*December 2021*

# THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

***Advanced economy growth was robust in Q3, and a similar outcome is expected in Q4 albeit with a shift in the source of growth away from Europe towards the US and Japan. The global composite PMI remained robust in November, but with stronger readings in advanced economies than emerging markets. Our global growth forecast for 2021 is marginally weaker at 5.6%. The global recovery is anticipated to continue into 2022 with growth of 4.4% expected (revised from 4.5%) while in 2023 we expect growth of 3.6% (previously 3.5%) which is around its long-term average. At the time of writing, it appears that the Omicron variant is more contagious than earlier variants, but the threat it poses to the outlook will depend on the combination of transmissibility/virulence and vaccine effectiveness which remains unclear.***

- **Financial markets** were shaken in late November, as details about the Omicron variant of COVID-19 emerged along with expectations that monetary policy may tighten faster than previously expected. In response, global equity markets retreated, the VIX volatility index rose and government bond yields fell – in part reflecting concerns that vaccines could have reduced efficacy against the Omicron variant, increasing the risk of economically damaging restrictions being reintroduced in many regions.
- This week the **US Federal Reserve** announced that it was speeding up the QE taper. We have also revised our forecasts for the **US Fed**, with three rate rises now expected next year, starting in Q2. This could add pressure on **emerging market central banks**, as higher US rates could drive capital outflows from these countries. Several emerging market banks have already started to lift rates – most notably Brazil, Russia and Mexico. Although the People's Bank of China recently eased policy through a cut to its Reserve Requirement Ratio, increasing the pool of funds for banks to lend, Fed rate rises may constrain its ability to cut policy rates as it seeks to address slowing domestic economic conditions.
- **Inflationary pressures** have continued to increase in recent months – particularly in measures of global producer prices, which rose by 14.9% yoy in October. Among the big advanced economies, producer price inflation is near peaks last seen in the early 1980s. A range of factors have contributed to the surge in prices, including the ongoing impact of COVID-19, rising commodity prices (albeit they have retreated since late November), persistent shortages of various key inputs (most notably semi-conductors), labour shortages and disputes and disruptions to global shipping.
- GDP data confirm that aggregate major **Advanced Economy** GDP continued to recover in Q3 despite headwinds from COVID-19 waves in the US and Japan as well as ongoing supply bottlenecks. Robust growth is also expected in Q4 but with weaker growth in Europe (where a rise in COVID case numbers has seen a reimposition of some restrictions) offset by an acceleration in the US and Japan (with the latter benefiting from a low COVID case count and the lifting of the State of Emergency early in the quarter). There are signs that constraints from supply bottlenecks have at least stabilised if not improved which will benefit all the major AEs. In particular, the hard hit auto sector is starting to see a lift in output. Business survey readings across the major AEs also generally remain at robust levels including in the Euro-zone.
- Aggregate **emerging market** (EM) purchasing manager indices were somewhat weaker for both manufacturing and services in November. China's two manufacturing PMI surveys converged to neutral levels in November suggesting that easing power shortages were providing some relief for hard hit heavy industry, although there remains a risk of winter power shortages remain a risk. China's services PMI, fell reflecting rising input costs and the impact of new COVID-19 cases, and November activity data disappointed (industrial production growth was only marginally stronger, investment is extremely weak and consumption growth appears minimal). As a result, we have revised down our China GDP forecast for 2021 from 8.3% to 8.0%. India's economy grew by 8.4% yoy in Q3 2021 – weaker than expected but there is potential for additional catch-up growth in Q4.
- The global composite PMI was marginally stronger in November due to an increase in manufacturing output. COVID-19 remains the key risk to our global economic outlook. The emergence of Omicron has raised fears in recent weeks, primarily due to it appearing more contagious than earlier variants and concerns that existing vaccines may provide less protection against Omicron. That said, early stage analysis suggests that Omicron may be less virulent than Delta. Overall, our forecast for **global economic growth** in 2021 is marginally lower at 5.6% (which would be the equal strongest growth since 1973). There are also modest changes to the out-year forecasts, with 2022 marginally lower at 4.4% (4.5% previously), while 2023 is marginally stronger at 3.6% (from 3.5%) but is still around the long-term average growth rate for the global economy.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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***For Australia, the Q3 national accounts showed a smaller hit to activity than we had expected but we continue to see a very strong snap back in activity in Q4. With GDP rising 2%, we see the losses from the virus this year fully recovered by end 2021. A very strong rebound in the labour market is underway with the jobs lost since June more than recovered in November alone. Beyond 2021, we see above trend growth continuing through 2022 (rising 4.1%), supported by rebounding household consumption and further gains in business investment and dwelling construction. Government spending and incentives will also continue to provide support. We see growth returning to around trend pace in 2023. Alongside this, we see the unemployment rate falling to around 3.8% by mid 2023 – its lowest level in decades. This should see wage growth begin to lift and eventually feed through to inflation. While there are a number of uncertainties on the magnitude and speed of this pass-through, by mid-2023 we expect wage growth will have risen enough for the RBA to be confident that inflation will stay within the target band, allowing the Bank to begin normalising the cash rate. From there, we see rates rising around once a quarter, taking the cash rate to about 2% by end 2024.***

- **Yesterday's labour market data showed a very strong rebound in employment and participation, with the unemployment rate moving decisively lower.** With employment rising a record 366k, the job losses through mid-2021 were completely reversed and the unemployment rate fell to 4.6%. From here, we see ongoing gains in employment with activity continuing to lift – and expect the unemployment rate to decline further over 2022, ending the year around 4.1% before heading lower in 2023. This tightening in the labour market should see wage growth accelerate but from a relatively soft starting point.
- **Household consumption led the decline in Q3 GDP but should also lead the rebound in Q4**. The 4.8% decline in Q3 was sharp, but less severe than expected. Since then, monthly nominal retail sales rose 4.9% in October, led by large gains in clothing, department stores, and cafes & restaurants as the economy reopened. NAB's internal data for November confirmed spending was powering ahead, with NSW and Victoria strongest, while the cashless retail sales index points to a rise of around 2.7% in retail sales for November.
- **The housing market is expected to cool in 2022 with price growth slowing, and forward indicators pointing to a softening in construction down the track.** The national accounts showed only a small gain in dwelling investment, with alterations & additions offsetting a decline in new construction. This soft result likely reflects the impact of lockdown disruptions in NSW and Vic, and therefore we expect some catchup in the near-term before the impact of weaker building approvals begins to eventually flow through to construction. For now, the pipeline of work remains elevated. House price growth has slowed appreciably in recent months, and we expect a further slowing with 2022 seeing gains of around 5% following a 23% rise in 2021. With rates rising and affordability constraints beginning to bind, we see a moderate fall in prices of around -7.5% in 2023.
- **Business investment declined in the September quarter following the strength in the first half of 2021.** However, the NAB Monthly Business Survey for November continues to show conditions tracking well above average and capacity utilisation again at a high level. While confidence pulled-back, it remains elevated across most industries, and both the capex and cash flow measures remain well into positive territory. The ABS Capex survey also saw a strengthening in investment intentions for 2022. We see business investment supporting growth into 2022, as the rebound from Q3 disruptions continues and demand strengthens.
- **We have slightly lowered our expectations for the AUD/USD by around US1c through 2022.** That sees the Aussie strengthen to US77c by end 2022 and rise further to around US787c by end 2023 before softening after that. The AUD/USD fell slightly over the past month and is slightly below the level prevailing around the time of the QE program's announcement in October 2020.
- **Trade made a solid contribution to growth in Q3, with exports rising 1.2% alongside a fall of 4.0% in import volumes.** More recent data shows the trade balance narrowing on the back of softer iron ore exports (both prices and volumes were lower). Services trade remains heavily impacted but with borders now reopening we expect this to begin to recover as students return and, eventually, international tourism restarts.
- **The RBA left the cash rate on hold but remained dovish on inflation at the December meeting, despite the strong outlook for activity.** However, the Bank appears to be shifting its central case for the first rate hike from 2024 into 2023, with the removal of any reference to 2024 in the post meeting statement. Yesterday's speech by the Governor also walked away from 2024 but continued to push back on the prospect of hikes in 2022. We continue to see rates rising from mid-2023. On QE, the RBA will review the bond buying program at the February meeting, with the strength in the labour market numbers for November adding weight to our view that purchases will cease all together from mid-February.
- **While we (and the RBA) see a very strong rebound in activity and the labour market, the magnitude and speed at which wage growth rises and passes through to prices is the key uncertainty for monetary policy**. The point at which wage growth accelerates as the unemployment rate declines – full employment – remains uncertain, with the unemployment rate having remained above 5% for an extended period. In addition, the reaction (magnitude) to a tightening labour market remains uncertain as does the speed at which wages adjust. Further, whether cost pressures are immediately passed on in full to prices or absorbed in margins will be important for generalised inflation.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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