

THE FORWARD VIEW: AUSTRALIA OCTOBER 2021



WAITING FOR THE REBOUND AFTER Q3 LOCKDOWNS

OVERVIEW

- With the NSW economy in the midst of re-opening, we have made little change to our forecasts this month. A very sharp fall in activity in Q3 is locked in – we expect a fall of around 3.5% – concentrated in NSW and Vic. In the near-term, the unemployment rate may drift higher but will likely be a less reliable indicator with large fluctuations in both employment and labour force participation.
- We continue to expect a solid rebound in Q4 with the two largest states, NSW and Vic, on track to reopen early-to-mid quarter. While we don't expect a full rebound in Q4, we see strong growth continuing into early 2022 such that the Q2 2021 level of GDP is recovered by Q2 2022. We also expect the labour market to resume its prior trajectory, with the participation rate normalising and the unemployment rate continuing its path south.
- In terms of forecasts, that sees through-the-year growth of just 0.8% this year, before a solid 4.3% rebound in 2022 and normalisation to around 2.0% in 2023. More importantly, we see unemployment declining to around 4.5% in 2022 and then nearer 4.0% in 2023 – its lowest level in over a decade.
- While we are optimistic of a relatively fast rebound in activity, we expect a more gradual build up in inflationary pressure. The soft starting point for wage growth as well as a notable period of spare capacity in the economy will need to be eroded before we see a material pickup in inflation. In addition, there will likely be a lag between the build-up of pressure on the costs side and the pass through to consumer prices.
- Therefore, we continue to see rates on hold until early 2024, when inflation should satisfy the RBA's condition by being sustainably within the band after rising to around 2¼% in H2 2023. However, a renewed brisk pace of recovery will see the RBA continue to reduce weekly bond purchases by tapering at a more aggressive pace. We see the weekly rate tapered to \$2bn per week before ending around mid-2022. That sees the current tranche total around \$130bn. Around 85bn is already locked in before the next review in Feb-22.
- We expect growth (particularly in the near-term) to continue to be driven by a mix of a rebound in the private sector as well as ongoing government support – both direct payments and stimulus measures. However, there are a number of risks around when support will fade and the pace of normalisation in consumption.
- Beyond the ongoing uncertainties around the pace of full reopening domestically as well as with respect to international borders, the implementation of macro prudential policies may work to cool the housing market in the short term.

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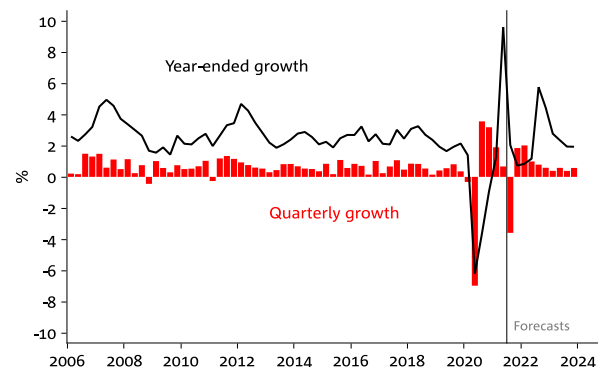
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KEY ECONOMIC FORECASTS

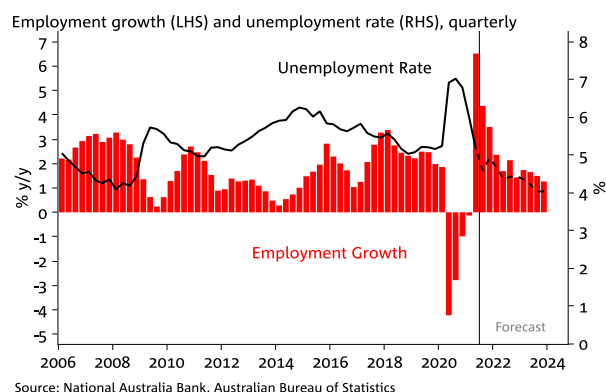
	2020	2021-F	2022-F	2023-F
Domestic Demand (a)	-2.6	4.6	2.8	2.9
Real GDP (annual average)	-2.4	3.3	2.9	2.3
Real GDP (year-ended to Dec)	-0.9	0.8	4.3	2.0
Terms of Trade (a)	-0.6	20.6	3.6	-0.8
Employment (a)	-1.7	3.4	1.5	1.5
Unemployment Rate (b)	6.7	4.9	4.4	4.0
Headline CPI (b)	0.9	2.5	1.6	2.0
Core CPI (b)	1.3	1.8	1.8	2.2
RBA Cash Rate (b)	0.10	0.10	0.10	0.10
\$A/US cents (b)	0.77	0.72	0.78	0.77

(a) annual average growth, (b) end-period, (c) through the year inflation

GDP FORECASTS



LABOUR MARKET FORECASTS



LABOUR MARKET, WAGES AND CONSUMER

The labour market deteriorated noticeably in August as lockdowns began to bite. Employment and hours worked fell significantly, with a fall in participation masking the impact on the unemployment rate itself, and there is more pain to come – but signs are positive for a rebound once lockdowns end.

After only limited lockdown impacts were seen in the July numbers, August saw employment decline by almost 150,000. That was enough for the employment-to-population ratio – which has been recovering fairly steadily since May 2020 – to fall back 0.7 ppts to 62.2%. Hours worked, which is perhaps the clearest measure of labour market activity at present, fell 3.7%. Both employment and hours are likely to fall further in October before reopening plans begin to take effect.

Interpreting the measured unemployment rate remains difficult. Unemployment edged lower to 4.5% in August as the fall in participation once again outweighed the fall in employment, and this pattern may continue next month. Whether the unemployment rate moves up or down when lockdowns end will likewise depend on the relative strength of employment and participation responses to reopening.

There are already indications that employment will rebound rapidly, with job ads up in NSW ahead of lockdown lifting. However, there is also likely to be a strong participation response as income support is reduced. As a result, we expect the unemployment rate to peak at around 4.9% in the near term.

Regardless of the initial adjustment, the unemployment rate should resume its prior trajectory once activity recovers, falling to around 4.5% by end 2022 and to near 4.0% by end 2023.

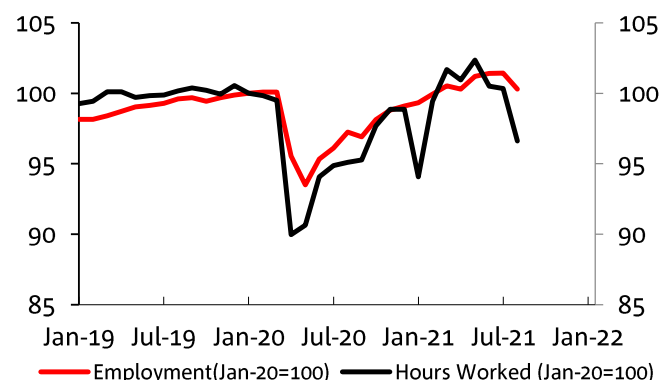
Household consumption also continues to be weighed down by lockdowns. Still, there are signs of an uptick in September and a rebound in spending remains likely once the economy reopens.

Monthly retail sales data fell a further 1.7% in August, backing up a 2.7% fall in July. The decline was again driven primarily by clothing and footwear, department stores, and cafes and takeaway, with NSW and Victoria well down. The ACT also saw a dramatic fall, but spending in SA rebounded from a July slip.

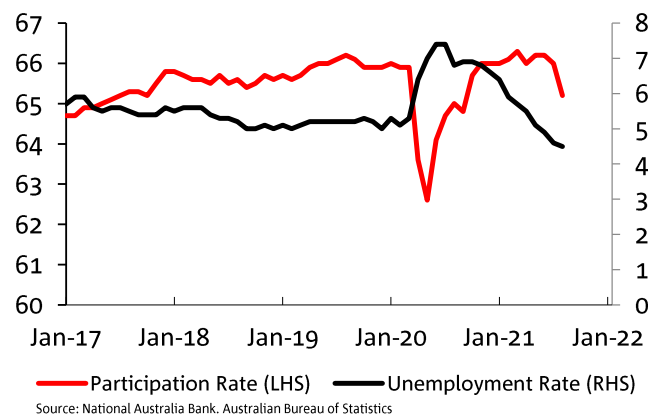
Still, NAB's measures of cashless retail sales suggest there may have been an uptick in spending in September with both NSW and Victoria recovering, although the hospitality sector has continued to face significant challenges. Consumption patterns also continue to adjust, with online sales up 8.8% in August – a behavioural shift that could continue even after lockdowns end.

We see household consumption rebounding in the coming months as lockdowns end in NSW in October and in Victoria in November. The strength of the rebound remains uncertain with the potential for consumers to display more caution with COVID still present.

HOURS WORKED FALL FASTER THAN EMPLOYMENT

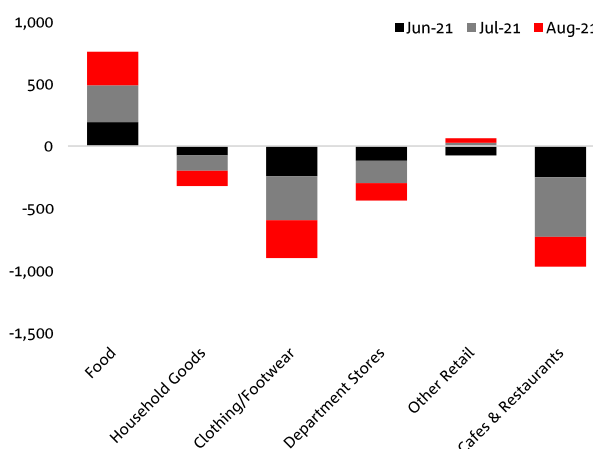


LOWER PARTICIPATION WEIGHS ON U'RATE



LOCKDOWN IMPACT BUILDS OVER TIME

Cumulative change in retail consumption since May 2021 (\$m, s.a.)



HOUSING AND CONSTRUCTION

Housing markets are still strong – approvals have come off their peak but remain high, and house prices are still growing rapidly. There are signs that the run-off in approvals due to the end of Homebuilder is close to done, but a new headwind has emerged in the form of a tightening in APRA's macro-prudential controls.

Dwelling prices grew by 1.5% m/m in September, unchanged from August. This represents a step-down from the rates of growth seen earlier in 2021, possibly due to a fading boost from the spike in household income and falls in mortgage interest rates last year, as well as growing affordability constraints. That said, it is still a strong growth rate (almost 20% annualised). There was a notable step down in Melbourne (to 0.8% m/m from 1.2%) and price growth remained soft in Perth and Darwin while in the other capital cities prices are growing around 2% m/m.

New home loan commitments (ex. refinancing) declined by 4.3% m/m in August. While new loan commitments peaked in May, the August fall may also reflect the impact of lockdowns on house and unit sales as the largest falls (including refinancing) were in NSW, Victoria and the ACT.

There has been a clear downwards trend in new loan commitments for dwelling construction by homeowners, which have fallen by 42% since May. However, the fall in August (-0.9%) was the smallest monthly decline over this period.

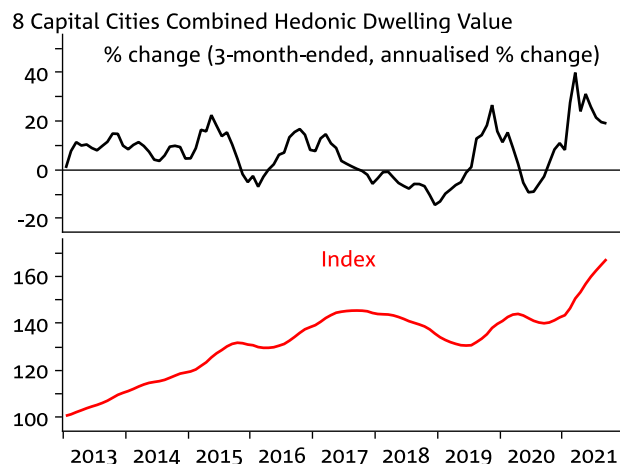
Also in August, building approvals increased by 6.8% m/m, ending a run of four consecutive monthly falls. With new construction loans still declining, however, it is too early to call the end of the run down in approvals. Nevertheless, the slower rate of decline in loans for new construction and signs of stabilisation in approvals does suggest that the unwinding of activity due to the end of Homebuilder in March may be close to reaching its conclusion.

If that is the case, this would leave building approvals above its pre-pandemic level, and at a high level considering the recent minimal level of population growth. Low mortgage interest rates and the strong growth in house prices that has occurred are factors that, even absent Homebuilder, would have supported a solid level of activity, but their impact will fade over time.

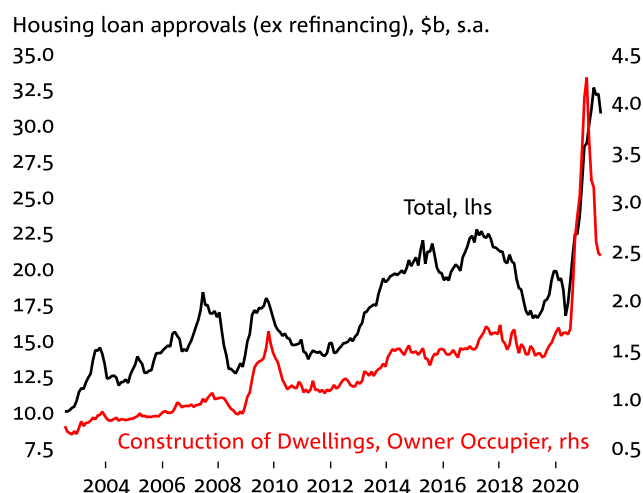
This month APRA increased the minimum interest rate buffer for banks to use in assessing the home loan serviceability. APRA expects only a 'fairly modest' impact on housing credit growth, but it has not ruled out further macro-prudential tightening.

Despite the fall in building approvals over the last five months – and the prospect of further falls – we still expect dwelling investment to grow into 2022, before starting to decline. There is a large pipeline of work (for detached houses) in place and reported capacity constraints by builders which could drag this work out over a longer period of time than normal, which will support activity for now, with lockdowns adding to this dynamic.

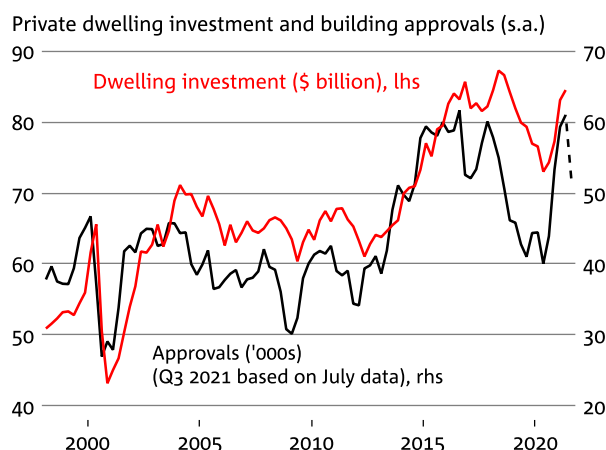
HOUSE PRICES STILL GROWING STRONGLY



NEW HOME LOANS OFF THEIR PEAK



APPROVALS ALSO DOWN RECENTLY BUT STILL SOLID



BUSINESS AND TRADE

Lockdowns have continued to impact the business sector but we continue to expect activity to bounce back as restrictions are eased.

Indeed, the NAB Monthly Business Survey for September showed a broad-based rebound in confidence, with large gains in NSW and the recreation & personal services industry. That said, confidence was up in almost all areas except mining where the pull-back in the iron ore price may have been a factor.

The activity side of the survey, however, showed further deterioration in the month, with business conditions, forward orders and capacity utilisation seeing notable falls. While there were notable falls in a number of industries and in most states, the sharp declines in these measures in NSW and recreation and personal services highlight the drag on activity from the ongoing lockdowns.

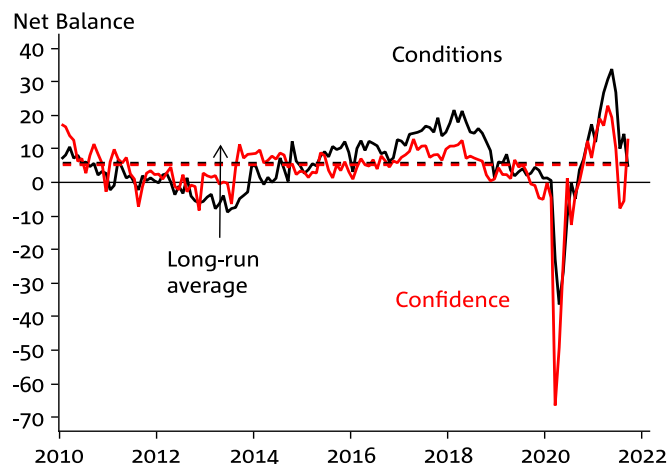
We remain optimistic that, once restrictions are eased and activity picks up, the healthy hiring and capex plans seen prior to the recent lockdowns will re-emerge. We expect investment to continue to lift in coming quarters, supported by policy measures, higher demand and capacity constraints in some sectors. Official measures of investment intentions are now well out of date, last released in August amidst renewed lockdowns. An updated set of expected Capex will be released in next week's Q3 NAB Quarterly Business survey (which were strong in Q2). We remain optimistic that investment intentions will have remained resilient as business looks through the current lockdowns in anticipation of a rapid rebound in activity as restrictions ease.

Despite the ongoing disruption to services trade, the trade surplus (in nominal terms) continues to set new records.

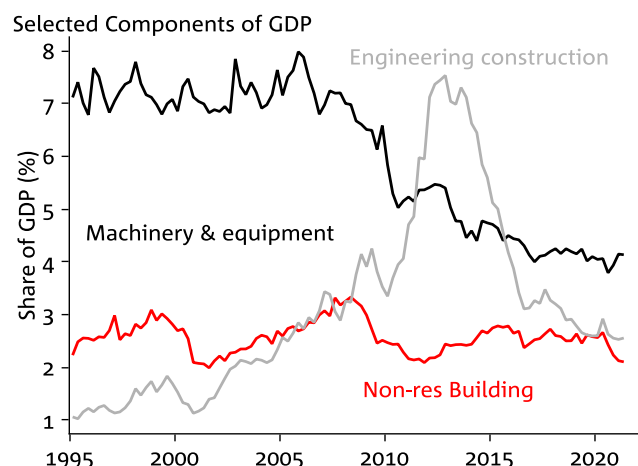
Driven by a 5% rise in goods exports, a 4% rise in exports and a 1% fall in imports saw the trade surplus reach \$15bn in August. The rise in goods exports was supported by both rural (up 11%) and non-rural (up 3%, driven by other mineral fuels and coal exports). This likely reflects the strength in energy prices and strength in demand from the northern hemisphere over recent months, while the monthly decline in iron ore exports also likely reflects price impacts with the iron ore price declining significantly in recent months (from a very high level).

In the near-term, the trade surplus is likely to remain elevated with ongoing strong energy demand and a quarterly rebound in iron ore volumes. In the medium term, as borders reopen, there will likely be a gradual normalisation in services trade with outbound international travel and education exports important to Australia. However, the timing of border reopening and the pace of recovery in travel remains highly uncertain.

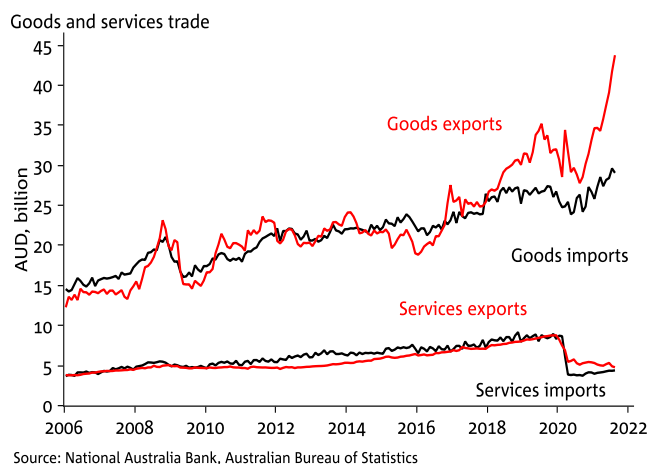
CONFIDENCE AND CONDITIONS TICK UP



INVESTMENT IS LOW AS A SHARE OF GDP



TRADE SURPLUS HITS A NEW RECORD



MONETARY POLICY, INFLATION AND FX

As expected, the RBA left policy settings including the cash rate, YCC and the planned weekly purchases of \$4bn under the QE program on hold in October, ahead of an updated set of staff forecasts to be released in next month's November SMP.

The post meeting statement highlighted the expected large hit to GDP in the September quarter and the impact on hours worked by the labour force. However, the RBA remains upbeat on the rebound in activity when COVID restrictions are eased over coming months. GDP is expected to begin the rebound in Q4, with the pre-lockdown path of GDP recovered by around mid-next year.

The RBA continues to point to a weak starting point for inflation and a focus on actual (rather than forecast) outcomes when setting policy. Recent communication has also pushed back on lifting interest rates as a tool for addressing financial stability risks. Consequently, the RBA's guidance of unchanged rates until at least 2024 remains in place (as does the Yield Curve Control (YCC) program).

We continue to expect a rates "lift-off" in 2024 with a gradual build-up of inflationary pressure from here but the tapering in QE to continue from February.

Like the RBA, we expect a solid rebound in activity once restrictions are eased – albeit at a slightly slower pace. We expect inflation to rise above the bottom end of the inflation target sometime in H2 2023 – though this will be highly dependent on the true level of "full employment" and inflation expectations in the wage bargaining process. Further, the rate of passthrough to consumer price inflation will be important, especially in the context of the pre-COVID experience of retailers tightening margins rather than passing on higher prices.

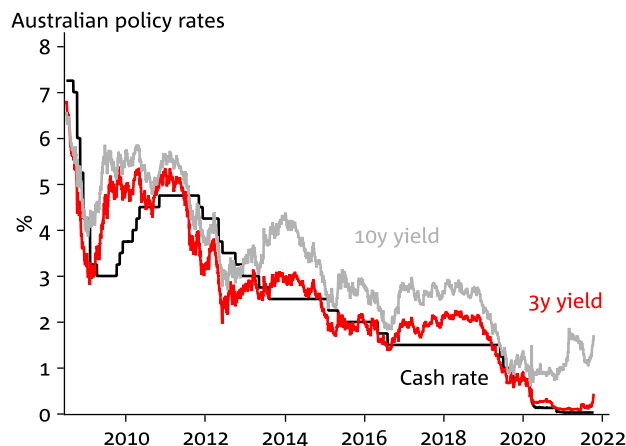
With inflation returning to the bottom half of the inflation target and the labour market continuing to tighten we see inflation as having satisfied the RBAs condition of "being at target" in 2024. The risk around rates then becomes the need to normalise more quickly as the risk of an inflation overshoot builds.

However, in the near-term we expect the RBA to continue to taper the QE program – likely at a more aggressive pace than previously expected. With a tranche of over \$80bn in new purchases to be completed by February, we see a further tapering to \$2bn a week for around 3 months at the next review before winding up the program by mid-2022 (totalling up to \$130bn from here).

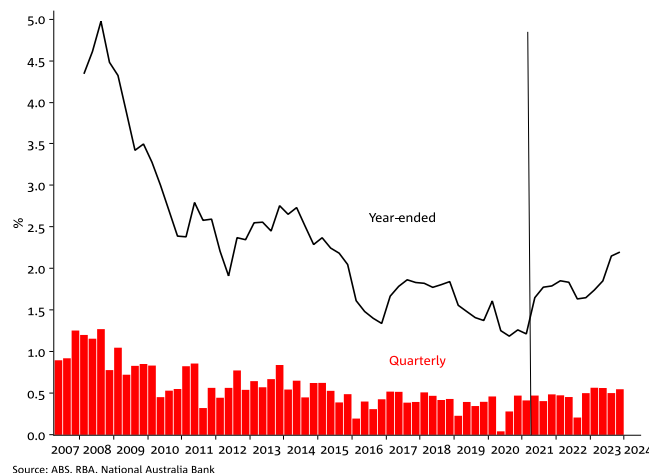
The Aussie has remained range bound, trading between US\$1.5c and US\$1.6c over the past month – well below our estimates of "fair-value".

Our forecasts for the exchange rate were recently updated to reflect the better than expected strength in the USD – especially in the face of strong commodity prices. We now see the AUD around 72c by end 2021. Thereafter we see the AUD moving up to around US\$1.08c by late 2022 and around US\$1.07c by end 2023.

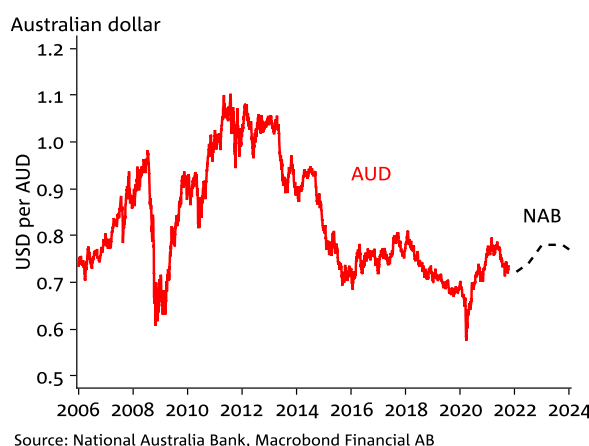
CASH RATE ON HOLD UNTIL 2024



CORE INFLATION TO BUILD OVER TIME



THE AUD TO APPRECIATE FROM HERE



RISKS TO THE OUTLOOK

The major risks to the outlook remain largely unchanged – with domestic lockdowns, state & international borders as well as the ongoing impact/withdrawal of policy support the key risks. However, as highlighted in recent months, the tightening of macroprudential policy has emerged sooner than we had expected.

As has been well publicised, APRA increased the interest rate serviceability buffer on new loans in early October by 50bps to 3.0ppts above the loan's interest rate. This follows increasing commentary by regulators around the potential build-up of financial stability risks arising from rising housing debt from already high levels, amidst strengthening credit growth.

House prices per se are not the primary concern with an increase in prices expected as rates fall. In fact, the RBA has noted that it doesn't see house prices significantly above fundamentals and the cost of servicing a mortgage has remained broadly unchanged (the debt-servicing ratio).

Given that the current assessment of regulators is that lending standards remain strong, there is little concern around banks' balance sheets but rather an emerging risk of rising debt levels in the household sector amplifying economic shocks.

There are number of tools available to macro prudential policy makers in addition to the existing interest rate serviceability buffer – and often, these tools are used in combination. Each brings a set of costs and benefits and often see significant distributional impacts. The existing interest rate buffer has a broad impact, with all new borrowers assessed against this benchmark. However, in practice this tool only impacts the marginal borrower, with the vast bulk of borrowers seeking loans below their full debt capacity. Accordingly, as noted by APRA, the widening in the current serviceability buffer is expected to reduce the average borrower's debt capacity by 5% and is not expected to have a significant effect on credit growth.

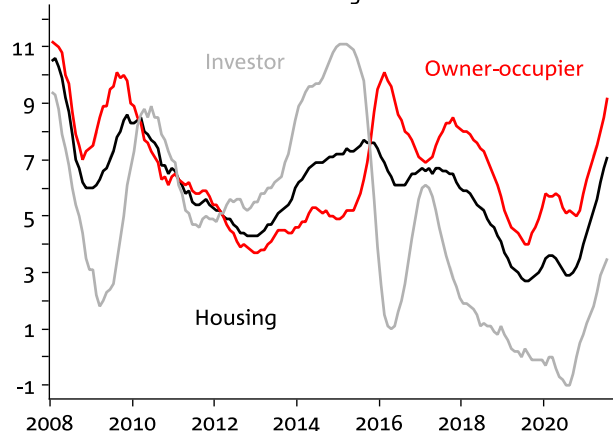
Should credit growth continue to strengthen while income growth remains weak, it is likely that regulators will introduce further measures. The two most obvious measures would be speed limits on high Debt-to-Income and Loan-to-Value Ratio lending.

These tools come with a different set of costs and benefits, namely that they will have a more direct impact on a smaller subset of borrowers but would directly target the area of concern for regulators.

The timing of further tightening in macro prudential policy remains uncertain. The current lockdowns have caused significant disruption to economic activity as well as housing market activity and regulators may resist further changes until activity normalises. Still, a rapid rebound in the economy may put further pressure on prices and debt growth so the need for additional macro-prudential measures will most likely only grow in the near term.

CREDIT GROWTH HAS PICKED UP

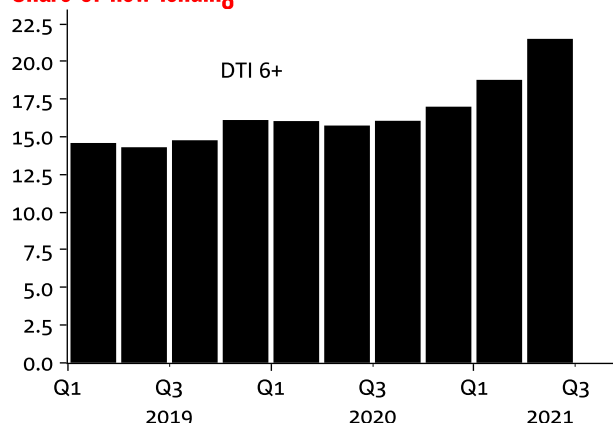
6-month-ended annualised credit growth



Source: RBA, National Australia Bank

THE SHARE OF HIGH DTI LENDING HAS RISEN

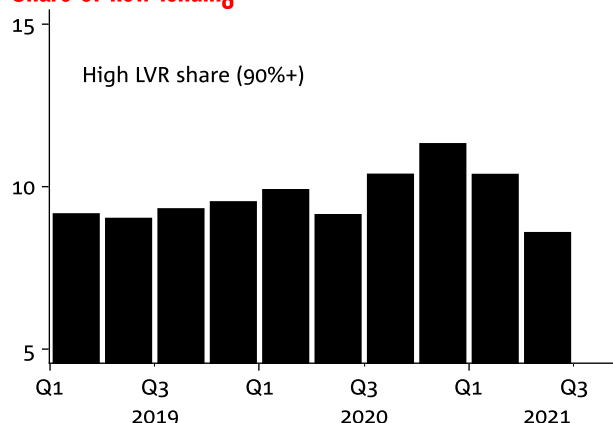
Share of new lending



Source: National Australia Bank, Australian Prudential Regulation Authority

HIGH LVR LENDING HAS EASED SLIGHTLY

Share of new lending



Source: National Australia Bank, Australian Prudential Regulation Authority

FORECAST TABLES

	Fiscal Year				Calendar Year				
	2019-20	2020-21 F	2021-22 F	2022-23 F	2019	2020	2021-F	2022-F	2023-F
Private Consumption	-3.0	1.1	-2.2	4.5	1.2	-5.8	2.5	1.6	2.9
Dwelling Investment	-8.1	4.4	10.2	-5.1	-7.1	-5.3	13.6	1.9	-8.3
Underlying Business Investment	-2.8	-2.6	5.1	9.4	-2.2	-5.7	4.9	5.8	8.0
Underlying Public Final Demand	5.7	5.8	4.4	2.8	5.5	6.0	5.0	3.5	2.4
Domestic Demand	-1.0	2.5	1.5	4.1	1.2	-2.6	4.6	2.8	2.9
Stocks (b)	-0.3	0.7	-0.3	0.1	-0.3	-0.1	0.5	0.0	-0.2
GNE	-1.3	3.2	1.2	4.2	0.9	-2.7	5.1	2.9	2.7
Exports	-1.8	-9.1	-0.1	2.5	3.4	-10.1	-2.8	1.9	1.9
Imports	-7.5	-3.1	1.5	4.3	-0.9	-13.4	5.8	1.8	4.0
GDP	-0.2	1.4	1.2	3.8	1.9	-2.4	3.3	2.9	2.3
Nominal GDP	1.6	4.2	6.0	5.5	5.4	-1.7	8.9	5.7	3.9
Current Account Balance (\$b)	-36	-68	-110	-109	14	52	92	112	107
(%) of GDP	-1.8	-3.3	-5.0	-4.7	0.7	2.7	4.3	4.9	4.5
Employment	0.2	1.1	2.1	1.7	2.3	-1.7	3.4	1.5	1.5
Terms of Trade	0.8	10.8	13.6	-0.2	6.1	-0.6	20.6	3.6	-0.8
Average Earnings (Nat. Accts. Basis)	3.0	2.6	2.0	2.7	2.8	3.2	1.6	2.7	2.9
End of Period									
Total CPI	-0.3	3.8	1.9	1.7	1.8	0.9	2.5	1.6	2.0
Core CPI	1.2	1.7	1.8	1.9	1.4	1.3	1.8	1.6	2.2
Unemployment Rate	8.2	5.1	4.4	4.2	5.1	6.7	4.9	4.4	4.0
RBA Cash Rate	0.25	0.10	0.10	0.10	0.75	0.10	0.10	0.10	0.10
\$A/US cents :	0.69	0.75	0.74	0.78	0.70	0.77	0.72	0.78	0.77
\$A - Trade Weighted Index	60.0	62.7	60.6	63.2	60.3	63.4	59.8	63.0	61.9

(a) Percentage changes represent average annual growth, except for cash and unemployment rates. The latter are end June. Percentage changes for CPI represent through the year inflation.

(b) Contribution to GDP growth

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