ECONOMIC UPDATE

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WEEK ENDING 28TH JANUARY 2022

BOQ GROUP

Key points

- **Inflation has risen quicker than anticipated;**
- **This has been due to a combination of strong demand and problems with supply;**
- **Some of this imbalance will self-correct;**
- **But it will also likely require interest rate increases;**
- **I now think the first rate move will happen in the second half of this year, maybe as early as August.**

Summary

For much of the past decade the main economic problem facing Australia was that economic growth had not been strong enough for long enough. Increasingly the new problem looks like it will be inflation. The Q4 CPI numbers was the third consecutive quarter that the annual growth of inflation was above the RBA's target band. The annual growth rate of one of the measures ('trimmed mean') was at 2.6%, its highest level since 2014.

The big picture is that demand has been a lot stronger than supply leading to pricing pressure. This has been mainly for goods although the prices of many services are not unusually low. The hope has been that global supply constraints would prove to be temporary and diminish as factories ramped up production and the logistics of transport and storing of goods improved. But then the Omicron wave appeared. Signs that the Omicron wave is starting to subside in Australia and other areas of the world gives hope that some of the recent supply problems will improve in coming weeks. But we don't know for sure when. Even if everything does go smoothly on the virus front supply problems will last at least into the second half of this year.

It is also possible that there will be permanent changes to the economics of the supply of goods and services. Global supply chains had been set to maximise efficiency and minimise costs. Following their experiences of COVID and rising geo-political tensions, a growing number of firms have indicated their desire to diversify their sources of supply and hold more inventories.

Another longer lasting supply concern might be the lack of skilled workers. A return of strong immigration flows is likely to be the best solution in the short term to meeting the strong demand for workers (improving education and training is a good solution in the long term). The opening up of borders will help, but the reappearance of Omicron and understandable ongoing caution of governments and people means it is likely to be sometime before immigration returns to pre-COVID levels.

But as has become increasingly clear, rising inflation pressures is also about strong demand. Demand for goods should moderate as consumers rebalance back towards services as spending patterns gradually return to 'normal'. But the economic rebound has been a lot stronger than virtually everyone had forecast.

Monetary policy is currently set at emergency levels at a time when the economy is either at or close to full employment. Inflation is above the top end of the target band. Wages growth is currently under target but all the signs are that it will pick up. Fiscal policy remains extremely supportive. One measure of the stance of monetary policy (real cash rate, or the cash rate after inflation) is at its most economically supportive level in over 40 years. In a world of increasing interest rates if Australia does nothing in effect they are easing monetary policy.

In this light it is virtually certain that the RBA will end Quantitative Easing in February. I have pulled forward my expectations of when the RBA will first move the cash rate into the fourth quarter, when I expect a 15bp rise (to 0.25%) in November, followed by another quarter percentage point rise in December (to 0.5%). It is possible that the RBA could move even earlier. Financial markets have priced the first move

(0.15%) now essentially by May. Whether the RBA does move that early will depend upon how the wages numbers print in late February.

Inflation is on the up

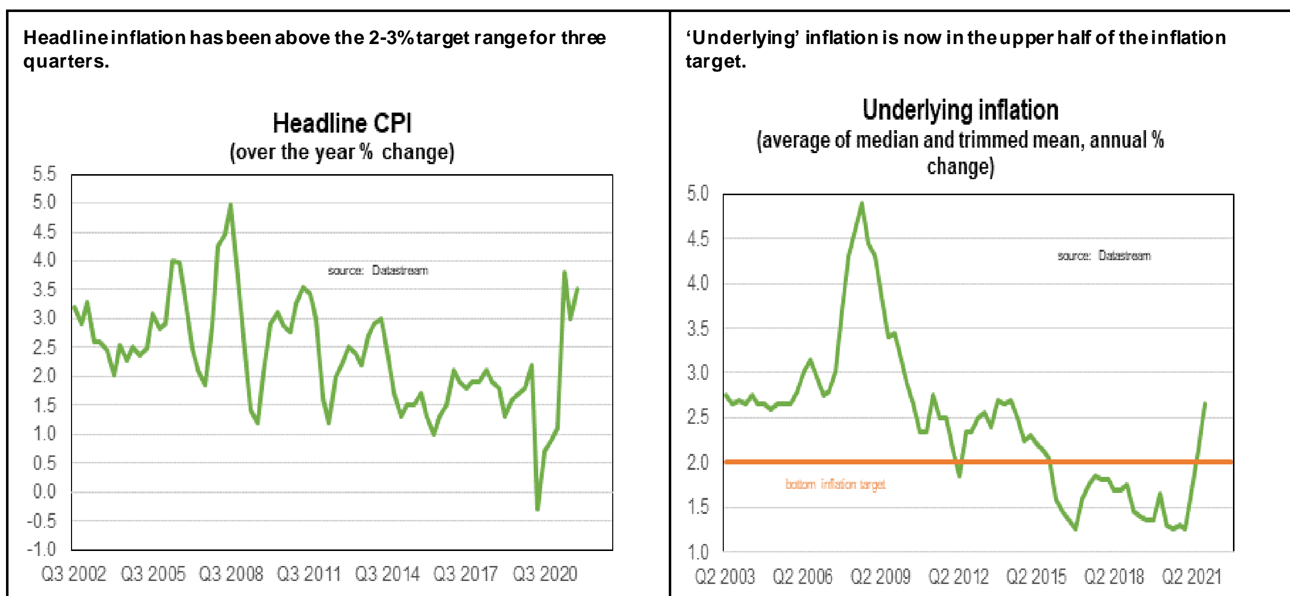
For much of the past decade the main economic problem facing Australia was that economic growth had not been strong enough for long enough. Strong population growth meant that we needed to build plenty of homes and roads. But an uncertain outlook led to firms not investing. Low wages growth didn't allow consumers to spend. So the economy could not gain the momentum to enable the unemployment rate to drop into the 4's. Low wages growth also made it hard for inflation to stay within the RBA's 2-3% inflation target.

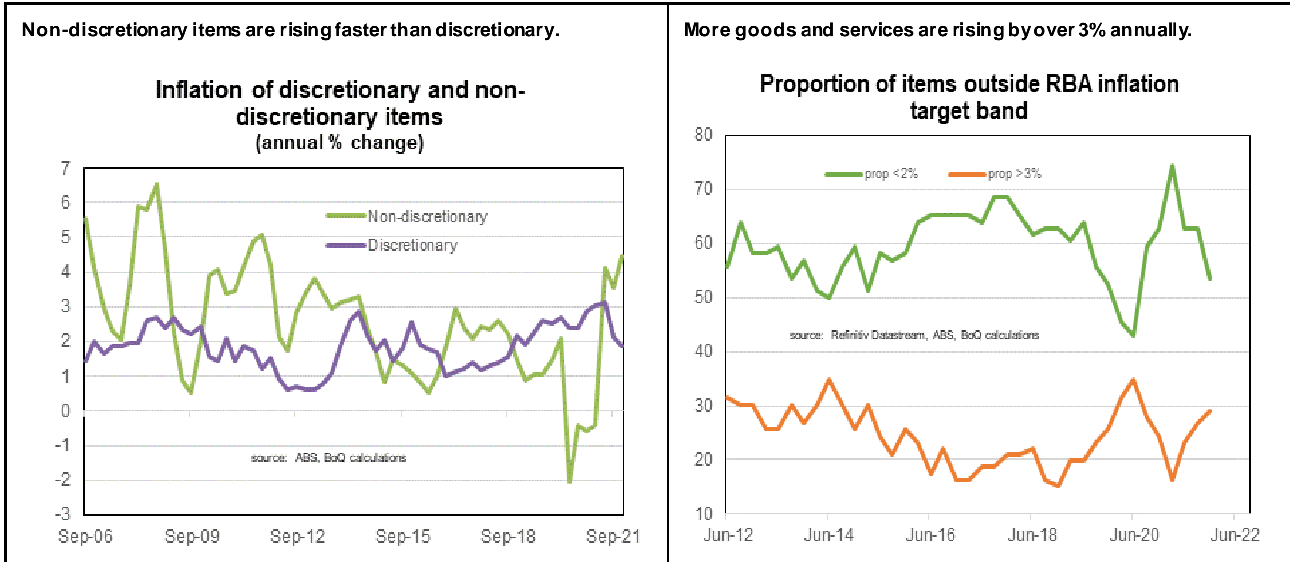
But those worries are all so pre-pandemic. Governments' and the RBA have successfully underpinned household and company incomes. This has meant that spending in the economy has only been limited by the timing of virus waves. The unemployment rate is already at its lowest level since 2008. With vacancies at extremely high levels the only thing stopping the unemployment rate heading into the 3's will be whether the unemployed have the right skills to take the jobs that are on offer.

The Q4 CPI numbers highlighted that the new macroeconomic problem is likely to be inflation. Headline inflation was up a big 1.3% in the quarter (3.5% over the year). This was the third consecutive quarter that the annual growth of inflation was above the RBA's target band. Rising petrol prices and construction costs were the main drivers of the quarterly rise.

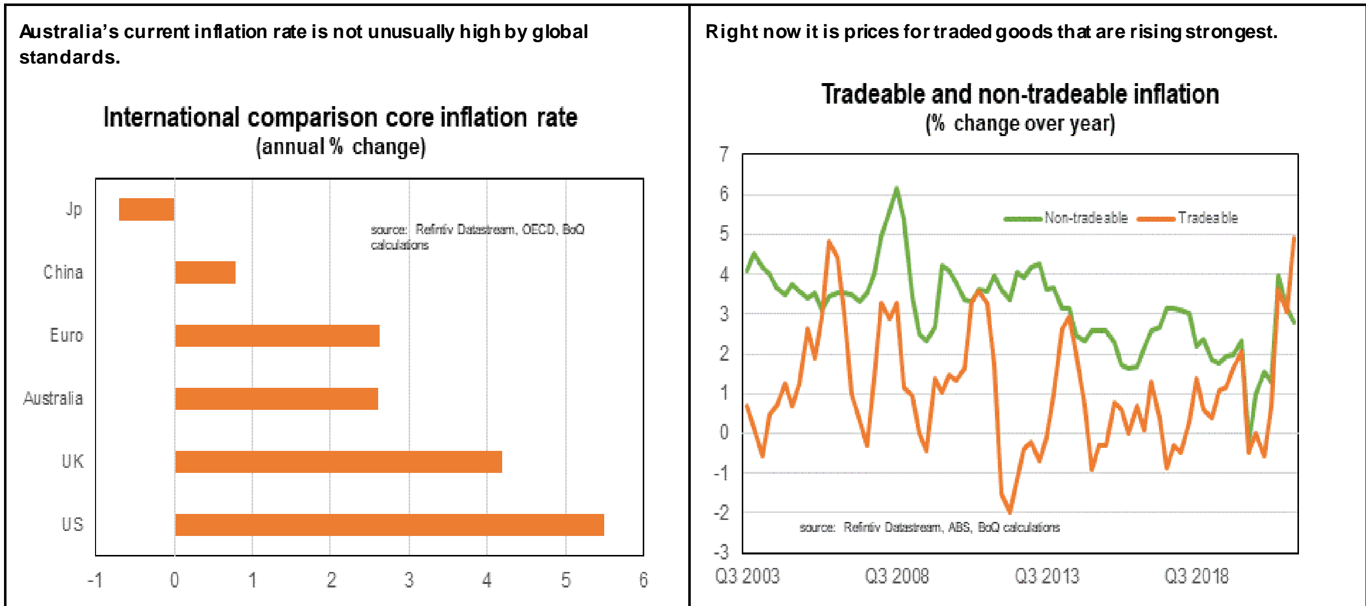
No matter how you slice and dice the numbers inflation rose strongly in the December quarter. The proportion of items rising by more than 3% was towards the top end the range over the past ten years. Strong demand meant that goods prices that have been rising by 4.3% over the past year. But service prices still rose by 2.3%.

Tradeable inflation that used to average under 1% because of strong global competition was up almost 5% in the year to December (non-tradeables such as haircuts was up almost 3%). The so-called 'underlying' inflation numbers (calculations designed to remove unusually large or small price movements) were up 0.9-1% in the quarter. The annual growth rate of one of the measures ('trimmed mean') was at 2.6%, its highest level since 2014.





The current rate of inflation in Australia though doesn't (yet) stand out globally. It is well below the levels recorded in the US and the UK but above the rate recorded in the major Asian economies.



Why has inflation been rising

Every quarter there are various 'one-off' factors that drive price changes. The opening up of borders led to a jump in the price of travel. Global oil prices were up strongly partly because of geo-political tensions.

But the big picture is that demand has been a lot stronger than supply leading to pricing pressure. This has been mainly for goods although the prices of many services are not unusually low. The big rise in construction prices reflected the diminishing impact of government subsidies. But the subsidy hid the extent of pricing pressure in the sector in previous quarters (and the subsidy was one of the catalysts for pricing pressure as it drove up demand for housing construction at the same time as supply of materials and workers were limited).

The hope has been that global supply constraints would prove to be temporary and diminish as factories ramped up production and the logistics of transport and storing of goods improved. Towards the end of last year there were signs that was starting to happen. Supplier-delivery times were declining. There had been a fall in shipping freight rates. But then the Omicron wave appeared.

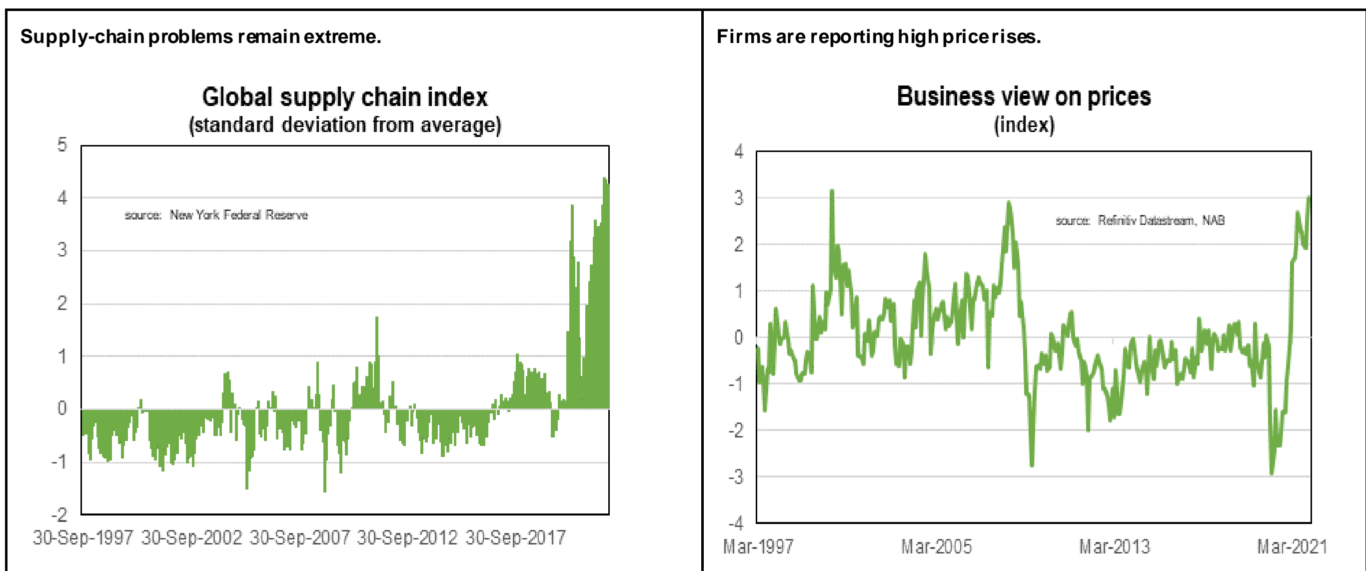
Signs that the Omicron wave is starting to subside in Australia and other areas of the world gives hope that some of the recent supply problems will improve in coming weeks. But we don't know for sure whether there will be other substantial Omicron waves. And we don't know whether there will be other COVID variants. We also can't be certain when consumers' will become comfortable with the concept of COVID becoming endemic (as it seems likely COVID will). In short the impact of COVID in time will diminish but we can't be certain of when.

Even if everything does go smoothly on the virus front supply problems will last at least into the second half of this year. A New York Federal Reserve measure of supply chain indicates that shortages are near a record level. Inventory levels in a number of industries (notably retail) are at a very low level.

It is also possible that there will be permanent changes to the economics of the supply of goods and services. Global supply chains had been set to maximise efficiency and minimise costs. Following their experiences of COVID and rising geo-political tensions a growing number of firms have indicated their desire to diversify their sources of supply and hold more inventories. Not many have done so yet but changing supply chains takes time. Historically firms' would not have felt comfortable about passing the higher costs such moves would entail onto customers. But firms now appear more willing to pass on cost increases, at least in the current environment of strong demand and excess saving.

The prices of many commodities (oil, gas, iron ore, food) have also been rising for the same reason of strong demand and problems with supply. In time many of these price rises are likely to be unwound as supply improves and demand wanes. But the economy is also making a structural move away from fossil fuels to more environmentally friendly energy sources. In the long term that is the right thing for the environment and (potentially) the economy. But in the short term demand will likely remain strong for oil, gas and coal. At the same time the likelihood that long-term demand will be lower for these commodities means less investment. The result could be a period a period of higher prices for commodities such as oil and gas.

Another longer lasting supply concern might be the lack of skilled workers. Concerns about finding workers are currently near the top of many firms list of worries. A return of strong immigration flows is likely to be the best solution in the short term to meeting the strong demand for workers (improving education and training is a good solution in the long term). The opening up of borders will help. But the reappearance of Omicron and understandable ongoing caution of governments and people means it is likely to be sometime before immigration returns to Pre-COVID the levels.



But it is not all about supply

But as has become increasingly clear rising inflation pressures is also about strong demand. Demand for goods should moderate as consumers rebalance back towards services as spending patterns gradually return to 'normal'. When that happens will depend upon the future path of the virus and consumer attitudes about future COVID cases.

But the economic rebound has been a lot stronger than virtually everyone has forecast. The unemployment rate was near 4% at the end of 2021, close to the full employment target set by the government and the RBA. Strong economic momentum, big construction and capex plans and high saving levels all mean that demand should stay strong. Households have a positive view of the state of their own finances.

Even the shift back in spending towards services and away from goods may not significantly drive down inflation in the current environment. A very low unemployment rate will likely see wages growth rise. And historically rising wages growth has led to higher service-sector prices.

There is a scenario though where rising inflation could though dampen demand. Over the past year wages growth has lagged the growth in prices (falling 'real' wages). What has made things particularly tough for some households is that has been the prices of non-discretionary items (such as petrol) that are rising the sharpest. The high level of saving means that this decline in real wages has yet to be a big constraint on consumer spending. But at some stage it could be unless wages growth rises above inflation.

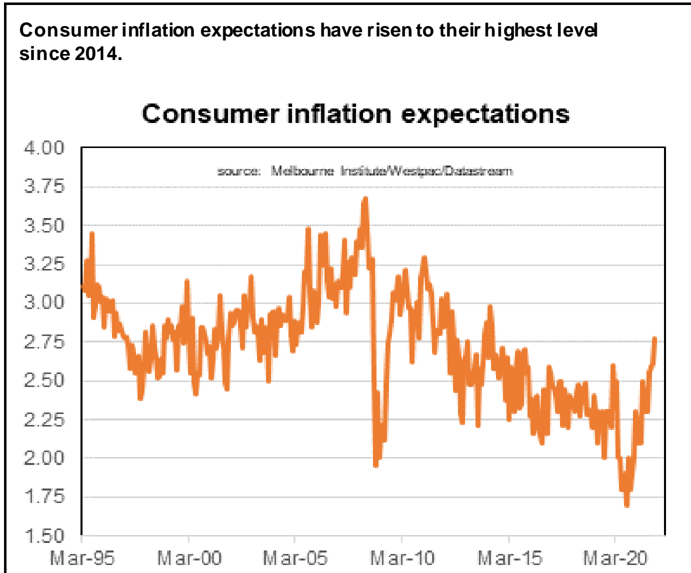
Inflation expectations

One of the indicators that central banks' put a lot of emphasis on is inflation expectations. The concept is that if households and firms expect prices to remain low they will modify their price setting and wage demands accordingly. The classic example is Japan. Despite an extended period of interest rates being set at zero and numerous fiscal support packages inflation has stayed around 0% largely reflecting the behaviour of firms and households.

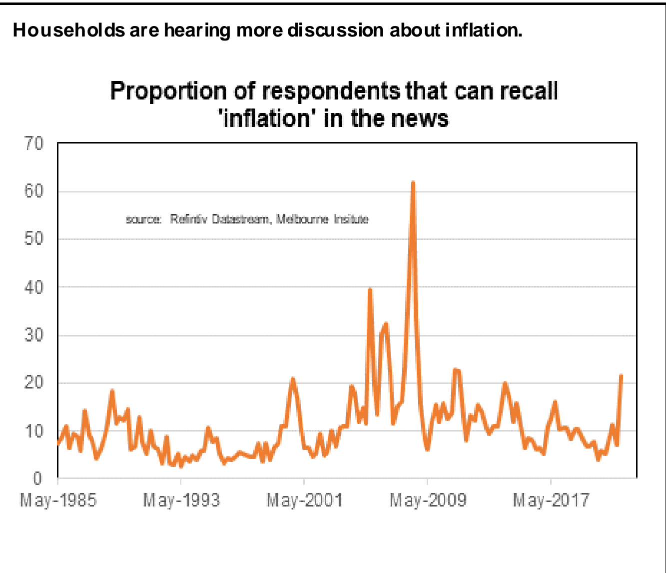
Following on from an extended run when inflation was under 2% inflation expectations becoming too low was a concern of the RBA. In recent months there has been a rise of consumer inflation expectations (to 2.75%), its highest level since 2014. To date that has shifted expectations back to the level it was pre-GFC, consistent with inflation returning to the middle of the 2-3% target band. At the end of last year people's recall of inflation in the news was at its highest level since the GFC. Firms report that price rises are at their highest level since the survey was started in 1997.

Research suggests that household and firms expectations about future inflation are largely a reflection of the experience of recent inflation trends. Short term rises (say, due to the impact of weather or temporary rises in petrol prices) appear not to have a significant impact upon expectations. But more sustained price trends are more likely to impact expectations. There are reasons to expect that the current supply problems and excess demand will abate in time. But the longer they last and lead to higher prices the greater the risk that inflation expectations will rise too high.

Consumer inflation expectations have risen to their highest level since 2014.

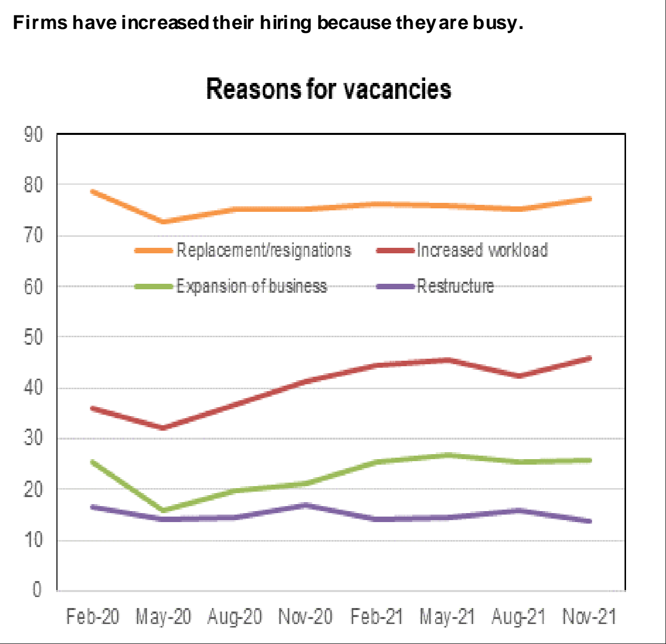


Households are hearing more discussion about inflation.



The strength of the labour market means it is getting harder to find workers.

Firms have increased their hiring because they are busy.

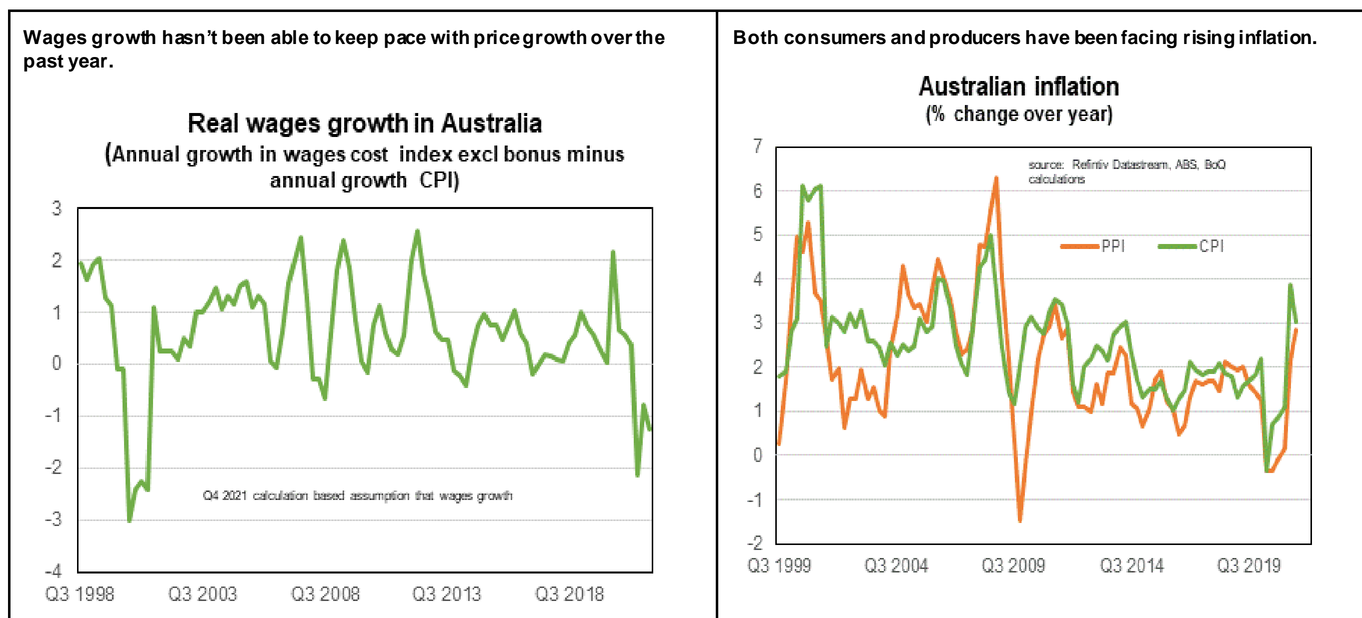


Ongoing inflation

Over the past six months 'underlying' inflation has averaged around 3.5% (the same as the headline rate). For much of the past thirty years an inflation rate at that level would have meant the RBA would be increasing interest rates within the next couple of meetings. But after a period of inflation being consistently below target the RBA wants to make sure that inflation stays in the target band. One of the key pieces of data in that regard is whether wages growth can be above 3%.

We won't get an update on wages until February (23rd). But the fundamentals do suggest that higher wages growth is on the way. The last time the underutilisation rate (the best measure of the state of the jobs market) was this low was since 2008. Firms are gaining confidence that they can pass on cost increases onto customers.

For the RBA an interesting scenario would be if inflation remained above 3% but wages growth remained less than 3%. As noted in the long-term such a combination is unsustainable as it would mean that consumer spending power is declining. But in the short term a scenario of inflation being above 3% and wages growth above 2.5% and looking like it will head higher could be enough for the RBA to increase the cash rate.



What this means for the monetary policy

Monetary policy is currently set at emergency levels at a time when the economy is either at or close to full employment. Inflation is above the top end of the target band. There are reasons to expect price growth will not be as high in coming quarters. But with demand likely to remain strong and supply constraints to be a feature of the landscape for a while the risks are that inflation will remain above 3% in coming quarters. Wages growth is currently under target but all the signs are that it will pick up. Fiscal policy remains extremely supportive. One measure of the stance of monetary policy (real cash rate, or the cash rate after inflation) is at its most economically supportive level in over 40 years.

Globally, most central banks have either begun increasing interest rates (many emerging economies, the UK, New Zealand), will soon do so (the US, Canada) or are reducing other support to the economy (reducing quantitative easing, as is starting to happen in Europe). The Chinese Government is reducing interest rates (and providing more fiscal support) to boost its economic growth. But they are likely to be an outlier this year. In a world of increasing interest rates if Australia does nothing in effect they are easing monetary policy.

In this light it is virtually certain that the RBA will end Quantitative Easing in February. Economic growth and inflation have both been stronger than I expected. The Omicron wave is leading to a short-term pullback in consumer and business spending, and is impacting some parts of the economy particularly hard (Air Transport, Accommodation and Food Services, Recreation, areas of retail). Other parts of the economy (such as construction and mining) though are doing extremely well. The evidence of the past two years is that consumer and business spending bounces back as virus waves decline.

I have pulled forward my expectations of when the RBA will first move the cash rate into the fourth quarter, when I expect a 15bp rise (to 0.25%) in November followed by another quarter percentage point expect rise in December (to 0.5%).

It is possible that the RBA could move even earlier. Financial markets have priced the first move (0.15%) now essentially by May. That is unlikely given there is an election due around that time. But an earlier move than my forecast is possible depending upon how the wages numbers print in late February. We will get a far better idea of the RBA's thinking on interest rates in the week beginning 31st January.

We live in interesting times.

Regards

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