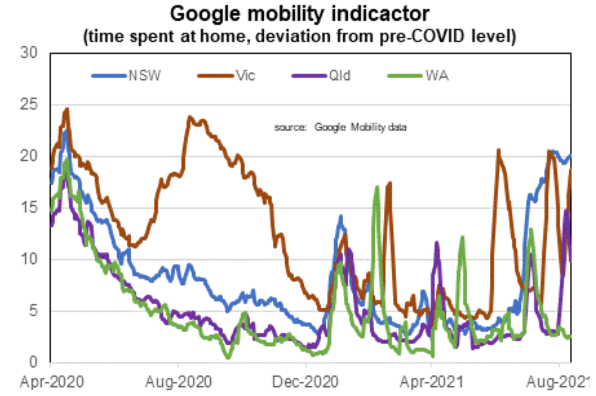
The lockdowns have got increasingly stringent in NSW. And they have generally started tough in the other states that have had to endure a shutdown. One gauge is the Google mobility data that shows the time spent at home. In NSW and Victoria that index is back to the level last seen during the nationwide lockdown of last year. The amount of time spent at home by West Australians right now is almost at pre-COVID levels. Queensland is somewhere in between.

The proportion of time spent at home right now in Australia is below what occurred in Italy and the UK during their significant outbreaks last year. Time spent at home in other countries has declined over this year in line with rising vaccination rates (and often despite rising case numbers). The Google data is consistent with the index calculated by Oxford University on the stringency of government regulations. The Oxford University suggests that Australia has been about middle of the pack in terms of stringency of regulations.

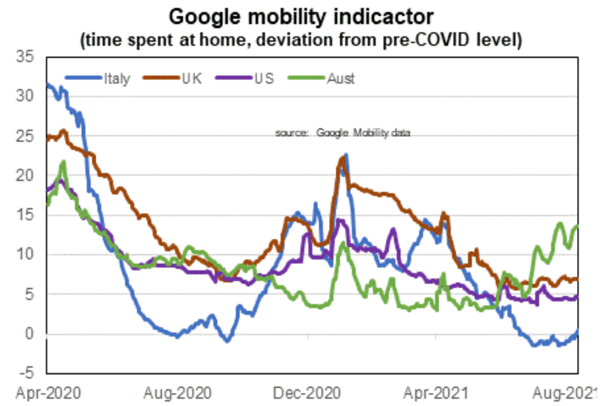
One index suggests Australia has been about 'middle-of-the-pack' on regulation stringency.



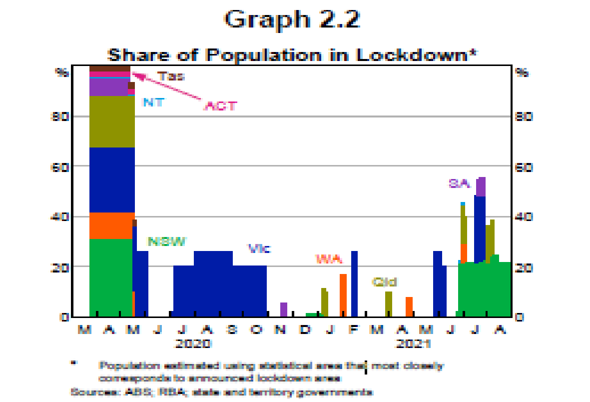
Time spent at home in NSW and Victoria is near its high of the nationwide lockdown of last year.



Mobility was even lower in Italy and the UK during their significant waves early last year.



There has been a rise in the proportion of people under lockdown since the RBA August meeting.



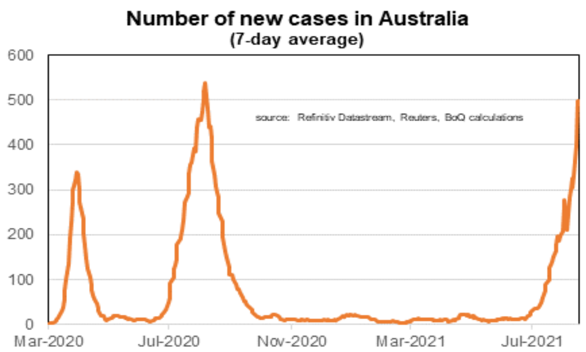
The NSW Government has announced that the lockdown will last longer than the end of this month. The 'waves' across OECD countries typically last for 2-5 months. This suggests that this wave may finish sometime between September and November. Rising vaccination rates and more stringent restrictions on movement should help to break this wave.

Australia has had different COVID experience to many other developed countries. The previous major waves in Australia (and some other countries such as NZ and Finland) have stopped with new cases essentially zero (the data includes overseas cases in quarantine). In many European countries and the US a new wave started when there was still quite a high level of cases in the community. There has also been a decent length of time between major waves in Australia (the Northern Beaches outbreak in Sydney and periodic ones in Melbourne were relatively modest in size). By contrast, in countries such as the Netherlands the next major wave started just as the preceding one finished. These outcomes reflect the different approaches governments have taken in dealing with COVID, from suppression (the US, UK, Netherlands) to elimination (Australia, China and New Zealand).

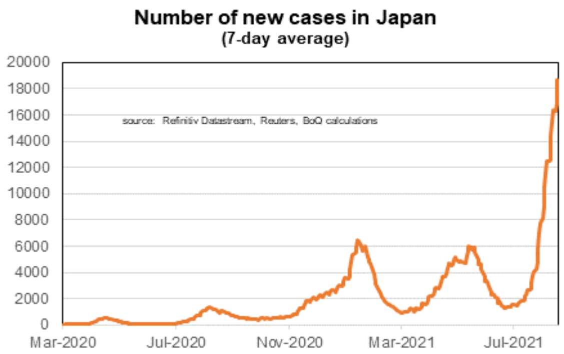
The international experience suggests that at some stage new cases will rise again once restrictions are eased. This will be despite higher vaccination rates. There will still be a sizeable minority of the community unvaccinated. And the evidence appears to be that vaccination reduces, but does not stop, transmission. Governments (and forecasters such as the RBA) have acknowledged that will likely result in periods of tightened restrictions, albeit nowhere near as stringent as they have been over the past 18 months. This has been the case even in the US where some states have again made mask-wearing mandatory in some public indoor settings and proof of vaccination in required when entering restaurants as a new virus wave appeared. But the US economy has remained largely open.

The US experience also highlights that government intervention is not required for economic activity to hit a flat spot upon the appearance of another virus wave. There was a significant dip in US consumer confidence in August. The retail sales numbers in the US (and China) for July were disappointingly low. Partly the weaker retail spending in the US reflected consumers directing more dollars towards a re-opening services sector (such as travel). Rapidly rising prices (or lack of product) would also have been an issue. But consumer surveys also point to rising caution as the new virus wave appeared.

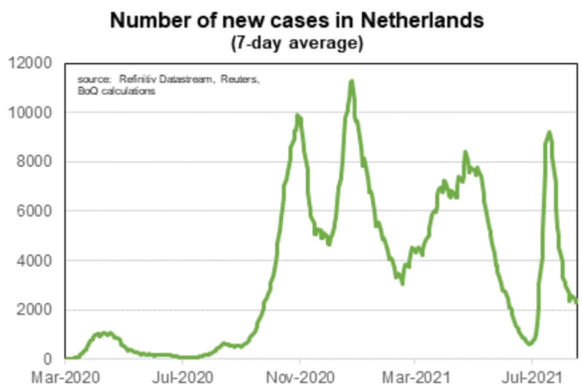
Australia has experienced three distinct major 'waves', and several smaller outbreaks.



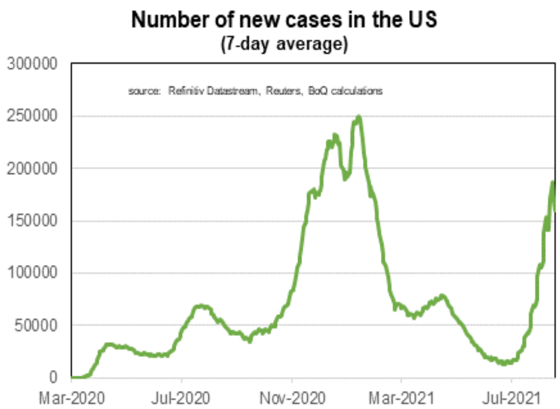
This has also been the case in Japan, although the minimum number of cases has always been higher.



The waves of new cases in the Netherlands have been closer together and started at a high level of cases.



This has also been the case in the US.



Negative third quarter, the start of the economic bounce back in the fourth quarter

The Australian economy entered this lockdown in good shape. In the second quarter firms indicated that they had not seen business conditions as strong for over 25 years. Consumer confidence was strong, with households indicating that jobs were plentiful. The unemployment rate in July was 4.6%, the lowest level since 2008.

Things have got worse since the July employment report. The lockdown has lasted longer in Sydney and extended into regional NSW and Victoria. In coming months we should expect some decline in jobs growth and some rise in unemployment. And even the July jobs report showed some of the impact of the July shutdown. There was a decline in the number of hours worked and in the participation rate. This was most notable in NSW where there was a fall in the number of employed.

At the start of the month the consensus range for Q3 GDP forecasts were in about a -1 to -3% range. Mobility data suggests that the size of the hit to the economy will be somewhere between what was experienced in the second and third quarters of last year. At the start of August the RBA thought that GDP might be -1% in Q3. Recently the Federal Treasurer thought it might be -2%. It looks increasingly likely that the outcome will be at the top end of the consensus range (and possibly higher).

With restrictions in NSW likely to last at least into October, Q4 GDP will also take a hit. Could GDP also print negative in that quarter (and so qualify for a 'technical recession')? That would likely need all of

Victoria, regional NSW, in addition to Greater Sydney, to be locked down with the same level of stringency (or tighter) for much of September and October, and into November. And then it would probably require at least one of the other states (particularly Queensland) to face restrictions for a number of weeks. Certainly this scenario is possible. But the Victorian lockdown was implemented quickly. And the spread of cases in regional NSW (outside the Western region) has so far being kept in check. And the rising level of vaccinations is leading the NSW Government to talk about easing (not tightening) restrictions in Q4.

Economic growth in 2022 and 2023 should be strong

I agree with the consensus that once Australia emerges from this wave the rebound of economic growth will be strong. Last week I noted the range of positive factors supporting the economy. These include very supportive fiscal and monetary policy. There is plenty of infrastructure and residential construction work in the pipeline. Firms are still indicating that they have decent sized Capex Budgets. There is a mountain of household saving that could be spent. A sharp rebound in the economy once restrictions has been eased has been the experience both in Australia and overseas.

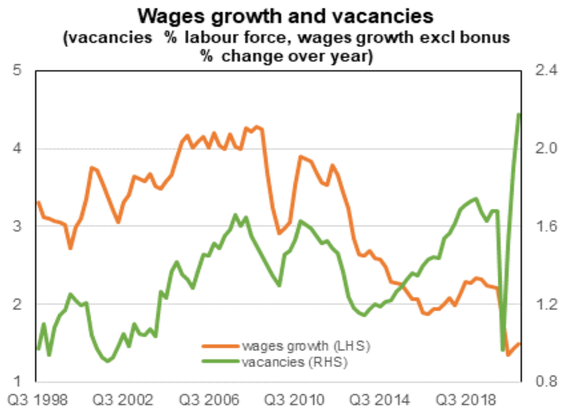
When the economy re-opens there should be a snap back in demand (including for workers). The likelihood of intermittent restrictions may impact some sectors of the economy (such as Recreation, Transport and Accommodation and Food Services) for parts of next year.

But without the stringent lockdowns that Sydney and Melbourne are currently experiencing I expect a return to the conditions experienced in June when the critical economic problem was not a lack of demand but a lack of supply. Globally, there continues to be supply-chain problems as economies re-open following their shutdowns. These will take some time to be cleared, not the least because restrictions remain in place in many countries. One of the most significant restrictions remains movement of people between countries. This is a particularly big issue in Australia.

Central banks are assuming that these problems are short term and will disappear as economies continue to re-open. That may well turn out to be correct. There have been signs in some of the recent overseas business surveys that supply-chain blockages are starting to be removed. And the recent CPI number in the US was not as high as feared. Certainly the problems we saw in Australia in the first half of the year of trying to find workers has not yet been translated into significantly higher wages growth.

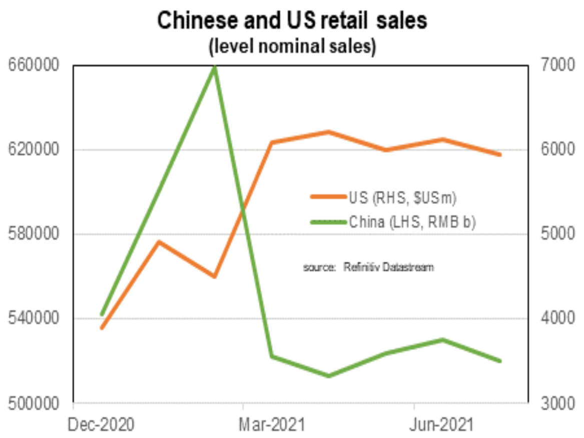
But producer price data indicates that there is still plenty of pricing pressure in the US economy. In Australia, business surveys indicate that firms are seeing plenty of evidence of higher prices. The longer that demand for workers remains strong in Australia and is not met by higher supply the greater the chance that wages growth will rise.

Strong demand for workers has not (yet) translated into higher wages growth.



Most of the impact of the lockdowns will be seen in less hours worked and reduced participation rate.

Retail sales in the US and China have softened, partially reflecting concerns about rising COVID.



There are still plenty of supply chain problems globally, although they have started to ease.

The evidence suggests that the Australian economy will have a tough time in August and September. This will lead to a very weak GDP number in Q3. And that impact will roll into the December quarter. Thereafter the economy should bounce-back quickly. Intermittent restrictions will have an increasingly smaller impact on the economy, although some sectors will be hit harder than others. While demand will come back quickly the supply side of the economy will take longer to adjust.

The pandemic has created an unusual economic shock and led to unusual government actions (lockdowns). When we eventually fully emerge from the pandemic we are likely to have a lower unemployment rate and a modestly higher level of inflation. But to get there society has had to endure some tough times.

We live in interesting times.

Regards,

Peter Munckton
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Bank of Queensland