ECONOMIC UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

WEEK ENDING 2 SEPTEMBER 2022

Key points

- **Oil prices have declined from their peak reflecting a weakening global economy;**
- **But supply constraints mean oil prices are likely to be structurally higher;**
- **Businesses are currently a lot more confident than consumers and that dichotomy is influencing the composition of economic growth;**
- **The main reason for the labour market shortage is that economic growth has bounced back substantially quicker than labour force growth.**

As I like to say the economy never sleeps. There is always plenty going on in the world of economics. But in recent years the pace of big events seems to have increased, whether that be pandemics, wars or major weather events. Maybe there was not quite anything of that magnitude over the past week. But there was still a bit going on.

Oil prices are structurally higher

The substantial rise in oil prices since the peak of pessimism about the pandemic (April/May 2020) has had a substantial impact on the global economy and financial markets. At first that rise was seen as a sign of increasing confidence about the global economy. But the sharp upward shift in oil (and other commodity) prices this year has led to a spike in inflation and a slowing of global economic growth. Concern about high inflation has led to very aggressive central bank interest rate responses that in turn has led to even more worries about the economic growth outlook.

As a result the outlook for oil prices, always important, has become even more important. Worries about the outlook for the global economy has seen many commodity prices decline from their peak (gas is a clear exception). Given central banks determination to return inflation back to their target, further reductions in economic growth expectations and therefore commodity prices (including oil prices) in coming months are likely.

Even leaving aside central bank actions, some of the factors that have led to high oil prices are likely to prove to be temporary.

- There has been a significant rise in the demand for transport (shipping, trucks) reflecting the strong buying of goods through COVID and the related desire of firms to boost inventories. The demand for goods is starting to moderate, and inventories (particularly in the US) have got too high;
- There has been a sudden rise in fuel demand as air travel re-opened with a spike in travel. Further growth will likely be more muted with plane travel now close to pre-pandemic levels and a slowing global economy;
- There was a sharp rise in the price of refining crude earlier this year. Largely that reflected that Russian refining capacity was removed from markets for a period of time. But weather and maintenance issues also created problems. These factors may prove to be temporary.

But a number of the factors that led to high oil prices are likely to last longer:

- Working from home and lingering worries about COVID has seen reduced demand for public transport and increased use of cars;
- In the long term higher prices lead to lower demand. That is after all the idea behind a carbon tax. But it takes time before people change behaviour. For example, it took much of the 1970’s before higher prices led to a notable decline in consumption of oil in Australia (such as a shift to smaller cars), something that was helped by a weaker economy due to rising interest rates;
- Higher prices should also encourage increased supply. But again it needs sustained period of high prices to induce more supply. This is particularly the case as there are recent memories of very low commodity prices. As recently as 2020 oil prices were for a short period of time negative (reflecting a sharp drop in demand and a lack of storage capacity for the excess oil). In the US the big fall in oil prices in the middle of the last decade led to significant number of bankruptcies amongst oil companies. The result has been a more muted supply response (as proxied by the number of oil rigs);
- Concerns about climate change has made investors increasingly cautious about investing in fossil fuels;

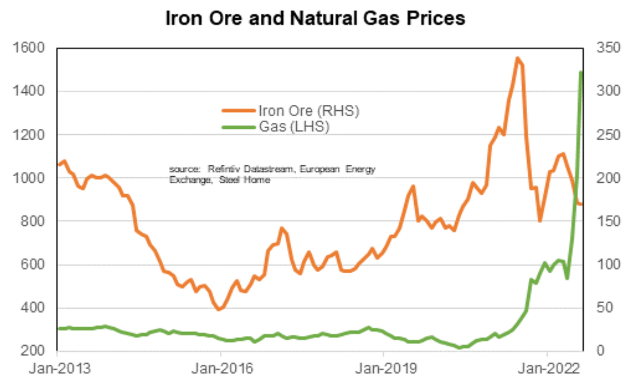
- It is just as possible that the ‘temporary’ factors that have impacted commodity markets (weather, geo-politics) will continue over the next 1-2 years

The other uncertainty is how much reduction there will be in the supply of Russian oil to the global market. The International Energy Agency reported that Russian production in July was only 3% below its pre-pandemic levels. Partly that reflected increased demand from within Russia. But it also reflected the ability of Russia to divert oil exports from Europe and the US to China, India and Turkey. No surprise that in a time of high oil prices that there were willing buyers of Russian oil. The open question is whether the EU embargo on Russian oil that comes into effect in February 2023 has any lasting impact.

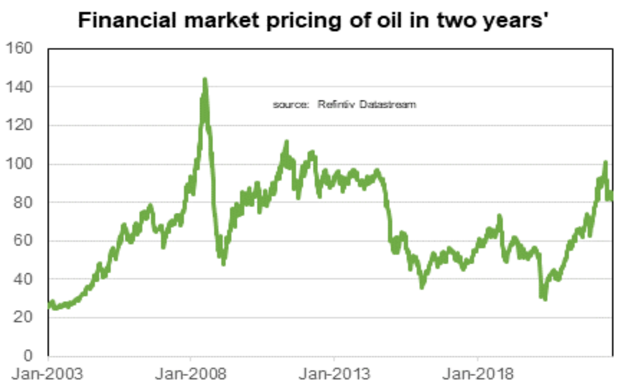
The result is that once economic growth bounces back there is a clear risk that oil prices also bounce higher (although perhaps not as high as they did on the announcement of the Russia-Ukraine war). In that respect what is happening now is more equivalent to what occurred in the 1970s than the 2000s. Earlier this century the rise of commodity prices reflected a positive demand shock due to the very strong growth of the Chinese economy in particular and the global economy in general. Monetary policy is suited to dealing with demand, with central banks increasing interest rates to deal with this strong demand and rising inflation concerns (the cash rate in Australia reached its highest level in 2007 since the early 1990s) until supply responded.

This time the higher prices has largely been a result of a negative supply shock (although strong demand has played a role). And as noted above elements of the supply shock are likely to last for some time. That will mean that global demand might need to be lower than otherwise for an extended period, at least until the supply shock ends or substantial changes to the level of composition of energy demand are made. Energy importers (such as Europe and Japan) are hardest hit by this shock. Energy exporters (such as Australia, the US and the Middle East) are in a better position.

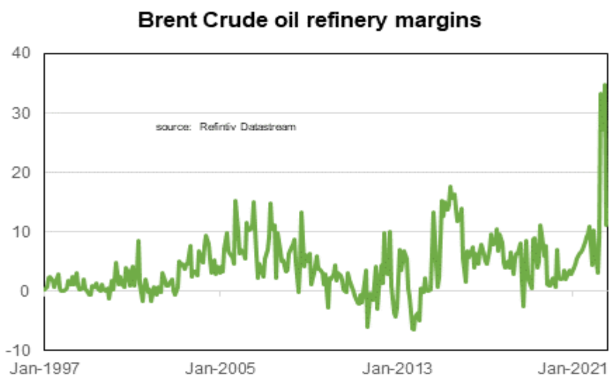
Most commodity prices have declined from their year high. Gas is the main exception.



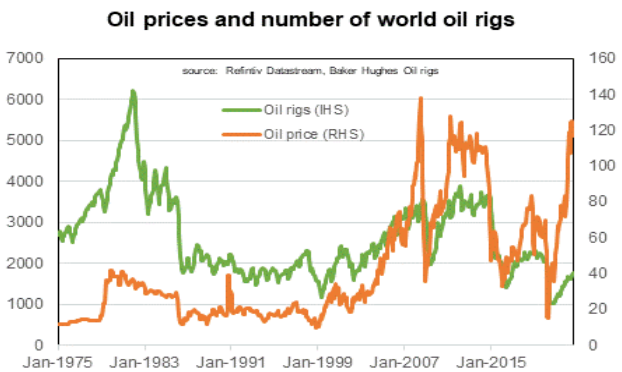
Expectations of where oil prices will be in two years’ time is below the current level but well above pre-pandemic levels.



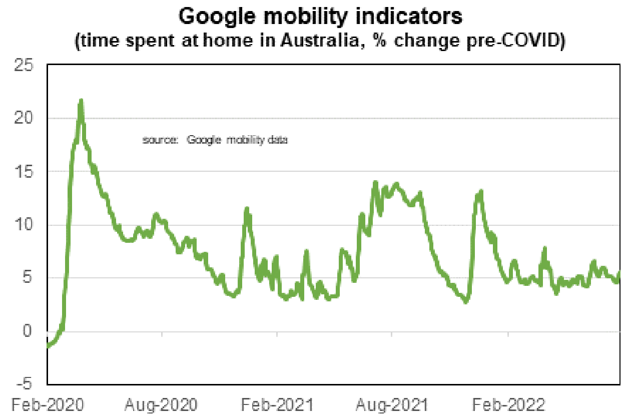
Oil refining margins spiked sharply following the Russian invasion of Ukraine.



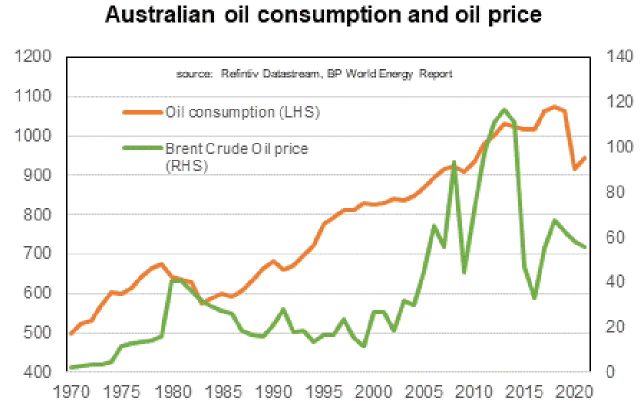
The supply response to higher oil prices has so far been subdued.



There has been a trend increase in driving due to working from home and residual fears of COVID.



It takes some time before higher oil prices results in lower demand, particularly from households.



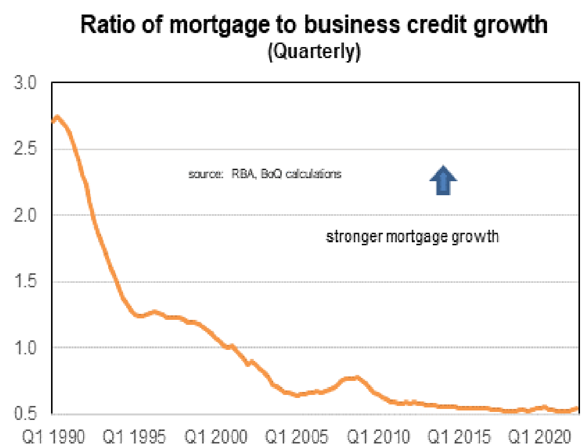
The Yin and the Yang: Business and consumer confidence

One of the notable features of the economy at the moment is the dichotomy between strong business confidence and weak consumer confidence. While not unusual, the current relative strength of business to consumer confidence is near its highest in over thirty years. In the micro, weak consumer confidence reflects inflation taking a slug out of household incomes and concerns about rising interest rates. Businesses are doing better reflecting the strong state of most firms' order books. More generally household confidence is more influenced by changes of interest rates and the unemployment rate while businesses are heavily influenced by the state of the economy.

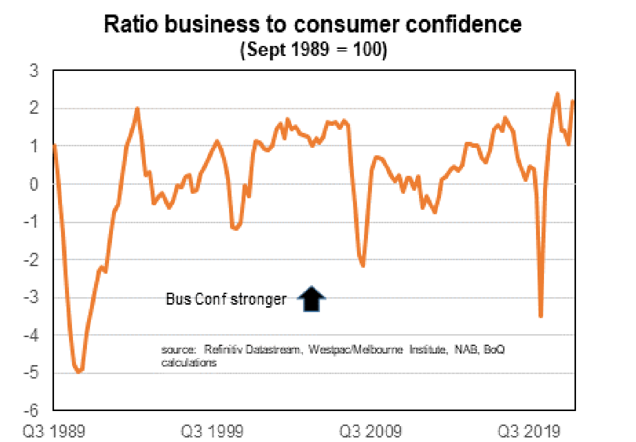
This difference in sentiment will influence the composition of economic growth over the next year. Robust order books and tight capacity utilisation is leading to significant business capex spending (that is being boosted by the rising cost of equipment and building inflation). This is leading to strong business credit growth. At the same time there has been a pullback of mortgage lending to households reflecting higher interest rates (and worries about housing affordability).

To date consumer spending in aggregate is still in reasonable state (as highlighted by the July retail sales number). Woolies though has recently noted a shift by some consumers towards cheaper food options (such as moving from beef to chicken mince). But aggregate discretionary spend (such as spending at cafes and restaurants) is likely to remain decent for the remainder of this year reflecting strong household confidence in the jobs market, a high level of saving and large amount of catch-up spending. But discretionary spending may then slow through next year as more household budgets start feeling the pinch of declining real wages and rising interest rates.

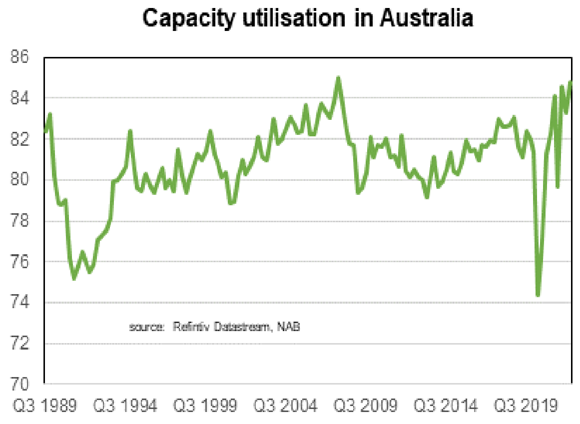
Business credit is now growing faster than mortgage credit.



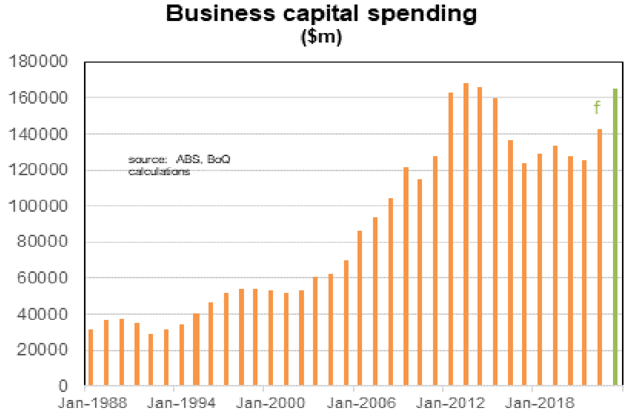
A key reason is that business confidence is stronger.



Spending in cafes has returned to 'normal'.



Business expects a sizeable boost in capex budgets this financial year.



Jobs and Skills Summit

We have just had a 'Jobs and Skills Summit'. Whatever solutions are proposed they are unlikely to lead to a substantial improvement in the supply of labour in the short term. The key issue is that economic growth has bounced back so strongly that it already is above its pre-pandemic growth path (and would have been even stronger if we had more workers). By contrast the closing of the borders for two years has resulted in the size the labour force still being below its pre-pandemic growth rate, despite the participation rate rising to be near a record high.

The only way in the short term to get a better match between the supply and demand for labour is for there to be less demand for workers. Partly that will happen naturally as consumer demand for goods slows, freeing up more workers to shift towards service-sector employment. But a more substantial part of the adjustment will come through slower GDP growth.

The level of job ads suggests that the growth in the demand for labour appears to have peaked. But that demand is still well in excess of current supply of workers. The consensus forecast of economists of a rise in the unemployment rate over the next two years would help reduce worker shortages as an issue.

Improvements in supply-side measures typically take longer to help. A return to stronger immigration would be a plus. But it could be 1-2 years away before pre-pandemic levels of immigration are achieved. Monthly permanent migration numbers are essentially back to pre-pandemic levels although student and working holiday immigration are well below those levels. Their absence is particularly being felt in the accommodation and food services and construction sectors.

Even if the level of permanent immigration is increased above the current 160,000 to the suggested 195,000 it will take some time to fill the 'hole' created by the couple of years of closed borders. Getting immigration numbers up quickly is already facing logistical constraints due to a lack of investment into people and technology (the Government also announced funding to help reduce those constraints).

Another way to increase the size of the labour force is to increase female participation. While Australia has above average level of female participation by OECD standards it is around five percentage points behind the nations with the leading rate of female participation (the Nordic countries, Switzerland and the Netherlands). One of the main reasons people are not looking for work is their need to provide child care, a task that typically falls to women. Research has found that increasing affordable childcare is likely to lead to higher female participation.

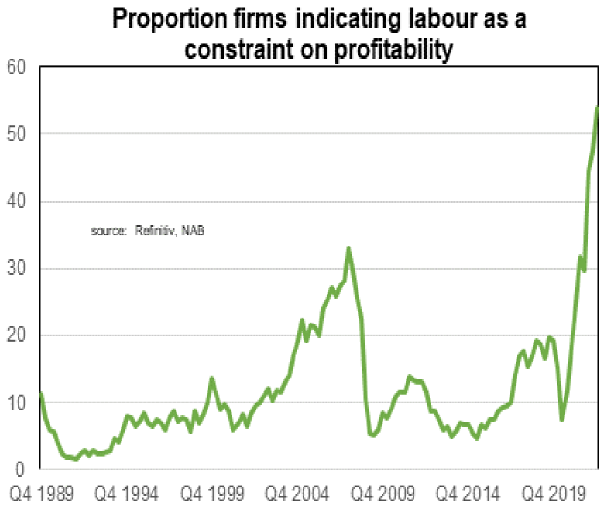
There are good economic and equality reasons to improve the affordability and availability of childcare. But it is not a short-term answer to the current worker shortage. Even if the Government could implement such a policy quickly (a big if given its current fiscal challenges) the current worker shortage would make it impossible to find all the required carers.

Another possibility canvased is to increase the participation of older people. That is a trend that is happening anyway as people live longer and the shift towards service sector employment makes jobs less physically taxing. Additional changes to retirement income rules might be necessary to provide the incentives to substantially increase older age group participation.

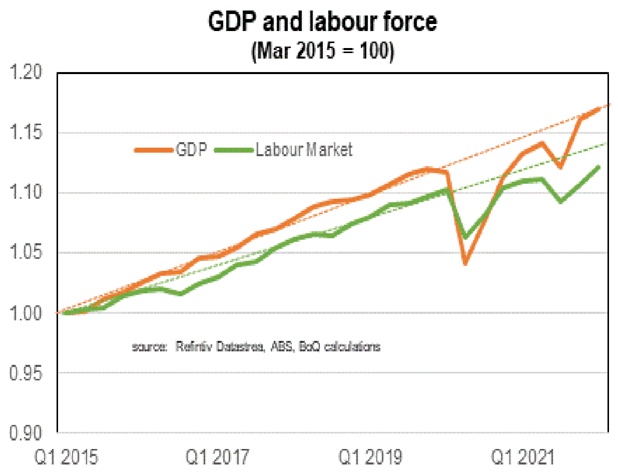
While most of the suggested supply-side fixed are longer-term in nature they are still worth considering. Concerns about skill shortages have been around longer than the problems caused by the re-opening of the economy from COVID. Part of that might be industry-specific. In recent years the construction sector activity has been very strong creating a lack of tradies.

But it also may reflect changes in how the economy is working. By OECD standards a high proportion of Australian firms use the internet in their business (such as receiving orders) as well as utilising the benefits of cloud computing. Some of the required skills from the greater use of digitisation are relatively new (big data, artificial intelligence) and so will take time to develop. But IT training for workers in Australia is not as advanced. The suggestion that there might be more Government funding for IT training could be useful in helping alleviate some of the skilled shortages.

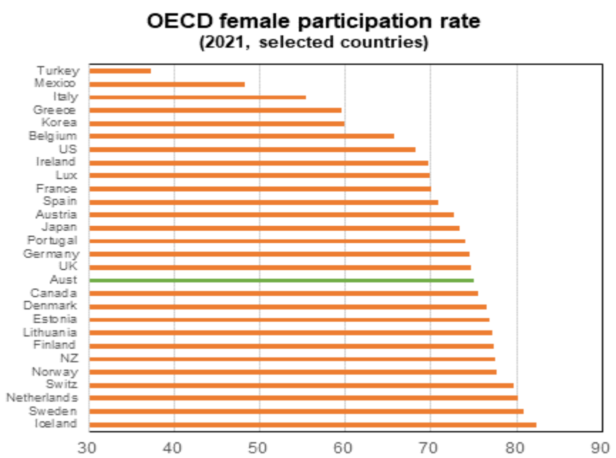
A lack of skilled labour is the number one for most firms.



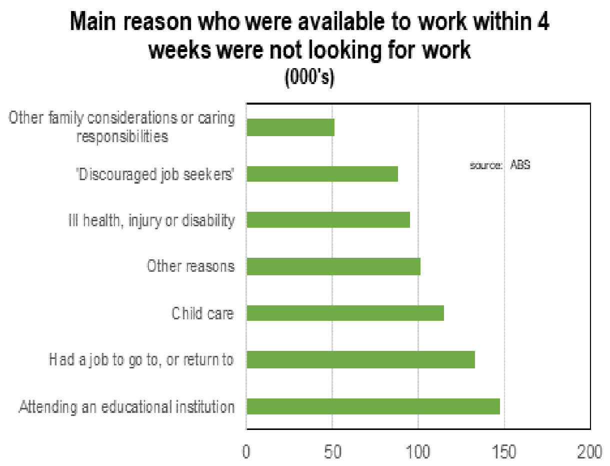
The growth in the economy has been very strong. Growth in the labour force has not been as strong.



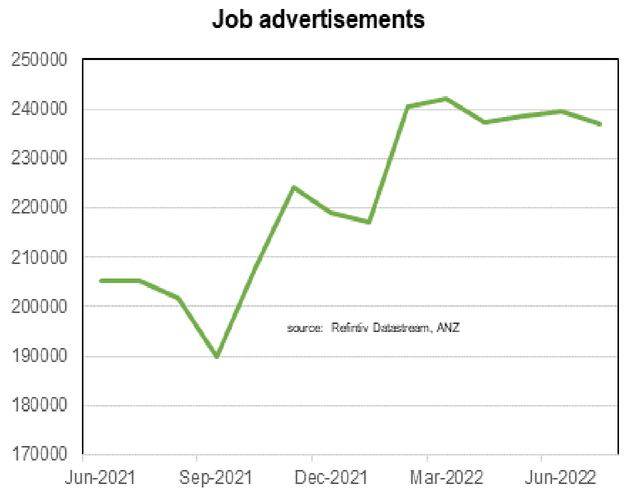
Female participation is above the OECD average but comfortably behind the leading nations.



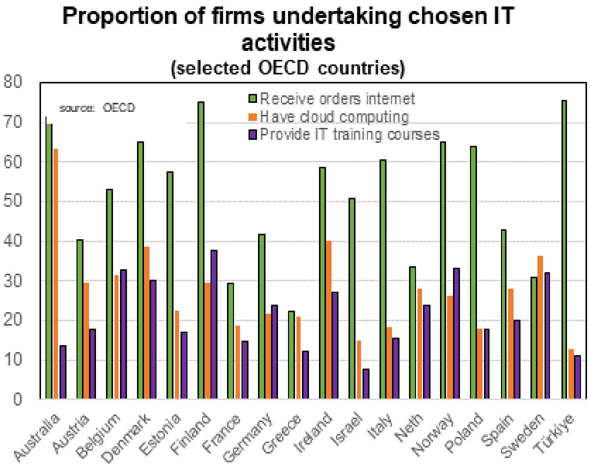
Childcare is a key reason keeping people from looking for work.



The number of job ads appears to have plateaued suggesting demand for labour may have peaked (albeit at a high level).



Australian firm use of IT is high by OECD standards although IT training is low.



We live in interesting times.

Regards

Peter Munckton
Chief Economist
Bank of Queensland